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280 Park Avenue, New York, N.Y. 10017 U.S.A.

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HONG KONG NEGOTIATING PRC SOVEREIGNTY

William H. Overholt

Vice President  
Political Assessment Group

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## HONG KONG NEGOTIATING PRC SOVEREIGNTY

Hong Kong's prospects are being determined by one political event, one economic trend, and one political-economic development: the negotiations over the British-Chinese treaty which will return Hong Kong to Chinese sovereignty in 1997; the fluctuations of the world economy; and the ramifications of the Carrion scandal. Of these, the 1997 negotiations are the predominant influence. The economic environment and the ramifications of the Carrion scandal help set the tone with which political developments are interpreted. These interpretations then drive the economy.

The British and the Chinese share a deep interest in the success of their negotiations. Mrs. Thatcher's image as a competent "iron lady" could be 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 suffer significant setbacks to its efforts to increase trade, promote foreign investment, and promote development of its Special Economic Zones, if the Hong Kong negotiations were to fail. Deng Xiaoping would suffer increased political opposition, and Taiwan would reaffirm its unwillingness to negotiate with Beijing.\*

### Chronology of Developments

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. This produced an exchange crisis in September 1983 which shook both parties and led to more sober negotiations.

After this, the British privately conceded sovereignty and gave up hope of retaining an administrative role after 1997; Sir Geoffrey Howe made this decision public in the spring. 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. Hong Kong will retain its citizens' freedom to travel, remain a party to international agreements, control access to and from the outside world, maintain a Western legal system, and have a separate currency. (A principal ambiguity concerns freedom of speech.) The Hong Kong government will produce a Green Paper in July 1984 with proposals for Hong Kong's future governance. Britain and China are aiming for a general agreement by September of 1984 and are likely to sign one at least within a few months of that date. China will then spend up to four years drafting a basic law for Hong Kong, which for China will serve as an amendment to the Chinese constitution and for Hong Kong will serve as a "mini-constitution." China has promised that the mini-constitution will apply for at least 50 years beyond 1997. After the mini-constitution is drafted, China and Britain will negotiate the transition details.

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\* For a more thorough discussion of the background to the current Hong Kong situation, see William H. Overholt, "Hong Kong after the 1982 Crisis," May 23, 1983.

Britain and China share the basic goal of maintaining Hong Kong's existing system, and particularly its capitalist prosperity, after 1997. They disagree as to the form an agreement should take. The PRC would prefer an agreement based on broad generalities. The British would prefer a finely detailed agreement, so that the details of Hong Kong's future governance would have standing in international law. Much of Hong Kong's future may well depend on the degree to which the British achieve their objective. A Hong Kong agreement which depends on China's constitution would be vulnerable, since China's constitution has been rewritten several times since 1949. An agreement without detail would be much more subject to crucial differences of interpretation, between Hong Kong people who know how a capitalist system works and Beijing people for whom Hong Kong's ruthless, speculative capitalism is incomprehensible. In the past, China has generally honored the letter of both domestic and international agreements, but has frequently transformed its interpretations of those agreements; hence the need for details. For all these reasons, a detailed agreement will bolster Hong Kong's confidence, whereas an agreement consisting principally of broad generalities could cause a collapse of confidence. The final agreement will satisfy neither British nor Chinese predilections fully, but it remains unclear whether it will have enough detail to avoid another currency/stock market/real estate shock in the colony.

#### The Two Crises of Confidence

From the outset of the negotiations, Hong Kong has experienced two major crises of confidence. The first came in the fall of 1982 immediately after Mrs. Thatcher's visits to China and Hong Kong. The shock of political uncertainty coincided with a downturn in Hong Kong's foreign markets and the peaking of its real estate boom. The real estate market lost roughly 40 percent of its value, the stock market lost nearly half of its value, and the Hong Kong dollar dropped significantly. Subsequently, the Hong Kong dollar and (even more) the stock market revived to some extent, while the real estate market, which was massively overbuilt, failed to revive. There were large outflows of capital, somewhat masked by inflows from Indonesia and from the Hong Kong government's transactions.

