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**Why Hong Kong
is so important
to China**

A hidden helping hand

Beijing's post-1997 approach

An active role behind the scenes

- In an under-reported and highly significant move, Beijing is working behind the scenes to support Hong Kong's economic recovery and integration with the mainland, even at the expense of other Chinese cities. Beijing takes an intense interest in Hong Kong's wellbeing because it is a national priority that the "one country, two systems" experiment should succeed.

To hasten recovery

- Intervention is likely to accelerate in 2002 and could well underpin a faster recovery in Hong Kong than many sceptics deem possible. It also calls into question the relevance of the Hong Kong vs. Shanghai debate at a time when each is burnishing its financial-centre credentials.

Well-timed goodies in the pipeline

- With Chief Executive Tung Chee-hwa up for reselection in March 2002, Beijing has swung into action to improve the public mood in Hong Kong. Since the aim is to improve the economy and thereby public sentiment, expect well-timed goodies in the pipeline.

Details start to emerge

- The Beijing municipality has announced a favourable package for HK-Beijing joint ventures. A free trade area between Hong Kong and the mainland is being considered. It would give Hong Kong companies first-mover advantage (post-WTO) and attract more foreign companies to use Hong Kong as a business centre.

Boosting investment flows

- One of the more intriguing possibilities is a scheme to let mainland investors buy shares listed on the Hong Kong exchanges. Another possibility might be to allow Hong Kong companies to raise renminbi on the mainland to finance business expansion. Moreover, Beijing could well place more of its US\$200 billion foreign exchange reserve to be managed in Hong Kong and launch its next tranche of US-dollar bonds there next year.

Hong Kong needs to keep up with China's rapid change

- Perhaps as significant as the measures themselves is Beijing's determination to keep Hong Kong relevant and important to China as a whole. Past success for Hong Kong was driven by a confluence of favourable historical circumstances. Today, with China's opening up, Hong Kong's role is changing and the HKSAR Government has to think smart and be bold to capture new opportunities. So far, Hong Kong decision-makers appear sluggish.

Prepared to take strong measures

- Even China's Premier Zhu Rongji was moved to remark in September that Hong Kong was always "discussing without deciding, and deciding without acting". That was strong stuff in the Chinese cultural context. Now, signs are that Beijing is quite prepared to be pro-active to nudge things along, and the Hong Kong economy and market may well benefit as a result.

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"Thinking gets better when we think often. Thinking is fun because it creates new possibilities in the way we live our lives. Research helps to drive thinking. Thinking in groups helps leverage our collective intelligence and can lead to breakthroughs."

Christine Loh

Christine Loh is CEO of Civic Exchange, an independent, non-profit, public-policy think tank established in Hong Kong with a mission to:

1. Promote civic education, public awareness and participation in governance by strengthening civic participation in public life;
2. Undertake research and development in economic, social and political policies and practices to help shape the breadth and depth of public-policy debate and so to advance policies that are sustainable, resilient, non-violent, economically efficient, just, participatory, locally appropriate and spiritually rewarding; and
3. Integrate skills and experience across various disciplines including academia, business, politics, finance, technology and the non-profit-making sectors.

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Beijing's Hong Kong

Don't ever think that everything would be all right if Hong Kong affairs were administered solely by Hong Kong people while the Central Government had nothing to do with the matter. That simply wouldn't work – it's not a realistic idea. The Central Government certainly will not intervene in the day-to-day affairs of the special administrative region, nor is that necessary. But isn't it possible that something could happen in the region that might jeopardise the fundamental interests of the country?

Deng Xiaoping

Statement to drafters of the Basic Law 1987

Zhu Rongji's lament

On 3 September 2001, Chinese Premier Zhu Rongji made a cryptic comment about Hong Kong that started weeks of guessing – to whom and what was he referring? Hong Kong, complained Zhu, was always “discussing without deciding, and deciding without acting”. It was certainly a calculated criticism – but was he referring to the city's Chief Executive, Tung Chee-hwa, or something else?

Tung's supporters interpreted Zhu's sphinx-like statement as being directed at top civil servants in the Hong Kong administration whom they argued have not always given their best to promote the Chief Executive's policies, making him appear a poor leader. Tung's critics, on the other hand, believed it was a sign of Beijing's disappointment in the Chief Executive's ineffective leadership.

An interpretation

If Beijing leaders had wanted to criticise the Chief Executive, they probably would have told him in private, which they may well have done, but public criticism of their chosen Hong Kong leader would be embarrassing, particularly when there appears to be no ready successor with popular support for now.

Zhu's comment needs to be read in context with other things he said about Hong Kong. He also said that Hong Kong people should look for solutions to problems “together” and that “it's important for Hong Kong people to unite and discuss solutions in the spirit of democracy. Once a decision is made, everyone should make full effort to move forward”. Taken together, these statements indicate that Zhu was referring to the ineffective Hong Kong decision-making process within the administration more than the lack of leadership ability of the Chief Executive.

The practice on the mainland is that, prior to a decision being taken, peers and underlings can debate and voice disagreement (“discuss solutions in the spirit of democracy”) – but once a decision has been made, everyone is expected to pull in the same direction to implement the decision (“everyone should make full effort to move forward”). Zhu's comments reflected the central government's belief that the Hong Kong Special Administrative Region (HKSAR) Government was ineffective.

