

## HONG KONG AFTER THE CHINESE-BRITISH AGREEMENT

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In September 1982, responding to assertions by British Prime Minister Thatcher, China unmistakably demanded the eventual return of Hong Kong to Chinese sovereignty and engaged in heated rhetorical exchanges with Thatcher. Because this coincided with a downturn in the world economy and the peaking of a cycle in Hong Kong's property market, it precipitated collapse of the property market, decline in the Hang Seng stock index from 1400 to 700, weakness of the Hong Kong dollar, capital flight, near-disappearance of local investment, and huge lines of panicky people trying to get visas at Western embassies.

Despite their rhetoric, the British and the Chinese shared a deep interest in the success of their negotiations. Mrs. Thatcher's image as a competent "iron lady" could have been destroyed by a collapse of Hong Kong, the last major British colony and the world's third largest financial market. China's economic development program would have suffered significant setbacks to its efforts to increase trade, promote foreign investment, and promote development of its Special Economic Zones. Deng Xiaoping would have faced increased political opposition, and any chance of persuading some Taiwanese of the wisdom of negotiating with Beijing would have been lost.<sup>1</sup>

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1. For a more thorough discussion of the background to the Hong Kong negotiations, see William H. Overholt, "Hong Kong after the 1982 Crisis," *Asian Survey* Vol. XXIV, No. 4 (April 1984). There is an enormous literature on the negotiations, comprising several books, numerous articles, the proceedings of some major conferences, and the reportage of the *Far Eastern Economic Review*, *Asia Week*, and Hong Kong newspapers. This article, written in March 1985, uses interview information to provide an integrated political-economic analysis.

From late 1982 through the summer of 1983, Britain stuck to its efforts to maintain sovereignty after 1997 or at least to retain an administrative role. While Britain honored an agreement to keep quiet about the negotiations, the PRC engaged in petty sniping and delivered ultimatums, for instance about unilateral imposition of a decision if negotiations were not successful by September 1984. In September 1983, this precipitated another crisis. There was a run on the Hang Lung Bank, which the government subsequently took over, and on four Macao banks. The Hong Kong dollar's exchange rate with the U.S. dollar went to 9.50, and the overnight interest rate on the Hong Kong dollar went to 41 percent. On September 24, the Hong Kong and Shanghai Bank faced such severe demand for U.S. dollars that it had to wake the head of a major U.S. bank at 2:00 a.m. and have dollars airfreighted to Hong Kong from all over the world. For most of the succeeding year, the visa lines remained long, the currency remained weak, and local investment remained negligible. A severe January 1984 taxi strike highlighted the risk of anomic rioting, and political leaders from the New Territories spoke privately of using violence to send a message to Beijing. All of this shook both parties and led to more sober negotiations.

After the crisis, the British privately conceded sovereignty and hopes for a post-1997 administrative role; Sir Geoffrey Howe made this decision public in the spring of 1984. Meanwhile, Beijing committed itself to maintain Hong Kong's capitalist social system and to allow it to administer itself except for military and foreign affairs. By early summer, both sides had semi-publicly committed themselves to the basic points of the agreement which was concluded in September 1984.

Britain and China shared the basic goal of maintaining Hong Kong's existing system, and particularly its capitalist prosperity, after 1997. They disagreed as to the form an agreement should take. The PRC preferred an agreement based on broad generalities. The British preferred a finely detailed agreement, so that the details of Hong Kong's future governance would have standing in international law. The British felt that a Hong Kong agreement which depended on China's constitution would be vulnerable, since China's constitution has been rewritten several times since 1949. An agreement without detail would be vulnerable to differences of interpretation, especially because for many Beijing people Hong Kong's ruthless, speculative capitalism is incomprehensible. In the past, China has generally honored the letter of both domestic and inter-

national agreements, but has frequently transformed its interpretations of those agreements.<sup>2</sup>

## I. Key Issues

(1) *The Prerequisites of Capitalism.* Although China said from the first moment that it would retain Hong Kong's social system, there was deep concern that it would not fully accept or understand the prerequisites of freewheeling capitalist success: a free press for accurate information; freedom of travel; freedom of trade; freedom of contract; free capital flow; a Western legal system; and Western-style education.

