

## **Does Hong Kong Have a Future?**

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### **Abstract**

Hong Kong, China's highly autonomous Special Administrative Region, appears to have uncertain future. Affected by social unrest, and overshadowed by its increasingly mighty sovereign, Hong Kong seems to have less and less going for it. Yet within high-value-added areas such as finance, management, and professional services, Hong Kong still plays a crucial role as China's gateway to the world. More importantly, China itself will have open-up further to access the international input crucial to its future development, but nationwide opening-up is incompatible with its state-permeated system. The only realistic option for China, then, is opening-up via the enclave model – of which Hong Kong is the supreme exemplar. Hong Kong thus has a doubly-assured role as China's gateway to the world and China's gateway to its own future.

**Keywords:** *One Country Two Systems, China gateway, development strategy, Belt and Road, Made in China 2025, enclave model*

## 1. Introduction

*Fortune Magazine*'s iconic June 1995 cover story, "The Death of Hong Kong", may have been premature. But in recent years, more and more commentators have sounded a similar note.<sup>1</sup> China's remarkable rise to economic and geopolitical prominence has made the Special Administrative Region (SAR) seem less important. Hong Kong's traditional role as a China gateway is threatened as the international connections of other Chinese cities multiply. Meanwhile, the erosion of Hong Kong's autonomy and the unrest triggered by the Bill (now withdrawn) to facilitate extradition to Mainland China have done further harm, prompting at least one credit rating agency to downgrade<sup>2</sup>, thus impacting the city's economy. Is it Hong Kong's fate to lose its autonomy and become just another Chinese city?

Questioning a society's future is usually a rhetorical exercise. Britain's Remainers might lament Brexit, but post-Brexit Britain clearly has a future, just not one that Remainers might wish for. However, in Hong Kong's case the question is real. Hong Kong exists as an entity distinct from Mainland China under the Joint Declaration, a treaty between China and former sovereign the UK which China has already dismissed as a "historical document that no longer has any realistic meaning".<sup>3</sup> Even if honoured, the arrangement expires fifty years after the transfer of sovereignty, in 2047. There were concerns even prior to the present unrest about China's growing intervention in Hong Kong's affairs. Hong Kong's special status seems to depend on China's pleasure, which can be – perhaps is already being – withdrawn.

This paper considers the basis for Hong Kong future. It describes Hong Kong's proposition, clarifying related misperceptions. The paper then elaborates the value of that proposition to China and to the world. China's existing development model is then considered, together with

the impending exhaustion of that model. Options for the model's extension are discussed, namely expansion via the Belt and Road Initiative and innovation via "Made in China 2025". The limitations of these options are elaborated. Finally, a special role for Hong Kong in China's future is suggested.

## **2. Hong Kong's Proposition**

From its establishment as a British colony in 1842, Hong Kong's rationale has been that of a free port and a base for international trade with China. In the early twentieth century, Hong Kong was overshadowed by Shanghai which with its International Settlement and foreign participation became the "Paris of the East". However, with Shanghai's closure to the world following the Communist revolution in 1949, Hong Kong became the de facto international gateway to China, a role it has played ever since. How does Hong Kong's China gateway role fare today, and what are its prospects in the future?

### ***2.1. Challenges and Misperceptions***

Hong Kong, a tiny territory 1/190 of China's population and 1/9,000th of its land area, punches above its weight. On transfer of sovereignty in 1997, Hong Kong's economy was about 20 percent the size of China's. However, with China's rapid economic growth and development since, Hong Kong's economy is now about 2.7 percent of China's, although its per capita GDP is still 5 times as high.<sup>4</sup> Hong Kong's contribution is significant, but much less so than before.

Meanwhile, China has emerged as a global power, the world's second largest economy. China has investments and influence not only in the Asia-Pacific but also in Africa, Latin America, Eastern Europe and Central Asia – now loosely connected under the Belt and Road

rubric (discussed in section 4.2 below). Hong Kong has limited contact with these regions, and – because foreign affairs and defence rest with the sovereign – it is constrained in its geopolitical outreach. Moreover, China’s economy, of continental size and diversity, is now generating world-leading initiatives in artificial intelligence, quantum computing, FinTech, and even space travel – fields in which Hong Kong has little showing. What does Hong Kong have to offer its vast, diversified, and increasingly advanced sovereign?

