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William H. Overholt

# Hong Kong After 1997

## *The Question of Sovereignty*

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*Ever since British-Chinese negotiations over the return of Hong Kong began in 1982, there has been a dialogue of the deaf about Hong Kong's future. Overholt provides a thorough overview of the historical, political, economic, social and legal issues regarding Hong Kong's transition and of China's self-interest in Hong Kong's major functions as an airlock, entrepot, financial center, regional headquarters and manufacturer. Through his careful discussion of the foreseeable problems, Overholt reaches the conclusion that Hong Kong is "useful pretty much the way it is" to China and doesn't see China disturbing the balance.*

**Former Singapore Prime Minister Lee Kwan Yew** was once asked what would happen to the people of Hong Kong after 1997. His answer: "1998." The same answer suffices for questions about the business environment after 1997. China will retain the Hong Kong system because it is in China's interest to do so and because there is a consensus among Chinese leaders on that point.

Ever since British-Chinese negotiations over the return of Hong Kong began in 1982, there has been a dialogue of the deaf about the subject of Hong Kong's future. For the following decade, most of the Western press reported that Hong Kong was a declining, perhaps dying city. A brain drain, we were told, was depriving Hong Kong of all its trained manpower. Capital flight was draining its financial vital force, and all the multinational corporate headquarters were fleeing to Singapore. Typical of this reporting was an article in the politically correct *New York Review of Books*:

*As I prepare my own departure, I often think of an image that captures the melancholy of this slowly breaking city. It is a scene I saw on the television news, almost surreal in its intensity, the scene of a great bulldozer crushing a mountain of fake gold watches, all made in Hong Kong, until there was nothing left but dust.<sup>1</sup>*

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*This article makes use of two chapters from Mr. Overholt's book, The Rise of China (New York: W. W. Norton, 1993).*

After a decade of such reportage, Hong Kong has experienced such a net influx of executive talent that its housing prices are the highest in the world, its economy has been boosted by huge net capital inflows and it has more multinational corporate headquarters than all other Asian cities combined, partly because of a net inflow from Singapore. Parenthetically, its per capita income is now substantially higher than that of the colonial power, Britain, and continues to grow at a multiple of British growth rates. The bulk of the investment in Hong Kong and nearby parts of China is done by those who have the most knowledge of China's dangers: the great entrepreneurs of Hong Kong, whose families fled there to escape Communist persecution.

### **Hong Kong's Central Dilemma**

The extraordinary divergence between reality and Western images has derived from different assumptions about the role and purpose of Hong Kong. To Britain and much of the West, Hong Kong is now regarded as primarily a political entity. From this presupposition it follows that the basic issue in Hong Kong's future is one of political ideology: a

struggle between democracy in Hong Kong and communism in China. British commentators further tend to believe—falsely—that China agreed to accept continuation of Hong Kong's system for an additional 50 years (from the year 1997 to 2047) because of British negotiating pressure. In actuality, it arose as a crucial part of Deng Xiaoping's strategic vision. Given this set of British/Western assumptions, and given the relative sizes of giant China and diminutive Hong Kong, a pessimistic outcome of the struggle seemed foreordained. To the extent that the inevitable can be minimized or postponed, this line of thought suggests maximum effort to make Hong Kong maximally independent of China and to entrench as many Western political institutions as possible.

In historical perspective, China was an early beneficiary of the export processing zone concept. China has long felt endangered by the activities of Westerners and yet has needed to deal with them on a fairly large scale. An early adaptation to these contradictory requirements was the Imperial Maritime Customs Service, through which China delegated management of customs functions to the British. Later the treaty ports, which were large areas of coastal cities where Western law and customs prevailed, evolved as airlocks through which China could deal effectively with the Western world but contain deleterious foreign influences within a narrow geographic space. For the most part these were imposed on China, but much of their functioning was accepted by China because they also served an important Chinese purpose.