With sovereignty returning to China in 1997, Beijing now believes it has gained deeper insight into how things work in Hong Kong, its most prosperous city. While Chinese leaders are not about to tell Hong Kong people directly what to do, honouring the “one country, two systems” and “Hong Kong people ruling Hong Kong” principles, they have formed views about what works and what doesn't in the city, and they clearly have some concerns.

“Discussing without deciding and deciding without acting”

Any criticism of the Chief Executive would have been done in private

Criticism most likely directed at the HK decision-making process

Beijing has some concerns

Beijing is aware that legitimacy has to be earned

Beijing can help Hong Kong in positive ways

China's stability throughout the 1990s and its commitment to reform are impressive

Domestic psychology has also turned positive over the last few years

Beijing is sophisticated enough to know that the HKSAR Government cannot claim to have the people's mandate as it was not formed through election. In other words, the government's legitimacy is deficient. The only viable substitute is to earn its legitimacy through solid performance, which is why Beijing has become concerned about the Chief Executive's perceived ineffectiveness.

The question is what can Beijing do about it? Beijing seems to think that it has to help where it can.

Chinese honeymoon

China has some positive cards to play. As a closed economy, China was not much affected by the Asian financial crisis. Even as the rest of the world is showing economic sluggishness, particularly after the events of 11 September, China's economy is chugging along steadily and is a bright star among the clouds. It is about to enter the World Trade Organisation (WTO) and is gearing itself up to host the Beijing Olympics in 2008. These are honeymoon days. Whereas people used to talk about how Hong Kong could help China, today, the table has turned and Beijing is lending a helping hand to capitalist Hong Kong in its hour of need.

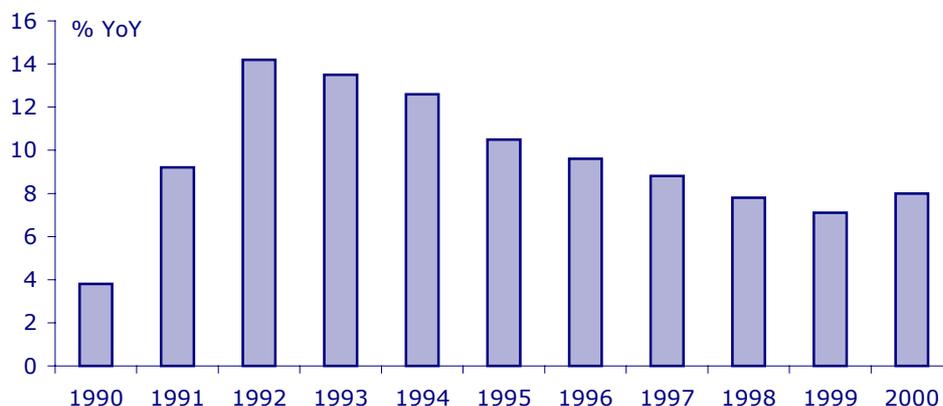
Changed perception of Beijing

Beijing is enjoying growing international stature. After the events of 4 June 1989 and even up until the transfer of sovereignty in 1997, there was widespread concern about whether Beijing could avoid unrest on the mainland, and maintain confidence over Hong Kong. It is fair to say that since 1997, international perception about Beijing has improved significantly.

Firstly, despite many doubts, China has enjoyed political stability in the 1990s. Secondly, it has continued to aggressively push its economic reform agenda. Thirdly, the current crop of top leaders have shown themselves to be quite skilful at handling political as well as economic issues. Fourthly, the top state elite also seems to be able to put their differences aside, which is probably due to a shared belief that economic reform is the only way for the regime to maintain public support and survive. Lastly, China's international stature has grown because of its relatively pragmatic and restrained way of handling foreign affairs issues, including its handling of Hong Kong. There has been a gradual positive change in the domestic public psychology and a sense among the Chinese people that China is making progress in the world.

Figure 1

China's real GDP growth since 1990



Source: CLSA Emerging Markets

Beijing municipality's special incentive package to Beijing-Hong Kong joint ventures . . .

. . . and more goodies still

More of China's foreign exchange reserves could be managed in Hong Kong

Chinese Government may also launch US\$ bonds in Hong Kong

Free trade area to give Hong Kong post-WTO, first-mover advantages

High profile of announcements means action is likely soon

Mood enhancers . . .

With the current economic downturn in Hong Kong, the ebb in confidence, and with the Chief Executive's selection coming up in March 2002, the central government has swung into high gear to do what it can to improve the public mood in Hong Kong.

On 23 October 2001, Beijing's mayor, Liu Qi, surprised a group of visiting Hong Kong business people by announcing to them a special incentive package to boost relations between the Beijing municipality and Hong Kong. Currently, Hong Kong has 6,230 registered enterprises in the capital. Hong Kong-mainland joint ventures in the capital will be treated as local businesses, qualifying for a range of lower taxes, lower borrowing rates and fee exemptions.

Furthermore, Beijing will disclose planned infrastructure projects to Hong Kong in advance, set up special channels to assess Hong Kong-backed projects, allow Hong Kong investors a head start in projects open to foreign investment, and increase by 15% the number of Beijing residents allowed to visit Hong Kong as tourists. Beijing will also open job vacancies in the city government – such as the Foreign Economic Co-operation and Trade Bureau – to Hong Kong people.