This question has, rightly, concerned Hong Kong’s leaders (Chief Executives), who under the territory’s unique constitution are elected by a 1,200-strong committee controlled by Beijing. Unfortunately, these leaders have come up with ideas that in many cases hinder rather than help the territory. The ideas include, bringing Hong Kong into China’s Five-Year Plans, fostering “innovation” by tech cooperation with Shenzhen, pursuing the Closer Economic Partnership Arrangement (CEPA) with the Mainland, and aligning with Mainland infrastructure.

The ideas are considered below in turn.

Firstly, inclusion in China’s central plan. As discussed in section 3.1 below, China is a state-permeated economy (Otero-Iglesias and Vermeiren, 2015) where even private sector companies have their communist party cell, banks lend according to state direction, and the state itself decides on and invests in major initiatives – all cohered by a flow of propaganda and censorship, and sanctioned by courts which are subordinate to the Communist Party of China (CCP). In contrast, Hong Kong is a free market economy, its firms making investments according to the views of their owners and managements rather than government plan, in which all parties, including the government, are subject to the rule of law. Article 5 of Hong Kong’s constitution the Basic Law provides that the capitalist system be maintained and the socialist system not practiced there. The Hong Kong government does not even have a

planning apparatus. It had no business trying to insert Hong Kong into the Mainland plan.

The “innovation” strategy is actually rather un-innovative, its main project being the development of the Lok Ma Chau Loop as the Hong Kong/Shenzhen Innovation and Technology Park<sup>5</sup> – in effect, a base for imported Shenzhen tech workers. The site is presently a wasteland of toxic mud, its ownership equally opaque; the park will take years to create.<sup>6</sup> More importantly, Hong Kong does not have particular strength in high-tech products. The government’s attempt to help by expanding research grants and fostering smart city initiatives is unlikely to change that materially – links between academia and business in Hong Kong are not strong<sup>7</sup>, and the smart city effort has problems of social acceptance<sup>8</sup>. Nor is Hong Kong necessarily a good base for developing products targeting the Mainland market, as seems to be the main purpose of the park<sup>9</sup> – Hong Kong’s strengths lie rather in facilitating Mainland outreach into the international arena. The Hong Kong private sector is already cooperating with Shenzhen in ways that it finds fruitful to do so.

CEPA is now in its 16th year, the original agreement having been expanded by ten supplements and three subsidiary agreements.<sup>10</sup> However, it does not respect the reality of local (and indeed national) protectionism in China. Agreements to open particular sectors or industries to Hong Kong players in Guangdong or farther afield are repeatedly stymied by layers of local regulation or non-cooperation (Goodstadt, 2018). Lei (2017) finds that the efficiency of Hong Kong’s exports to China has been on the decline since 2000; nor is there evidence to support CEPA having attracted foreign investment to Hong Kong for tariff-free export to the Mainland. Meanwhile, Hong Kong manufacturing investment in Guangdong has been decimated by the province’s decision to end the processing trade; by 2015, the numbers employed by Hong Kong firms there had halved from the 2007 figure,

the Chief Executive being powerless to help (Goodstadt, 2018).

Infrastructure alignment could be useful. However, because the projects are highly politicised, time- and cost-budgets are routinely overrun and the design is poorly adapted to the community's needs. The Macau-Zhuhai road bridge cost Hong Kong HK\$120 billion,<sup>11</sup> yet traffic so far is modest. The HK\$624 billion Lantau Tomorrow vision is intended to develop housing on artificial islands aligning with Pearl River Delta development.<sup>12</sup> Yet while housing is needed, this project's huge cost, twenty-year timeline, and doubtful practicality in an era of climate change render it a likely white elephant, while Hong Kong's core areas and present needs are neglected.

The above ideas, even if successful, would only help to make Hong Kong a second-tier Chinese city – and are too piecemeal even to achieve that. Essentially, these initiatives run against the grain of Hong Kong's attributes, and yield marginal benefit if not net disbenefit. Meanwhile, Hong Kong's core strengths receive little attention or understanding from its leaders.

## ***2.2. Enduring Advantage***

What are Hong Kong's core strengths? What is Hong Kong's proposition?

Taking Hong Kong's proposition first, this is what it has always been – that of a gateway between China and the wider world. Far from being “old hat”, the nineteenth century concept of an entrepôt linking a closed China with an open world is as relevant as ever.