(2) *Group Interests.* In order to avoid panic or violence or financial disruption, key interests needed specific reassurances. Property interests, the core of Hong Kong's economy in many ways, needed to know that their leases and mortgage contracts would be valid through the period of the contract. Farmers and small property owners in the New Territories feared loss of their land through expropriation or taxation. The government needed to be able to sell leases on land to pay its own bills. Professionals needed assurance that careers in Hong Kong would not be built on sand. Intense fears on the part of any of these groups translated quickly into capital flight, emigration, stock market collapse, declines in the value of the stock market and real property, and potential anomic violence by groups which could not move capital and families abroad.

(3) *Leadership and Legitimacy.* There is a persistent myth that Hong Kong's government is administration without politics. In fact, governing such a seething mass of conflicting ethnic groups, not to speak of achieving spectacular rates of economic growth, requires high-level political leadership. Deciding what kind of power to buy, where to build the roads, whether to have a subway, which banks to bail out, and which crimes to prosecute is as politically sensitive in Hong Kong as anywhere else. The government achieves some legitimacy from the economic successes resulting from good decisions. But it also acquires legitimacy by consulting with various councils representing different interests, by making valued awards to those who serve Hong Kong well, and by maintaining British justice. An

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2. On this point, as applied to the other principal territory China wants to recover, namely Taiwan, see William H. Overholt, "Would Chiang Find Mao an Excessively Strange Bedfellow?" *Asian Survey*, Vol. XIV, No. 8 (August 1974).

autonomous Hong Kong under China's sovereignty requires firm leadership with legitimacy.

(4) *Administration.* Hong Kong's efficient economy and stable social order depend totally on the civil service and the police, particularly on 2,000 senior civil service officers and 6,000 gazetted police officers. These groups feel naked without Britain. Local Chinese administrative leaders had not previously had the leadership experience or the social prestige of senior leaders. There had not been a systematic effort to groom successors, because the 1997 issue came fairly suddenly. Moreover, even British political leadership and administration had declined in quality in recent years. The senior civil servants therefore feared being treated by China as lackeys of Britain, feared being damaged by democratic forces inside Hong Kong, and feared loss of their pensions. If these fears led to an early, massive exodus, then Hong Kong would risk collapse into corruption, stagnation, and disorder.

The British and Hong Kong Chinese pressed China to accept the idea of an offshore pension fund guaranteed by both Britain and China. This would be expensive, because hitherto all pensions have been paid out of current revenues. Given Hong Kong's rapid growth, there have been no difficulties with such a system. However, rising numbers of civil servants, rising salaries, and declining government revenues could portend future difficulties. And China could regard demands for such a fund as insulting. Second, the Hong Kong Chinese pressed the British for guarantees that senior Hong Kong administrators would have the right to emigrate right up to the transfer of sovereignty on June 30, 1997. With the assured right to emigrate to Britain, the senior administrators could stay in Hong Kong and participate until the last minute in efforts to train their successors.

The police represent a particularly sensitive issue for Hong Kong's future. Hong Kong society is extraordinarily divided and possesses an unusual variety of criminals. Public order depends on an unusually effective police force, upon strong fear of the Communist alternative to obeying Hong Kong's government, and upon unusual economic opportunities. As the political alternative comes closer, and as fears rise about the economic future, the importance of the police rises. Ironically, however, the police are the unit of Hong Kong government most susceptible to fears of PRC reprisals. The Hong Kong strategy for retaining the effectiveness of the police has been to increase salaries and benefits disproportionately in

recent years, thereby raising the quality of the force. Second, Britain will ensure the right of emigration of those special forces (such as intelligence) who spent their careers doing things which would make them particularly unpopular in Beijing. For the remaining senior officers, the efforts to ensure loyalty will be similar to those for senior civil servants.

