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HONG KONG'S REVERSION TO THE PEOPLE'S REPUBLIC OF CHINA: IMPLICATIONS FOR CALIFORNIA

By

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EXECUTIVE SUMMARY

This paper provides information on the economic significance of Hong Kong for California. It includes a brief description of Hong Kong's political history, a brief profile of its economic policies, and discusses a variety of concerns regarding the potential economic consequences for the United States and California of Hong Kong's reversion to China.

Currently, Hong Kong is a free society with legally protected rights. It has a market economy, with very liberal investment and trade policies. Hong Kong is a key Asian financial and trade center, with a freely convertible currency, a developed financial structure, and a working legal system. The strong position of Hong Kong as a trade center is the result of its economic policies.

Next month, after almost 100 years of British rule, Hong Kong rule will revert to China. The British had acquired this territory through a combination of wartime concessions, and a 99-year lease negotiated and signed with China, which expires on July 1, 1997. According to an agreement signed after a series of negotiations between Britain and China, control of Hong Kong is scheduled to be transferred to China on July 1, 1997. The agreement states that for 50 years after that date, the Hong Kong Special Administrative Region will retain its autonomy except in foreign and defense affairs. This means that Hong Kong will maintain its status as a free port, and will be able to continue its free trade and liberal investment policies.

Hong Kong's transition to Chinese sovereignty is important to the United States and California for many reasons:

- Hong Kong is one of the world's most rapidly growing economies and a major regional and international trade and investment center. It has been the main gateway for trade and investment with China and East Asia.

- The United States has a significant economic presence in Hong Kong:
    - ⇒ Hong Kong has Asia's largest proportion of American businesses, with over 1,200 U.S. firms located there.
    - ⇒ Total U.S. foreign investment in Hong Kong was $13.8 billion in 1995, or 12 percent of Hong Kong's total foreign investment.

- Hong Kong represents an important market for U.S. exports, consuming more U.S. goods per capita than almost any other world economy. Hong Kong is the 11th largest market for the U.S. and the ninth largest market for California. California produces a high proportion of U.S. exports that go to Hong Kong. In 1996, California exported $3.6 billion to Hong Kong, more than one-fourth of U.S. exports to that country. Most of these exports were electronic products and industrial machinery. Exports of agricultural and food products were also important. About 78,000 California jobs are supported by trade with Hong Kong.

- Hong Kong, China, and Asia in general represent not only one of the largest markets for U.S. high tech and agricultural and food products, but also one with the greatest potential for future growth.

- If developments in Hong Kong lead to deterioration of U.S.-China relations, the economic effects on California would compound, since China is also an important market for both the U.S. and California.

Potential trade issues that might emerge between the United States and Hong Kong after July 1997 include:

- The protection of individual and property rights for foreign investors in Hong Kong.
- The maintenance of a reliable system of commercial dispute resolution.
- The possibility that some trade barriers may emerge, since Hong Kong trade policies are much more liberal than China's. Hong Kong is currently a member of the World Trade Organization (WTO), while China is not.
- The controversy over renewal of China's most-favored-nation status by the United States will now cast a shadow over the economy of Hong Kong.
- The extent to which intellectual property rights are going to be enforced.
- Potential problems related to the spread of dangerous weapons and technology, since China is not part of the Wassenaar Agreement, a multilateral accord that regulates transfers of conventional arms and dual-use goods and technologies.

It is impossible to determine in advance the consequences of Hong Kong's reversion to China on Hong Kong's economic autonomy. On the one hand, some think that China will not do anything to stall Hong Kong's prosperous economy, because it has a significant vested interest there. The economies of Hong Kong and China are intertwined and it is in the interest of both sides to maintain the conditions that have brought growth in the region. On the other hand, others are concerned that looming restrictions on political activity could hurt the free flow of information, a crucial part of doing business.

The economic significance of the way U.S.-China relationships will be handled after July 1997 is very important for California. Hong Kong, China, and Southeast Asia are the fastest growing economies in the world, and it is to the benefit of the United States to continue to capture a large share of these markets. In 1996, Hong Kong and China purchased more than five percent of total California exports, and U.S. foreign investment in this region is significant. Prospects for future demand for California products in these rapidly growing markets are excellent, especially for high value products such as multimedia, aircraft, and electronic products.