Consider Hong Kong's actual role today. Hong Kong's relative footprint in physical trade has diminished since the handover, although it is still Mainland China's fourth largest trading partner contributing a far-from-negligible 6.7 percent of the latter's total trade.<sup>13</sup> However, in the more sophisticated trade services Hong Kong still excels. Its airport has

170 international routes and some 50 to the Mainland, making 220 in all; it is also the world's busiest air cargo terminal.<sup>14</sup> Guangzhou Baiyun International Airport has 100 routes, mostly domestic.<sup>15</sup>

Of higher value-added than even air transport is finance. Hong Kong is a major financial centre<sup>16</sup>, arguably the leading international financial centre in Asia. It has 200 authorised institutions, including 70 of the world's top 100 banks. In HKEX it has the world's fifth largest stock exchange by market capitalization, ranking first in initial public offerings (IPOs) in 6 of the past 10 years. In terms of funds under management, Hong Kong is the largest centre in Asia. It is Asia's third largest bond issuance centre.

Hong Kong's financial proposition is particularly geared to China. The stock market is the major international listing venue for China enterprises – the “gateway” for these enterprises to meet international investors. Hong Kong lists over 1,200 China enterprises, which make up 69 percent of market capitalization and 76 percent of turnover.<sup>17</sup> HKEX also hosts the leading derivatives markets on China stocks. Hong Kong has the world's deepest offshore RMB pool, and settles 70 percent of international RMB payments.<sup>18</sup>

In terms of foreign direct investment, both stock and flow, Hong Kong plays the leading intermediating role between China and the world. Hong Kong has channeled a cumulative 54% of China's inward foreign direct investment (FDI), and in 2017 channeled 66 percent; the corresponding contributions to outward FDI are 54 percent and 57 percent respectively.<sup>19</sup>

However, Hong Kong's service is not only to China. Its gateway opens in both directions. Hong Kong is the natural entry point for international firms seeking to expand into China and East Asia. For these firms, it is a window onto China and the region. Hong Kong hosts some 1,500 regional headquarters,<sup>20</sup> which are attracted by the territory's

strategic position, its sound legal framework, and its excellent professional and business services.

Nor is Hong Kong's contribution limited to the economic. Its academic sector excels, with three of its thirteen higher education institutions in the global top sixty, compared with three of the Mainland's 2,900 universities and colleges in the top ninety.<sup>21</sup> Hong Kong's academic advantage appears to relate to the autonomy of its institutions, their effective governance, institutional leadership based on merit rather than politics, the internationalism of their faculty and approach, their use of English, and the high social status and pay of academics in society (Altbach and Postiglione, 2012).

Overall, Hong Kong has played and continues to play a crucial role for China and for the world. In the 1980s and 90s, Hong Kong's channeling of manufacturing investment, trade, professional services, and knowhow helped launch and sustain China's high-growth trajectory, distinguishing the nation from other transition economies that were not so fortunately endowed. By the same token, Hong Kong enabled the world to benefit from China's low-cost manufacturing capability and vast new markets. In the current era, Hong Kong provides crucial high-value-added services that China cannot provide for itself, facilitating China's relationship with the world to the continuing benefit of both sides. Far from being of lower relevance, Hong Kong today is as valuable as ever.

On what factors or core strengths does Hong Kong's proposition rest?

The foundation of Hong Kong's continuing value in the post-retrocession era is the One Country Two Systems policy elaborated in Hong Kong's constitution, the Basic Law. Under this policy Hong Kong maintains its preexisting free market capitalist system. The *Joint Declaration* summarises the rights and freedoms which Hong Kong



enjoys, which include, "... those of the person, of speech, of the press, of assembly, of association, of travel, of movement, of correspondence, of strike, of choice of occupation, of academic research and of religious belief ... Private property, ownership of enterprises, legitimate right of inheritance and foreign investment will be protected by law."<sup>22</sup> The *Basic Law* sets out the totality of the rule-based system under which Hong Kong maintains its openness to flows of goods, services, capital, people and information, operating under the rule of law in accordance with common law principles. Hong Kong's open and rule-based system is the foundation of its success.

It may be asked whether the social unrest triggered by the Extradition Bill will damage Hong Kong's system or degrade its proposition. At time of writing, although the retail, hotel, and tourism sectors have been hard-hit such that the economy is in recession, the overall impact has been less severe. The US-China trade war is a more important factor for the health of the economy as a whole. Into the sixth month of the unrest, the benchmark Hang Seng Index is only slightly lower (26,359 on 15 November) than it was before the unrest began (26,761 on 4 June).

