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The Economic Consequences of 1997

*Y.L. Wu**
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I. INTRODUCTION

This Article deals with the economic consequences of the scheduled transfer of Hong Kong to the People's Republic of China (P.R.C.) in 1997 and the present and future economic relationship between Hong Kong and China. We will begin by postulating several premises schematically and then raise simple but fundamental questions. The three premises are as follows.

(1) Two economies exist side by side with intimate contacts between their respective citizens for ethnic and geographical—and therefore also economic—reasons. One of the two, Hong Kong, is a highly developed, internationally oriented, market economy. It is very small in size and scantily endowed with natural resources. The PRC, on the other hand, is a vast, populous and extremely poor country that tries to project its economy on to a path of rapid development by modifying, but without totally abandoning, its hitherto centrally administered system which rests on public ownership and socialist principles of management and practice and by partially relaxing its self-imposed semi-insulation from the rest of the world.

(2) The two economies have thus far been under two different political administrations, each being separate from the other on the basis of independent sovereignty.

(3) Given these assumptions, there is little doubt that flows of goods and services in both directions are bound to be quite high, especially as each economy's relative share in the other's total world trade and flow of capital (which may be either high or low) tends to be dominant at least in one direction—from the small developed economy to the large less developed country striving to develop in the case of capital and in the reverse direction in the case of exports.

Schematically, several points concerning the impact of developments in each country on the economy of the other can be raised. First,

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there is no doubt that under the assumption of separateness in terms of both political sovereignty and civil administration, the two economies can enjoy prosperity simultaneously. Second, history has shown that under the same legal and political framework, the small market system can prosper even as the larger planned economy languishes or flounders economically. This condition has prevailed during most years since the founding of the PRC in 1949. Third, the opposite situation in which the larger system enjoys prosperity while the small one is depressed has not occurred once in the post-1949 period. This is theoretically conceivable, however, since the latter is also dependent upon the rest of the world, excluding China, and the other market economies may be the source of depressive influence.

But what happens if we alter the assumption of separate sovereignty and political administration? (A subsidiary question is whether political administration can be kept separate while only sovereignty is nominally transferred.) Under some such condition, the "question of simultaneous prosperity" must be reexamined. If the large economy is prosperous in this new legal-political framework, the small system, *a priori*, is likely (albeit not necessarily) to do well, although doing well must not be equated to doing better than before the legal change. But can the large economy languish and flounder while the small one continues to prosper? Will it then be able or be allowed to remain prosperous? The possibility of a depressed Hong Kong and a very prosperous China is so unlikely that we can leave it out in the interest of saving space.

II. BACKGROUND

The 1984 agreement to transfer sovereignty over Hong Kong from the United Kingdom to the PRC in 1997 marks the first time since the end of World War II that a free and economically highly developed territory is to be handed over to a communist state under a negotiated treaty.¹ Before 1982, Hong Kong enjoyed the reputation of being one of the fastest growing economies in the world, a member of the four little dragons of Asia. From a small entrepôt before World War II, Hong Kong had by the mid-1960s transformed into an export-oriented industrial city-state. Since the late 1960s, Hong Kong has emerged as a leading financial center in the Asia-Pacific region.² Hong Kong's per capita gross domes-

¹ Since the legal and political aspects of the impending transfer have been extensively treated elsewhere, this Article is confined to an analysis of the economic implications and consequences. For two recent collections of essays on the political, legal, economic, and social aspects of the Sino-British agreement on Hong Kong, see HONG KONG AND 1997: STRATEGIES FOR THE FUTURE (Y.C. Jao, C.K. Leung, P. Wesley-Smith, & S.L. Wong eds. 1985); THE FUTURE OF HONG KONG: TOWARD 1997 AND BEYOND (H. Chiu, Y.C. Jao, & Y.L. Wu eds. 1987) [hereinafter THE FUTURE OF HONG KONG].

² The literature of Hong Kong's postwar economic growth and metamorphosis is too vast to be

tic product ("GDP"), measured at current prices and exchange rates, increased by twenty-three times from about US\$243 in 1947 to US\$5,594 in 1981. This growth was achieved during a period when the population of Hong Kong grew three-fold to 5.15 million. The average annual growth rate of the economy in real terms was 8.7% from 1947 to 1981. More recently from 1976 to 1981, this growth rate was 11.9%, arguably one of the highest in the world.³ In 1985, according to World Bank statistics, Hong Kong's average per capita income was \$6,230 (compared with \$310 for the PRC).⁴

Hopes that this brilliant record of economic growth and prosperity could be sustained over the long run faded in 1982. When the severe world economic recession caught up with Hong Kong in 1982, domestic exports which normally provided the main impetus to growth actually declined in volume. An even more portentous development occurred on the political front when China set forth its demand for sovereignty over all of Hong Kong—not just the New Territories, the lease of which expires in 1997. Officially confirmed during Prime Minister Margaret Thatcher's visit to Beijing in September 1982, this demand dealt a shattering blow to public confidence in Hong Kong's future.⁵ People became increasingly apprehensive about the viability of the socio-economic system, the protection of private property, and the respect for personal freedom and human rights consequent on a change in regimes.⁶ The diplomatic negotiations between Britain and China that began after Thatcher's trip dragged on slowly under the shadow of China's threat that it would announce a unilateral "solution" for Hong Kong if the bilateral talks failed to produce an agreement by the end of September 1984.⁷

For a two-year period following the September 1982 Thatcher visit,

cited here. For an overview and extensive bibliography, see *THE BUSINESS ENVIRONMENT IN HONG KONG*, (D. Lethbridge 2d ed. 1984) (essays include E.K.Y. Chen on the economy, Y.C. Jao on financial structure, and C.L. Hung on foreign investment).

³ Jao, *Economic Prospects after the Sino-British Agreement*, in *THE FUTURE OF HONG KONG*, *supra* note 1, at 57-58.

⁴ *HONG KONG: CENSUS AND STATISTICS DEPARTMENT ESTIMATES OF GROSS DOMESTIC PRODUCT, 1966-1986* (1987) (for underlying data). Official estimates of national income of Hong Kong date only from 1961. For earlier unofficial estimates, see E. SZCZEPANIK, *THE ECONOMIC GROWTH OF HONG KONG* (1958); K.R. CHOU, *THE HONG KONG ECONOMY* (1966). See also *WORLD BANK, WORLD DEVELOPMENT REPORT 202-03* (1987).

⁵ Jao, *supra* note 3, at 58.

⁶ The apprehension is easily understandable in view of communist China's abysmal record in human rights, especially during the Cultural Revolution, and also the fact that over half of Hong Kong's population is first or second generation refugees from mainland China. Even in the post-Mao period, when conditions are supposed to have improved considerably, China's human rights record still falls far short of the standards common in civilized societies. For a documented study, see J. COPPER, F. MICHAEL, & Y.L. WU, *HUMAN RIGHTS IN POST-MAO CHINA* (1985).

⁷ See F. CHING, *HONG KONG AND CHINA: FOR BETTER OR FOR WORSE* 22 (1985).