Hong Kong is the last survivor of the old enclaves, but it is far more than an obsolete remnant of the colonial era. It is also the most complex and successful of the modern export processing zones. Critically, it is primarily a services export processing zone rather than a goods export processing zone. Therefore, rather than just modifying the rules for import and export of goods in order to facilitate manufacturing, Hong Kong modifies a broad range of rules in order to facilitate a broad range of modern service functions: global financial center, regional headquarters for manufacturing firms, regional center for other services such as accounting and taxation, trade window for China, technology purchase window for China, international financial capital for China and management-consulting and design center for southern China.

In order to fulfill these functions, Hong Kong must have different rules from those of the People's Republic on these subjects: it must ensure free inflow and outflow of capital,

free inflow and outflow of people, a convertible currency, free flow of a wide range of information (including political information that affects financial markets) and a Western independent legal system. It was such aspects of Hong Kong that China promised to maintain, and China made this promise because it was advantageous for China's economic development—and also advantageous as an example to Taiwan.

The coincidence of the economic requirements of a dynamic enclave with the prerequisites of freedom that the British want to preserve made the Joint Declaration possible. Where this overlap does not occur, British and Chinese interests diverge. For instance, the British have periodically debated a shift to full Westminster democracy. That would serve no Chinese economic requirement and might create a political threat, so the Chinese have always been unwilling to concur with anything more than very gradual, cautious movement in that direction. The Joint Declaration says nothing about democracy. When the two sides agreed to maintain the existing system until the year 2047, China had in mind the economic system, together with the social and political prerequisites of that system, which just happen to coincide with Western freedoms. Those prerequisites ensure continuation of a high degree of freedom for the people of Hong Kong, together with a greater degree of democracy than ever existed under the British. They do not necessarily include full electoral democracy.

Remarkably, the two approaches coincide to a very high degree. Without the promises China has made for economic reasons—free movement of goods, people and capital, a convertible currency, continuation of the British legal system and a variety of other freedoms—Hong Kong's highly skilled entrepreneurs, bankers, lawyers and accountants would move elsewhere. These ensure the maintenance of existing freedoms. Inevitably there remains a fuzzy political boundary region. Within this fuzzy area, there is an unspecified prerequisite for maintaining the economic dynamism that falls within the area of British political concerns: Hong Kong can maintain its economic momentum only in an environment stable and free enough to attract and retain the most successful firms and a large number of the most educated and ambitious people.

There also remains an area of serious divergence in the policy implications of the two views. Starting from the Chinese perspective, the way to ensure Hong Kong's success is to maximize the economic integration with China and

thereby ensure both maximum prosperity for Hong Kong and maximum benefits for China of its export processing zone; the better this works, the more China's leaders will be committed to their view that Hong Kong is a vital force for China's economic betterment and that the concessions of freedom and capitalism that they have made to Hong Kong people have been a sound investment. From the Chinese perspective, these policies have been successful beyond anything they had dreamed; Hong Kong has been an economic gold mine without posing any significant political threat. Based on this, Deng Xiaoping has repeatedly said that preservation of Hong Kong's capitalist, free system should continue for 100 years rather than 50 and that China needs additional Hong Kongs.

The one thing that could turn Hong Kong into a liability from Beijing's perspective would be for Hong Kong to become a base of political challenge to China. In this respect the leadership in Beijing does have serious concerns. Historically, Hong Kong and nearby areas have been loci of foreign pressure and domestic subversive movements. To take only two examples among many, Britain used this pressure point to begin the dismantling of Qing dynasty sovereignty in the mid-nineteenth century, and Sun Yat-sen's republican movement ultimately destroyed that dynasty from this region. Beijing's nightmare is that its export processing zone could be turned into a base for organized subversion of China, a base with essentially unlimited financing. This nightmare coincides almost precisely with the aspirations of outspoken British and British-style pressure groups to transform Hong Kong into a full-fledged Western democracy led by an outspoken advocate of overthrow of the Beijing leadership.

