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COMMENTARY

The Hong Kong Special Administrative Region at 20: Celebrating Decline?

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On July 1, Hong Kong will commemorate the twentieth anniversary of its transfer of sovereignty from Britain to China. The government of the Hong Kong Special Administrative Region (SAR) has budgeted an extravagant HK$640 million ($82 million) to celebrate this historic milestone, but ironically has also revealed that it will mobilize ten thousand police officers to "protect" the attending state leaders from China, including President Xi Jinping. The local authorities have also disclosed that "huge barriers" will be erected to cordon off the hotel where China's VIPs will take up their three-day residence.

For those who have followed Hong Kong's tumultuous political developments in the past three years, the planned implementation of such tight security measures does not come as a surprise. Rather than aiming to protect the dignitaries, they are more intended to shield Chinese state leaders from the embarrassment of being harassed by unruly local pro-democracy protestors and pro-independence "separatists." Tellingly, these over-the-top security procedures only serve to highlight the political and socioeconomic malaises that have been brewing in the SAR for nearly a decade. This NBR Commentary analyzes the economic and social causes of the recent political unrest and concludes by examining the formidable economic challenges facing Hong Kong.

Economic and Social Fault Lines in Hong Kong Today

On the pretext of the lack of progress in constitutional reform and universal suffrage, the eruption of the Umbrella Revolution in October 2014, which spurred tens of thousands of protestors to occupy public areas over a three-month period, was a clear manifestation of the local people's long-standing discontent with what they perceive as an unresponsive and unrepresentative SAR government. They hold this government accountable for the development of several economic and social "fault lines" that have detrimental impact on their livelihoods.

Hong Kong's fault lines stem from chronic income stagnation and growing inequality, the soaring cost of living driven by ever-rising housing prices, and poor employment prospects for the young, especially those without a university education. According to official

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statistics, the real-wage index for nonprofessional and nonmanagerial employees has been on a downward trend for several years. Even university graduates are facing increasingly bleak employment prospects due to oversupply by eight government-funded academies and a myriad of privately funded postsecondary institutions, as well as a mismatch between salary expectations and skills. Meanwhile, Hong Kong's Gini coefficient (which measures income inequality) has climbed to a record high, from 0.518 in 1996 to 0.539 in 2016. Likewise, housing prices have become severely unaffordable, with the city's median home price being 18 times the median household income, which is the world's highest price-to-income ratio.

The root cause of Hong Kong's economic and social fault lines is the government's fiscal dependence on high land prices through its continued collusion with real estate developers, which has sent housing prices skyrocketing in the past decade. The conviction and incarceration of the SAR government's former no. 1 and no. 2 officials—Chief Executive Donald Tsang in 2017 and Chief Secretary Rafael Hui in 2014, respectively—for accepting bribes and favors from real estate and banking tycoons illustrate the breadth and depth of decay within the SAR public administration. Adding to these two cases, the current chief executive–elect, Carrie Lam, who had received many of her campaign donations from business magnates, is being investigated by the Independent Commission Against Corruption for "transferring benefits" by appointing an architect for a public building project without an open tender. Even before these episodes of public washing of dirty laundry, the *Economist* had already in 2014 placed Hong Kong at the top rank of its Crony Capitalism Index, which measures the extent of business tycoons profiting from close relationships with government officials.

Economic Challenges Confronting Hong Kong

Besides alleged business-government collusion, the SAR suffers from an unsustainable economic structure that deepens the fault lines. Specifically, Hong Kong's industry pillars—financial services, entrepôt trade and logistics, and regional headquarters services for multinationals corporations (MNCs)—are increasingly facing fierce competition from China's ambitious first-tier cities.

In financial services, the market capitalization of the Shanghai Stock Exchange surpassed Hong Kong's in 2011, followed by the Shenzhen Stock Exchange in 2015. These advancements, coupled with encouragements from the China Securities Regulatory Commission, have led to a rising diversion of mainland Chinese initial public offerings from Hong Kong to China. Likewise, offshore renminbi payments are increasingly handled by centers beyond Hong Kong, with the combined share of these centers surging from 17% of total payments in 2013 to around 30% in 2017. This is clear evidence that Hong Kong is losing its edge as the premier offshore renminbi center. Last but not least, the inception of the Shanghai Free Trade Zone in 2013, with a clear mandate from Beijing to become "the global center of yuan trading, clearing, and pricing," poses a long-term threat to the SAR. In short, facing multiple challenges, Hong Kong's status as a financial hub will be less secure going forward.

In entrepôt trade and logistics, the rapid expansion of mainland Chinese ports, which offer lower costs and competitive services, is eroding Hong Kong's hitherto tight grip on this industry. For example, the SAR charges \$276 per twenty-foot equivalent unit, whereas Shanghai's port only charges \$185. Beijing's relaxation of cabotage rules since 2013, which now allow foreign-flagged ships to move their cargos between China's coastal ports, is a severe blow to Hong Kong. The decision sets in motion an irreversible decline of the territory's role as the key transshipment center for China. As a result of these negative developments, the SAR's container cargo throughput has recorded a persistent downward trend in recent years, averaging an annual contraction rate of 4.7% between 2011 and 2015. From being the world's busiest port in the early 2000s, Hong Kong has now fallen to the fifth position, outpaced by Shanghai, Singapore, Shenzhen, and Ningbo-Zhoushan. Guangzhou and Qingdao, currently ranked seventh and eighth, are catching up expeditiously.

Last but not least, Hong Kong also faces mounting challenges to its attractiveness as a hub for the regional headquarters of MNCs. Exorbitant operating costs, pervasive air pollution that is approaching China's level, and aggressive self-promotion by some of China's ambitious tier-one cities are the key threats to the SAR's stranglehold on this business segment. Mercer has rated Hong Kong as the most expensive location in Asia for expatriates, while CBRE Research ranks the territory's prime office market the most costly in the region. To lure MNCs to relocate their greater China/Asia-Pacific headquarters, Beijing and Shanghai, aided by the Ministry of Commerce, have promulgated attractive schemes offering generous tax rebates and exemptions, special distribution and export-import rights, and wider market access, among other incentives. Today, Beijing can boast the presence of nearly two hundred MNC regional headquarters, while Shanghai hosts over five hundred of these high value-added commercial entities. This trend is clearly developing at the expense of Hong Kong.

With the steady erosion of the competitive advantages of the SAR's main industry pillars by its mainland rivals, a fractured legislature split between Beijing-leaning and pro-democracy lawmakers, an executive government beholden to vested business interests and hiding behind an archaic policy of "positive noninterventionism," and an old economy captured by self-serving crony capitalists, Hong Kong's descent seems as inevitable as it is inexorable. The 2014 Umbrella Revolution may thus be seen as a manifestation of the public's desire to directly elect a more responsive and activist government that can help reverse the SAR's declining economic fortunes. However, with constitutional reform being stalled and the government in limbo (unable to secure policy consensus and support from the divisive legislature and deeply entrenched business interests), the territory's fault lines will only deepen and widen. On July 1, President Xi Jinping will come into town to "celebrate" the twentieth anniversary of a Hong Kong SAR that is facing a much cloudier outlook after two decades under Chinese rule. ~

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