Hong Kong was engulfed by a confidence crisis which at one stage nearly destroyed the whole financial system. The prices of shares, land and real properties fell in 1982 by 50-70% from their peaks in 1981.⁸ Erosion of asset values and the escalation of bad debts resulted in many property firms and financial institutions facing a severe liquidity squeeze. Those especially hard hit were the less prudent banks and deposit-taking companies ("DTCs") as demonstrated by the numerous failures and bankruptcies. The fiscal system, which had grown accustomed to annual budgetary surpluses, also fell on hard times. The 1982-83 fiscal year was the first of three consecutive years of fiscal deficits of an unprecedented size for Hong Kong, largely because of plummeting land sales as a result of the depressed real estate sector.⁹ The real growth rate of the economy in 1982 dropped to 1.1% from 9.4% a year earlier.¹⁰ The Hong Kong dollar faced heavy pressure from two sources: outright capital flight and internal portfolio shift from domestic currency to foreign currency denominated deposits.¹¹

The value of the Hong Kong dollar against the U.S. dollar fell relentlessly from US\$1.00=HK\$5.69 at the end of 1981 to US\$1=HK\$9.6 (a record low) on "Black Saturday," September 24, 1983. In response to the drop in value, many shops began to quote prices in U.S. dollars and refused to accept payment in Hong Kong banknotes. Panic buying of staples and imported items occurred, and rumors spread quickly about the solvency of banks and DTCs. Faced with the threat of an imminent breakdown of the financial system, in late September the Hong Kong government took over the insolvent Hang Lung Bank, and participated in a rescue operation for another local institution, the Sun Hung Kai Bank. On October 15, 1983, the Hong Kong government set forth a two point stabilization plan—a plan that local economists had been advocating for some time. The first measure, of overriding importance, was the replacement of the floating exchange rate regime of 1974-83 with a "linked exchange rate system," whereby the issue of banknotes must be backed 100% by U.S. dollars at a fixed rate of

⁸ The Hang Seng index of stock prices (July 31, 1964) declined steadily from a July 1981 high of 1,810.20 to 676.30 in Dec. 1982. The prices of land and properties, depending on locations, fell 50-90% from their 1980-81 peaks. See C.L. WU, GOVERNMENT LAND SALES IN HONG KONG (Hong Kong Economic Papers No. 17, forthcoming).

⁹ Jao, *supra* note 3, at 58-59. The deficits were HK\$4,586 million, HK\$8,197 million, and HK\$3,539 million for the three fiscal years 1982-83, 1983-84, and 1984-85 respectively, on a "consolidated" accounting basis. See H.K. GOVERNMENT INFORMATION SERVICES, HONG KONG 1987, 314-17 [hereinafter HONG KONG 1987].

¹⁰ HONG KONG GOVERNMENT ECONOMIC SERVICES BRANCH, 1987 ECONOMIC PROSPECTS, statistical app., table 3 [hereinafter 1987 ECONOMIC PROSPECTS].

¹¹ Jao, *supra* note 3, at 59.

US\$1.00=HK\$7.8.¹² The other measure was the abolition of the 10% withholding tax on interest income from Hong Kong dollar denominated deposits with financial institutions.¹³

The linked-rate system, despite initial confusion and skepticism, has succeeded in saving the Hong Kong dollar from total collapse. With the exception of a brief speculative attack in July 1984 after Deng Xiaoping's much publicized insistence that Chinese troops must be stationed in Hong Kong after 1997 and that a joint liaison group must be established to monitor any Sino-British agreement, the Hong Kong dollar has held remarkably steady against the U.S. dollar at the fixed rate of 7.8% with fluctuations no more than 2% either way.¹⁴ The stability of the new monetary system depends on full convertibility and the process of "arbitrage and competition," whereby any deviation from the officially predetermined rate can automatically generate market forces to restore equilibrium.¹⁵

Although the unprecedented financial crisis of 1982-83 had some economic origins (e.g., the excessive growth of money and credit in 1977-81; the imprudence, mismanagement or even fraudulent practices of certain financial institutions; and the laxity with respect to prudential supervision), there can be little doubt that it was the pervasive anxiety and apprehension over Hong Kong's future that made the crisis so severe and threatening.¹⁶

III. RECENT DEVELOPMENTS AFTER THE 1984 AGREEMENT

A. *Recovery of the Economy*

Before 1982, the people of Hong Kong fondly, perhaps unthinkingly, hoped that post-Mao China would have the good sense, in view of Hong Kong's usefulness to China, to let Hong Kong's status quo continue indefinitely by concluding a friendship pact with Britain to finesse the 1997 issue.¹⁷ The PRC's intransigent stand on sovereignty, therefore,

¹² For a fuller analysis, see Jao, *The 1997 Issue and Hong Kong's Financial Crisis*, 2 J. CHINESE STUDIES 113 (1985).

¹³ Jao, *supra* note 3, at 59.

¹⁴ Jao, *Hong Kong Dollar Looking for Political Parity*, ASIAN BANKING, Sept. 1984, at 47-55.

¹⁵ Jao, *supra* note 3, at 59. For an exposition of the linked exchange rate system, see *The Stabilization of the Hong Kong Dollar*, ASIAN MONETARY MONITOR, Nov.-Dec. 1983, at 9-37; Greenwood, *The Monetary Framework Underlying the Hong Kong Dollar Stabilization Scheme*, CHINA Q., Sept. 1984, at 631-36.

¹⁶ In 1982-83, China's propaganda machine launched a strident campaign attacking Britain's position that any agreement on Hong Kong's future must secure the consent of three parties, namely, China, Britain, and Hong Kong. It also accused the British and Hong Kong governments of engineering the currency crisis as a bargaining counter. These campaigns had an extremely unsettling effect on confidence and made the crisis worse than it would otherwise have been.

¹⁷ Public opinion polls taken in Hong Kong in 1982-83 showed that a majority of the respon-

came as a great shock. During the initial stage of the negotiations, Britain tried to trade sovereignty for some form of British administration beyond 1997, but even this was categorically rejected by China.¹⁸ In the end, Britain had to give up both sovereignty and administration. This was a great disappointment to the majority of the population. Moreover, the agreement between Britain and China to hand over Hong Kong was strictly a bilateral affair with no participation by the people of Hong Kong at all.¹⁹ Nevertheless, the Joint Declaration initialed in September 1984 was still greeted with relief, though not enthusiasm, by the population, who realized that the alternative, a unilateral "solution" proclaimed by China, would be even worse. On paper, the Joint Declaration, which promises a high degree of autonomy for Hong Kong and the preservation of its existing socio-economic system and life style, seems reasonable. Moreover, the Joint Declaration also legitimizes British rule from 1984 to 1997. Given that the time span for economic decision making in Hong Kong is short—normally 5-7 years—the Sino-British agreement insures a period during which orderly planning for the future—including exit as an ultimate alternative—can be made. Thus the acute confidence crisis of 1982-84 gradually subsided, though it has by no means entirely disappeared.