## II. Reactions of Social Groups

Hong Kong relies on a thin elite to ensure its stability and economic progress. In addition to the 2,000 key civil servants and 6,000 key policemen, Hong Kong has about 40,000 entrepreneurs (who provide 800,000 jobs), 1,200 solicitors, 200 barristers, 1,400 engineers, and 900 architects. Loss of a large proportion of this elite would mean the end of Hong Kong in its present form.<sup>3</sup> During the negotiations virtually every member of the elite moved to assure that he or she had the means to migrate abroad if necessary.<sup>4</sup> Of Hong Kong's total 5.8 million population, 200,000 already possessed the travel documents and funds to leave. Another 300,000 could probably gain the means to leave. The entire elite mentioned above falls within the 500,000 who have the potential to depart.

Reactions to the 1997 negotiations varied widely with occupation, class, and origin. Of course, the vast majority of Hong Kong's population did not have the option of sending funds abroad or acquiring a travel document. Of those who did, the quickest to send their funds overseas, acquire travel documents, or actually move abroad were the successful entrepreneurs. Virtually all of Hong Kong's major entrepreneurs were born in China, particularly Shanghai, and could not live with the Chinese Communist Party. From 1948 to 1950, the Chinese Communist Party assured them that they were needed, that they could keep their businesses, and that they would be delegated the management under the economy under the leadership of the Chinese Communist Party. Those who listened to such promises lost everything. They mostly perceived China's message in 1983-84 as similar to the message 1948-50, and they prepared to move.

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3. Figures provided by a member of the Executive Council, who cited a private study done for the Council.

4. What follows is based on interviews conducted in Hong Kong in October 1982, March 1983, June 1984, and January 1985.

Local professionals, on the other hand, are mostly Hong Kong born. Likewise the children of the entrepreneurs were mostly born in Hong Kong and are now managers rather than entrepreneurs. This group began moving its funds, in an important second wave. However, the strategies of this group varied substantially by age. Members of the older generation had made their mark and earned enough to live out their lives comfortably without additional income. This generation was the most fearful of China's moving in and possessed the most comfortable prospects if it moved overseas, and therefore moved. At the other end of the age scale, those in their teens and twenties were either completing their educations, frequently abroad, or had recently completed them, and were comfortable with the idea of starting up in Britain, the United States, or elsewhere; their parents provided them the wherewithal to get a good start. On the other hand, the in-between generation, particularly those between thirty and forty-five years of age, were already established in Hong Kong, earning good salaries, and would have found it painful to move abroad and start from the bottom again. They had not yet made their professional marks and they had not yet earned enough to live comfortably without further income. They kept their jobs in Hong Kong, but did not want to risk the possibility that their children would suffer in the way that they or their parents suffered after their grandparents lost everything in Shanghai, so they sought to ensure the option of moving abroad.

Another critically important group was one whose constituents must mostly remain in Hong Kong. The Heung Yee Gook comprises the leaders of district boards in the New Territories, representing primarily the clans which have lived in the New Territories for centuries and who are determined to maintain their traditional rights. Members of the Hueng Yee Gook feared that China would alter landholding rules. They also feared being squeezed by banks which, concerned about the 1997 deadline, might insist on shorter tenor for land loans and therefore make individuals and local governments unable to afford land. The Hueng Yee Gook was also deeply concerned about passports and was urging Britain to take full responsibility for those already holding British dependent passports. Leaders of the Hueng Yee Gook visited Beijing to press their views, but did not initially receive answers satisfactory to them. The Heung Yee Gook, as the largest political organization in Hong Kong and the one whose constituents are most committed to what they view as fundamental moral principles, possessed substantial capacity to

disrupt the orderly progress of a British-Chinese settlement. Clearly they could not stand up to Beijing, but they could force intervention by Beijing.

Hong Kong also has powerful urban pressure groups which have less formal organization. Earlier in 1984, the taxi drivers demonstrated an ability to shut much of Hong Kong down in protest over a rise in their costs without a compensating rise in their fares. Anomic violence by such people could have greatly affected of Hong Kong's prospects.