On 7 November, after meeting officials in the capital from China's central bank, (People's Bank of China) and State Administration for Foreign Exchange, the Hong Kong Monetary Authority's head, Joseph Yam, announced that China was considering letting more of its US\$200 billion foreign reserve be managed in Hong Kong. The plan could enable a larger portion of the national reserves to be traded in Hong Kong's foreign exchange, bond and gold markets by locally based financial institutions. Discussion is also ongoing about whether mainland institutional investors would be allowed to trade in Hong Kong stock markets. China has capital controls and currently bans mainland investors from buying Hong Kong stocks.

On 19 November, Hong Kong's financial secretary, Antony Leung, announced that he had asked Beijing to consider launching its next tranche of United States-dollar bonds in Hong Kong next year rather than overseas to help boost the local debt market. China issued 1.7 trillion yuan in government bonds with 10-year maturity between 1998 and 2001 raising about US\$2 billion for the Chinese Government.

Furthermore, on 28 November, Long Yongtu, China's vice minister and chief representative of trade negotiations, said that Beijing was considering setting up a free trade area between Hong Kong and the mainland, a proposal that the Hong Kong General Chamber of Commerce has been pushing for the last two years. The benefit is for Hong Kong to have an early-mover advantage so that it will enhance the attraction of Hong Kong businesses as partners for foreign companies who want to do business on the mainland. This could be especially attractive to foreign small and medium-sized enterprises. Large multinationals would probably feel they do not need a Hong Kong connection to do business in China but smaller companies could well find it an advantage to work through Hong Kong intermediaries.

. . . and their political significance

The political significance of these moves should not be lost. Yam and Leung must have been fairly confident that their requests would be met in the not-too-distant future before deciding to make high-profile announcements. The go-ahead could well be timed to give maximum positive impact during 1Q02 or 2Q02 to coincide with the selection of the Chief Executive for a second term of office due in March.

Symbolic if nothing else

Hong kong will expand trade offices on the mainland

Even more goodies – QFII and CDRs may also be on the cards further down the road

Allowing Hong Kong companies to raise RENMINBI on the mainland would really be beneficial to Hong Kong businesses

While the Beijing mayor's package may appear less significant – since with China accession to the WTO, Beijing will have to grant equal treatment to everyone next year – it was nevertheless a sign from the top that the central government wanted to show some favour to Hong Kong business now, when the public mood is downbeat.

The Beijing package could also be seen within the framework of the yet-to-be-finalised free trade area agreement, which is being actively pursued by the Tung administration. The HKSAR Government is likely to announce in the near future the expansion of trade offices in key cities on the mainland. It should also be noted that negotiations between Hong Kong and the mainland would be taking place between two separate WTO members, as China is about to accede to it. Both will be especially careful to ensure that any agreement will fall within the WTO framework rather than be seen as a special "one country, two systems" deal, forestalling criticisms of any breach of the WTO. Beijing is keen on such an agreement since it will put pressure on Taiwan to improve relationships with Beijing otherwise Taiwan businesses may set up companies in Hong Kong to take advantage of the agreement, which could compound the hollowing out problem of local business to the mainland.

Other goodies in the pipeline?

What will be interesting to watch is how the mainland and Hong Kong can improve opportunities for both to deal with problems China needs to solve in the foreseeable future.

As the mainland starts to reform its welfare system and develop its insurance and fund-management businesses, more cash can be expected to flow in and yet it will still be some time before China is ready to run an open capital account system. The money can be channelled through Hong Kong but close-pipe systems have to be developed, such as with Qualified Foreign Institutional Investors (QFII) and Chinese Depository Receipts (CDR).

With QFII for example, it would involve them being registered in the mainland and having special accounts, perhaps with Bank of China in Hong Kong, which would monitor the investments. Alternatively, under a CDR system, the mainland would keep the money onshore and allow Hong Kong-listed companies to issue CDRs in Shanghai, which would be traded in renminbi. The latter system would ensure liquidity and quality in the mainland market without the need for offshore supervision as per the QFII route. These possibilities are good for the mainland and give Hong Kong additional status. Beijing has yet to really give any solid indication on these possibilities though.

What would really be beneficial to Hong Kong companies is for them to be able to raise renminbi on the mainland. If Hong Kong companies could raise mainland currency, Hong Kong's investment there would really soar, as Hong Kong businesses want to use domestic currency to fund mainland business expansion.

Hong Kong means much more to Beijing than it ever did to Whitehall

The success of "one country, two systems" is a national priority

. . . even at the expense of Shanghai and other Chinese cities

A bit of history

Why Hong Kong is very important to China

It may be useful to pause here to reflect upon a bit of history, so as to be able to place the Hong Kong-China relationship in clearer perspective.

China's resumption of sovereignty over Hong Kong in 1997 had much greater significance for Beijing than it did for Whitehall. For Britain, the goal was to relinquish its last colonial "jewel" with some degree of honour and to leave in place a system that Britain could justify to the world that it had done its best for Hong Kong. For China, the significance remains far-reaching.

It represented closure to a past historical shame where a weak China was forced by gunboat diplomacy to cede territory. The return of Hong Kong was also an important step in the evolution of China's political identity vis-à-vis the international community. Indeed, 1997 provided a very special opportunity for that ancient civilisation to adapt to greater openness and tolerance. Since 1997, Beijing has shown the world that it has basically left the HKSAR to administer itself. That relaxed attitude demonstrated Chinese leaders' capacity to understand how capitalist Hong Kong works.