### **The Diplomacy of Shared Interests and Divergent Priorities**

British rule over Hong Kong originated as an overwhelming diplomatic humiliation of China. The British were determined to continue selling opium to China in huge quantities in order to finance other interests. The Chinese were determined to stop the drug trade. When the Chinese sealed off their port and seized large quantities of British opium, Britain attacked. After the ensuing Opium War, a defeated China was forced in 1842 to cede sovereignty in perpetuity over Hong Kong island. In 1860 it was forced to cede the nearby Kowloon Peninsula in perpetuity, and in 1898 it leased the New Territories, the bulk of contemporary Hong

Kong's territory, for 99 years—i.e., until 1997. It was as if General Noriega of Panama, infuriated at George Bush's efforts to stop Panamanian drug sales to the United States, had seized Long Island in perpetuity and decades later had used this seizure to impose an alien political ideology on part of New York State.

In 1949 the Communist Party seized power in China, determined among other things to rescue China from foreign humiliation and from foreign-imposed divisions. The fact that the Communist Party seemed more determined than its competitors to terminate foreign humiliations of China was one of the major reasons for the Party's domestic success. It was determined, among other things, to liberate Taiwan, and would have done so had not the vicissitudes of the Korean War led the United States to defend Taiwan. In this context, one would naturally have expected the immediate liberation of Hong Kong from colonial rule. That was not, however, what happened. Mao Zedong, advised by Zhou Enlai, decided that Hong Kong was more useful to China as it was. Through all the upheavals of Chinese politics in the ensuing three decades, the policy of continuity was maintained. Hong Kong's stability during that period was not maintained by British military superiority, but rather by Chinese pragmatism. For most of that period China could have regained sovereignty over Hong Kong simply by walking in and taking it.

Moreover, even in its moments of greatest insanity, China has chosen to protect Hong Kong. The most insane time in several centuries was 1967, the height of the Cultural Revolution, when the degree of turmoil, irrational behavior and xenophobia exceeded anything that occurred in the Iranian Revolution. Through the entire twentieth century, only the Cambodian revolution exceeded the Cultural Revolution in xenophobic fury. But when Red Guards approached the Hong Kong border, Beijing, in the person of Zhou Enlai, ordered the local army commander to clear them away. Most surprisingly, China—concerned *inter alia* about the impact on Hong Kong—refused to accept sovereignty over Macau when Portugal attempted to give it back. Another key incident showed that China was even willing to take positive action to support Hong Kong during a period of turmoil at home: the deadline for construction of the desperately needed water pipe to provide Chinese water to Hong Kong fell during the worst period of the Cultural Revolution, and the Chinese side went forward anyhow, even accelerating the construction in order to meet the deadline.

As the 1970s came to an end, Beijing had to face the question of the future of Hong Kong. The Party leadership considered three options. One was to let the current situation of that time continue indefinitely. This, however, entailed ratification of the outcome of the Opium War and was politically unthinkable. The second option was to seize Hong Kong in 1997 by whatever methods were necessary. That option was the normal one that a former colonial power would have expected. India had suddenly invaded Goa, a Portuguese colony which sat on the Indian coast the way Hong Kong sat on the Chinese coast, and the world had little to say about it. Indonesia had suddenly and bloodily seized East Timor, a former Portuguese colony which was geographically part of Indonesia but had never been under Dutch rule; because guerrilla warfare has continued in East Timor, the world has said a bit more about it. Hong Kong would in the normal course of events have been taken like Goa. But to Chinese leaders such a strategy seemed politically and economically counterproductive.

The third option was to resume sovereignty while retaining the existing capitalist, free system in Hong Kong with all its benefits to China and others. That option was judged the only acceptable one. Within that option, China chose to have the system administered by Hong Kong people rather than by the British. Historians will note that, in the wake of this generous and pragmatic decision, China has received more Western criticism than the Indians, the Indonesians and many others combined.