In September 1984, the accumulation of negative Chinese remarks about the negotiations triggered another crisis. This time, the major consequence of the crisis was a run on the Hong Kong dollar and on several banks. The overnight interest rate on the Hong Kong dollar went to 41 percent. The Hong Kong dollar's exchange rate with the U.S. dollar went to 9.50. There was a run on the Hang Lung Bank, which the Hong Kong government subsequently took over, and on four Macao banks. On September 24, 1983, the Hong Kong and Shanghai Bank faced such demand for U.S. dollars that it almost was unable to meet the demand. A senior officer of one U.S. bank was wakened at 2:00 in the morning with a desperate request for U.S. dollars. Subsequently dollars were air freighted in from the Philippines, the Middle East, and around the world, and the situation calmed down by the following Monday. On October 15, for the first time, the Hong Kong dollar was linked to the U.S. dollar, at a floor of 7.8 to 1.

Meanwhile, the real estate market has declined still further, so that the average Hong Kong property has lost about 50 percent of its mid-1982 value. A

substantial outflow of capital continues. The current exchange rate can hold, but interest rates may rise, and another crisis of confidence would push interest rates to staggering levels and force a choice between capital controls and further bankruptcies.

### Hong Kong's Future Governance: the Green Paper

In the future, Hong Kong people are supposed to govern Hong Kong. The obvious form for such governance is democracy, but neither China, Britain, nor the Hong Kong elite wants too much democracy. None of these interests wants welfare state pressures to dilute Hong Kong's allegedly ruthless capitalism and hence reduce its growth rate (but see the remarks on the economic context later in this paper). There is an almost universal belief that Hong Kong cannot stand a politics of single-issue groups. Hong Kong looks from the outside like a simple, easily governed society. The reality is precisely the opposite. Hong Kong is full of different ethnic groups (British, Americans, Indians, and numerous varieties of Chinese) different classes (from the shanty towns of recent immigrants to the most numerous Rolls Royce owners on the face of the earth); and different ideologies (from a substantial pro-Communist group to an even more substantial pro-Taiwan group). Governing Hong Kong requires both strong political leadership and firm administration.

The British effort to create a democracy that really isn't a democracy bears a striking resemblance to some of Beijing's practices. The Green Paper will propose a system intended to run Hong Kong somewhat on the model of the Board of the Hong Kong and Shanghai Bank, with electoral influences at the margin: there will be lots of elections, but the people who really count will be elected very indirectly. Eighteen current appointed and elected district boards, with purely advisory powers, will become nineteen mainly elected boards with real local power. The present Urban Council, which advises on issues affecting urban Kowloon and Hong Kong, will be supplemented by a Regional Council dealing with the New Territories; both Councils will be more democratic and more powerful. The district boards and the Urban and Regional Councils will then elect the Legislative Council, possibly adding functional representatives from unions, the Chamber of Commerce, and PRC interests such as the Bank of China. The Legislative Council in turn will elect an Executive Council, including a Governor who will appoint a cabinet for approval by the Legislative Council. The indirect election system will perpetuate the current Chinese elite as the managers, so long as public opinion does not get inflamed and strong pressure groups do not mobilize. Maintaining these latter conditions will be a delicate job.

This structure will be vigorously supported by China, Britain, and the local economic elite. Various groups of professors and other professionals will make demands for more democracy, but the establishment will dismiss them as effete snobs. So far, the advocates of direct democracy have formed only political clubs and conversation circles, not political parties with deep social roots.

### Leadership

Insofar as this formula is able to perpetuate the existing Chinese elite in Hong Kong, it will maintain in power an extremely powerful and intelligent

group of leaders. The test will be whether squabbles arise among them or between themselves and the PRC. The risk is that there will be so many vetoes on key appointments and on key actions that government will become indecisive, unimaginative, and immobilized. Instead of pushing through elite decisions, the various councils will increasingly have to take into account the passions of electorate. Instead of keeping an eye only on the economy, they will have to pay more attention to key social groups in Hong Kong and above all to the PRC. The current elite is attempting to offset these problems by mobilizing its own most able members and by creating rules which will attract to elective office a greater proportion of businessmen, professionals, and other potentially strong leaders. Success or failure will depend a great deal on details of the agreement and on the degree of public support.