### III. Response of the Economy

Following the 1983 upturn in the world economy, and a substantial devaluation of the Hong Kong dollar, Hong Kong's competitiveness rose and its markets expanded. As a consequence, real GDP rose 5.9 percent in 1983 while inflation declined. This return to growth was as important psychologically as economically, but growth remained far below the boom during the years of the 1970s and real incomes in early 1984 remained below those that preceded the September-October 1982 crisis of confidence.

Textiles were the first industry to respond to the U.S. recovery. Textile orders began to increase in October 1982, simultaneously with the beginnings of the U.S. recovery. In 1983, however, they hit a ceiling determined by foreign quotas. Simple electronics are also boomed. Telephones, calculators, and television games require very small investment and generate very rapid paybacks.

Despite these relative successes, domestic investment in manufacturing remained miniscule prior to the agreement. Typically there is a three to six month time lag between an export boom and strong investment in capital goods. Hong Kong's strong export boom began in the first quarter of 1983, and exports grew 47 percent in the following year, but investment was negligible. Even taking into account the long-term sectoral decline in manufacturing, such a trend would, if long continued, imply severe damage to Hong Kong's prospects in sophisticated industries which should constitute a vital source of future dynamism.

Part of Hong Kong's folklore (especially for foreigners) is a belief that virtually all Hong Kong investments have always aimed for a two to three year payback. This is incorrect. A large proportion of Hong Kong's investments have had more-than-five-year

payback periods, and most personnel management has been based on the assumption of long-term commitments. Thus, a shift to time horizons of only a few years could cause a substantial decline in Hong Kong's growth rate and long-term technological prospects.

Most large firms, and some smaller ones, sought to give an international color to their capital. Swire's long ago make London its legal domicile. Jardines' relocated its official headquarters to Bermuda. Virtually any firm with significant overseas assets sought to protect them by similar means. For assets held within Hong Kong, there was a shift from equity to fiduciary loans.

Services, particularly financial services, nonetheless boomed. Hong Kong's highly skilled population provides the personnel needed for sophisticated service industries. Its light regulation is attractive to service companies which need to be fast on their feet. The collapse of real estate costs was a boon to firms whose competitiveness was being threatened by rising real estate prices. Although there was some domestic investment in service industries, much of that investment came from foreigners. While Hong Kong Chinese were sending their money abroad, foreigners on balance were heavily investing in Hong Kong. Japanese and American firms invested across the board. Japanese banks moved in to purchase properties, whereas in earlier years they rented. Motorola began building a major manufacturing plant. The bulk of the foreign investments were in services, however.

Investment in Hong Kong by China rose steadily. Chinese firms, particularly Bank of China, bought substantial amounts of real estate. China made a major loan to finance the Hong Kong subway and began funding most of a nuclear power plant that will largely service Hong Kong. Everbright entered into a large number of joint ventures. China Resources diversified beyond resources and bought a major electronics firm, Conic. Guangdong Enterprises, Ltd. purchased a large wharf complex and engaged in everything from selling large volumes of Guangdong Province's poultry in Hong Kong to undertaking major construction projects on Saipan and conducting guided tours of Hong Kong for newly enriched PRC farmers and managers.

The sector which experienced the most difficulties was real estate. By the late 1970s, Hong Kong's role as entrepot and manufacturing center had become eclipsed by its role as a global center of land speculation. The government fueled this real estate boom by increasing its public housing program from 15,000 units to 40,000



units per year shortly before the 1982 bust. An oversupply of hotel rooms depressed rentals for a luxury room to U.S. \$50-60 per night. Huge blocks of office space remained unsold and unrented due to massive oversupply, but large amounts of construction continued because of commitments made before the bust. Only mass housing was doing well. The real estate bust took with it many important firms: Carrion, Eda, Associated Hotels, the Kevin Hsu Group, Aik San Brothers, Truong Brothers, Dollar Credit, and Hang Lung Bank. Even Hong Kong's largest firms suffered severely in the real estate bust.