During tense periods of Sino-British negotiations over Hong Kong's future from 1981 to 1984, China subsidized financial stability in Hong Kong. Since that time, China has made huge investments in Hong Kong. The Bank of China Building, Asia's tallest structure, holding many of the bank's 14,000 Hong Kong employees, symbolizes China's investments in Hong Kong real estate, buildings and companies. China has large holdings in Hong Kong companies, including 20% of HK Telecom and 22.5% of Cathay Pacific Airways. Chinese companies like CITIC are rushing to list subsidiaries on the Hong Kong Stock Exchange. In fact, during the period since the British-Chinese negotiations, China has become by far the largest single investor in Hong Kong. These huge investments by a regime short of capital belie any intentions to take arbitrary actions that would severely damage the Hong Kong economy and destroy the value of China's investments.

## Can China Be Trusted?

Pervasive concern that China cannot be trusted to honor its promises to Hong Kong has its roots in Western misunderstanding of Chinese motives in signing the Joint Declaration. The image of a radical Communist China itching to impose its own system on Hong Kong derives from the assumption that the China's primary interest in Hong Kong is ideological. The entire history of China's behavior since 1949 belies such an assumption. For two generations China has protected Hong Kong and profited from it while all other colonies around the world were simply "liberated."

The prospects for China's honoring its agreements over Hong Kong rest on three foundations. First, China has an excellent record in honoring past international agreements.<sup>2</sup> However, given the great importance of Hong Kong (and the high risks to China if Hong Kong somehow goes wrong), given the ambiguity of the agreement and given that Hong Kong is predominantly a domestic issue for China, this pillar might be regarded as weak if taken alone.

Second, China's effort to use the success of the "one country, two systems" formula as a basis for eventual unity with Taiwan has proved both consistent and successful. Despite the psychological setback to this strategy after Tiananmen Square, China has stuck to it without deviation under both liberal and reactionary leaderships. And if unity is measured in broad functional terms, the strategy is working: despite Tiananmen Square, Taiwan investments in China and trade with the mainland, formerly negligible, are now measured in the billions of dollars, and millions of Taiwanese tourists have visited China. Even Taiwan officials visit the mainland, and Taiwan is vigorously inventing legal channels for all this trade, investment and tourism to follow.

Third, and most important, China's vital economic self-interest is at stake. Two-thirds (65.7%) of foreign direct investment in China comes from Hong Kong. Some 25% to 30% of all Chinese foreign-exchange earnings come through Hong Kong, and most of China's technology purchases and managerial advice come through Hong Kong. More broadly, the whole Chinese effort to rejuvenate the country is based on economic growth, and the growth payoff of Deng Xiaoping's "one country, two systems" policy has been greater than anyone could ever have imagined in the early 1980s. This growth in Guangdong alone more than justifies continuation of Deng's policy, and all factions in Beijing recognize this. It is difficult to think of

a comparable initiative anywhere in the world that has had a proportionate payoff.

Finally, the post-Tiananmen Square period has severely tested China's promises to Hong Kong. The Chinese leadership was fearful of instability at home, determined to repudiate the excesses (as it saw them) of its liberal predecessor and, not incidentally, furious at the way Hong Kong residents demonstrated against the leaders. In this difficult period, China took firm steps to control its own organizations in Hong Kong and to prevent subversion by Hong Kong, but its senior spokesmen repeatedly promised that there would be no retribution against people who demonstrated inside Hong Kong against Chinese policies. On April 4, 1990, less than a year after Tiananmen Square, China's conservative President Yang Shangkun affirmed in the preamble to Hong Kong's Basic Law that "the socialist system and policies will not be practiced in Hong Kong." For this leadership, in this particular period, such commitments showed considerable restraint and willingness to honor promises under pressure.