#### 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 have not previously had the leadership experience or the social prestige of senior leaders. There has not been a systematic effort to groom successors, because the 1997 issue came fairly suddenly. Moreover, even British political leadership and administration has declined in quality in recent years. The senior civil servants therefore fear being treated by China as lackeys of Britain, fear being damaged by democratic forces inside Hong Kong, and fear that political and economic uncertainty may deprive them of their promised pensions. If these fears were to lead to an early, massive exodus, then Hong Kong would risk collapse into corruption, stagnation, and disorder.

The British and Hong Kong Chinese are addressing this problem intelligently. Both are pressing China to accept the idea of an offshore pension fund guaranteed by both Britain and China. This would be extremely 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 may portend future difficulties. Whether China will accept the fiscal burden and the humiliating implications of such an offshore fund is a crucial issue for the future.

Second, the Hong Kong Chinese are pressing the British for guarantees that senior Hong Kong administrators will 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 in efforts to train their successors until the last minute.

The police represent a particularly sensitive issue for Hong Kong's future. Hong Kong society is extraordinarily divided, in the ways described above, and possesses an extraordinary variety of criminals and potentially disruptive groups. Public order in Hong Kong depends on an unusually effective police force, upon strong fear of the Communist alternative to accepting Hong Kong's government, and upon unusual economic opportunities. As the political alternative comes closer, and as fears rise about the future of

the economic opportunities in Hong Kong, the importance of an effective police force 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, its image, and the financial attractions of staying with the force. These benefits, plus efforts to establish offshore pension funds (if they are successful), might well ensure the loyalty of the ordinary policemen, who constitute the vast majority. 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 crucial remaining senior officers, the efforts to ensure loyalty will be similar to those for senior civil servants. Here again, one cannot firmly predict success or failure, but one can watch the progress of each component of the effort and make judgments as to how things are moving.

### The Economy

#### Ongoing Shifts in the Hong Kong Economy

Quite aside from the effects of the 1997 negotiations, Hong Kong's economy has been experiencing crucial shifts. The effects of some of these parallel the effects of the 1997 negotiations.

First, manufacturing has been declining sharply as a proportion of Hong Kong's GNP, and services have been rising. Manufacturing now constitutes only one quarter of Hong Kong's GNP and it is difficult to imagine that it would ever again exceed one-third of GNP. While decision-making, design, and marketing remain in Hong Kong, much of the actual manufacturing is shifting to Shen Zhen, the adjacent special economic zone in China where labor is naturally cheaper. The development of oil in the South China Sea and the emergence of ten new free zones inside China (in addition to the present four) will accelerate this trend. The rapidly growing sectors are services and trade. As noted below, fears about 1997 accelerate these trends.

Second, Hong Kong's vaunted ruthless capitalism is in fact becoming a welfare state, even without the democratization so feared desperately by British, Chinese, and Hong Kong elites. The Hong Kong government had only about 20,000 employees in 1960. Today it has about 600,000, more than one out of every ten people in Hong Kong. A generation ago, the Hong Kong government hardly had any personnel to collect statistics. Now it has the full range of modern government services. The creation of a mass transit system, particularly the subway (MRT), added hugely to employment. The creation of the Independent Commission Against Corruption (ICAC) required a system of checks and counter-checks within the whole range of Hong Kong administration and therefore dramatically increased employment. Former governor MacLehose promised everyone in Hong Kong housing, and the government has undertaken the massive building of housing units (currently at a rate of 40,000 per year). Public sector housing accommodates 44 percent of Hong Kong's population. Hong

Kong even has 135 people on an Environmental Control Board, whose functions are purely advisory. The Hong Kong police have moved from being an elite force which ignored much of what happened in Hong Kong, to a British-style police system with all the community relations, accountability procedures, associated personnel and costs implied by such a system.

#### Reactions of Social Groups to the 1997 Negotiations

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), 1200 solicitors, 200 barristers, 1400 engineers, and 900 architects. Loss of a large proportion of this elite would mean the end of Hong Kong in its present form.

Virtually every member of the elite is moving to assure that he or she has the means to migrate abroad if necessary. Of Hong Kong's total 5.8 million population, 200,000 already possess 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 vary widely with occupation, class, and origin. Of course, the vast majority of Hong Kong's population does not have the option of sending funds abroad or acquiring a travel document. Of those who do, the first to send their funds overseas, acquire travel documents, or actually move abroad have been the successful entrepreneurs. Virtually none of Hong Kong's major entrepreneurs was born in Hong Kong. Virtually all were born in China 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. There is a particularly large contingent of leading entrepreneurs (including financial sector entrepreneurs) from Shanghai who lost all, then rebuilt in Hong Kong, and are sure that the message they are receiving this time is the same one they received in 1948-50. They are moving.