#### IV. The Aftermath of Sino-British Agreement

The September 1984 agreement on return of Hong Kong to Chinese sovereignty eliminates the risks of currency collapse and violence. It assures for some years Hong Kong's role, partially shared with Singapore, as the financial capital of Asia. It also assures that Hong Kong will remain the principal commercial and financial gateway to an expanding Chinese market and that it will remain a major manufacturing and tourist center.

This outcome required one of the great diplomatic triumphs of modern history, plus some luck. In order to achieve their success, Britain and China had to overcome a massive Chinese-Western cultural gap, set aside Mrs. Thatcher's and Deng Xiaoping's prickly sense of pride, educate China's communist leaders about the workings of a *laissez-faire* enclave, and suppress Beijing's revulsion at some of those workings. These obstacles were overcome because Deng Xiaoping was as determined to make his economic reform program work as he was to recover China's territory, and because the British were as professional and patient in negotiating the best deal possible as they were forthright in accepting that they had no alternative to Chinese sovereignty.

Luck helped. As noted, the risks of fatal panic sporadically became so severe and unmistakable that they impressed upon Chinese leaders the necessity for caution and compromise. In other words, Chinese leaders perceived and avoided the abyss in part because they edged so close to it. Luckily, too, the conclusion of the agreement coincided with an upturn in Hong Kong's principal foreign markets, especially the U.S. market for textiles, and, to a lesser extent, in the home real estate market. This combination created a euphoria which

mirrored the near-panic of the previous two years.

The agreement provides that all of Hong Kong will return to Chinese sovereignty on July 1, 1997, but that Hong Kong, under self-rule and with its present economic and social system, will then be preserved as a Special Administrative Region of China at least until 2047. Existing leases will be honored until 2047, satisfying the needs of property owners. Farmers will retain their land and will not have their taxes increased until 2047. The government can issue up to 50 hectares of new leases each year until 2047; this facilitates sound government finances while assuring China that Britain won't empty the cookie jar. Hong Kong will remain a free port; retain its own treaties, travel documents, and currency; continue to allow a free flow of people and capital; and continue to possess most basic freedoms. Hong Kong will retain control of its own police, but China will have the right to station troops there. A Joint Liaison Group, based in Beijing until July 1, 1988, and in Hong Kong thereafter, will provide a forum for Sino-British discussion and coordination. Hong Kong will be governed after 1997 by a Basic Law to be drafted by China in consultation with Hong Kong representatives.<sup>5</sup>

The credibility of the agreement is greatly reinforced by the evident determination of China's leadership to press forward with an economic development and reform plan in which Hong Kong will play a central role, by China's willingness to sign a formal international agreement with far more detail than is customary for China, and by China's interest in using a successful Hong Kong agreement to show Taiwan that Beijing's "one country, two systems" formula can work to the benefit of an autonomous, capitalist enclave under Chinese sovereignty.

Hong Kong's confidence in the agreement is high. The stock market has doubled in value to regain its pre-negotiation level of about 1,400 (but not the all-time high of 1,800). Aside from the still-overbuilt office space market, real property has regained much of its lost value; housing for workers and the middle class never suffered much, and luxury apartments and hotel space are suddenly scarce again. Domestic investment is rising quickly. Hong Kong dollar deposits at Hong Kong and Shanghai Bank in January 1985 were 30 percent greater than a year earlier. Hong Kong's interest rates,

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5. For details, see "A Draft Agreement Between the Government of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Future of Hong Kong," Her Majesty's Government, London, September 26, 1984.

which previously carried a premium over U.S. rates, dropped below U.S. rates, yet money still flowed in, particularly from Southeast Asia. Visa lines at Western embassies were sharply down. Representatives of major groups who in 1984 expressed a strong inclination toward violence expressed euphoria in early 1985.

## V. Residual Concerns

Confidence is not, however, unlimited, and euphoria is temporary. Most business executives voice strong confidence in the next five to seven years, which is a very long time by Hong Kong standards and notably longer than the payback period for most investments outside real estate, but fear difficulties as 1997 comes closer. The textile market, whose takeoff underlay much of the 1984 euphoria, is expected to be weaker in 1985. There is residual concern that, while honoring the overall agreement, Chinese leaders or factions may be tempted to state opinions or intervene in details that could gradually alter Hong Kong. Professionals, whose careers are less easy to transfer than those of businessmen, are far less comfortable. For instance, many university professors still plan to emigrate eventually, and most feel they must make plans outside Hong Kong for their children.