"One country, two systems" must not fail

The stakes are high. If Hong Kong lapsed into becoming just another shinier Chinese city, it would not serve the national purpose. It would be wrong to think that once Hong Kong became a part of the mainland that Beijing would not care whether it succeeded or not. Beijing wants Hong Kong to flourish as a major international city because that is a win-win result for China as a whole. Hong Kong has staked itself out to become "Asia's World City" with Beijing's blessings. Beijing is nothing if not pragmatic, with the larger picture in mind. China will gain immeasurable international prestige with a successful Hong Kong. It can show the people of Taiwan that there is nothing to fear from reunification with the mainland. The unique experiment of the "one country, two systems" formula cannot be allowed to fail.

Shanghai, stand aside . . . for now

Some Shanghai people obviously feel hard done by with Beijing showing such favour to Hong Kong. Fang Xinghai, the relatively young assistant president of the Shanghai Stock Exchange, expressed that feeling when he visited Hong Kong to attend the East Asia Summit of the World Economic Forum in October.

Hong Kong had four disadvantages over Shanghai in being China's financial capital according to Fang. He said that, firstly, it lacks connections in Beijing; secondly, Hong Kong's hinterland is smaller than Shanghai's; thirdly, Hong Kong does not pay tax to the central government; and lastly, that making Shanghai the financial centre would raise the overall financial standards of the mainland.

Fang's last three points are arguable. He also did not give due weight to the one area where Hong Kong is way ahead of Shanghai with its system of rule of law. His oversight could be due to his lack of appreciation of just how crucial the rule of law is to a financial centre. Furthermore, Hong Kong has an open capital account system, which Shanghai does not. The Shanghainese' cockiness is to an extent based on their cash going to an increasingly overheated stock market to companies that are overvalued. The reality is that their paper wealth cannot be converted into real money outside the mainland.

Hong Kong plays on a regional and international stage that no other Chinese city does

On Shanghai's better political connections in Beijing he was undoubtedly right but what he overlooked was the symbolic nature of the return of Hong Kong to China. President Jiang Zemin spent three hours in private discussions with Tung Chee-hwa, a privilege accorded to very few Chinese mayors or indeed, many other people, during the October Asia Pacific Economic Cooperation (Apec) meeting in Shanghai.

Furthermore, Hong Kong is a world-stage player on such bodies as the WTO and Apec. As the Apec meeting showed, the Hong Kong Chief Executive got to hobnob with world leaders even though in reality he is more like a city mayor than a head of state. If Hong Kong plays its cards right, it has local, national as well as international stages to play on.

Fang's words do show one thing - Beijing actually has to play a skilful role within the mainland to ensure that there is no undue jealousy among the provinces and municipalities for the favouritism shown to Hong Kong. Chinese leaders have to be able to explain to others why treating Hong Kong well is a national priority.

Learning about Hong Kong

Beijing is a keen student of how things work in Hong Kong

While London took a disinterested view on the details of how things worked, Beijing takes a much closer interest in many aspects of Hong Kong. It has had streams of people within the mainland system studying Hong Kong for many years. There were Hong Kong researchers and specialists in the obvious places prior to 1997, such as within the Hong Kong and Macao Affairs Office, the New China News Agency - Beijing's *de facto* official presence in colonial Hong Kong - and the Ministry of Foreign Affairs.

For years, there were and still are many researchers closely studying Hong Kong events within many other political institutions, including various wings of the Chinese Communist Party, which is after all the ruling party in China and plays a central role in determining all areas of policy, and within some of the top leaders' private offices. For example, Vice Premier Qian Qichen, who was the foreign minister for many years, still takes a close interest in Hong Kong affairs.

Obviously, with nearly five years having passed, Beijing feels reasonably certain about its understanding of many aspects of Hong Kong since it has been able to take a close look from the vantage point of an intensely interested but hands-off sovereign.

Beijing's concerns about absorbing Hong Kong post-97

Beijing does not want a "political city"

The past affects the present

Beijing's post-97 concerns

Having solid research analysis on Hong Kong is particularly important for Beijing, since prior to 1997 it had identified a list of post-resumption concerns it needed to watch out for. That list included securing sovereignty, dealing with unfriendly forces seeking to transform Hong Kong into a "political city", and ensuring that there would be no undue haste in developing democracy.

Nearly five years on, there is no doubt that sovereignty has been secured. Hong Kong people have, by and large, accepted Chinese rule. Surveys show that Hong Kong folk even hold top Chinese leaders, such as Premier Zhu and President Jiang, in high regard. What remains of concern today in Beijing are the other issues. All of them are worth exploring within the context of Hong Kong today in order to assess trends.

Hong Kong as a "political city"

Beijing's perspective of a "political city" and developing democracy are related. In the mid-1990s, Lu Ping, the then top official with direct day-to-day responsibility for dealing with the transfer of sovereignty, coined the phrase that Hong Kong should not become a "political city" but should remain an "economic city". While what that meant was never made entirely clear, Michael Yahuda, in his book *Hong Kong: China's Challenge*, said that when he pressed the point in private, Chinese officials explained that they feared the:

. . . emergence of many quarrelling parties who would prevent the passing of government bills in the Legislative Council. That would diminish the effectiveness of government and cause foreign investors to doubt the territory's political stability. Hong Kong would then cease to be an international financial centre.

In other words, there should not be too much party politics lest it makes the government ineffective. Beijing had understood that Britain's success in controlling Hong Kong was in establishing strong executive-led government that coordinated with the legislature but could not be obstructed by it.