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 is now moving its funds, in an important second wave. However, the strategies of this group vary substantially by age. Members of the older generation have made their mark and earned enough to live out their lives comfortably without additional income. This generation is the most fearful of China's moving in and possesses the most comfortable prospects if it moves overseas, and therefore is moving most quickly. At the other end of the age scale, those in their teens and twenties are either completing their educations or have recently completed them. Those educations have usually taken place abroad, and these young people are comfortable with the idea of starting up in Britain, the United States, or elsewhere in the Western world where they received their educations. They are setting up abroad, and their parents are providing 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, are already established in Hong Kong, earning good salaries, and would find it painful to move abroad and start from the bottom again. They have not yet made their professional marks and they have not yet earned enough to live comfortably without further income. They are keeping their jobs in Hong Kong, but do 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 keep as little as possible in Hong Kong itself.

The people and the money that have gone abroad can come back. During and after the 1967 riots, there was a vast exodus of people and capital all over the world. After two years, the Hong Kong situation calmed down, and it became clear to the emigrants that growth rates there were four to five times higher than in the West, and that, for people with education and capital, opportunities were even disproportionately higher than Hong Kong's growth rates. They returned, made long-term investments, and contributed mightily to the great economic boom of the 1970s. But this time the fear may be more protracted and difficult to dispel. Most people do not believe that they would really have thirteen full years to earn before the PRC takes over. Very few are willing to bet on Hong Kong's prosperity after the thirteen years are up.

Another critically important group is one whose constituents will mostly remain in Hong Kong. The Heung Yee Gook consists of the leaders of district boards in the new territories. It represents primarily the clans which have lived in the New Territories for centuries and who are determined to maintain their traditional rights. Members of the Heung Yee Gook fear that China would alter landholding rules. They also fear being squeezed by banks which, concerned about the 1997 deadline, insist on shorter tenor for land loans and therefore make individuals and local governments unable to afford land which would previously have been theirs without difficulty. The Heung Yee Gook is also deeply concerned about passports and is urging Britain to take full responsibility for those already holding British dependent passports. Leaders of the Heung Yee Gook have visited Beijing to press their views, but have not received answers satisfactory to them. The Heung Yee Gook, although virtually unknown to expatriates in Hong Kong, represents the largest political organization in Hong Kong and the one whose constituents are most committed to what they view as fundamental moral principles. They possess 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 and are even less accessible to researchers than the Heung Yee Gook. 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. The anxieties, principles, and organization of these people remain largely invisible to foreigners, but all, despite invisibility, remain a major determinant of the future.

## Sectoral Response of the Economy to these Uncertainties

Following the 1983 upturn in the world economy, and a substantial devaluation of the Hong Kong dollar, Hong Kong's competitiveness has risen and its markets have expanded. As a consequence, real GDP rose 5.9 percent in 1983 while inflation declined. This return to growth has been as important psychologically as economically, but it is also important to note that the growth rate remains far below the boom years of the 1970s and that real incomes in early 1984 remained below the real incomes 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. Further rapid growth remains impeded by that ceiling.

Simple electronics are also booming. Telephones, calculators, and television games require very small investment and generate very rapid paybacks.

Despite these relative successes in textiles and small electronics, domestic investment in manufacturing remains miniscule. 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 according to a major manufacturer, investment grew only 0.4 percent. Even taking into account the long-term sectoral decline in manufacturing discussed earlier, any such trend which is long continued would imply severe damage to Hong Kong's prospects in the sophisticated industries which should represent the most dynamic part of its future.

Virtually all local investments today seek short-run returns. 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, despite a common opinion to the contrary, a shift to time horizons of only a few years can and will cause a substantial decline in Hong Kong's growth rate and long-term technological prospects.

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

Services, particularly financial services, are booming. Hong Kong's highly skilled population provides the personnel needed for sophisticated service industries. Its light regulation, especially compared with South Korea, Taiwan, Singapore, and Japan, is attractive to service companies which need to be fast on their feet. The collapse of real estate costs has been a

boon to firms whose competitiveness was being threatened by rising real estate prices.