Against this background, the economy staged a recovery from the trough of 1982. Credit for this recovery must be given to the "linked exchange rate" system implemented since October 17, 1983, which as mentioned earlier, succeeded in stopping the free fall of the Hong Kong dollar. The stabilization of the currency enables entrepreneurs, businessmen, and other economic agents to carry on their normal economic activities instead of devoting their time and energy to currency speculation. After reaching its nadir of 57.2 on "Black Saturday," September 24, 1983, the trade-weighted exchange rate index steadily recovered—in line with the extraordinary strength of the U.S. dollar in 1983-85—to 78.2 in February 1985. (Table 1) After the U.S. dollar started weakening in March 1985, the index also declined *pari passu*, but this did not give rise to any panic as in 1982-83, since people realized that the depreciation basically reflected problems of the U.S. economy.

Responding characteristically to the U.S.-led world economic recovery, Hong Kong's exports rose sharply. Because the Hong Kong economy is export-oriented, the growth rate of GDP in real terms doubled to 6.5% in 1983 and rose further to 9.5% in 1984. In 1985, however, in a delayed response to the strength of the Hong Kong dollar (as a mirror

dents favored the status quo. See HONG KONG: IN SEARCH OF A FUTURE, 75-109 (J.Y.S. Cheng ed. 1984).

¹⁸ F. CHING, *supra* note 7, at 20-21.

¹⁹ See G. Hicks, *Hong Kong on the Eve of Communist Takeover*, in THE FUTURE OF HONG KONG, *supra* note 1, at 23, 33-35.

Table 1
 HONG KONG DOLLAR EXCHANGE-RATE INDEX
 (December 18, 1971 = 100)

<u>End of Month</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
January	87.6	85.8	79.0	69.1	76.9	69.5	62.7
February	88.5	86.3	78.7	68.9	78.2	67.7	62.9
March	88.8	88.7	78.3	67.8	76.2	68.0	61.4
April	89.2	87.7	76.2	68.0	76.6	66.0	60.3
May	90.1	89.5	73.9	69.4	76.7	67.4	60.9
June	89.6	89.7	73.8	69.9	76.4	65.4	61.4
July	88.3	89.1	73.7	71.4	74.4	64.9	62.0
August	85.1	88.2	71.3	71.9	74.2	64.3	
September	81.5	86.9	65.3	73.4	72.6	64.4	
October	84.2	79.8	67.8	74.5	72.2	65.8	
November	85.3	80.5	68.2	75.2	70.9	65.4	
December	85.9	80.1	68.3	75.4	70.6	64.8	

Source: Hong Kong Government Census and Statistics Department, *Hong Kong Monthly Digest of Statistics* (various issues).

image of the U.S. dollar due to the peg), exports slumped and the real growth rate plummeted to only 0.6%. After the U.S. dollar started weakening in March 1985, Hong Kong's exports regained their competitiveness, and the real growth rate of the economy in 1986 recovered once more to 8.7%.

In 1987, although the Hong Kong government predicted a real growth of 6.2% in its annual budget (presented in February), current indications are that the real growth rate is likely to exceed 9%, again due to the vigorous performance of the export sector. Meanwhile, mainly as a result of currency stabilization, the annual inflation rate has fallen from the double-digit to the single-digit level. The unemployment rate, another leading indicator, also fell from 5.1% in March 1983 to 2.1% at the end of 1986. (A summary of Hong Kong's macroeconomic performance in 1976-86 is given in Table 2.) Note that while the per capita GDP measured in Hong Kong dollars registered an uninterrupted growth throughout the period, the same variable denominated in U.S. dollars declined in 1982 and 1983—reflecting of course the sharp depreciation of the Hong Kong dollar during the currency crisis.

Another important pillar of the economy, the real estate sector, has also been recovering from the slump of 1982-84. Since the market bottomed out in 1984, residential property prices have risen by between 25 and 45% (depending on grade), and prices and rentals in the office sector by 25 to 30%.²⁰ Land prices have risen correspondingly. As a result, government land sales have soared to such an extent that by the 1985-86 fiscal year a surplus was once again achieved, ending the fiscal crisis of the previous three years.²¹ The tourist industry was, however, not affected by the 1982-84 crisis at all: if anything, the depreciation of the Hong Kong dollar has stimulated the increased number of incoming tourists. Thus, the number of visitors increased annually from 1.56 million in 1976 to 3.44 million in 1985, while their expenditures grew from HK\$3,888 million to HK\$14,804 million during the same period.²²

Finally, a popular short-term indicator of the state of confidence is the index of stock prices. As shown in Table 3, the Hang Seng Index of stock prices rose more than four times to 3,479.24 by the end of July 1987 after touching a low of 746.02 three years earlier, just two months before the initialing of the Joint Declaration. The booming stock market reflects not only the improving economy but also the growing integration of world financial markets, as foreign institutional investors (mainly those from the United Kingdom, United States and Japan) perceived that

²⁰ See *Hong Kong's Property Market—Greater Stability Likely*, H.K. BANK ECONOMIC REPORT, June 1987.

²¹ HONG KONG 1987, *supra* note 9, at 314-17.

²² H.K. TOURIST ASSOCIATION, A STATISTICAL REVIEW OF TOURISM IN HONG KONG 44-47 (1985).

Table 2
HONG KONG'S ECONOMIC PROFILE 1976-86

	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Gross Domestic Product (GDP) (HK\$ million)	59,339	68,905	81,163	107,047	137,081	164,973	186,328	207,562	248,728	263,579	291,897
Per Capita GDP (HK\$)	13,353	15,279	17,656	21,942	27,075	31,827	35,393	38,832	46,079	48,308	52,759
Per Capita (GDP) (US\$)	2,853.2	3,307.1	3,670.7	4,423.8	5,267.5	5,593.5	5,428.4	4,984.8	5,892.5	6,185.4	6,764.0
Real Growth Rate of GDP (%)	17.1	12.5	9.5	11.7	10.9	9.4	2.9	6.5	9.5	0.6	8.7
GDP Deflator (1980=100)	66.0	68.1	73.3	86.6	100.0	110.0	120.6	126.1	138.1	145.5	148.2
Consumer Price Index (1979-80=100)	70.7	74.8	79.2	88.4	102.1	117.9	130.3	143.2	154.9	159.8	164.3
Labor Force ('000) (September)	1,918	1,951	2,058	2,195	2,371	2,499	2,513	2,568	2,644	2,637	2,722
Unemployment Rate (%) (September)	4.6	4.1	2.7	3.4	4.3	3.8	4.0	4.1	3.9	3.6	3.0
Rate of Exchange (HK\$:US\$1, year-end)	4.68	4.62	4.81	4.96	5.14	5.69	6.52	7.79	7.82	7.81	7.80

Source: Underlying data from *Hong Kong Monthly Digest of Statistics*; Hong Kong Government Economic Services Branch, *1987 Economic Prospects*.

Hong Kong stock prices were comparatively cheap in terms of their average price-earnings ratio and the depreciated Hong Kong dollar. However, Hong Kong's stock market is notoriously volatile and speculative. Since foreign investors can come and go and sentiments change overnight, the index of stock prices cannot be regarded as a reliable guide to long-term trends.