Beijing favours a de-politicised Hong Kong

The governing strategy before the Asian financial crisis . . .

. . . became redundant very quickly

A bit more history:

Seize the window of opportunity

From the mid-1980s through to 1997, the issue of Hong Kong was highly politicised. Hong Kong politics was characterised by constant bickering between Britain and China. Political scientist Lau Siu-kai believed that the sustained highly politicised environment for so many years turned Hong Kong people off public interest politics with the majority becoming increasingly apathetic. He wrote that: "Political alienation, cynicism and inefficacy are on the rise . . . The major reason for declining political interest among the people of Hong Kong despite democratisation has to do with public recognition of their powerlessness vis-à-vis the mainland and Britain".

Beijing had calculated that there would be a period of thankful calmness after the transition providing a window of opportunity for the new HKSAR Government to consolidate political authority as fast as possible. The fact that ordinary folks in Hong Kong had become politically apathetic was seen as a good thing. Lau pointed out that they are "less susceptible to political appeal and mobilisation by the politicians, thus further contributing to a de-politicised environment".

A sure win strategy

The strategy for the first HKSAR Government was to run a conservative, pro-business regime in order to maintain the capitalist nature of Hong Kong, increase homeownership to promote political stability, improve education, and give a compassionate face by providing modest improvements for some disadvantaged groups, such as the poor elderly.

The new government under Tung Chee-hwa aimed to increase the building of public housing units and increase homeownership rate by 20% to over 70% within a decade in the belief that homeownership increased political loyalty and stability. The Chief Executive made encouraging noises in 1997 that people should buy property. This policy was felt to be a sure win during the early days. In retrospect, his housing policy became his albatross.

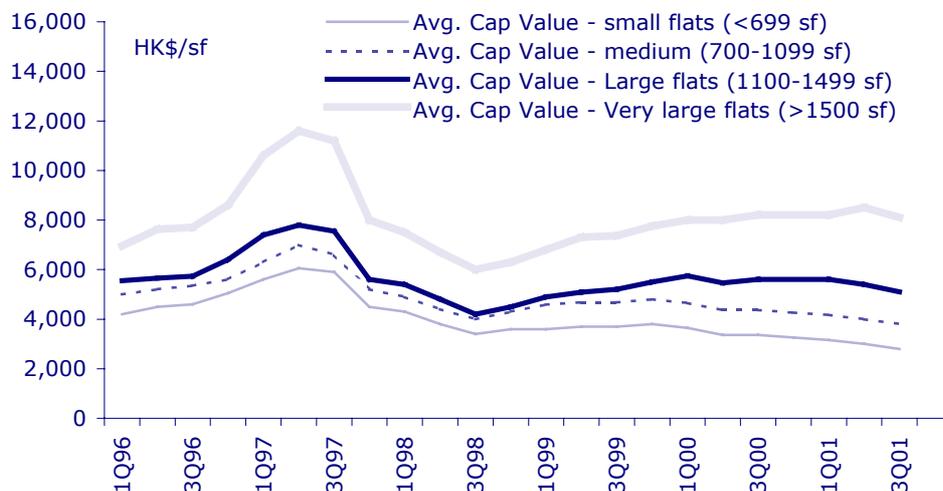
. . . surprise scenario

Almost as soon as the new housing policy was announced, Asia was hit by a whirlwind financial crisis that brought many regional economies to their knees. Hong Kong survived but asset prices fell by more than 50%. The Hong Kong Monetary Authority estimated that 60,000 homeowners bought at the height of the market in the run-up to 1997 and now suffer "negative equity" – that is where the mortgage is higher than the value of the property. Many property owners today blame the Chief Executive for misjudging the severity of the crisis and acted too slowly to rein in his massive home building program thereby forcing prices to drop even lower.

While the HKSAR Government has started to adopt a more sensible housing policy by reducing its role as a housing provider (some 50% of Hong Kong households live in publicly provided housing of one sort or another) this year, the Chief Executive has left a poor impression on the people of his economic management ability.

Figure 2

Hong Kong residential prices since 1996



Source: Vigers Property Review, CLSA Emerging Markets

Some new challenges for Hong Kong post-97

... everyone is unhappy

There does not appear to be a new strategy yet with Tung Chee-hwa's second term selection looming

An unexpected set of challenges

The Asian financial crisis made the initial ruling strategy redundant. The crisis gave new urgency to Hong Kong businesses to restructure in order to stay competitive. The old franchise based on a property bubble has burst. Adaptation is always painful. Economic restructuring has brought about social dislocation. The HKSAR Government has to face a range of agonies that would have tested more experienced governments – deflation, asset depreciation, personal and corporate bankruptcies, as well as rising unemployment.

These difficulties have created a more disgruntled working class and a less happy middle class. Even the business elite has been complaining to Beijing about the new administration's inability to steer the economy through rough waters. Some of them also feel that the Chief Executive had shown particular favors to certain tycoons. Despite having substantial fiscal reserves to cushion the pain and to give Hong Kong sufficient breathing space to ride out these rough times, public confidence remains at an all time low today.

These circumstances are quite different from those that Tung had expected. Despite the looming election a few months away, a new strategy has yet to be articulated, which makes any mood enhancers Beijing can provide even more important to shore up short-term confidence. Ironically, Beijing's help will improve the image of Chinese leaders in Hong Kong but not necessarily help Tung Chee-hwa's popularity.