Although there is little risk of complete collapse, confidence would suffer severely if there were to be a major reversal of China's economic reform; the Hong Kong dollar and the stock market would fall in response. In fact, some tremors could occur soon if current mid-course corrections in China's reform become very extensive. Major political conflict in China, even if only indirectly related to the economic reforms, would have a similar effect. There will almost certainly be a temporary fall in the currency and the stock market when Deng Xiaoping (now 80) dies.

A further set of concerns relates to domestic governance. If one is going to run a ruthless capitalist society, it helps to be an outsider—as the British colonial government has been. The gradual disappearance of that outside governance has raised two concerns in Hong Kong: too much democracy, and not enough.

The fear of too much democracy is in essence fear of the welfare state and of erratic policy-making. But the Hong Kong elite is in pretty firm control, and both the British and the Chinese are acting to reinforce that control and to limit welfare state pressures.

The British are edging up on democracy very gradually, by avoiding sudden shifts from primarily appointed bodies to wholly elected bodies, and are, at least initially, insulating policy from populist pressures by ensuring that the Governor and members of the Legislative and Executive Councils will be indirectly rather than directly elected. (See below.) Beijing for its part has clearly communicated that it does not want its future flow of funds impaired by welfare state liberals; Beijing wants rapid growth and full treasuries and assumes that a ruthless capitalism no longer practiced in the Western democracies is the way to those goals. Given this perspective, China has been active in suppression of leftist union activities, and its known attitude has aborted proposals for a Central Provident Fund.

Thus, for the moment, China and Britain have contained the "threat" of too much democracy. The keys to the future will be policies on taxes and wages; a more indigenous government will eventually have a test of wills over wages, which could make Hong Kong uncompetitive if raised too high, and also taxes if civil service and infrastructure costs should outpace the revenues from growth and from property sales. But in the meantime Hong Kong can certainly afford some additional expenditures on health and welfare and might benefit from them.

The second fear is of too little democracy. Hong Kong has been apolitical at all levels, happy making money while the British ruled, appeased by the British willingness to ask for non-binding advice from various Hong Kong elite groups. The British fear two things from a continuation of the apolitical tradition: a political vacuum which would have to be filled by China itself, or an abdication by the elite which would relegate political power to populists. Hence the British are now telling the Hong Kong Chinese elite that it will have to stoop to running for election in order to retain political control, and they are seeking to stimulate enough interest in the elections to bestow a sense of popular legitimacy on the regime—without ever, as noted above, risking real popular sovereignty. Conversely, everyone in Hong Kong understands that the Chinese would not tolerate the emergence of truly powerful indigenous political leaders; Hong Kong will have no Lee Kwan Yew—or at least not for long. China's, as well as Britain's, goal is government of the fat cats, by the fat cats, not so assertive as to give China indigestion, not so subservient as to catch pneumonia every time cold ideological winds blow from Beijing. Here, too, China's communists and Britain's democratic imperialists have made considerable joint progress based on almost

complete mutual interest.

As this balancing act proceeds, there will be controversies and quite possibly sporadic episodes of fear. Among the key controversies will be:

- direct vs. indirect election of the Legislative Council;
- how to choose the Governor, the Executive Council, and ministers;
- what role Beijing will play in choosing the Governor;
- the content of the Basic Law;
- the fate of the first inevitable effort to appeal interpretations of the Basic Law from Hong Kong courts to the Chinese People's Congress;
- the range of authority of the Joint Liaison Group.