### Hong Kong's Roles

Much of Hong Kong's future depends on whether Hong Kong can maintain, in the face of competition, its key roles.

*Airlock.* Hong Kong's first role is as an airlock for China, an entry point for technology, capital, management skills and ideas. No other country can compete with Hong Kong in this respect. In theory, the special economic zones could become competitors. In practice, they have become colonies of Hong Kong because its investment dominates these zones; effectively, Hong Kong owns the zones. As China has soared, the role of airlock between China and the outside world has become far more important than in the past. While the opening of China reduces the need for some aspects of the airlock, China's overall relations with the outside world are expanding at such a rate that any attrition is more than offset. Note that most of China's exporters seek to export from Hong Kong, even when other ports are closer, and that Hong Kong managers are assuming potentially dominant roles in China's other main ports. In the future, Shanghai or even Taiwan could become competitors, but that possibility is decades away.

*Entrepot.* Hong Kong and Singapore are the world's greatest ports primarily because of their roles as entrepots. During the 1980s it became part of the conventional wisdom that these entrepots would inevitably lose their

value as other countries liberalized their trade. The basis for this belief was that the entrepots were valuable primarily because they allowed free trade at a time when other countries severely restricted or taxed trade. It followed that, with the vast liberalization under way, Hong Kong and Singapore would no longer be special. Such an analysis misses most of the rationale for an entrepot, which is a concentration of special skills for bringing together sellers and buyers. In former decades, this was a relatively simple matter, involving a few sellers, a few buyers and a few products. For instance, China had tungsten to sell and the United States needed to buy tungsten, and both found Hong Kong a useful intermediary. Today the situation is much more complex. A very large number of countries are sellers. Virtually all countries are buyers. The range of products to be bought and sold ranges from raw materials to toys to petrochemicals to sophisticated software. Hong Kong's role may be to connect a Hitachi tape recorder manufactured in China to a Peruvian buyer. The permutations of seller, product, buyer, mode of transport and financial terms have become virtually infinite, and an enormous concentration of highly specialized skills is required to make the whole process work. The role of entrepot has become more important than ever, and only Hong Kong has the concentration of skills to play that role.

*Financial Center.* Hong Kong's second major role is as a major financial center, the world's third largest if measured by the number of banks present, fourth largest if measured by the number of offshore loans originated and fourth largest if measured also by equity market capitalization of its stock market. Hong Kong is also a major center for funds management, with U.S.\$114 billion under management in 1989, as compared with U.S.\$15 billion in Singapore. Most potential competitors are disqualified from the start: Bangkok because its telephones and infrastructure are inadequate, Manila and Jakarta because of that and many other reasons, Kuala Lumpur because it is politicized and Taipei because its security environment is restrictive. Tokyo is the region's capital for the distribution of loans, but it cannot take over Hong Kong's origination role because it is too expensive a place to do business, because the language is not yet widely understood by foreigners, because Japan's culture is both esoteric and xenophobic and because its financial markets are so large and complex that they have become all-absorbing preoccupations for Tokyo financial executives.

That leaves Singapore. A serious competitor with none of the above deficiencies, Singapore has managed to surpass Hong Kong in the volume of foreign-exchange transactions. But Singapore's tight controls on most markets and on the press will limit its role until controls are changed—and there is no prospect of early change. Most modern financial enterprises need the *Asian Wall Street Journal*, *Asia Week*, the *Far Eastern Economic Review*, CNN television news and other sources of information that are banned much of the time in Singapore, and they cannot thrive in an atmosphere of heavy-handed business regulation. While a number of financial firms did move to Singapore in the period after Tiananmen Square, many subsequently moved back because of what they viewed as repressive regulation in Singapore. While Singapore is one of the world's great success stories, it is not particularly attractive to most of the kinds of information-intensive, freewheeling financial industries that tend to headquarter in Hong Kong.