Although there has been some domestic investment in service industries, much of that investment has come from foreigners. While Hong Kong Chinese have been sending their money abroad, foreigners on balance have been heavily investing in Hong Kong. Japanese and American firms have invested across the board. Japanese banks have moved in to purchase properties, whereas in earlier years they rented. Motorola is building a major manufacturing plant. The bulk of the foreign investments are in services, however. While risk in Hong Kong is probably still less than in most Southeast Asian countries, the flood of foreign investment from Southeast Asia, particularly Indonesia, has dried up after the Indonesian devaluation and the Malaysian difficulties (see discussion of Carrian below).

Investment in Hong Kong by China has risen steadily. Chinese firms are buying substantial amounts of real estate. China made a major loan to finance the Hong Kong subway. The Bank of China has been particularly prominent in land purchases. China is funding most of a nuclear power plant that will largely service Hong Kong. Everbright, a Chinese firm which knowledgeable Hong Kong Chinese businessmen believe to have a \$600 million line of credit from the Bank of China's Beijing branch, is entering into a large number of joint ventures. China Resources has diversified beyond resources and recently bought a major electronics firm, Conic. Guangdong Enterprises, Ltd. has purchased a large wharf complex and it is 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 has experienced the most difficulties, and has the poorest prospects, is 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. Despite an oversupply of hotel rooms that has depressed rentals for a luxury room to U.S. \$50-60 per night, existing construction will increase the number of hotel rooms from 14,000 to 18,000 in the next three years. Huge blocks of office space remain unsold and unrented due to massive oversupply, but large amounts of construction continue because of commitments made before the bust. Only mass housing is doing well. The real estate bust has taken with it many important firms: Carrian, Eda, Associated Hotels, the Kevin Hsu Group, Aik San Brothers, Truong Brothers, Dollar Credit and Hang Lung Bank. Even Hong Kong's largest firms have suffered severely in the real estate bust. The most famous land firm in Hong Kong is described by senior officials and businessmen as being in fairly serious difficulty. Jardine's has retrenched substantially.

Most current construction was financed with loans in 1980-1982 for space to be finished in 1985-86; in order to avoid immediate losses, construction is continuing even on real estate that has few prospects of ever repaying its costs. Beginning in 1985, banks will begin to take major losses on much of this real estate. Following the example of the Bank of Tokyo, banks in the period before the bust had provided mortgages for 70 percent of the value of

the construction, but the value of the collateral has declined by 50 percent. The conventional wisdom in Hong Kong is that local banks had been far more conservative in funding real estate speculation than the local offices of foreign banks, so the latter will bear the largest losses.

As noted earlier, the consequences of all this are mixed. Many important players have been damaged by loss of half the value of their real estate. At the same time, every other kind of business in Hong Kong has benefitted from the reduction of Hong Kong's formerly extraordinary real estate prices.

### Carrian

A major facet of the real estate collapse has been the Carrian scandal. Hong Kong business has always been rough and tumble, and the full flavor of it does not come through in any technical economic analysis. James Clavell's novel, Noble House, is a much more accurate guide to the flavor of Hong Kong business. Carrian, the latest episode of high finance and high scandal, threatens to eclipse the events described in Noble House.

The Carrian episode began when Bank Bumiputra, which is supposed to be Malaysia's premier institution promoting the economic interests of the country's indigenous Malay (in contrast to its Chinese) population, decided that it would pursue a strategy based on a highly speculative relationship with a Chinese businessman, George Tan. Tan received two weeks' float on Bank Bumiputra's foreign exchange transactions, with instructions to set up profitable businesses one by one. Tan became ambitious and set up a vast business pyramid, apparently thinking that he could quickly make himself so powerful as to control his Malaysian bosses. Along with the prestigious management of management of Bank Bumiputra, senior members of the Malaysian cabinet are reported to have been directly involved. Tan received unsecured loans from major Hong Kong banks. Many local and foreign banks, seeing the conspicuous participation of the prestigious Hong Kong and Shanghai Bank, lent money to more than 100 pieces of Tan's burgeoning business empire. Almost every Chinese businessman interviewed in Hong Kong spoke of the lavish gifts Tan distributed to the wives of highly placed officers and officials of many businesses and governments. Not surprisingly, Tan eventually became overextended, and the empire collapsed.