B. Banking Crisis

Although the currency crisis was brought to an end by the stabilization plan of October 1983, the banking crisis lingered on for a few more years. The banking crisis began in November 1982 when the collapse of the property market caused some "fringe banks" or deposit-taking companies to founder. The government at that time did not, however, take any direct measures to stabilize the banking sector. They preferred to use the largest commercial bank, the Hong Kong and Shanghai Banking Corporation, to serve as a *de facto* central bank. But when the currency crisis reached its height and the whole financial system teetered on the brink of total collapse, the government reversed its stand by taking on the role of the lender of last resort on a massive scale. As mentioned earlier, the Hong Kong government took over Hang Lung Bank and rescued Sun Hung Kai Bank in September 1983. Then in June 1985 it took over the Overseas Trust Bank and its subsidiary, the Hong Kong Industrial and Commercial Bank, when they could not meet their obligations, by using the resources of its Exchange Fund. Between June 1985 and January 1987, the authorities further intervened to save problem banks either in the form of temporary administrative control and credit lines (Union Bank and Hon Nin Bank), or guarantees for doubtful loans (Wing On Bank and Ka Wah Bank). Eventually, Union Bank and Ka Wah Bank were taken over by China-owned entities, Wing On Bank was taken over by Hang Seng Bank, and Hon Nin Bank was taken over by First Pacific Bank, owned by Indonesian Chinese. Space does not permit an exhaustive analysis but some observations are in order.²³

First, the banking crisis, lasting some four years and involving scores of banks and quasi-banks, was unprecedented in its duration and scale. While imprudence, mismanagement, and fraud probably would have resulted in a shakeout anyway, what made the crisis so protracted and intractable was the superimposition of political uncertainty that exacerbated the disruptions to the underlying economy. Second, the Hong Kong government's massive intervention seems at first glance at variance

²³ For a fuller analysis of the banking crises, see Y.C. Jao, *Recent Banking Crises in Hong Kong and Taiwan: A Comparative Perspective*, in *CHINESE BANKING IN THE ASIA-PACIFIC REGION* (M.K. Nyaw and C.Y. Chang eds. forthcoming). It is estimated that the Hong Kong government spent about HK\$5 billion (US\$641 million) for the rescue operations.

Table 3
Hang Seng Index of Stock Prices
 (July 31, 1964=100)

<u>End of Year/Month</u>	<u>High</u>	<u>Low</u>	<u>Closing</u>
1981	1,810.20	1,113.77	1,405.82
1982	1,445.32	676.30	783.82
1983	1,102.64	690.06	874.94
1984	1,206.83	746.02	1,200.38
1985	1,762.51	1,220.74	1,752.45
1986	2,568.30	1,559.94	2,568.30
1987			
January	2,614.87	2,449.88	2,553.25
February	2,879.01	2,585.22	2,877.87
March	2,939.05	2,629.28	2,713.81
April	2,785.47	2,589.54	2,659.85
May	2,949.06	2,685.37	2,919.70
June	3,178.98	2,934.19	3,178.19
July	3,479.24	3,207.21	3,479.24

with its traditional *laissez faire* philosophy. Only a little reflection is needed, however, for one to realize that the government's hand was forced by the new political reality. Had the Hong Kong government not used its Exchange Fund—whose primary function is to protect the integrity of the currency—to rescue problem banks and arrange deals acceptable to all the parties concerned, it would have been accused of sabotaging the Sino-British agreement and deliberately undermining Hong Kong's "stability and prosperity." This conjecture gains credence when one recalls that during a previous banking crisis in 1965, the government did not spend a cent of the Exchange Fund for bailing out banks, but relied mainly on the two note-issuing banks (the Hong Kong and Shanghai Banking Corporation and the Chartered Bank) as a kind of surrogate lender of last resort.²⁴

C. *Portfolio Shift*

Since the confidence crisis erupted in 1982, anecdotes of capital flight from Hong Kong have been regularly featured in the popular press of Australia, Canada, and the United States—the three countries which admit most of the emigrants from Hong Kong. However, there has been no systematic quantification of such capital flight due largely to the lack of a comprehensive balance of payments accounting system in Hong

²⁴ See Y. C. JAO, BANKING AND CURRENCY IN HONG KONG 235-69 (1974).

Kong.²⁵ Previous attempts to tackle the problem have failed to yield any plausible estimate.²⁶ Moreover, even when an official balance of payments accounting system exists, it is well known that many transactions escape official monitoring and therefore are not recorded. There is also the conceptual problem of defining precisely what is capital flight, since the distinction between capital flight and foreign investment is not always clear-cut.²⁷

A less obvious form of capital flight, namely, internal portfolio shift, can however be fully documented. This takes the form of switching from domestic currency denominated to foreign currency denominated deposits within the banking system. Banking data show that in 1980 foreign currency denominated deposits in all depository institutions accounted for only 13.8% of total deposits, but by the end of 1983 the proportion had shot up to 47.5%. (This was the year, it may be recalled, of the great currency crisis.) The linked exchange rate system established in October 1983 could not entirely prevent portfolio shift, for the proportion of foreign currency denominated deposits continued to rise to 56.4% by the end of 1986.²⁸ But it did succeed in slowing the pace of portfolio shift and in enabling such shift to take place without causing a currency crisis at the same time.

The portfolio shift as shown in the raw banking data may, however, have overstated the foreign currency component of total deposits due to two effects. The first is the "valuation effect." This arises because the government statistics are all expressed in Hong Kong dollars, yet the depreciation of the local currency automatically inflates the value of foreign currency denominated deposits. The second is the "swap deposit" effect. A swap deposit is one where a customer deposits a sum of foreign currency with a financial institution, and then immediately enters into an agreement with that institution to receive repayment in Hong Kong dollars at an agreed forward rate of exchange. At present, such deposits are classified as foreign currency denominated deposits, but many econo-

²⁵ The Hong Kong government publishes only a "visible and invisible trade account," but not a "capital account." See 1987 ECONOMIC PROSPECTS, *supra* note 10, statistical app., table 4.

²⁶ According to Hong Kong's former Deputy Secretary for Monetary Affairs, "there is sufficient evidence to support the view that there has been an increased outflow of certain types of capital" in 1982-84, though he did not quantify it. See Latter, Changing Patterns of External Flows, (paper presented to the Hong Kong Management Association, Aug. 22, 1984); L. Cheng, *An Economic Analysis of Capital Flight in Hong Kong*, 17 N.Y.U. J. INT'L L. & POL. 683 (1985) (The title of the Cheng article is, however, rather misleading since it is largely a descriptive account of Hong Kong's economic situation in 1982-84, based on secondary sources, without any quantitative estimate of capital flight.)

²⁷ See CUDDINGTON, CAPITAL FLIGHT: ESTIMATES, ISSUES, AND EXPLANATIONS (Princeton Studies in International Finance No. 58, Dec. 1986); Khan & Haque, *Capital Flight from Developing Countries*, FIN. & DEV., Mar. 1987, at 2-5.

²⁸ For underlying data, see *Hong Kong Monthly Digest of Statistics*.

mists argue that they should be more properly classified as domestic currency denominated deposits. Proper classification depends upon the future intention of the depositor.

