



HONG KONG: CHINA'S LABORATORY

The territory's close economic relationship with the mainland cuts both ways

KEY TAKEAWAY

Chaotic, bustling with life, overthrown with smog and pollution, a bundle of confluences and contradictions, and hailed as a glittering capitalist jewel, Hong Kong stands as a colossal might in the heart of Asia. The 11th largest trader in the world and the largest source of foreign direct investment among Asian economies, Hong Kong is tethered to the economic might of China.

As the last rays of light settle gently into the sea, dusk gives way to the inkiness of the night. At Hong Kong's Victoria Harbor, this everyday spectacle turns into an awe-inspiring sight. With every last breath of the day, as the immense vast darkness sets in, the city is magically transformed.

A million lights sparkle into life. Hong Kong's towering skyscrapers reach into the sky, touching the night. It is a breathtaking orchestra of lights and one of the most dazzling city skylines in the world. Chaotic, bustling with life, overthrown with smog and pollution, a bundle of confluences and contradictions, and hailed as a glittering capitalist jewel, Hong Kong stands as a colossal might in the heart of Asia. The 11th largest trader in the world and the largest source of foreign direct investment among Asian economies, Hong Kong is tethered to the economic might of China, and stands as a city in symphony with progress.

HONG KONG AND THE WORLD

Nominal GDP (\$)	290.9 billion
GDP Rank	38/194
Per Capita GNI - Nominal (\$)	\$40,320
Per Capita GNI Rank	35/213
Population Rank	100/228
Geographical Area Rank	184/257
Global Competitiveness Rank	7/144
Economic Freedom Index Rank	1/178
Human Development Index Rank	12/188
Major Industries	Financial Services, Tourism, Trading and Logistics

OWNERSHIP CHANGES HANDS, AGAIN

A minor neglected outpost of the Qing dynasty, Hong Kong rose to the forefront when it was captured by the British, signaling the beginning of the infamous Opium War. This small village inhabited by pirates, farmers and fishermen became the center of a bloody battle between the Qing regime and the British Empire. Unhappy about the emperor's decree banning the import of opium, the British, with their superior naval force, easily occupied Hong Kong Island in 1841. One year later, China was to sign the humiliating Treaty of Nanking, which ceded Hong Kong and the adjacent islands in perpetuity to Britain. Another defeat followed in the Second Opium War in 1856, giving the British more land on the Kowloon Peninsula. Finally, the New Territories as well relinquished control to the British, on a lease of 99 years in 1898.

Under British rule, strategically placed between Japan and Singapore, Hong Kong grew from being predominantly dependent on trade to a manufacturing hub. Growth was rapid, especially as hordes of Chinese immigrants flocked to the region, attracted by the development of light industries.

World War II then intervened, and Hong Kong was forcibly invaded and occupied by the Japanese for almost four years. During the Communist regime in China, which began in 1947, Hong Kong suffered an uneasy calm, yet maintained its sovereignty. In 1984, the U.K. agreed to hand over all of Hong Kong and the New Territories to China upon the expiration of the lease in 1997 under the Sino-British Joint Declaration. Following the secession back to China, Hong Kong is seen as a Special Administrative Region (SAR) and is governed under the 'one country, two systems' policy advocated by Beijing. Hong Kong is assured of a high degree of autonomy, and has its own government, with complete financial freedom. Post-handover, doubts were raised over the extent of Beijing's interference in Hong Kong. Following the peaceful 10th anniversary of the handover in 2007, it appears that such fears may have been exaggerated. Hong Kong continues to exercise greater freedom than any other place in mainland China although pleas for universal suffrage and complete democracy continue to be ignored by Beijing so far.



Originally invented in 220 B.C. during the Han dynasty, this Hong Kong Junk sails in Victoria Harbor against the contrasting backdrop of the modern city skyline.

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EAST MEETS WEST

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The Hong Kong film industry is one of the most vibrant and active in the world – having produced such stars as Jackie Chan, Bruce Lee and John Woo. The region remains a 'shopper's paradise' and brands from all over the world find a place here in one of the most exotic celebrations of materialism there can be. Glitzy shopping malls lie juxtaposed next to crowded food streets, and the world's tallest seated Buddha on Lantau Island meets the swank showrooms of Yves Saint Laurent, Louis Vuitton, Givenchy, and Chanel.

Buddhism and Confucianism, with its emphasis on family values, remain inherent traditions among the people. The Chinese concept of 'losing face' is common here as well, and many Hong Kongese would go to great lengths to avoid any kind of social embarrassment. The Hong Kong Arts Festival and the Hong Kong International Film Festival are annual events, and the Hong Kong Philharmonic Orchestra, Hong Kong Dance Company, and the Hong Kong Chinese Orchestra perform regularly, adding a touch of élan to this diverse city.

HONG KONG MAKES ITS MARK

Hong Kong's reputation as an entrepot for global trade was firmly entrenched even before it came under the control of China. Under the British scheme of things, manufacturing was the mainstay of the economy of Hong Kong, thanks to its buzzing port which facilitated the movement of goods. Geographically, Hong Kong stands at the center of the Greater Pearl River Delta region, which also includes Macau and a part of Guangdong.

The economy, which was primarily driven by trade, commerce, and shipping witnessed rapid growth in manufacturing between 1950 and 1980, as it became a leading producer of textiles, furniture, plastics, watches, and clocks. But Hong Kong's manufacturing prowess would gradually give way to lower-cost bases such as Guangdong in southern China, and Singapore would snatch away its preeminent position as the busiest seaport in the world.



At 85 feet high, the bronze Tian Buddha found on Hong Kong's Lantau island is the world's tallest seated Buddha.