Despite this lack of effective competition, it is conventional wisdom among bankers that Hong Kong will lose its role as a great financial center. After all, Hong Kong's rise as a financial center was for the purpose of recycling Middle East oil profits (petrodollars) and Japanese surpluses to Third World countries. Now that the oil boom is finished, much of that petrodollar role has vanished and therefore, according to this line of argument, Hong Kong's role should decline. Moreover, much of Hong Kong's special financial role has derived from its openness to international financial flows in a region of previous tight controls of capital markets. As Bangkok and Taipei liberalize and seek to become financial centers, Hong Kong should lose its special advantages.

But the petrodollar argument ignores the fact that Asia has nearly two billion people growing at 7% per year, and such growth must be financed. This is the largest-scale financing job in world history. If growth must be financed in the absence of petrodollars, then it will be financed through more sophisticated methods: leases of equipment from American pension funds, global bond issues, stock market placements, private equity funds and many others. In the absence of petrodollars, money is scarcer and (except during recessions) more expensive, so heroic efforts will be made to reduce financing costs through a variety of financial engineering techniques. These complex financing techniques require a concentration of cosmopolitan bankers, accountants, lawyers and computer services that is found only in Hong Kong. Japan has the skills but is focused

on its own market. Singapore does not have the same critical mass of such skills. Just as in the case of trade in goods (the entrepot role), the more complex trade in financial services and other services heightens the value of Hong Kong's special concentration of skills. The reason that New York, London and Tokyo prosper as global financial centers is not because of the protectionism of their region, but rather because of their critical mass of skills. New York does not lose its role as a global financial center just because Minneapolis has liberal financial rules and aspires to a larger role; the same applies to Hong Kong and Bangkok.

*Regional Services Headquarters.* The late 1980s and the 1990s are the era of the takeoff of the services sector in Pacific Asia. Complex cross-border trade and investment deals, governments' newfound determination to create and enforce modern tax systems, the rising role of stock markets and their associated need for analysis and many other developments have created an explosion of demand for high-level, cosmopolitan, regionally oriented services from accountants, lawyers, information specialists and computer consultants. Hong Kong and Singapore are the regional capitals of such services, with Hong Kong playing a substantially more significant role—a role that is expanding exponentially.

*Manufacturer.* Hong Kong's third role is that of a major manufacturer. Actually, Hong Kong is going out of the manufacturing business, except for certain specialized sectors. But it is becoming the manager of manufacturing in southern China and a principal manager of manufacturing throughout Asia. Like New York, Hong Kong has evolved from manufacturing to management, design and finance. The more than three million employees of Hong Kong firms in China are five times the total number of industrial workers in Hong Kong itself. Before the opening to China, Hong Kong firms never employed more than about 900,000 industrial workers. In 1992 they employed 3.65 million; thus Hong Kong's manufacturing role has expanded by nearly a factor of four, but the work done by Hong Kong people themselves has moved upmarket to management, design, finance and the like. As Hong Kong itself has abandoned manufacturing, its role in global manufacturing has increased tremendously and the profitability of Hong Kong's involvement in manufacturing has risen as it has confined itself to the higher-value-added tasks. With manufacturing in China expanding faster than anywhere else in the world, and with China's export manufacturing largely in Hong Kong's hands, the market

share of Hong Kong firms in world manufactures is growing rapidly.

An important change is occurring in Hong Kong's role as the result of the availability of China as a manufacturing base and market. For the first time, Hong Kong is capable of supporting regional-class and potentially world-class firms. Until recently, the Hong Kong and Taiwan markets were simply too small to support the kinds of world-class firms that characterize Japan (such as Mitsubishi or Sony) and South Korea (Hyundai, Lucky-Goldstar). Hong Kong will likely always be a more fragmented economy than that of its larger neighbors, but Cheung Kong is becoming a world-scale firm in real estate; Hutchison in satellite television, ports and mobile phone systems; and Hopewell a major regional builder of infrastructure. As Chinese companies make Hong Kong their base of international operations, and as they seek to use it as a center for commercializing their broad base of scientific research, Hong Kong could well emerge for the first time as a center of recognizable firms and brand names.