To eliminate these distortions, standard methods can be used to adjust the raw data.²⁹ (Table 4) It will be seen that, even after adjustment, the foreign currency components of the balance sheet structure of all depository institutions still show an unmistakable upturn. Thus, foreign currency denominated deposits rose steadily from 9.2% in 1980 to 42.4% in 1986.

What are the motivations for this portfolio behavior? The conventional explanation in terms of factors such as Hong Kong's rising stature as a financial center, interest rate arbitrage, etc. which is, in our view, grossly inadequate. We submit that anxiety and uncertainty about the future is perhaps the most significant factor, without denying that other factors may also be relevant, especially in the short run. First, holding foreign currency denominated deposits enables one to hedge against the possibility that the Hong Kong dollar might become worthless after 1997. Second, if such deposits are held with branches of foreign banks, they are as good as deposits held abroad, since it is a well-established principle in international banking that the parent bank is responsible for the liabilities of its branches to an unlimited extent.

D. Stagnant Capital Formation

Another macroeconomic indicator which has given rise to concern is Hong Kong's gross domestic fixed capital formation. As shown in Table 5, although in nominal terms (at current prices) gross capital formation increased by 10.2% between 1982 and 1986, in real terms (at constant 1980 prices) it actually fell by 3%. It will be readily seen that the principal culprit for the stagnant state of capital formation is building and construction, which during the same period declined by 2.2% in nominal terms and by 14.2% in real terms, a phenomenon reflecting the depression in the real estate market in 1982-84 as a result of the confidence crisis. Whether the current recovery of the property market will lead to a sustained rise in building and construction activity remains to be seen. A more comforting thought is that plant, machinery and equipment which reflect largely investment in the manufacturing industries increased by 67.7% in nominal terms and by 20.8% in real terms between 1982 and 1986. This indicates that Hong Kong's export expansion can still generate positive investment in the industrial sector. However, the increase may be in foreign ownership, and these growth rates repre-

²⁹ First, we readjust the banking data with respect to deposits by assuming that the exchange rate index during the relevant period had not changed. Second, we reclassify "swap deposits" as domestic currency denominated deposits.

Table 4
 ADJUSTED BALANCE SHEET STRUCTURE BY CURRENCY DENOMINATION
 (end of year percentage)

	1980		1981		1982		1983		1984		1985		1986	
	HK\$	FC	HK\$	FC	HK\$	FC	HK\$	FC	HK\$	FC	HK\$	FC	HK\$	FC
<u>Licensed Banks</u>														
Total liabilities	51.9	48.1	48.8	51.2	42.8	57.2	41.5	58.5	38.3	61.7	38.2	61.8	32.4	67.6
Customers' deposits	94.5	5.5	89.2	10.8	65.6	34.4	64.6	35.4	63.4	36.6	59.4	40.6	58.3	41.7
Total assets	45.5	54.5	44.2	55.8	42.6	57.4	40.8	59.2	35.5	64.5	35.8	64.2	30.1	69.9
Loans and advances	65.5	34.5	68.1	31.9	68.9	31.1	67.0	33.0	61.7	38.3	63.9	36.1	62.3	37.7
<u>DICs</u>														
Total liabilities	39.6	60.4	36.9	63.1	27.8	72.2	28.1	71.9	27.0	73.0	25.0	75.0	28.4	71.6
Customers' deposits	83.1	16.9	82.4	17.6	65.0	35.0	60.9	39.1	52.3	47.7	51.9	48.1	52.8	47.2
Total assets	40.8	59.2	38.9	61.1	30.8	69.2	29.2	70.8	26.9	73.1	24.8	75.2	28.0	72.0
Loans and advances	37.5	62.5	38.6	61.4	37.1	62.9	35.5	64.5	22.8	67.2	35.3	64.7	42.2	57.8
<u>All Depository Institutions</u>														
Total liabilities	47.9	52.1	44.7	55.3	38.2	61.8	37.7	62.3	35.1	64.9	34.4	65.6	31.6	68.4
Customers' deposits	90.8	9.2	86.6	13.4	65.5	34.5	63.9	36.1	61.3	38.7	58.1	41.9	57.6	42.4
Total assets	43.8	56.2	42.4	57.6	38.3	61.7	37.5	62.5	33.0	67.0	22.7	67.3	29.6	70.4
Loans and advances	56.5	43.5	57.2	42.8	57.4	42.6	56.2	43.8	52.7	47.3	56.0	44.0	58.2	41.8

Note: FC=Foreign Currency

Source: Underlying data from *Hong Kong Monthly Digest of Statistics* (various issues).

Table 5
Gross Domestic Fixed Capital Formation in Hong Kong
 (million Hong Kong dollars)

	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
<u>At current prices:</u>					
Gross Domestic fixed capital formation	57,858	51,868	55,578	54,706	63,779
Transfer costs	1,601	1,262	1,373	2,064	2,723
Building and construction	24,787	25,112	24,414	22,802	24,243
Developers' margin	14,482	7,200	6,369	6,951	8,318
Plant, machinery and equipment	16,988	18,294	23,422	22,889	28,495
<u>At constant (1980) prices:</u>					
Gross domestic fixed capital formation	50,414	46,197	46,928	45,807	48,892
Transfer costs	1,517	1,433	1,429	2,046	2,654
Building and construction	20,417	20,373	19,110	17,508	17,524
Developers' margin	14,958	11,385	10,900	11,095	12,385
Plant, machinery and equipment	13,522	13,006	15,489	15,158	16,329

Source: Hong Kong Government Economic Services Branch, *1987 Economic Prospects*, Statistical Appendix, Table 2.

sent a significant slowdown when compared with those of an earlier period: between 1976 and 1981 plant, machinery and equipment increased by 274.5% in nominal terms and 154.2% in real terms. The annual growth rates in the more recent period were lower by some thirty-seven percentage points in real terms. Again, in the absence of political uncertainty, such a sharp slowdown would have been inexplicable on economic grounds alone.

E. Precautionary Relocation and Diversification

The confidence crisis and the impending transfer of sovereignty have inevitably affected the strategic decisions of firms regarding their future. While most firms, especially the largest and most prestigious ones, publicly profess their faith in the Joint Declaration and deny any intention of leaving Hong Kong, their private actions indicate otherwise. Locally incorporated firms, in particular, are much less sanguine about their long-term future than their foreign incorporated counterparts for quite obvi-

ous reasons. In recent years, therefore, they have followed what may be called a strategy of "precautionary relocation or diversification." This strategy may take many forms. Relocation may be pursued separately from or together with diversification, but the essential elements are the same: (a) removal of the registered head office from Hong Kong to a foreign country, especially a tax haven; (b) establishment of branches or offices in foreign countries, or acquisition of foreign firms in whole or in part; (c) sale of the firm's equity to a foreign firm, or formation of a joint venture with a foreign firm in Hong Kong; and (d) transfer of liquid assets abroad leaving only sufficient money balances for transaction purposes in Hong Kong.