The activities of the Joint Liaison Group, the writing of the Basic Law, and the extent to which Beijing comments on Hong Kong's policies and methods of choosing its leaders all represent, in the eyes of the British and of people in Hong Kong, risks of Chinese tampering, however well-intentioned, with a system Beijing does not completely comprehend. The Joint Liaison Group is supposed to clarify ambiguities in the agreement, fix problems that arise, create momentum for the consultation process on the Basic Law, and review the enormous body of Hong Kong's and Britain's international agreements that might be affected by the Chinese takeover. Controversies in the Joint Liaison Group could occur any time prior to 1997, but the risks are probably highest in the next few years.

Writing the Basic Law requires China's communist leaders to write, albeit in consultation with Hong Kong people, the constitutional system of a capitalist, quasi-democratic system. But China, in both its communist and pre-communist phases, lacks a tradition of law. While it may delegate much of the actual writing to Hong Kong lawyers, the Western-trained Hong Kong lawyers most attractive to Beijing might well have views at odds with most of the British and Hong Kong elite. Thus there is plenty of room for disputes. Although there is no official timetable, Premier Zhao has indicated that China would like to finish the Basic Law by 1990.

The system for choosing officials remains a potential controversy within Hong Kong, and between Hong Kong and China. Hitherto, Hong Kong has been governed by a Governor imposed from Britain; a fifteen member Executive Council comprising key government officials plus six "Unofficial" members from the private sector appointed by the Governor; a Legislative Council composed of twenty-seven officials and 27 appointed members; and local district boards which were one-third officials, one-third appointed, and one-

third elected. Popular influence over the system came through neighborhood associations, and a series of advisory councils provided a bridge between the government and various interest groups. While this system was hardly a democracy, government leaders said that their surveys indicated that most Hong Kong people thought of the system as democratic, because they defined "democratic" as meaning benevolent, responsive rule and freedom to speak one's mind. The same surveys showed that the population greatly feared loss of these and the emergence of strife among political factions.

The theory of the new government is to replicate the old system as closely as possible in the new context of self-rule. Elected district boards are to play the old role of the neighborhood associations. Functional representatives in the Legislative Council are to play the role of the advisory councils. Ultimate authority will be insulated from direct popular pressure through a series of indirect elections. After March 1985, district boards will be two-thirds elected and only one-third appointed. In September 1985 the Legislative Council is to acquire a large number of indirectly elected members, including some elected by an electoral college from the district boards, some elected by functional groups (unions, lawyers, medical professionals, social workers, educators), and some chosen from Urban and Regional Councils, as well as officials and appointed members. In 1987, this system of indirect elections will be reviewed.

This system has the virtues of closely resembling an existing, widely accepted, and economically successful system, of providing genuine indigenous rule, of probably being acceptable to Beijing, and of balancing popular representation with the potential for authoritative leadership. Its risks are several. It forces members of the elite to run for district office (dealing with local garbage and lamppost issues) in order eventually to attain high leadership positions, and the elite could prove unwilling to do that. The indirect election system might not generate enough electoral enthusiasm to legitimate the system and prevent the emergence of a political vacuum. District boards representing very small districts might maximize ethnic conflict. These concerns are real, but manageable, and the British have left a great deal of room for future pragmatic adjustments. In particular, they have begun with a system of very indirect elections, on the plausible theory that one can always make an electoral system more direct but that, on the other hand, the scope of direct elections, once increased, can never be narrowed again.

It remains to be decided how the Governor and the Executive

Council will be chosen, and what the relationships among the Governor, the Executive Council, and the Legislative Council will be. One suggestion is that the Legislative Council should elect the Executive Council, the Executive Council should make a list of candidates for Governor, and the Legislative Council should then designate one of those candidates as its preference. Beijing could then be invited to accept or reject the designated Governor. If this system is chosen, and if Beijing accepts it, a further controversy arises as to whether cabinet ministers must be chosen from the Legislative Council.

China's basic policy is that Hong Kong can govern itself so long as it governs itself well. In this respect, it is noteworthy that China nominated only four candidates for district boards and that, while it nominated one of four members of a labor advisory group, it did not oppose the two independents and one rightist who took the other seats. (It will, however, oppose any candidate with ties to Taiwan.) Governing well means governing profitably, governing without disorder, preserving China's financial nest egg in Hong Kong, and abjuring unseemly attitudes toward Beijing's domestic and international interests. Hong Kong must resist the temptations to apply the concept of a free press too broadly or to treat too freely with brethren on Taiwan. Beijing must resist the temptation to dampen Hong Kong's speculative excesses or to improve its morals. Any sign that either side is succumbing excessively to such dangerous temptations would ring a warning bell for the future. So far, both sides seem to understand the taboos and respect them.