*Regional Headquarters.* A fourth major role for Hong Kong is as a regional headquarters. Most major firms require a headquarters in Tokyo and another for non-Japan Asia. In addition to the reasons for choosing Hong Kong or Singapore as a financial center, tax and other incentives make these two city-states the locations of choice. Hong Kong is regarded as a superior environment for cultural and entertainment opportunities. Singapore has a more placid physical and social ambience. Both city-states appear to have entrenched roles in this respect, depending on a particular firm's sector and geographic orientation. The most recent regional survey indicated that Hong Kong held 51% of Pacific Asia's regional headquarters, Singapore 29% and Tokyo 20%.

In addition to these functional perspectives, it is appropriate to characterize Hong Kong as the commercial, managerial and financial capital of Guangdong Province. Economically, Hong Kong and Guangdong, a province with the population of France, are fully integrated. Guangdong is growing faster than any substantial territory in world history, and Hong Kong profits more than anyone from that growth.

## Foreseeable Problems

So China's view of Hong Kong is that it is useful pretty much the way it is, and that view is consistent over long periods of time and relatively consensual among various factions. Nonetheless, there are predictable problems from two sources, the interpenetration of two different systems and the British effort to change Hong Kong's system and priorities at the last historical moment.

Hong Kong has begun to receive the costs as well as the benefits of an open border with Guangdong Province. As more than 20,000 trucks cross the border every day, some of the cargoes contain Chinese guns bound for Hong Kong criminals in what used to be a fairly gun-free city. While Hong Kong remains far more crime-free than virtually any substantial American city, gun-toting criminals have brought fear to the territory's gold and wristwatch shops. This will get worse. So will the transit of illicit cargo in the other direction, especially stolen luxury cars. It will take a long time for Hong Kong's crime to reach the levels of Manila or Bangkok, but it is already clear that post-1997 Hong Kong will no longer be a competitor of Tokyo or Singapore as a relatively crime-free city.

Similarly for corruption. Graft and corruption have become omnipresent in China, and it will become difficult or impossible to isolate Hong Kong from these. Chinese political figures and regulatory authorities routinely own and regulate companies in the same business. They mix their personal business with corporate business. Everyone extracts fees and kickbacks for doing his or her job. Very powerful officials and businesspeople will bring such habits to Hong Kong, and even Hong Kong's resilient system will probably be unable to avoid some resultant stains, possibly serious ones.

There may also be problems from Chinese interpretation of the laws governing Hong Kong. The Basic Law, written by China to serve as Hong Kong's post-1997 constitution, faithfully follows the agreement of the Joint Declaration. But any constitutional document is subject to interpretation—as is shown by the myriad struggles over interpretations of the U.S. Constitution.

One particularly sensitive area is freedom of the press. Here there is evidence for both pessimism and optimism. On the pessimistic side, China's overseer of Hong Kong, Zhou Nan, has been known to write angry letters to the British governor when a Hong Kong newspaper publishes bitterly anti-Chinese editorials. That is definitely a bad sign.

On the other hand, Hong Kong contains the world's two most anti-Chinese newspapers of stature, namely the *South China Morning Post* and the *Asian Wall Street Journal*; these are widely available in China proper and are usually made available free to visitors in China's major hotels. China is much more open to such newspapers and journals than are Singapore, Malaysia and Indonesia. If the papers are freely available on the other side of the border, there is a case that they will continue to be available, regardless of editorial content, in Hong Kong.

Another area of reasonable concern is the interpretation of China's right under the Basic Law to manage everything connected with foreign affairs and national security. If this right is interpreted narrowly, there is no problem. If it is pushed to an extreme, then Hong Kong businesspeople who come into possession of previously unavailable market statistics could conceivably be put in jail as spies stealing national secrets.