KEY TAKEAWAY

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Nonetheless, the trading and logistics services sector, which contributes about one-fourth of Hong Kong's GDP, is still the lifeblood of the economy. Hong Kong is a trader's paradise, as it does not levy tariffs on imports and slaps excise duties only on hard alcohol, oil, methyl alcohol, and tobacco.

However, it was the realignment with the world's second-biggest economy at the turn of the century that opened up new vistas for Hong Kong and made it a sought-after destination for global investors who seek a slice of the Chinese growth pie. Among Hong Kong's numerous epithets, its reputation as a center of international finance is probably the most appropriate. China's resolve to maintain a separate economic policy for Hong Kong has contributed immensely to the evolution of the city as a free market economy, confirmed by its consistently high rankings in the Index of Economic Freedom. Besides helpful policy, the moving of Hong Kong's manufacturing industry to the mainland also fostered the rise of its services industry, of which financial services is an integral part.

First of all, Hong Kong's deep ties with mainland China, sans the opaque regulations usually associated with the Middle Kingdom, made it attractive to global investors and businesses. The administrator of Hong Kong is designated as chief executive, a corporate rather than a political title, a pointer to the minimal role of the government. In practical terms, Hong Kong offers foreign investors a platform to purchase Chinese equities and bonds, while multinational banks are allowed to lend to Chinese firms. What's more, the legal system offers protection to investors, who can freely do money transactions unhindered by capital controls. The Hong Kong currency's peg to the U.S. Dollar also adds to its global appeal. Small wonder that Hong Kong's financial services sector, which includes banking services, asset management, financial leasing, and insurance services, is the second biggest contributor to its gross domestic product. Among other industries, the contribution of the construction sector to the territory's GDP is expected to increase in the years ahead as construction spending is estimated to go up.

GETTING A CHINESE BEAR HUG

However, as much as Hong Kong has tried to maintain some economic distance from the mainland, it appears that it is increasingly becoming a part of China's economic orbit. The economic relationship between China and Hong Kong is more or less symbiotic. China, which makes up about 50% of Hong Kong's total trade value, has been the city's long-standing trading partner. Moreover, the mainland is still the principal source of external direct investment in Hong Kong. Politically, Beijing wields considerable power in Hong Kong, be it in maintaining a vise-like grip on the local administration or in restricting democratic freedoms to the residents of the city.

In financial services too, there have been attempts such as the well-advertised Hong Kong Shanghai Connect Program to give overseas investors access to the Shanghai stock market as part of the Chinese government's move to improve the country's capital market institutions. Moreover, the Hong Kong stock market is the preferred destination for Chinese companies which seek to list abroad. Efforts are on to develop Hong Kong as the main offshore center for trading the Chinese currency – the yuan. Furthermore, about one-tenth of deposits in Hong Kong's banking system are denominated in yuan, while the banks' lending to Chinese corporates is also increasing, according to *The Economist*. Besides financial cooperation, Hong Kong and China have invested in infrastructure to develop better physical connectivity such as a high-speed train link between Hong Kong and neighboring Shenzhen

and a bridge to connect the city to interior China.

Economically, Hong Kong's tourism sector, though it contributes less than 5% of its GDP, is important to allied sectors such as retail and the hospitality industry. Visitors from the mainland comprise the bulk of tourist arrivals in Hong Kong, highlighting the city's dependency on China. Though tourism-related jobs are mostly low-paid and do not require specific skill sets, they are vital in keeping unemployment low. Moreover, others sectors offer limited opportunities for unskilled workers as Hong Kong makes the transition to a knowledge-based economy.



With its strategic location, Hong Kong serves as a pivotal distribution center of goods from China. Once the busiest seaport in the world, the city has since been displaced by Singapore.

KEY TAKEAWAY

However, on closer scrutiny, Hong Kong would appear to be caught between two worlds. While its currency peg to the U.S. Dollar would make its monetary policy dance to the tune of the Federal Reserve, the territory's financial and trade links with China make it vulnerable to swings in Beijing's economic fortunes. Furthermore, as China integrates itself more with the global economy, Hong Kong's role as a trade intermediary is also on the wane.

CAUGHT BETWEEN THE TWO WORLDS

On the face of it, Hong Kong has everything going for it: a stable administration, low level of corruption, low taxes, and adherence to the rule of law. Undoubtedly, these factors have contributed in a major way to make the city a favorite hub for global investors. Regulations are not cumbersome, which place Hong Kong among the top-ranked countries for the ease of doing business.

However, on closer scrutiny, Hong Kong would appear to be caught between two worlds. While its currency peg to the U.S. Dollar would make its monetary policy dance to the tune of the Federal Reserve, the territory's financial and trade links with China make it vulnerable to swings in Beijing's economic fortunes. Furthermore, as China integrates itself more with the global economy, Hong Kong's role as a trade intermediary is also on the wane. Neighboring ports in the Pearl River Delta such as Shenzhen also give Hong Kong a run for its money. Though the economic relationship has largely been mutually beneficial, the Big Brother's political heavy-handedness has often rubbed Hong Kong and its pro-democracy citizens the wrong way.

Hong Kong's open economy made it an easy prey to the global recession of 2008-09 from which it recovered rather quickly, thanks to its close ties with China. However, the continued dependence on foreign trade and investment exposes Hong Kong to the vagaries of market volatility and global economic slowdown.

Notwithstanding these challenges, the small fishing harbor of yesteryear has established itself as an oasis of free market in an otherwise chaotic Asia. The soothing breeze of democracy may well be the tailwind which Hong Kong badly needs.

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