There are enough controversies, plus the inevitable setbacks when Deng dies, when the world economy turns down, and when there is some (probably limited) reaction against Deng's economic reforms, to ensure that euphoria will not last forever in Hong Kong.

Nevertheless, under almost any scenario Hong Kong will for most of the next decade be the freest place in Asia to do financial business and one of the three most efficient places to do it. Taiwan is so heavily regulated that it cannot compete. Singapore, although far better than Taiwan, is still far more controlled than Hong Kong. Japan, although gradually liberalizing its far larger domestic market, remains a highly controlled and culturally xenophobic environment, with an impermeable language barrier. The setbacks of the Hong Kong real estate market since September 1982, and the devaluation of the Hong Kong currency, have controlled somewhat the extraordinary real estate costs that were threatening Hong Kong's

competitiveness as a base for service industries. Conversely, the risks in Hong Kong's future are basically the same kinds of credit and currency risks that banks face anywhere, albeit with somewhat wider swings. For these reasons, Hong Kong has the advantage in the race to be the financial capital of Asia.

A second critical role of Hong Kong has always been to serve as a gateway to China. The Chinese reform program is developing enormous momentum. This momentum which may well suffer some temporary reverses, but has already been institutionalized in agriculture and some aspects of industry. Chinese industry's demand for foreign inputs is accelerating, and Chinese consumer demand is accelerating even faster. China's need for Hong Kong's specialized financial services is skyrocketing, and China's need for Hong Kong as an airlock for Western technology and expertise is expanding. China has been increasing its investments in Hong Kong real estate and Hong Kong commerce and, even when other banks have been holding back from further commitments in Hong Kong, China's 13 "sister banks" have been opening new Hong Kong branches. China is systematically making itself more dependent on Hong Kong, and is effectively expanding Hong Kong physically by the way it is managing the adjacent Shenzhen Special Economic Zone. The opening of much of the rest of the China coast to foreigners and foreign enterprise has not reduced Hong Kong's role; on the contrary, it has greatly expanded the Chinese market for Hong Kong's special talents. Likewise, each further opening of China enhances Hong Kong's role as a gateway for tourists.

Third, Hong Kong's role as a major export manufacturing center has been reinforced. The low end of Hong Kong's market, for instance cheap calculators, is booming because of exports to China, and the high end, for instance sophisticated telephone equipment, is booming because of exports to the West. Hong Kong's sophisticated skills frequently combine with China's cheap labor to enhance Hong Kong's exports. Now that investors no longer fear to commit resources to five or seven year payback programs, the high end as well as the low end should prosper.

Hong Kong already is acquiring a fourth role as a haven for China's elite families to live in comfort and freedom while retaining their influence in China proper. The sons and daughters, and nieces and nephews, of China's power elite are already taking up residence in Hong Kong, now that it is regarded once again (in principle, if not yet in British law) as part of China. They bring with them



enormous influence; already certain large neighborhoods of Hong Kong are acknowledged by local Chinese as the political turf of this or that dignitary from Beijing. Eventually, such notables will bring with them enormous sums of money.

Hong Kong will quickly become a much more Chinese city—in language, in the influence of personal relationships on business, and in the way politics evolves. The use of English in schools and administration is likely to decline. Professional standards based on British criteria will gradually begin to alter. The interpretation of laws, hitherto based exclusively on British Common Law, is likely to become gradually influenced by Chinese attitudes. (Singapore is a model of how successful accommodation of British and Chinese institutions could be achieved.) Family obligations will rise in importance relative to contract obligations, and political considerations will assume a larger role in business dealings. PRC Chinese businesses and officials will become a much larger part of the Hong Kong market. Much of this has already happened.