The Hong Kong system is by no means perfect. Its weakest part is the governmental institutions. Governmental effort should be directed towards meeting citizens' aspirations and protecting and strengthening the system that makes Hong Kong's proposition possible. The government should try to make Hong Kong a good place to live and work, and one which continuously upgrades its offering to provide services and attributes which Mainland China lacks. Unfortunately, as described in section 2.1 above, the Hong Kong government too often works in the opposite direction, mistakenly attempting to align with the Mainland and neglecting or even undermining the Hong Kong system while favouring big business. Nonetheless, despite its imperfections, the

Hong Kong system has fundamental strengths and constitutes an enduring advantage.

How will the Hong Kong proposition play out in the future? As China grows yet more developed and powerful, will Hong Kong be marginalized even despite its advantages?

### **3. China's Development Model**

To answer this question, it is necessary to consider China's development model in more depth, together with how the model will likely evolve in the future.

#### ***3.1. Existing Model and Challenges***

China's rapid development since 1978, following the exhaustion of central planning and self-reliance under Mao, is based on the policy of reform and opening-up ("*gaige kaifang*": 改革開放). International know-how and resources were harnessed – to a large extent via Hong Kong – and exploited in increasing numbers of special zones which were allowed to experiment with new forms of industrial and administrative organization. The successful initiatives were then promulgated nationwide. The policy was successful, lifting hundreds of millions out of poverty, creating wealth for many, and enabling the nation to become a global power. China is now an emerging middle-income country, with 2018 per capita GDP at US\$9,776.<sup>23</sup> This success helped legitimize the rule of the CCP, enabling it to resist demands for political reform. As a result, China today is a hybrid – a state-permeated system that retains controls over the movement of capital, goods, services, information and people, while market-based mechanisms operate throughout much of the economy.

Under the Xi Jinping government, the state has expanded its role, to some extent reversing the trend of reform and opening-up. China's private sector contributes some 60 percent of GDP and 80 percent of urban employment, but state-owned enterprises enjoy priority access to finance, favourable regulatory treatment, and more secure property rights – and their role seems to be expanding.<sup>24</sup> Larger private enterprises, including those listed overseas, are required to establish a CCP branch so that their operations and management fall under a degree of central control (Yan and Huang, 2017). The state takes an active role in setting development priorities and building national champions. Expression of ideas and flow of information are censored; human rights are subordinate to ideological and national security concerns; the courts are subject to the overriding control of the CCP.<sup>25</sup>

However, the continuing legitimacy of the CCP depends on the continuation of relatively high economic growth. Sustaining such growth, and avoiding the so-called “middle-income trap”, is becoming a challenge. The twin engines of growth have been exports and infrastructure spending, and both have run into difficulties (Schnabl, 2019).

As regards exports, China has exploited the international trading system in a mercantilist manner, since 2001 exporting under cover of World Trade Organisation membership while keeping its own market relatively closed. By 2007, China's trade surplus had reached 10 percent of GDP,<sup>26</sup> while by June 2014 foreign exchange reserves had reached US\$4 trillion.<sup>27</sup> These problems have since moderated. China's current account is now nearing balance, with a 2018 surplus equivalent to 0.4 percent of GDP, and by August 2019 forex reserves had reduced to US\$3.1 trillion.<sup>28</sup> Restrictions on foreign investment have been somewhat loosened, leading to a record US\$135 billion of FDI in 2018.<sup>29</sup> However, trading partners continue to complain of continuing

unfair trading practices, including closed markets, forced technology transfer, theft of intellectual property, state subsidies enabling unfair competition, and non-tariff barriers.<sup>30</sup> In 2018, US President Donald Trump launched a trade war, imposing tariffs on Chinese imports and pursuing alleged violations by Chinese companies like Huawei.

The trade war is damaging to the US as well as China – and indeed to the rest of the world – and may not continue for too much longer. However, even in the event of a US-China trade agreement, China could not continue to rely on mercantilist export-led growth. The world economy is not large enough to absorb endlessly-increasing China exports, even if trade partners were willing to receive them. So China's development model must turn towards domestic consumption.

This need is well recognized in China policy circles and indeed progress has been made. Domestic consumption has risen from a low of 35.6 percent of GDP in December 2010 to 39.4 percent in December 2018.<sup>31</sup> However, exports are still a crucial contributor to China's growth, and rebalancing of the economy will take a long time (Liu and Yang, 2019). Because of constraints – such as the insecure condition of migrant workers, and the limited nature of welfare, health and pension arrangements for the general population – Chinese consumers still tend to prefer precautionary saving to current spending.<sup>32</sup>