The most sensational cases of relocation are the decision by the oldest British conglomerate, Jardine Matheson, to move its legal domicile to Bermuda in March 1984, and the giant Sing Tao publishing group's transfer of its ownership to an Australian holding company in May 1985.³⁰ Undoubtedly there are numerous other cases that have escaped media attention. The most prominent case of "precautionary diversification" is that of the Hongkong and Shanghai Banking Corporation ("HSBC"), a British bank founded and incorporated in Hong Kong in 1864. Because it is also Hong Kong's *de facto* central bank, it cannot move its head office elsewhere without causing immediate financial panic. This need for caution, however, has not prevented it from embarking on a global diversification. In 1980 the HSBC acquired 51% control of Marine Midland Bank of the United States, and in July 1987, it offered to purchase the remaining 49% of the same bank. Although a 1981 attempt to acquire the Royal Bank of Scotland was vetoed by the British Monopoly and Merger Commission, the HSBC did not slacken its programs of overseas acquisition and expansion. Thus in 1985, it acquired James Capel, a leading London brokerage house, four New York City branches of the failed Golden Pacific National Bank, and all the branches of the failed Canadian Commercial Bank. Between July 1985 and June 1986, the HSBC raised a capital fund of US\$11.2 billion in international financial markets by issuing primary capital undated floating rate notes, for the purpose of further acquisitions—most probably in the United Kingdom or Europe. Because the HSBC in 1985 still derived about 70% of its total profits from Hong Kong, it will not abandon the territory overnight, but clearly its ultimate aim is to diversify to such an extent that it can survive as an international bank even if it loses its Hong Kong interests entirely after 1997.³¹ Other notable cases of precautionary di-

³⁰ *Jardine's Holding Company Quits Hong Kong*, S. China Morning Post (Hong Kong), Mar. 29, 1984; *Sing Tao's Assets Set To Go Down Under*, S. China Morning Post, May 23, 1985.

³¹ For a detailed analysis of the policy and strategy of the Hong Kong and Shanghai Banking Corporation, see Jao, *The Hong Kong Banking Group*, in JAO & HO, *THE MAJOR BANKING GROUPS IN HONG KONG AND THEIR FUTURE*, ch. 2 (1987).

versification are property tycoon Li Ka-shing's acquisition of 52% of Husky Oil Ltd. of Calgary worth C\$484 million, and shipping tycoon Sir Yue-kong Pao's acquisition of about 15% of the stock of the Standard Chartered Bank of Britain during a takeover battle for that bank in July 1986.³²

F. *Emigration of Managers, Technicians and Entrepreneurs*

Along with capital flight and the relocation of businesses, large numbers of entrepreneurs, managers, professionals and technicians have begun to emigrate from Hong Kong. The most popular destinations are the United States, Canada, Australia and New Zealand. The immigration quotas of these countries set the limits. The United Kingdom has effectively banned emigration from Hong Kong through its Nationality Act, though there is a widespread rumor that a secret deal has been struck to admit the top elite, such as senior government officials and police officers, members of the Executive Council and Legislative Council, etc., should circumstances warrant such a step after 1997. The PRC's interference in the matter of direct elections mentioned in the next section and its apparent disregard of Hong Kong's public opposition to the construction of a nuclear power plant on the border are cited as examples that seem to presage worse things to come.³³

Our analysis of the lingering banking crisis, stagnant capital formation, continuing portfolio shift and precautionary relocation or diversification, and emigration of the elite illustrates that, despite the recent boom in the economy and the stock market, a deep-seated uncertainty over the long-term future still remains. In any case, there is no justification for extrapolating the recent short-term upsurge into the more distant future, bearing in mind that Hong Kong's average business planning horizon spans have been from five to seven years.

IV. ECONOMIC REFORM IN THE PRC AND PRC-HONG KONG RELATIONS

The question we face is whether the PRC economy can develop steadily, if not at an accelerated rate, in the next decade³⁴ and beyond 1997 under current reform policies.

³² Reguly, *The Hong Kong Links*, The Financial Post (Canada), May 11-17, 1987; Truell, *Pao, Other Asian Investors Sink Lloyds Standard Bid*, Asian Wall St. J. (Hong Kong), July 14, 1986.

³³ HONG KONG ECON. J., Aug. 1987, at 50-52.

³⁴ For an expanded discussion of this subject, see Wu, *Planners and Entrepreneurs in the PRC: Sources of Systemic Instability and Their Political Implications*, ASIAN AFFAIRS, Sept.-Oct. 1981, at 31-49. See also Wu, *The Rocky Road of Beijing's Economic Reform: Can Trial and Error Lead to Dynamic Equilibrium?*, 4 J. N.E. ASIAN STUDIES 3 (Fall 1985).

A. *Goals and Measures of Reform*

In general, the desired goals of reform are to correct the devastating economic and general consequences of Maoist policies which became apparent after the coup which overthrew Mao's immediate successors (the so-called gang-of-four led by Mao's radical widow, Jiang Qing) in 1976. Since Maoist policies had aggravated the extreme poverty of the population—the worst sufferers being the farmers and those living in the least developed areas of the country—one of the first sharp turns in policy was aimed at increasing general personal consumption and farm income. To accomplish this objective, the responsibility system was established whereby farm households were allowed to decide what crops they would plant, to deliver their sales quotas (after taxes) to the state at better prices than before, and to retain the remaining output and dispose of it more freely. This was followed subsequently by scrapping the commune system, the epitome of Maoist collectivization which had completely eliminated private property ownership.³⁵

Second, reform was urgently needed because resources were being wasted through overproduction of goods not in demand and defective products. Overemphasis on investment project starts, attempts to produce too much in capital rather than consumer goods, and use of quantitative indicators in enterprise management and the provision of incentives were inherent problems of centralist planning shared by the Soviet and Eastern European economies.³⁶ The corrective policies, introduced piecemeal and to different degrees, included: an attempt to cut back on investment, selective curtailment of public sector consumption (notably military manpower expenditure³⁷), price reform by partial readjustment or abolition of government-set prices, greater use of a bonus system and widening of income differentials to enhance both worker and management productivity, and giving enterprise managers greater power over the work force.

Reform was needed to reduce the rigidity and lethargy of the bureaucratic and over-centralized system and practice in economic planning and administration that were originally imported from the Soviet Union but had become an integral part of the PRC's own political and economic culture. The reformers' solution was decentralization, allowing individual enterprises greater leeway in decision-making and,

³⁵ See PRYBYLA, *READJUSTMENT AND REFORM IN THE CHINESE ECONOMY*, 1-58 (Occasional Papers/Reprints Series in Contemporary Asian Studies No. 2 1981); Prybyla, *Economic Developments in the Mainland*, in *SURVEY OF RECENT DEVELOPMENTS IN CHINA (MAINLAND) AND TAIWAN, 1985-1986* 49-71 (Occasional Papers/Reprints Series in Contemporary Asian Studies No. 2, H. Chiu ed. 1987).

³⁶ See M. BORNSTEIN, *COMPARATIVE ECONOMIC SYSTEMS* 188-241 (5th ed. 1985).

³⁷ According to one report, 400,000 of the one million men were demobilized. WENT'I YU YENCHIU (Issues and Studies), Apr. 1987, at 5.

within the public sector, giving provincial and selected local governments and agencies greater power to make production, trade and investment decisions.