The unavoidable democracy question

Beijing's concerns

Even if a general election were to be held, there would have to be a transition period, and preparations for the election would have to be made step by step.

Deng Xiaoping

Selected Works Vol. III 1982-1992

Key aspects of the Basic Law give Beijing final powers over Hong Kong

During the 1980s, Beijing had two main concerns when drafting the Basic Law – Hong Kong's post-1997 constitution. Firstly, it wanted to retain final control in matters relating to the autonomy of the HKSAR. Thus, the Central People's Government formally appoints the Chief Executive even though a selection process for the post takes place in Hong Kong. The most senior civil servants, called principal officials, while nominated by the Chief Executive, are also appointed by Beijing. Moreover, the final right of interpretation of the Basic Law rests with the Standing Committee of the National People's Congress, China's parliament.

Beijing definitely wants Hong Kong to be capitalist

Secondly, Beijing wanted to ensure that the capitalist economic system remains. The Basic Law is explicit that the capitalist system "shall remain unchanged for 50 years". Chinese leaders believe that capitalism must remain in order to attract local and international investors and if investors feel secured then political stability could be maintained. It is a paradox that socialist China should bend over backwards to ensure that socialism could not take root in Hong Kong.

Business and professional elites enjoy substantial influence in the political system

Entwining business and politics

Beijing's two concerns greatly influenced politics in Hong Kong. Since the early 1980s when Britain and China embarked upon negotiating the transfer of sovereignty, Beijing made it a top priority to cultivate key business people in Hong Kong and was prepared to give them a voice in the Basic Law drafting process and in the 150-member Preparatory Committee, which was set up in 1996 to organise the final stages of taking over power from the British. Of the 94 appointees, more than 50 of them were well-known Hong Kong businessmen, who collectively controlled 21 listed companies accounting for 36% of the capitalisation of the Hong Kong stock market at the time. Even today, important business people enjoy access to the top leaders in Beijing.

The selection process for the Chief Executive illustrates the conjunction of these two concerns. In 1996, Tung Chee-hwa, a shipping tycoon, was nominated by a 400-member Selection Committee for the First Government of the HKSAR set-up by the Preparatory Committee. The Selection Committee also had heavy representation from the Hong Kong business sector. Even though there were several other candidates, it became clear that Tung was Beijing's choice and he was duly selected.

The composition of the Legislative Council also shows the confluence of business and politics. In the current term (2000-2004), there are 24 legislators who were directly elected by universal suffrage, 6 members elected by an 800-member Election Committee, and the remaining 30 by functional constituencies, which are made up of business, professional, labour, political and community representatives. The voters for the 800-member Election Committee are by and large made up of the constituents of the functional groups. In other words, the same 200,000 people in Hong Kong control 36 of the 60 seats in the legislature, while some 3.75 million registered voters only got to elect 24 lawmakers. The same 800-member Election Committee will select the second-term Chief Executive on 24 March 2002.

However, under the Basic Law, universal suffrage is possible after 2007

There will be more pressure for political reform during the Chief Executive's second term

March 2002 selection likely to be a one-horse race

A couple of rumours

Pace of electoral reform

The Basic Law provides that if there is a need to change the selection process for the terms "subsequent to the year 2007", the change has to be endorsed by a two-thirds majority of the Legislative Council, obtain the consent of the Chief Executive, and then approved by the Standing Committee of the National People's Congress. The ultimate aim is the selection of the Chief Executive by universal suffrage upon nomination by a broadly representative nominating committee.

As for the Legislative Council, the number of directly elected seats in for the 2004-2008 term will be increased to 30, with the other 30 seats being occupied by the functional constituency representatives. The Basic Law provides that electoral reform is possible after 2007.

To date, Tung Chee-hwa has been able to ignore discussing political reform in a meaningful way because 2007 is still some way off. However, with the Basic Law being explicit that political reform is possible after 2007 and the ultimate aim is universal suffrage, there will be growing pressure for the second-term Chief Executive to discuss the issue and put in place some process to draft a new blueprint. Since Tung is expected to run for another term, he should know that he would not be able to ignore the issue for much longer.

Indeed, the 2004 Legislative Council election could force his hand. That election will return 30 directly elected seats and 30 functional seats. It is highly likely that the future of electoral reform will be a key issue for that election, with candidates preparing campaign strategies at least a year ahead.

24 March 2002 – foregone conclusion?

Nomination for selection of the second-term Chief Executive will open in mid-January 2002 and election date will be on 24 March. While Tung Chee-hwa has not formally announced his candidacy, he is expected to do so any day and is expected to win. A number of top Chinese leaders have indicated that they "support" him. If Tung is the only candidate, he will be automatically selected and his position will then be confirmed by Beijing.

There does not appear to be another candidate who has Beijing's blessings for now. For the first selection in 1996, there were three other candidates: Peter Woo, former chairman of Wharf Holdings and current chair of the Trade Development Council; and two former Hong Kong judges, T L Yang (a current Executive Councillor) and Simon Li. They all had good relations with Beijing. Indeed, it seemed that they were encouraged by Chinese officials to stand for selection.

There are two current rumours circulating. The first is that there could be a "friendly competitor" who would help to provide the semblance of an election process so that there will not be a one-horse race. The second is that Tung will not serve out the full 5-year term but will step down halfway enabling a younger, more able person to succeed him. Having a friendly rival will add much colour to a predictable selection process but it will not change the result. Indeed, the purpose of having a friendly rival in the first place is to show that Tung wins by a comfortable margin. The second rumour may be just wishful thinking. In view of the fact that there will be major leadership changes on the mainland in 2002 and 2003 at both the Politburo and government levels respectively, Beijing is unlikely to want a change in Hong Kong midway. Chinese leaders are in general a cautious bunch.