The judicial system also has vulnerabilities. While all parties have agreed that British law will continue to be practiced, the language of justice will inevitably change to Chinese, creating problems for the Common Law tradition. The principal judges will have to be reappointed, and this will create opportunities for abuse.

The other problems result from British-Chinese conflict. When, in the name of democracy, Britain decided to ignore its promises to China and make changes in the way Hong Kong is governed without Chinese consent, it opened a Pandora's box. To understand the nature of the problem, one must go back to the basic principles of the two sides. In signing the Joint Declaration and writing the Basic Law, China abandoned every ideological principle of its system. It conceded, indeed proposed, that Hong Kong's capitalist economy, free society and moderately representative political system would take precedence over powerfully felt Chinese ideological precepts. Ultimately, there was only one thing that mattered to China, namely, restoration of its sovereignty and with it an end to the humiliation of the Opium War.

When the British decided to make unilateral changes in Hong Kong's governance, the Chinese felt their sovereignty was being stolen once again. If Britain could once again make changes in the way a small piece of China was governed, without consulting the Chinese, then Britain, not China, remained sovereign. For the British the issue was democracy, and they characterized Chinese resistance to small changes in the way the legislature was to be elected as

authoritarian resistance to democratization. For the Chinese it was not the substance of the changes but the fact that the British were making them without consulting China and, indeed, that Governor Patten was loudly and sarcastically flaunting his determination to make the changes without consultation. (Patten later modified his tone, but went ahead and imposed the changes unilaterally.)

Similarly, the British proposed to give the legislature the power to change the constitution without consulting China; as one particularly candid Chinese official said, "The agreement was to return sovereignty to China, not to the Hong Kong people." Beijing had written into the Basic Law that the socialist system shall not be practiced in Hong Kong. In other words, even if Hong Kong people vote for communism, Hong Kong is not allowed to go communist. China expected the British to honor a parallel commitment to maintain certain aspects of the existing Hong Kong system in the face of ideological pressures. After all, Connecticut's legislature cannot vote to become communist; why should Hong Kong be allowed to vote to change its system (as opposed to changing policies, where Hong Kong is granted autonomy) without central permission?

Ultimately Britain and China agreed in practice to disagree. Britain imposed its changes unilaterally. China will change them back again. Since the original deal was a good one for Hong Kong, at first sight this should present no problem. But there is a problem, a very serious one. The process of Beijing's changing the system back will involve communist officials in very detailed decisions about the structure of Hong Kong governance and about the individuals who will fill those posts. Instead of having the early 1997 legislature simply carry on through the transition, there will now be a temporary legislature designated by Beijing. Nothing on this scale would even have been imaginable had the British simply stuck with their original commitments. This process will greatly magnify the problems of interpenetration of two different systems, probably enhancing corruption and installing a considerably less representative government than Hong Kong would otherwise have had.

For the business environment, the impact of these problems may well be minimal. For the stock market, they will mean enormous nervousness and volatility. For personal freedom, the margin of change is unclear, but my best guess is that very little will change; the families of Chinese officials now have a vested interest in the freedom

of Hong Kong. For representative government, the prospect was always for very gradual democratization and probably never the full populist democracy that has become the norm in the West; now the standard of representative government

will probably start lower and evolve more slowly than it would have if the British had been more sensitive regarding the one absolute of Chinese policy toward Hong Kong, namely, the restoration of sovereignty.

## Notes

**1** Ian Buruma "The Last Days of Hong Kong," *New York Review of Books*, April 12, 1990, 46.

**2** There is an extremely extensive literature on this point. For a review of some of it, focused on the worst of the Maoist era, see also: William H. Overholt, "Would Chiang Find Mao an Unacceptably Strange Bedfellow?" *Asian Survey* XIV, No. 8 (August 1974).

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