A Decade Later: Hong Kong's Economy Since 1997

By William H. Overholt

In the decade preceding Hong Kong's reversion to Chinese sovereignty, the principal theme in the Western media was the death of Hong Kong. Virtually every major newspaper publicized the basic "facts." As the handover drew close, panicky emigration was draining away Hong Kong's pool of talent. There was a vast exodus of Hong Kong people and companies to Singapore. Democratic Party leader Martin Lee told all who would listen (and nearly everyone in the West did listen) that Chinese soldiers would be roaming the streets of Hong Kong arresting people. The new Chinese masters in Beijing would deliberately suppress Hong Kong in order to promote Shanghai. One year before the handover, the New York Times News of the Week in Review, the most prestigious section of America's most prestigious newspaper, filled in additional details of the horrors to come, stating as fact that prudish mainlanders would close Hong Kong's bawdy bars and, following mainland rules, prohibit rickshaws. Many newspapers published as a simple fact that the annual commemorations of the June 4, 1989, massacre near Tiananmen Square would be banned.

As if such ominous trends were not enough, Hong Kong reverted at the worst possible moment for its economy. Part of the British legacy was one of the great financial bubbles of Hong Kong history, with Hong Kong property prices the highest in the world. Sovereignty shifted on July 1, 1997, and the next day the collapse of the Thai baht initiated the Asian financial crisis. Having risen with the Asian Miracle, Hong Kong risked sinking with the Asian Debacle. The core of the Asian crisis was the withdrawal of Japanese bank funds from the smaller Asian countries, and this hit Hong Kong like the great withdrawal of water preceding a tsunami. In 1997 and 1998 Japanese banks withdrew funds from Hong Kong equal to 150% of Hong Kong's gross domestic product; short of a declaration of war, it is hard to imagine a more devastating blow. On top of that, hedge funds deployed tens of billions of dollars of shorts against the Hong Kong dollar.

Three years later the technology bust slammed Asian markets, including Hong Kong. For a place that the newspapers said was dying anyway, Hong Kong faced a regional economy that seemed to be unplugging life support.

Hong Kong suffered but more than survived. Indeed it reverted to a boom mentality well before the 10th anniversary of Chinese sovereignty. While its neighbors' banks and property companies collapsed, in Hong Kong not one bank or major property company failed or required rescue. The currency held against possibly the world's fiercest hedge fund onslaughts. How could all that have evolved into a boom?

The most important answer was that Hong Kong wasn't nearly as moribund as Western journalists had reported. The brain drain was a myth. People did migrate to Canada and Australia, but in every year more people moved into Hong Kong than moved out; the journalistic convention of the day was to report the numbers moving out but never to report the (easily available) numbers moving in. (In a text search at the time, I could not identify a single major Western newspaper that reported the number moving in.) Contrary to the brain drain thesis, as the handover approached, the number moving out steadily declined and the number moving in steadily rose. In many years when the media story was about Hong Kongers evacuating to Singapore, the actual number of Hong Kong people moving to Singapore was fewer than 10 per year while the movement of several thousand Singaporeans to Hong Kong during those years necessitated the opening of a new Singapore International School.

As promised all along by Beijing, Chinese soldiers had no authority to arrest people or to interfere any other way in Hong Kong life. Rather than suppressing Hong Kong, Beijing took vigorous efforts to strengthen it—by stepping in with the Closer Economic Partnership and pressuring nearby provincial governments to open their economies more to Hong Kong. And, pace New York Times, Hong Kong's bawdy bars and rickshaws were not suppressed; had the reporter checked his facts, he would have known that rickshaws and bawdy bars had become quite the rage throughout the mainland. The annual June 4 vigils continued.

Contrary to fears in the retail and property sectors that further opening the borders with China would invite devastating competition, it turned out that the flood of Hong Kong tai-tais going to Shenzhen to buy cheap knock-off fashions was more than matched by the flood of mainlanders coming to Hong Kong to buy real Louis Vuitton and other luxury brands. Richard Wong of the University of Hong Kong, to whom I am indebted for many insights, points out that Hong Kong is assured of many rich and powerful visitors from the mainland because 97% of the Viagra sold on the mainland is fake.

The economy survived in substantial part because Hong Kong's social structure and freedoms survived. The judicial system was if anything strengthened during the transition, with a strong new chief justice. Freedom of information prospered despite some publishers' pulling their punches in order to pursue a mainland market; no story was ever censored by the government. The big disappointment was that democratization did not proceed faster. Beijing didn't break any promises, but it was stingy and defensive rather than trusting and generous. That stinginess induced big pro-democracy demonstrations, but these orderly, disciplined events did not affect the economy and may yet provide the foundation for (disappointingly gradual) democratization.