The mainland leadership succession

Jiang Zemin, 75, will step down as head of the Communist Party in the October 2002 party congress, and as state president in 2003. He is likely to retain his position as chairman of the Central Military Commission.

Premier Zhu Rongji, 75, will retire as premier in 2003, probably returning to teach at Tsinghua University.

Vice-president Hu Jintao, 58, is expected to succeed Jiang in both his party and state president positions.

What is less certain is who will succeed Zhu. Those jockeying for positions are vice premiers, Wen Jiabao, 59, and Wu Bangguo, 60, as well as Li Changchun, 57, party secretary of Guangdong Province, and perhaps even Xu Guangdi, 64, Shanghai's mayor.

*For more background, please see CLSA China strategist Andy Rothman's March 2001 report *Leadership succession (Who's next?)*.

A governing strategy for the second term is needed

Economy will be tough

Tung's interventionist tendencies may not be best for Hong Kong's future

Second-term priorities

The Basic Law provides that the Chief Executive's term of office is for five years and the same person cannot serve more than two consecutive terms. Thus, a second term for Tung Chee-hwa will also be his last. He sees himself being able to act more resolutely during his next term. He will have two particular challenges that will require clear thinking.

Economy but . . .

The economy will remain a big headache. The HKSAR Government announced on 30 November that it has cut its growth forecast for the year from 1% to zero and for the economy to shrink 2.5%, year-on-year, in 4Q01. Furthermore, prices are forecasted to drop 1.6% this year. The government is likely to record a budget deficit of more than HK\$50 billion for the financial year ending in March 2002. In Tung's own words: "More jobs will disappear before they reappear. Government revenue will fall short of its target, whereas expenditure will rise".



His team is watching the US economy closely and hopes that its early rebound will provide the lift that Hong Kong needs. Yet, a true turnaround may not happen before 2003. Moreover, the future of the Japanese economy may present another headache – some economists, such as Paul Krugman, believe the Japanese economy is heading for a meltdown in the near future, which could put pressure on Asian countries to devalue their currencies. All in all, there are still many external uncertainties and downside risks prevailing.

. . . a more interventionist management style?

For a small economy, it makes no sense for the government to exert control of its economic activities, but smallness alone does not prevent government activism in economic management: look at Singapore. Tung has already shown himself to be temperamentally and philosophically different in the way he deals with economic issues than pre-1997 administrations, which were by and large laissez-faire in outlook except in the area of land ownership. Arguably, the Hong Kong laissez-faire model has been more successful than the Singapore model in stimulating enterprise.

Tung should ensure the whole Pearl River Delta is globally competitive

Guangdong and Hong Kong should collaborate, not compete

Tung wants a new political appointment system

If it works to provide better policies, that will be positive for Hong Kong

... but there are risks

While he has not articulated a development policy, Tung has shown greater interventionist tendencies. For example, he invested taxpayers' money into the Cyberport (a residential development that finances a commercial complex developed by the Pacific Century group), and Hong Kong Disneyland opening in 2005. He also supported the creation of a Science Park, a technology centre and another industrial estate. Time will tell whether with a second term, Tung will show a heavier hand in economic management.

While there is much talk about the importance of economic integration with the Pearl River Delta, a lot of the discussion is about improving physical infrastructure, such as air, road and rail links. While these improvements may be useful, the key challenge is how Hong Kong and Guangdong Province can collaborate to ensure that this region remains competitive on a global basis as a processing centre. Hong Kong and Guangdong need to work closely together rather than compete if the region is to benefit as a whole. It is much more important for the HKSAR Government to concentrate on working with Guangdong on policy than to focus too much on investing in physical infrastructure, much of which can be left to private sector investors.

System of political appointments . . .

Tung has already made it clear in his October 2001 Policy Address that he intends to strengthen the position of the Chief Executive by putting in place a new system of political appointments. A year ago, he indicated that the inherited colonial systems and institutions would need adjustment and adaptation in order to function "optimally".

The Chief Executive has indicated that he could nominate candidates from within or outside the civil service. The political appointees would be appointed on terms different from those in the civil service and will serve at the Chief Executive's pleasure. It has yet to be decided whether individuals with political party affiliation would be appointed. The appointees would have new titles and would sit on the Executive Council – Hong Kong's cabinet. The new system would be put in place during the second term of office of the Chief Executive. Since Tung has been thinking about it for some time, he obviously hopes to have it in place soon after the reselection.

The new system will be a significant departure from the existing one where bureaucrats act as both administrators and politicians. Under the new system, the bureaucrats will administer and the political appointees will act as ministers. Yet, there will still be the problem of legitimacy. Those who govern will not have been returned by election.

Tung has promoted the new system as one that would "respond more comprehensively and quickly to public demands". He also hopes that having all appointees serve on what will become a full-time, professional cabinet, will improve coordination of policy formulation and implementation. If achievable, it would be positive since executive decision-making today is often disjointed.

There are risks

However, there are risks involved. As Hong Kong is still at the early stage of cultivating its own breed of political leaders, it may be difficult for the Chief Executive to find a suitable line-up of individuals who are both willing and able to serve. Appointing senior civil servants may just be putting old wine in new bottles. Those from outside the civil service will be on the whole untested. It may be that Tung has little choice but to cut the cloth that he has but he could run the risk that if the new team cannot deliver the promise of better government, public disappointment could be great.