The financial consequences of the Carrian collapse are already wide-ranging, but may become far more extensive. The political consequences have probably just begun. The fate of the current government of Malaysia, of many Hong Kong officials, and of many officials of foreign governments and of major firms may well hang on the vigor, or lack of vigor, with which the Hong Kong government and others pursue their investigations. The Malaysian government has already expressed outrage that Hong Kong officials would actually have the temerity to investigate the allegedly illegal operations of Bank Bumiputra officials in Hong Kong.

Within Hong Kong, the Carrian incident and others like it are more portentous than at historically less sensitive moments. They risk loss of local political confidence. They risk Beijing's loss of confidence in its ability to master and control events in Hong Kong without more direct

involvement. They risk providing an excuse for wide-ranging intervention by Beijing in order to minimize corruption; Beijing has shown a certain insensitivity to arguments that an excessive concern for cleaning up corruption might seriously damage Hong Kong. And they risk creating a British sense that it is necessary to preempt PRC concerns by imposing much stricter regulation.

### Chinese Concerns

Through many kinds of Communist and non-Communist governments, China's leadership has always in modern history been aware of the tremendous economic benefits of having Hong Kong as an airlock through which it can deal with the capitalist world. Most of Beijing seems to understand that a Communist government is not competent to run ultra-capitalist Hong Kong. In the past, even during the Cultural Revolution, it was simply not true that China's policy toward Hong Kong has oscillated wildly; the constant in China's policy toward Hong Kong is steady defense of Hong Kong's integrity and its of its capitalist value to China.

Nonetheless, there are concerns about China's future policy toward Hong Kong. As noted earlier, it is likely to honor the letter of any agreement, but might well reinterpret a vague agreement in ways severely detrimental to Hong Kong.

Second, particular Hong Kong issues can become a political football in Beijing. Recently former foreign minister Huang Hua and former defense minister Geng Biao stated that the Chinese army would not station troops in Hong Kong. Deng Xiaoping reacted with uncharacteristic vehemence, dismissing their views with a contemptuous epithet and saying that China would indeed position troops in Hong Kong after 1997. Later, current defense minister Zhang Aiping tried to cool the controversy by saying that the issue would be decided after 1997. To many people in Hong Kong, the prospect of having impoverished Chinese troops stationed in glittering Hong Kong is a perfect recipe for trouble. And having their potential presence become a major political football, as Deng Xiaoping attempts to mollify military officers whose budgets he has squeezed, frightens them even more.

Another issue is how the PRC will react to Hong Kong's corruption and its penchant for wild speculation, both of which Beijing finds reprehensible. The Carrian scandal represents one kind of problem. Widespread gambling and prostitution represent a second kind of problem. The third is more sophisticated. China is making huge investments in an effort to profit from Hong Kong, but has taken many serious losses and has the prospect of further such losses in the near future. The Bank of China lost substantially in the real estate collapse. China Resources purchased Conic, a major electronics firm, only to discover that the firm's chairman had loaned most of the firm's assets to another of his firms which could not repay. China was left with a firm that was a financial hollow shell and whose technology was increasingly obsolescent. China Resources' competitor Everbright has been embarrassed by, for instance, having bought Mercedes trucks from Argentina only to find that it had no spare parts. Guangdong Enterprises purchased a huge wharf complex and suffered large losses when it had to pay very high interest rates on an

empty property for two years. If China regards such losses, which local businessmen call "tuition fees," as a necessary investment in learning about capitalism, then all could proceed smoothly. If China decides to put an end to "excessive" speculation, then Hong Kong's economy will never be the same again.

Finally, any marketing of China's firms in Hong Kong must pay attention to the political overtones of China's major involvements. Everbright is run by a former big-time Chinese capitalist relative of former premier Liu Shao-Chi, who died in humiliation during the Cultural Revolution. Deng Xiaoping has personally backed Everbright and ensured that he has a line of credit direct from the Beijing branch of the Bank of China. This is bitterly resented by local Hong Kong officials of the Bank of China and by China Resources, which is back by a more radical faction that was close former Party Chairman Mao Zedong. After Everbright began its wide-ranging moves, China Resources demanded and received the right to diversify out of the resources business, and its first large scale investment was the disastrous Conic purchase. These firms may wax and wane as factional struggles in Beijing wax and wane. Marketing officers who run afoul of the two firms' rivalries, or associated rivalries within the Bank of China, may find their business waning quickly.