The other growth engine, infrastructure investment, has therefore had to take up the slack. The creation of infrastructure can boost productivity – indeed, in many instances such as China's unrivalled high-speed rail network (Yao *et al.*, 2019) it appears to have done so. However, there have been many wasteful projects. Excessive infrastructure spending has been a major contributor to total social indebtedness rising by March 2019 to 248 percent of GDP.<sup>33</sup> The externalities of the rapid growth decades, such as depleted water resources, pollution, and climate change, are also catching up on policy

makers. Although much is being done to address these problems, with China the world leader in renewable energy, there is still much more to do – it is the world’s biggest carbon emitter.<sup>34</sup> Meanwhile, the demographic dividend China enjoyed in the boom years with cohorts of young workers thronging its factories is now going into reverse. The population is ageing rapidly as habits ingrained by the former One-child policy prove difficult to change. Migrant workers, themselves ageing, are returning home.<sup>35</sup>

Facing this daunting complex of problems, the Chinese leadership has narrowing options. Before discussing these, however, it is necessary first to dispose of two strategies that appear to allow the long-term continuation of the present model. They are, the Belt and Road Initiative (BRI), and “Made in China 2025”.

### ***3.2. Extension via Belt and Road?***

The Belt and Road Initiative (BRI) was promulgated by President Xi Jinping in 2013 in response to the US-led Trans-Pacific Partnership that was to exclude China, but which in the event was not ratified by the US Congress.<sup>36</sup> The BRI was essentially a rebranding of initiatives that were already in progress as China reached out internationally for commercial and geopolitical clout commensurate with its economic size. Based on an Economic *Belt* recalling the historic Silk Road between China and Europe, and a notional 21st Century Maritime Silk *Road* through the Indian Ocean,<sup>37</sup> the BRI focuses on infrastructure investment to better connect less-developed countries with the world economy – and with the economy of China itself. The main objectives are, Policy Co-ordination among the countries concerned, Facilities Connectivity, Unimpeded Trade, Financial Integration, and People-to-people Links.<sup>38</sup>

The shortfall in infrastructure is real, and there is certainly room for new providers. The Asian Development Bank has identified a need for

US\$26 trillion of infrastructure investment in the region over 15 years. China itself envisages US\$5 trillion of investment within 5 years via the BRI, although without a definite plan. China founded the Asian Infrastructure Investment Bank (AIIB) to support BRI financing, albeit that the bank's contribution so far is marginal. RMB Internationalisation is also intended partly to support the BRI, although the modest progress made – in September 2019, the RMB contributed less than 2 percent of international payments and foreign exchange reserves<sup>39</sup> – means that BRI financing is largely in dollars. In any case, China cannot finance the BRI by itself.<sup>40</sup>

The BRI promises a more open world – a more level playing field for developing nations outside the West's hegemony (Zhang, 2018). Some 138 countries have signed up for it, including advanced nations such as Italy, and even nations in Latin America, Oceania and Africa that are remote from the original geographic concept.<sup>41</sup> Through the BRI, China gains influence over these nations, in some cases acquiring specific assets such as a port, and enhances its soft power (Rahman, 2019). At the same time, China gains new markets for its excess production, so extending the life of its existing export-driven development model.

However, although the idea of the BRI has merit, delivery is another matter. Less-developed countries like Pakistan and Sri Lanka need infrastructure but may lack the means to pay for it. The fact is that the BRI is supposed to be commercial, not a system of grants like the post-World War 2 US Marshall Plan with which it is sometimes compared. As part of a debt restructuring, the Chinese enterprise concerned did take over management of Sri Lanka's Hambantota port,<sup>42</sup> although to date that seems to be the only case. Hambantota's main problem was lack of profitability, and this has bedeviled other BRI initiatives. Moreover, China has applied its domestic practices directly to overseas projects,

employing Chinese workers and China-sourced materials and driving the project through without regard to local sensitivities; there are also allegations of bribery of local officials and opaque project terms.<sup>43</sup> Some see the BRI as “neo-colonialism” based on debt diplomacy (Diamond, 2019). At home, some question whether the resources going into the BRI would be better spent on China’s domestic needs.<sup>44</sup>

Overall, the BRI has much to offer the world, but to be sustainable it has to become less China-centric. China’s rhetoric of a more open world has to be matched by a fairer and more transparent mode of project management – and also by better commercial sense in project selection. It is hard to see the BRI constituting a new informal empire for China, let alone a self-contained trading bloc. The BRI countries are too disparate, too far-flung, and too diverse in their interests to be so managed. In any case, imposing as it does so many barriers on its own people’s interaction with the wider world, China lacks the deep bench of internationally-experienced personnel that would be needed.