Hong Kong's recovery has fed on the dynamism around it. The neighboring Pearl River Delta has experienced one of the great booms of human history. The Pearl River Delta has succeeded in large part because of Hong Kong's influence, and Hong Kong companies own disproportionate shares of areas reaching far into China. Conversely, the stimulus from Shenzhen and the Pearl River Delta region have been crucial to Hong Kong's post-Asian crisis success. Shenzhen, a big rice paddy in 1980, is now more populous than Hong Kong and has become one of the world's greatest manufacturing cities, exporting over $50 billion per year. The Pearl River Delta around Hong Kong is the core of Chinese manufacturing prowess.

The Chinese clean-up of Macau has created a mini-Asian miracle there; Beijing has endowed post-handover Macau with a good chief executive who has suppressed crime, built infrastructure, created competition and thereby transformed a sleepy, sleazy, corrupt, crime-ridden Portuguese town into an entertainment center that has already surpassed Las Vegas in gambling revenues and soon will become an Asia-wide center for family entertainment and recreation. New roads, bridges and ferries will make this entertainment complex part of the attraction of Greater Hong Kong.

Pre-handover Western wisdom was that Singapore would replace Hong Kong as Asia's regional business center. Instead, Singapore has remained what it always was, probably the most successful island economy in history, while Hong Kong is more like the capital of a global business empire. Hong Kong manufacturers play large roles from Guangdong and Fujian to Mauritius and Jamaica. Hong Kong hotels, restaurants and theaters are everywhere in China's mainland. Hong Kong value-chain and logistics managers like Li & Fung and DHL manage vast global businesses, much of which never touches Hong Kong proper. Hong Kong's economic success is simply calibrated in a larger universe than Singapore's otherwise awesome success.

Perhaps the greatest measure of Hong Kong's triumph lies in comparison with its other determined competitors, starting with Tokyo. In GDP and financial market size Tokyo is the logical financial center of Asia, but Hong Kong is the place that combines the freedom, the cosmopolitanism, the rule of law, the freedom of information and the level playing field that in combination defeat its competitors. Seoul, Taipei and Bangkok have been striving for two decades to become regional centers, but their inability to dent Hong Kong's dominance speaks eloquently about the validity of the death of Hong Kong thesis.

On the other hand, pre-handover skeptics, including me, about Shanghai's regional role relative to Hong Kong have some humble pie to eat. The big companies and the companies that focus on the China market have moved from Hong Kong to Shanghai. Statistics show that Hong Kong has more regional headquarters than ever but these are deceptive. Membership in the American Chamber of Commerce in Hong Kong declined precipitously as the big companies moved to Shanghai. Executives who remained behind formed numerous small companies, raising the numbers but hardly replacing the giant departures.

The big companies focused on the mainland market found that Shanghai had the pulse of the mainland market, was better situated for much large-scale manufacturing and had a very competitive, big-business-friendly environment. In interviews, foreign business leaders in Shanghai say that Hong Kong's rule of law is less important to them because, if they have serious problems, they can call up Shanghai's mayor and he will impose an equitable solution—faster and less expensively than Hong Kong's courts. They also say that, when they need visionary, English-speaking top executives, they are much easier to find in Shanghai than in Hong Kong. In addition, Shanghai is much more open in many respects. It is easier to build a new international school in Shanghai, and there are far fewer restrictive, price-raising cartel arrangements than in Hong Kong.

Hong Kong nonetheless retains its traditional competitive advantages: financial sophistication, the rule of law, Western-trained staff and market tentacles reaching throughout the world. Banks that need to do derivatives and need to be able to settle complex bond, debt and equity trades in multiple currencies must headquarter in Hong Kong; China's fixed currency and relatively rudimentary legal and banking infrastructure can't compete for such high-end business. Small and medium-size companies need Hong Kong's rule of law, and companies using China as an export platform need Hong Kong's global market reach, value-chain management and logistics. Companies that need numerous international-style, rudimentary-English-speaking staff, as opposed to top executives, fare better in Hong Kong.

Hong Kong is no longer the primary air lock for foreign companies entering China. Now they go directly. But it has become an important air lock for Chinese companies jumping into the sea of foreign markets. Chinese companies wanting to list in truly market environments attract investor interest in Hong Kong that would be greatly diluted in London or New York. Importantly, they avoid the poisonous political ambience that U.S. labor unions organize against any Chinese company trying to list in New York. Through 2005, U.S. unions and protectionist politicians boasted privately that keeping Chinese companies out of New York would cripple China's financial system; instead they boosted Hong Kong at the expense of New York.

There is plenty of prosperity for both cities, which are now more partners than adversaries—as symbolized by the fact that, in 2006, the combined value of their initial public share offerings (IPOs) surpassed those of the New York Stock Exchange. Much of the Hong Kong business and social elite has Shanghai roots, and Hong Kong investments and expertise have both underwritten much of Shanghai's success and greatly profited from it. As a result, a decade after the handover, Hong Kong was again in the midst of one of its great property and stock market booms.