#### Scenarios for the Future

The British-Chinese negotiations have made excellent progress, and both sides have made major concessions which demonstrate good will and create the possibility of a slow transition. However, the issues raised earlier in this paper show that neither a fully favorable nor an unfavorable outcome can yet be predicted. The following scenarios show the range of alternative possibilities. That range seems very wide indeed, but is far narrower than the range represented the paper of one year ago.

##### Scenario I: Temporary Downturn and Bounceback

Fear, capital flight, and concern over details, and of the negotiations continue for up to five years, but people become inured to the situation and there is an eventual bounceback to economic dynamism. Deng Xiaoping remains firmly in control in Beijing for several more years. Beijing continues to be forthcoming in terms of verbal assurances and, more importantly, acquiesces in a rather detailed agreement with Britain in late 1984. Most professionals and middle managers in Hong Kong adopt a "wait and see" attitude; they acquire travel documents and establish financial bases overseas, but focus their efforts on building their businesses in Hong Kong. The U.S. economy continues to grow through 1985 and 1986, and the resulting Hong Kong growth puts a rosy glow on the ongoing negotiations. Western investment in China speeds up, and Hong Kong profits. China allows Hong Kong to become an important service area for its oil industry. The PRC successfully sells its opening of fourteen cities to greater foreign economic activity as implying a brilliant future for Hong Kong as an intermediary. Beijing continues to produce detailed and satisfactory rules for foreign investors in China and in the special economic zones. Property related firms do not collapse en masse, and the political consequences of the Carrigan scandal are successfully contained. By 1989, Hong Kong's stability in the face of the negotiations over details (which will

still be going on at that time) leads investors to focus once again on Hong Kong's extraordinarily high labor productivity, its prospects as a bridge to the PRC, and its growth rates, which continue to be far higher than U.S. and European rates. The key people by this time will have their passports and their established positions abroad, and they will feel more comfortable coming back and bringing some of their money with them. In this scenario, textiles remain successful throughout the period, simple electronics remain highly competitive, trade with the PRC booms, and so do services. Hong Kong's role as a base for doing financial and non-financial business with the PRC is highly rewarding in this scenario. The property market remains down until excess capacity has been absorbed by about 1988 or 1989. A new generation of top managers and entrepreneurs becomes established by this time, and some of the old ones begin to return. The basis is then established for a return to eight or nine percent annual growth.

#### Scenario II: Drift Into Stagnation.

The September 1984 agreement receives mixed reviews. Domestic investment remains extremely low. Foreign investment and services continue to grow rapidly, but textiles and simple electronics are increasingly living off past capital investments. Labor discontent rises in textiles and electronics. Continuing uncertainties lead to a steady leakage of professionals. Turnover among key mid-level people in services disturbs major domestic and foreign firms moderately but not severely. The bills for the subway, major highways, low cost housing, and a funded pension system become due, while continued depression in the property market drastically reduces government income from this primary source of revenue. Taxes therefore rise. Concern over crime and welfare issues leads to a rapid increase in regulation of business. Strikes and electoral pressures greatly accelerate the transformation of Hong Kong into a welfare state--at a time when its fiscal capacity for such changes is low. Taiwan, Japan, and Singapore make major moves to reduce the regulatory burden on the service industries, particularly financial services, and therefore growth in Hong Kong proceeds at a lower rate. The children of entrepreneurs, professionals, and managers alike choose to remain abroad because Hong Kong's 5-6 percent growth rates, although higher than those in the U.S., Canada, Australia, and Western Europe, are inadequate to entice them to make long-term family commitments in the face of large-scale political uncertainty. Hong Kong remains a better place to do business than most of the Third World. It remains a key entrepot and a principal bridge to China. But it loses its extraordinary dynamism.