### ***3.4. Extension via Innovation – “Made in China 2025”?***

If the BRI offer no external escape from China’s looming development trap, what about internal escape via self-reliance? Under the 2015 plan, “Made in China 2025”, China seeks to rely less on international input, driving the domestic content of production to 40 percent by 2020 and 70 percent by 2025. Further, China aims to contest advanced industries presently dominated by foreign companies, including pharmaceuticals, automotive (green vehicles), aerospace, semiconductors, IT (Artificial Intelligence (AI), Internet of Things (IoT), smart devices), and robotics (AI and machine learning). The aim is to become a powerful manufacturing country by 2025, a middle-level world manufacturing power by 2035, and a top world manufacturing power by 2049.<sup>45</sup> World leadership implies trading with the rest of the world rather than total

isolation, but the aim is self-reliance in key sectors – a go-it-alone strategy – and hence the continuing relative closure of China’s borders. Is this a feasible path?

The Chinese leadership has itself had to downplay “Made in China 2025”, as the plan’s protectionist overtones upset trading partners.<sup>46</sup> Since then, with the deepening of the trade war, such feelings have hardly gone away. Yet, more fundamentally, the plan is not realistic.

In international trade, to quote President Xi’s own words, China is, “big but not strong”.<sup>47</sup> It produces goods which are of medium quality and price but fall short on the increasingly important inputs of service and design. With an underdeveloped service sector, China will be hard-pressed to make up this shortfall. Even in the key sectors targeted by the plan, China is highly dependent on international inputs, particularly US-developed software and microchips. Huawei leads in 5G gear, but its networking gear uses semiconductors and other specialised components from US companies.<sup>48</sup> Import substitution for these is imaginable, and that is indeed the strategy – Huawei has declared plans to make its own chips, and the state has committed to investment in chip manufacture. Yet self-reliance is costly and cannot be done for everything. By the time China’s chip plants are built, overseas competitors may have moved on.

The quest for economic self-reliance is a persistent theme in China’s development policy, driven by the desire to avoid dependence on foreign powers (Tisdell, 2013). However, self-reliance has a cost, namely the loss of the benefits of trade based on comparative advantage. The nation has to do everything itself, rather than focusing on what it does best and buying in products and services produced better and more cheaply elsewhere. The associated benefits of exposure to overseas best practice are also lost. Such costs may be tolerable if borne in respect of limited sectors, such as those crucial for national defence. However, as a broad



strategy, self-reliance is ultimately the route to poverty – as demonstrated by examples such as Cuba, India in the post-independence decades, North Korea, and China itself under Mao. Long before such extreme conditions were reached, the CCP would encounter faltering growth, and would lose the Mandate of Heaven in the eyes of the people.

### ***3.5 “Sinicization of Everything?”***

If neither the BRI nor self-reliance ultimately offer a viable path, China is faced with a dilemma. To continue high economic growth and escape the middle-income trap, China needs international input – not only goods but increasingly the services and structured information that are critical to the functioning of a modern developed economy. China will have a growing need for international capital as well, since its current account will likely trend into deficit as consumption rises. However, international providers of services, information, and capital are more demanding than international manufacturers, requiring law-based protection and the right of withdrawal. Their involvement in the economy is difficult to contain, tending as it does to stimulate ideas and discussion. This is unpalatable to the CCP leadership, which under the Xi Jinping government has clamped down on independent thought, denied legal rights, and enforced party orthodoxy to strengthen the state-permeated model.

The US trade war demands illustrate the stark nature of the dilemma. They include, protection for foreign investment, an end to subsidies to state-owned enterprises (SOEs), protection for intellectual property, a ban on forced technology transfer, and a level playing field for foreign enterprises. All these commitments are to be embodied in Chinese law and regulations so that enforcement will be effective and can be monitored.<sup>49</sup>

These demands are difficult for the CCP to accept. Chinese laws are generally vague, to leave room for the exercise of the official discretion on which the state-permeated model depends. If China were to accede to an independently adjudicated law-based system, the state-permeated model would collapse and an existential crisis for the CCP ensue. It will not happen. And while China may be able to buy off Trump with lesser concessions or otherwise segue to a less-conflicted relationship, even that will not suffice for too much longer. To sustain growth, China needs to be more open to international input. But how?

If nationwide opening is ruled out, there remains opening in selected areas via the enclave model. This model has seen a revival in recent years via the creation of Free Trade Zones in China with a mandate to experiment with new administrative and business forms. However, before discussing the enclave strategy it is necessary to address one more, apparent possibility of obtaining needed international input without changing the existing development mode.