Reform also was necessary in order to increase employment opportunities for the still expanding labor force, laid off government and public sector employees (including demobilized soldiers), and persons returning from involuntary exile. The partial opening of the service industry to private proprietors in both rural and urban areas became the reform solution of the early 1980s.

Furthermore, economic decision making needs were placed in more competent hands. Technocrats were first recalled from exile. In this area the slogan of "political reform" has assumed increasing importance since 1986 and in reality entails administrative personnel changes that would remove "communist party hacks" (euphemistically, guardians of the faith) from positions of influence at all levels of economic administration and management.

Externally, economic reform has been pursued to raise productivity through inward transfers of technology and capital imports. Exports are promoted to increase the ability to import, and efforts are made to meet the demands of foreign investors and lenders.

B. Policy Vacillations and Confusion

Students of Chinese affairs, press reporters and occasional observers have been exposed to and become aware of various outward expressions of 1) policy measures that can be classified under some of the preceding reform categories and 2) outcomes of these policies and their interactions. One's impressions differ depending upon what one sees and reads, and misinterpretations occur. PRC authorities themselves often seem to misinterpret the results of their own policies because of their ideological heritage and predilections as well as their inadequate understanding of how "economic levers" instead of administrative commands are supposed to work in a system that for more than thirty years had muddled along, first under socialist planning and, later Maoist fantasy and disordered thinking.³⁸

C. Perceptions and Reality

Those who would like to see the transformation of the PRC system

³⁸ Among the characteristics of Maoist economic policy was Mao's overwhelming emphasis on nominative, rather than material incentives, and his belief in the net benefit of an increasing population, the unending possibility of substituting labor for capital, and the inventiveness of the revolutionary class steeped in communist ideology and Mao's own teachings, which can replace conventional education and technical training. Application of these ideas to the Chinese economy led to disastrous results in 1958-61 and 1966-76.

into a predominantly market economy can find various measures of reform as benchmarks in an evolving progress. Among these benchmarks are the abandonment of the commune system and the partial restoration of private farming. The stipulation of private proprietorship as an enterprise form in the preliminary outline of the Civil Code promulgated in April 1986³⁹ might seem to foreshadow the restoration of full scale private ownership of property although thus far private property rights are limited to the right of use. The announcement in the Seventh Five Year Plan (1986-1990) that market pricing would be extended to an increasing number of commodities may point to increasing use of economic indicators in resource allocation and enterprise management.

For foreign observers interested in seeing a more liberalized Chinese economy and its effects on the PRC as a market and recipient of foreign capital and technology there have been equally tantalizing developments. Among the latter are the formation of the special economic zones—within which practices of the command economy have been relaxed to a greater extent—the adoption of a Chinese-foreign joint venture law; the negotiation of bilateral commercial and investment treaties with foreign countries; the invitation to international oil companies to bid for offshore exploration rights; the visit of members of the New York Stock Exchange in 1986 to talk about securities issues; increased borrowing from foreign governments and commercial banks; decentralization of import and export negotiations, etc. Yet beauty lies in the eyes of the beholder. To some observers these are unmistakable indications of “liberalization” which, for persons willing to take another giant mental leap, is then identified with political democratization. On the other hand, to those who are more skeptical, and among them are many serious long-time students of Chinese Communist affairs, there are unfortunately equally valid signs of changes in the reverse direction. In addition to policy hesitations and reversals, it must be noted that most of the reform measures have tended to be limited in scope, restricted in their geographical application, and therefore experimental in nature. They have either not been applied in earnest or have been adopted singly without the mutually supporting elements that are necessary for meaningful change.

Especially disturbing have been the periodic renewal of political campaigns that negate previous reform: notably the 1983 campaign against “spiritual pollution” and the campaign against “bourgeois liberalization” which began in the spring of 1987 and was heralded by the fall

³⁹ Article 75 provides in pertinent part: “Individual property of a citizen shall include . . . means of production and other lawful property permitted by law to be owned by a citizen.” The General Rules of the Civil Law of the People’s Republic of China, art. 75 (adopted by the 4th Sess. of the 6th National People’s Congress, Apr. 12, 1986), *reprinted in* COMMERCIAL, BUSINESS AND TRADE LAWS: PEOPLE’S REPUBLIC OF CHINA (O. Nee ed. 1987) (binder III).

of Hu Yaobang, Deng Xiaoping's hand-picked Secretary-General of the Chinese Communist Party. A careful examination of these anti-reform campaigns shows that the PRC leadership is honeycombed by political factions not at all anxious to see the full-scale consequences of the economic reform outlined. Many do not seem to understand that individual reform measures require continuing adjustment of the system so that they will really work.⁴⁰ Lack of coordination between government spending and decentralization of control over investment and production have led to price inflation. This is then treated, on the one hand, as the result of economic crime and speculation; on the other hand, it becomes a source of complaint about income inequality and social unrest. Many other examples can be cited to demonstrate such misinterpretations and misunderstandings.

D. Fluctuations and Unsteady Growth

Empirical evidence since 1976 suggests that the PRC economy at this stage of change can be described as a model of fluctuations which at best is one of unsteady growth. At worst, one should not be surprised to see fluctuations of greater amplitude that result occasionally in absolute declines. (Statistical problems of output valuation, however, make measurement in real terms not really meaningful under current conditions of reporting and of pricing.)

On the basis of the preceding discussion, we can discern three component elements in the reform process each of which can produce a cycle of output change. First, the emergence and expansion of an unplanned sector (which may or may not be private) alongside the planned state sector will lead to the shift of resources, especially in an economy of shortages and bottlenecks, away from the state sector. Because the decentralized sector is more efficient and nimble than the state sector, realization of the existence of this problem occurs only after the resource redirection has already gone quite far. (The observed phenomena are delays and unfinished state projects, black market prices, corruption of public officials and illegal means to obtain materials in short supply, etc.) The reaction by the authorities is to clamp down on the decentralized sector, which then produces an "upper turning point" in the upswing phase of the growth cycle initiated by decentralization of decision making.

⁴⁰ For instance, in order to increase the supply of consumer goods by enterprises working under a new material incentive system, the prices of the products must be allowed to rise. Rising prices must then be permitted to lead to an increase in workers and materials used in production. This implies permission for workers to change jobs, factories to expand payroll, and for managers to redirect investment, raise more capital—maybe at the expense of the public sector—and deal directly with suppliers and buyers, etc. But some of these additional changes are often not permitted by administrative commands.

Second, the effort to allow personal income and consumption to rise at unequal rates for different individuals and groups— and in different parts of the country—leads of course to greater actual income differentials. This creates changing expectations and consumption patterns and styles, especially when viewed against nearly forty years of egalitarianism in poverty. These new “inequalities” are grist in the ideological mill of orthodox communists like Peng Zhen and Chen Yun—to mention but two prominent names. Political ferment is fanned by popular complaints about inflation, and economic and other “crimes.” When such ferment reaches a boiling point in policy struggle, the upper turning point in another sub-cycle is reached.