The new system will have to fit into the post-2007 political system

Who might succeed Tung Chee-hwa?

The field is wide open for the 2007 Chief Executive selection

What is left unsaid

Tung has not said much about how the new political appointment system will dovetail with political reform in the future. It is unclear what ideas he has about how to face a second term in office where the demands for reform will grow. With the leadership change in Beijing in 2002 and 2003, the next five years could be crucial for Hong Kong as to whether it can find a way to move ahead. To do so will require a clear commitment to reform by the Chief Executive who has a key role to play in making Beijing comfortable with a reform agenda.

So far, Tung has shown little inclination in that direction. It may well be that putting in place the political appointment system is about as far as Tung will be willing to go, leaving further change to his successor. Moreover, if the political appointment system does not work well and Hong Kong people become more disgruntled, it is unclear what Beijing's reaction might be. It could certainly make Beijing leaders more gun-shy about political reform for Hong Kong.

Standing in the wings

The next five years of politics in Hong Kong will sieve out the next generation of political leaders. Beijing thinks long-term. It has always thought about who will manage Hong Kong for the mainland. Beijing will be more interested to identify and cultivate future leaders. As a final term Chief Executive, Tung will also be more interested to ensure that there will be a successor as that becomes a national priority for Beijing.

Who might succeed Tung? When he became the Chief Executive designate in 1996, it was probably not fixed in Beijing's mind whether Tung would serve one or two terms. If Beijing felt by 2002 that sovereignty had been secured in Hong Kong and that suitable choices were available, Tung could then make way for someone else.

In the early days of the transition, there were others who could be possible successors. For example, former chief secretary, Anson Chan, who took early retirement in April 2001, was one such possibility. It would appear that she was considered insufficiently loyal in the sense that she was unwilling to support Tung when he took decisions against her counsel. Another possibility was CY Leung, the current convenor of the Executive Council, a chartered surveyor by profession, who played an important role in the drafting of the Basic Law and the Preparatory Committee. He is believed to have engineered Tung's early land and housing policy. In any event, he has yet to show the kind of leadership quality that galvanises the people despite having played a number of high profile roles.

The field for the third term Chief Executive, starting in 2007, is wide open. The current chief secretary, Donald Tsang, and financial secretary, Antony Leung, as well as CY Leung, may all be contenders. Another name often being mentioned is Victor Fung, chairman of the Airport Authority, who has a high international profile and is well respected in the business community. Ideally for Beijing, the next generation of Hong Kong leaders should be acceptable to all quarters of society and be considered loyal to China's interest. As for Tung, when he retires, he will be given an honorific title in the Chinese political hierarchy as a gesture of appreciation for his hard work.

Concluding observations

Hong Kong people need to feel better about themselves

Hong Kong people appear to have lost their self-confidence for now.

The old economic franchise based on a property bubble has burst with many people suffering substantial losses in asset values. The “feel bad” factor is broad and deep and filters through to people feeling dissatisfied with the Chief Executive’s performance during his first term and with the HKSAR Government as a whole. The good news is confidence can return quite quickly once people feel things are moving forward again.

There is a new economic franchise round the corner . . .

A new franchise will come from making the whole of the Pearl River Delta structurally competitive in global terms.

Hong Kong should not overlook its traditional strengths as a superlative trader. In discussing economic integration with the Pearl River Delta, policy makers needs to recognise the distinctive development pattern that Hong Kong traders, especially the SMEs, have brought to South China. Hong Kong and Guangdong Province needs to be able to collaborate to make the Pearl River Delta region structurally competitive in global terms rather than compete with each other for small gains. That is to say there must be the right regulatory and “software” infrastructure that can ensure that the region remains nimble and flexible enough to continuously transform itself as world demands change.

. . . by making the PRD globally competitive

The Hong Kong pattern of diffused development may be unique and needs to be better understood rather than dismissed.

The uniqueness of the Hong Kong development pattern cannot be judged using the yardstick for more focused industrial investment as has happened in other economies since the Hong Kong pattern is diffused and yet has proven to remain competitive in world trade. The SMEs experience is well worth further study since this is where Hong Kong’s strength has always been but has often been ignored.

Beijing wants Hong Kong to succeed

Hong Kong’s success is vital to China’s national interest.

Hong Kong is fortunate because its success is important to China’s national interest at least in the foreseeable future. For a variety of economic and geopolitical reasons, Beijing does not want Hong Kong to become just another Chinese city. It wants Hong Kong to be a World City to serve the national purpose and Beijing is prepared to lend a helping hand at this time to improve the downbeat mood in Hong Kong.

Hong Kong needs to develop the right social and environmental policies as well

While running a pro-business policy, Hong Kong needs to develop better social and environmental policies.

Hong Kong will continue to be pro-business in orientation but it needs to embrace the notion of sustainable development, which calls for high environmental standards and the right mix of social policies to improve quality of life and maintain social cohesion at a time when unemployment and deflation persist.

Can’t ignore political reform forever

The second-term Chief Executive cannot ignore political reform.

Pressure is expected to grow over the next few years for political reform, which the second-term Chief Executive will have to deal with. How this sensitive issue will be dealt with could have positive or negative impact on the already strained relationship between the government and the people.

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