Having said that, Hong Kong faces rising challenges. Its successes are in its regional and global reach and the prosperity of its wealthy residents. The manufacturing and low-level service industries that once assured universal employment for the less skilled have largely moved elsewhere. Under the rule that any children of Hong Kong parents have the right to Hong Kong residence, the city has attracted an influx of unskilled people supplemented by illegal immigrants from the mainland. From October, 1981, when the statistical series began, until the handover, a monthly average of 68,573 people were unemployed. In the month before the handover, the number was 68,200. In March, 2004, at the peak of the post-tech bust time of troubles, 247,900 lacked work. By the boom of April, 2007, that was down to 156,300 or a rate roughly similar to that of the U.S. (4.3% for Hong Kong) but one that requires a modern welfare system. For reasons that have nothing to do with the political transition, the number is unlikely ever to return to anything near the 68,000 typical of previous decades.

Because of all this, the gap between Hong Kong's wealthy upper and upper middle classes and the roughly 60% of the population who live in public housing remains severe. Among many other consequences, this casts a shadow over Hong Kong's majority aspiration to democracy. The poor majority of Hong Kong citizens does not accept the way the economy is managed. As shown by the policy proposals of the major parties, there is a broad demand for welfare-state protections that would make the left of France's Socialist Party blush. Knowing this, the center of gravity of the business elite adamantly opposes universal suffrage. If Hong Kong is to combine democracy with a vibrant economy, it needs urgent efforts to create a more just, middle class society. However, unlike the current mainland government, which is profoundly concerned about inequality, neither the government nor the parties in Hong Kong has articulated this need, much less proposed an ameliorative program.

The British legacy of an economy dominated by cartels and government regulations weighs increasingly on Hong Kong. (The annual Heritage Foundation rankings of the Hong Kong and Singapore economies as the world's freest apply only to international trade and investment, not to domestic economies that are among the most regulated and cartelized in the world.) Primary and secondary education are highly controlled by the government and dominated by a reactionary teachers union that has, for instance, been able to defeat proposed rules that, for example, English teachers should actually be able to speak English. Rigid government restrictions on immigration and the right to practice continue to prevent education, medicine and law from becoming the dynamos of economic growth that cities in India, Thailand and Singapore have enjoyed.

Hong Kong's restrictions on new private schools mean that foreign parents increasingly find it easier to work in Shanghai. Its lack of a serious competition policy raises prices to a degree that will drive companies away. When I lived in Hong Kong, I once compared the prices of my prescriptions at Hong Kong's Watson's to those at Harvard Square's CVS drugstore; Watson's was 800% higher—based on an unacceptably narrow sample, to be sure, but instructive. Hong Kong's restrictive air services regulation has been a boon to Singapore and others. Who would have imagined that Federal Express would end up putting its transport hub on the mainland rather than in Hong Kong—after many years of seeking flexibility in Hong Kong?

Hong Kong also has yet to come to terms with another British legacy—neglect of the environment. Scholarly studies have shown that blaming filthy air overwhelmingly on drift from the mainland just won't wash; recent university research indicates that local sources contribute slightly over half the air pollution. The government has done more than its predecessor, blocking some environmentally damaging development projects and enacting new laws against hazardous dumping. But the laws are weak and Hong Kong remains far behind the environmental activism of other high per capita income economies. Expatriates are beginning to stay away and locals are becoming more irritated.

China and Britain promised in 1982 to preserve Hong Kong institutions as they were. Skeptics contemptuously dismissed those promises. Hong Kong's experience has made the skeptics look not only silly but also in some cases a little dishonest; that death of Hong Kong from brain drain story was a triumph of sinophobia over easily available facts, and no retractions have been published. Following the Asian crises of 1997-98 and

2000-01, closer ties to the mainland have saved Hong Kong rather than destroyed it. Hong Kong's looming problems come not from failure to maintain British institutions but rather from failure to confront the obsolescence of the British system's old cartels, overregulation and environmental neglect.

On balance, Hong Kong's booming recovery from the pre-transition bubble, the uncertainties of the transition, and the post-transition Asian Crisis and global tech bust is a triumph. The triumph is magnified by the intense competition Hong Kong faces from competing financial, trade, administrative and investment hubs. The triumph reflects the resilience of Hong Kong's economy and the determination of Beijing to support Hong Kong and to keep its promises—albeit sometimes ungenerously. The essence of the triumph is the promised preservation of Hong Kong's British institutional legacy, combined with visionary business leadership. Future challenges, however, are sufficiently formidable that Hong Kong will sustain its triumph only if visionary political and social leadership emerge to address the territory's deep social divide, environmental challenges, and political aspirations, and Shanghai's less cartelized business and social environment.

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