Third, after the downfall of the Maoist leadership, the initial personnel shifts were at the expense of the Maoists. However, by 1985 and especially in 1986 when further reform required the removal of incompetent party cadres from economic control and management positions, the vested interests of many non-Maoist party and administrative bureaucrats (including those in the military) were at stake. One can therefore think in terms of a sub-cycle of personnel changes between political power holders and “technocrats” (including new and old “intellectuals” co-opted into the party) whose fight for privilege and access to power and goods will indirectly impact the performance of the economy.

The three sub-cycles in practice interact with one another and the aggregate result not only reflects the outcome of such interaction but also depends on the length and intensity of the upswings and downswings. To these cyclical influences on the PRC economy, we must add both 1) trend factors, notably changes in the number and quality (including the skill and technological level) of the population and labor force and the condition of resource availability through soil erosion, infrastructure deterioration, etc., and 2) exogenous shocks and influences (e.g., leadership change through generational change, availability of foreign aid, major world oil price shifts, etc.). A major disappointment in Chinese plans for Hong Kong could well be regarded as such an external shock.

E. The Relationship between the Hong Kong and the Chinese Economies

It follows from the above that continuous prosperity in China based on steady growth cannot be depended upon in the foreseeable future, certainly within the next several years when the current sub-cycles will have run their course. In addition, a major shock in the form of the departure of Deng Xiaoping from the active political scene is bound to occur. At age 83, Deng's active political years probably will end before 1997. Whether his successor(s) can consolidate power before that date remains to be seen.

The more realistic scenario to address PRC-Hong Kong relations will therefore correspond to the situation of a slow growing, if not actually floundering and depressed, PRC economy side by side with a far more prosperous Hong Kong. If such a situation occurs after the 1997 transition, or even before the practical transition prior to the legal date in 1997, what will happen to Hong Kong? The crux of the issue focuses on what benefit the PRC hopes to derive from Hong Kong when the Chinese economy is in distress and what other functions Hong Kong might perform for Beijing, irrespective of the ruling Chinese faction(s) at that time. In a nutshell, the benefit sought is an increased transfer of resources to China (including free foreign exchange and access to it) or, in the alternative, a safe haven in Hong Kong for those out of luck in China at that time. Assuming a PRC economy in distress, a firm authoritarian Chinese government would focus on taking more assets out of Hong Kong. Alternatively, under a weak Chinese central government, Hong Kong's function as a refuge for money and people from China would appear more desirable in some Chinese eyes. However, given Chinese sovereignty over Hong Kong, this function can no longer be performed by Hong Kong openly as was often the case in days of yore. What has happened between Hong Kong and China as well as what the PRC has tried to accomplish in Hong Kong since 1984 must therefore be examined from this perspective.

In general, it appears that the PRC has been busy on two counts: 1) bolstering Hong Kong whenever really necessary in order to preserve Hong Kong's economic prospects for the takeover ten years hence and 2) making sure that in the future Hong Kong will actually be governed by a pliable and obedient administration free from interference of potentially obstructionist local political interests. To insure that the second objective will be satisfied, the PRC has found it necessary to do things in and to present-day Hong Kong that makes its post-1997 prospects more grim. Even the pre-1997 objective of keeping Hong Kong viable may occasionally entail a high cost to the PRC.

The increased transfer of communist cadres to Hong Kong is one of the major PRC-initiated developments in its economic relations with Hong Kong in recent years. For example, the Xinhua (New China) News Agency, the PRC's *de facto* diplomatic mission in Hong Kong, has a staff of about 700.⁴¹ The number of PRC controlled enterprises in Hong Kong has been stated as over 3,000⁴² although another calculation determined that Guangdong Province alone had more than 2,000 governmental agencies stationed in Hong Kong in 1986.⁴³ Overall legal immi-

⁴¹ Ming Pao, Aug. 3, 1987.

⁴² *Id.*

⁴³ Report delivered at a 1987 Guangdong Provincial People's Congress meeting.

gration from China to Hong Kong has increased to over 221,000 persons in 1986, nearly doubling the total in 1983.⁴⁴ This total includes persons placed in Hong Kong business, financial, and professional organizations (including legal and accounting firms) to learn how the Hong Kong economy operates. The procedure resembles the steps taken prior to the establishment of tight central government control over Shanghai in the 1950s.

Along with the influx of personnel, Chinese capital investment in Hong Kong has also increased. This growth of capital commitment is mirrored in the multiplication of Chinese-controlled firms. Indeed, cases of financial investment—for instance, in banking and acquiring failing banks—has been mentioned earlier. Understandably, ferreting out details in such cases would be difficult, but the question of who will continue to provide backing in future banking and currency crises when the Hong Kong government's Exchange Fund is no longer able or willing to intervene has yet to be answered.

The influx of the PRC's own funds to provide support for the Hong Kong economy may not be in the overall interest of the Chinese balance of payments and may turn out to be an unexpected economic cost. The placement of PRC personnel in Hong Kong for future supervisory work seems to be an unavoidable step preparatory to the 1997 transfer of sovereignty. The most current exercise of overt intervention has followed the appearance of the Hong Kong government's Green Paper in May 1987⁴⁵ which outlines the several alternative forms of developing local representation. The Deputy Chief of the Hong Kong-Macao Office in the Beijing central government came out at first with an unequivocal objection to the direct election of members to the Legislative Council proposed as an alternative in the Green Paper. But the statement was subsequently retracted when it encountered a storm of protest.⁴⁶ This, however, is just one indication of the growing attempt to exercise influence that would make control after 1997 more effective and complete. To Hong Kong residents the main concern is the nature of the PRC's control once the power to exercise it has been established.

V. CONCLUSION

In view of the preceding analysis, it is plausible to argue that the case of simultaneous and growing prosperity after 1997 for both Hong

⁴⁴ See Ming Pao (Hong Kong), Aug. 3, 1987 (full report on P.R.C. immigrants and business in Hong Kong).

⁴⁵ H.K. GOVERNMENT, GREEN PAPER: THE 1987 REVIEW OF DEVELOPMENTS IN REPRESENTATIVE GOVERNMENT (May 1987).

⁴⁶ For commentaries and also reports on discussions at the University of Hong Kong, see Wah Kiu Yat Po (Hong Kong), June 25, 1987; Sing Tao Jih Pao (Hong Kong), June 23, 1987; S. China Morning Post, June 23, 1987.

Kong and China is not the most probable scenario for Hong Kong, although given a loss of prosperity Hong Kong can no longer be expected to continue as a major international financial center even if manufacturing and trading activities continue. A strong Chinese central government or even a strong Guangdong provincial authority in fiscal need may press Hong Kong to make special contributions that can vary from taxation to "voluntary" donations, and jacked-up export prices for water and power.

In the event of a weakened PRC central government and the emergence of persons in China anxious either to find refuge in Hong Kong or to exploit access to foreign markets Hong Kong still possesses at that time, it is not inconceivable that underground Hong Kong-China economic relations may develop. But this is hardly the kind of mutual prosperity one normally envisages.⁴⁷

⁴⁷ A number of reports on collusive activities involving Hong Kong residents and P.R.C. officials and their families have appeared in Hong Kong recently. See *TIDE MONTHLY* (Hong Kong), June 15, 1987, at 43-44.