#### Scenario III: Anomic Outbreak and Early Takeover.

The September 1984 agreement follows generally expected lines, but has an unsatisfactory lack of detail. The reaction of financial markets is poor. China again loses a lot of money in various enterprises and reacts angrily. Britain is weak in suppressing public demands for more direct democracy. Britain and China disagree about major policy details, such as the administration of travel documents. Deng Xiaoping's health, and his political health, appear shaky, and there is widespread speculation in Hong Kong about the emergence of a more provincial, military-oriented, nationalistic

leadership less sensitive to Hong Kong's special needs. In early 1985, the U.S. economy experiences a sharp downturn; as a result Hong Kong faces the prospect of low growth, rising unemployment, and increasing taxes. There is a rising sense in Hong Kong that Britain has betrayed them. The many who could not obtain British travel documents envy those who could. Complaints about Hong Kong's social inequality become widespread. A number of strikes occur. The Heung Yee Gook publicly voices its displeasure over the agreement's failure to satisfy its demands. Significant numbers of senior civil servants and police officers emigrate. On the surface, things proceed normally, except for these sporadic events, which the press portrays as relatively minor.

However, in September 1985, major rioting occurs in working class areas, and violence breaks out in parts of the New Territories with tacit support of the Heung Yee Gook. The senior police leadership is weaker than in the past, and the decisiveness of the rest has been weakened by uncertainty as to China's policy views. The police fail to contain the rioters. The Gurkhas can keep things under control only in a small area. China demands that the British intervene with troops. Britain debates the matter and decides that this is not the appropriate time in history to be dispatching thousands of British troops to Hong Kong. The People's Liberation Army reluctantly dispatches units to Hong Kong. Although the units are small, rioting immediately ceases. PLA leaders, Deng Xiaoping, and local Hong Kong Communist leaders declare that the intervention was done with British approval and in support of the British rule. However, after a period of time, it becomes clear that it will be difficult to withdraw the PLA troops and that it would be difficult for Britain to govern decisively while the PLA troops are present. In early 1985, Britain and China announce an agreement that the reversion to PRC sovereignty will occur on June 30, 1987 rather than June 30, 1997. There is a financial panic, a substantial exodus of professionals and managers, and a foreign exchange crisis which leads to the imposition of exchange controls. The Hong Kong dollar becomes worthless. This severely damages local banks and corporations and demoralizes the public. China would attempt to prevent this scenario from proceeding to completion by providing financial support to Hong Kong, and it would make strong efforts to restore the situation to normal if the crisis did occur. But it is difficult to assert with great confidence that China's support would be sufficient or sufficiently timely.

In this scenario, so long as local assets were allotted very prudently, Hong Kong might still be one of the better locations for managing regional business. Doing international banking business in Hong Kong would become similar to doing it in Taipei. One would have the advantages of being at the hub of an international communications network, along with the advantages and disadvantages of, in effect, having a branch office in a city which would rapidly become something like Shanghai. The problems of doing business in such an environment would be far less than the problems of doing business in, for instance, the Philippines of today, but it would be a very different kind of business from that of Hong Kong today.

#### Specific Risks and Opportunities

The detailed discussions of the economy and of the different scenarios outline the basic business risks and opportunities, so this section will be



brief. In some scenarios, there is a continuing risk of an exchange rate crisis, of runs on local banks, and of spectacular oscillations in interest rates. There will be continued risks of a high order in the property market, along with enormous potential opportunities in the weeks following a British-Chinese agreement if that agreement is favorably received. There is a substantial risk of Hong Kong falling into a more lazy welfare state pattern, a possibility driven both by pre-existing trends in Hong Kong and by preemptive reaction to Beijing's sensibilities. Higher taxes are not only possible but likely. An increasing number of Hong Kong firms are experiencing vigorous exports, but not repatriating the export profits; instead they are borrowing in Hong Kong, thereby shifting their risks to the banks. In the most extreme scenario, there is some risk of efforts by China to force repatriation of capital. In all scenarios, crime and corruption of various kinds will rise as people try to fund their escape options and react to anxiety and the potential decline of British authority.

Throughout all of this, there are the opportunities for business which, in a broad range of possible scenarios, make Hong Kong still more attractive than the vast majority of Third World countries, as a center for regional coordination, as a center of trade finance, as a booming services market, and as a point of access to the increasingly attractive market in China itself. The proposed offshore pension fund for government employees could become a major business opportunity. Helping capital move abroad has already become the principal business of some major foreign banks. To take advantage of this market will, however, require faster footwork than in the past.