This possibility which, consciously or unconsciously, is being pursued by the CCP leadership today, can be termed, the “sinicisation of everything” (Wong, 2019). The concept here is that China’s gravitational force as a market of 1.4 billion people and perhaps eventually the world’s largest economy will be strong enough for the CCP’s view to sway the world, or a sufficient portion of it, to trade with China on the latter’s terms. Already, many international businesses and organisations, even states, have felt the force of Chinese displeasure as voiced by netizens and amplified by Chinese corporates and state media, and have hastened to make amends. The list of recent converts includes international hotels, airlines, Disney, the US National Basketball Association, Gap, Dolce & Gabbana, Apple, Nike, and many more. If the BRI represents China’s bid to draw the developing world into its

orbit, the actions described here impact the commanding heights of the international economy. Can China indeed sinicise everything?

The sinicisation strategy is in effect a form of ideological mercantilism, and as such is subject to the same limitations as those of the trade version, discussed in section 3.1 above. As a point of fact, business corporations as such are not well-positioned to resist this kind of society-wide pressure. Focused by mandate on shareholder value, individual business executives may feel, whatever their personal convictions, that their duty to shareholders obliges them to go along with China's demands in order to tap the China market, it not being their main job to act as advocates for free speech. That view may ultimately not be supported by their shareholders, increasingly focused as they are on ESG (Environmental, Social and Governance) performance; domestic customers may also exert countervailing pressure. Governments, too, may take issue with abuse of their companies. However, the concentrated power of China's all-of-society assault, backed by its market size, can score initial wins, at least.

Nonetheless, such wins do not help China much economically, indeed they may hinder rather than help. Forcing Marriott Hotels to acknowledge Taiwan to be part of China, or an NBA executive to withdraw his tweeted support for Hong Kong protests is one thing. It is quite another to force an international firm to invest in China or to sell technology to a China firm or to buy China bonds. Even if China can cow business executives into acquiescence or silence over ideological questions, that does not necessarily translate into business advantages for China. Indeed, the experience of aggression and personal humiliation may make those executives more wary of China deals, and add to their respective governments' list of complaints about China market access. The aggression also affects China's soft power projection, turning it into "sharp power" which although penetrating may provoke reaction and be

less effective in the long run. Finally, there is the impact on China's own consumers. NBA matches were highly popular viewing in China; although many Chinese were outraged by Daryl Morey's tweet, that may not translate into indefinite support for the NBA boycott. Popular outrage can take an unpredictable course.

### ***3.6. Opening-up – via Enclaves***

The remaining option for gathering vital international input is opening via enclaves – geographically limited areas for experimentation. This too has been recognized by the leadership. From 2013 onwards, so-called Free Trade Zones (FTZs) have been created in Shanghai, Guangdong and other regions. However, the 12 existing FTZs are too small and their approach too piecemeal and inconsistent to make much difference.

Nonetheless, the enclave model represents China's best hope of sustaining growth while preserving the state-permeated system. An enclave is like an airlock – allowing two-way flow under a control mechanism. China has a long history of utilizing enclaves – Hong Kong and Macau from historic times, Shanghai in the pre-revolutionary era, and the vast numbers of special zones that sprang up from 1980 onwards under the Open-Door policy. Enclaves of some form may be the only route to a future that is acceptable to both the Chinese population and its leadership. But what form should these enclaves take?

The Special Economic Zones of the 1980s and 1990s were particularly successful in attracting low-cost manufacturing investment, much of it from Hong Kong. Low-cost manufacturing requires relatively simple inputs of land and labour, and can be conducted in a limited geographical area. However, in China's more developed economy, no longer low-cost, the requirement is for more sophisticated products and services. These require more complex inputs, including contact with the mass consumer markets the products and services are intended for. The

existing FTZs, some located in empty fields or the wharves of existing ports, are unsuitable for these activities, containing neither sufficient markets of their own nor specialised inputs such as professional services and adjudication by independent courts. Unclear legal and regulatory foundations and ongoing intervention by the central authorities further clouded the picture. On the other hand, an initiative to allow “FTZ accounts” to be opened at banks across the country threatened to disrupt the nation’s financial system and so had to be curtailed.<sup>50</sup>

The FTZs have had some success in physical trade and support for e-commerce; Mainland companies have registered to take advantage of the looser regulation. However, in general the FTZs have seen low innovation, high dependence on policies, and no distinctive advantages or functions (Chen *et al.*, 2018). There is no unified FTZ law; the roles of the various administrative authorities in the FTZs are not clear; measures taken in the FTZs may not be consistent with China’s WTO obligations (Peng and Fei, 2017). Foreign investment has generally been minimal. Potentially useful reforms such as a more independent court system and intellectual property court in Shanghai FTZ may not be constitutional (Liu, 2018).

While a small geographical area can provide a good base for physical trade and manufacturing (as under the SEZ model), it is not well-suited to services, especially financial services, in China’s now more mature economy. The FTZs were also intended to experiment with new administrative initiatives. However, they are too small and unrepresentative of the nation as a whole to act as a trialing ground for national reforms. The grand objectives of the FTZs were essentially unachievable.

A comparison between the existing FTZs and Hong Kong is instructive. Unlike the FTZs, Hong Kong is:

- of sufficient economic size to be self-sustaining and make a difference even to the vast China economy;
- a complete societal system, with its own executive, legislature and courts;
- highly autonomous vis-à-vis the central government;
- properly founded on its own constitution, the Basic Law, rather than on administrative departures from or waivers of national laws and regulations;
- governed by the rule of law adjudicated by an independent court system;
- delineated by clear physical and legal borders from the rest of China so that experimentation within the enclave is containable;
- operated in accordance with free market principles.

(An equivalent analysis could be done in respect of China's other SAR, Macau. However, Macau is one-tenth Hong Kong's size and has a different orientation; it will not be discussed in the present paper.)

The substantial, indeed, irreplaceable benefits China draws from Hong Kong are detailed in section 2.2 above. If China is to draw Hong Kong-scale benefits from any further enclaves, it has to make those enclaves more like Hong Kong. This requires much bolder thinking than has been evident to date.

The enclave strategy, then, would entail identifying one or more candidate areas within the Chinese mainland which could be revamped as SARs. Where can such candidates be found?

Mainland China has no Hong Kongs or anything like a Hong Kong. However, it is possible to imagine that certain areas that are today relatively developed and open, such as the Greater Bay municipalities and in particular Shenzhen, could make a start. Indeed, Shenzhen is

slated for bolder experimentation in the future.<sup>51</sup> The challenge will be to be bold enough. To make a difference, it will be essential to provide Shenzhen with its own constitution and grant it a high degree of autonomy from the Central Government.

#### **4. Implications for Hong Kong**

If the strategy of further enclaves is adopted by the Chinese leadership, what implications would that have for Hong Kong? Would it just mean supersession of Hong Kong's role by other means?

Promulgation of the enclave model more widely in China would be positive for Hong Kong.

Firstly, it would be a strong endorsement of the Hong Kong system. Secondly, since it is unimaginable that any new enclave could be granted freedoms equivalent to those in Hong Kong, let alone match the territory's accumulated 170 years of experience, it would elevate Hong Kong to the *de facto* chief among the enclaves – the leader of the flying geese. Thirdly, Hong Kong would be the model and exemplar of China's future – the nation's hope.

Fourthly, to the extent that these successor enclaves actually function as intended, it would provide healthy competition for Hong Kong. The territory's main problem – apart from its governance mechanism – is that in its China gateway role it is too secure. There is too little competition, which breeds complacency in Hong Kong's leadership and rent-seeking behaviour among its business conglomerates. More competition from Shenzhen, say, would prompt a creative response from business and meaningful reform from the government, releasing fresh energy in the people.

Last but not least, new enclaves would provide more development space for Hong Kong. These enclaves, particularly if like Shenzhen they

are in Hong Kong's near neighbourhood, could provide accommodation and recreation as well as business opportunity in a more secure and "Hong Kong-like" environment than the Mainland presently provides.

## 5. Final Words

Ideally, fundamental doubt about Hong Kong's future would not arise. The Hong Kong system is assured until 2047 by international treaty. In any case, the right to self-determination is the most fundamental human right recognized in Article 1 of the United Nations Charter.

Nonetheless in the real world, rights are not a given, or even if given they have to be continually asserted. Hong Kong has made a very convincing assertion of its right to a future. It has performed, and continues to perform, immense service to both China and the international community in its gateway role, not to mention its broader prowess as an international financial centre and as management headquarters and a professional services centre for the Asia-Pacific region.

Even this impressive catalogue is not the full statement of Hong Kong's value. For in its enclave role, Hong Kong represents the only viable model for China to transit to more developed status. China needs more Hong Kongs. It should cherish the Hong Kong that it has.

## Notes

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