HONG KONG'S REVERSION TO THE PEOPLE'S REPUBLIC OF CHINA: IMPLICATIONS FOR CALIFORNIA

THE HONG KONG POLITICAL SITUATION

Hong Kong consists of a peninsula attached to the mainland of China, and more than 235 islands. The mainland area has two sections-the New Territories in the north and the Kowloon Peninsula in the south. The main island, Hong Kong Island, lies to the south of the peninsula. Hong Kong was part of China from ancient times until the 1800's. Britain gained control of Hong Kong Island in 1842 and the Kowloon Peninsula in 1860 through treaty agreements imposed on China. In 1898, China leased the New Territories to Britain for 99 years. Under a 1984 agreement between China and Britain, control of Hong Kong is scheduled to be transferred to China.

Hong Kong has a population of about 6 million and a land area of only about 400 square miles. Most of Hong Kong's economic activity takes place in two urban areas, where most of the people live. Almost all the residents of Hong Kong are Chinese. Through the years, millions of people have moved from China to Hong Kong to find jobs. Hong Kong has two official languages, English and Chinese.

English common law applies to Hong Kong, with certain local variations derived from Chinese custom. Hong Kong is run by a British governor, a locally elected legislature, and a powerful civil service. Hong Kong is a free society in that it has legally protected rights. Its constitutional arrangements are defined by the Letters Patent and Royal Instructions. Executive powers are vested in the Crown-appointed Governor who holds extensive authority. The judiciary is an independent body adhering to English common law.

In 1982, the British government initiated a series of bilateral negotiations with China about the future of Hong Kong. These negotiations ended in 1984 with the signing of an agreement where China promised to rule Hong Kong under the general guidelines of "one-country-two systems." The Sino-British Joint Declaration states that the Hong Kong Special Administrative Region:

- will maintain a high degree of autonomy, except in foreign and defense affairs, and
- may conclude agreements with states, regions, and international organizations.

China Promised to Leave Hong Kong's Socioeconomic System Virtually Unchanged for 50 Years After 1997. As pledged in the Sino-British agreement, Hong Kong will retain its status of a free port, and be able to continue its free trade and liberal investment policies.

In accordance with the Sino-British Joint Declaration, the basic policies of the People's Republic of China (PRC) concerning Hong Kong's future governance are stipulated in the Basic Law, which was approved by the National People's Congress of the PRC.

Negotiations over the Basic Law took place between 1984 and 1989, and it was adopted in April 1990. During these negotiations, Britain argued for the maintenance of the territory's autonomy, proposing direct elections for Hong Kong's legislature, the Legislative Council. China opposed these efforts, considering them attempts to interfere with China's ability to administer the territory after 1997. The 1989 events in Tiananmen Square raised many concerns and influenced British and Chinese attitudes towards Hong Kong. The British felt pressure from many in Hong Kong to expand the colony's institutions of representative government, while China was concerned about security. The language of many of the Basic Law provisions is vague, leaving room for continuing controversy, particularly on political matters. For instance, the Basic Law provided only that the Hong Kong Legislative Council "shall be constituted by election," and that elections were to be implemented "with gradual and orderly progress."

The British Have Reaffirmed Their Support for Hong Kong in Several Ways. British government actions oriented to preserve Hong Kong's autonomy after reversion include:

- **The Reopening the Legislative Council Seats to Election in 1995.** In 1995, the Hong Kong government implemented legislation abolishing all appointed seats in the Legislative Council and, for the first time, opened them to elections. China did not agree to the electoral rules adopted by the Hong Kong government and has announced its intent to dissolve the 1995 Legislative Council, district boards, and municipal councils in July 1997. China also announced that a PRC-appointed preparatory committee will decide how to form the first post-1997 Legislative Council.

- **The Construction of a Large Expensive Airport and Port Facilities.** This huge project, of great size and expense, was originally objected to by the Chinese government because it was seen as a British strategy for draining Hong Kong's substantial treasury surplus before the reversion. The Chinese government also felt that they were not sufficiently consulted on this development, the consequences of which would be strongly felt after the reunification. In June 1995, after much negotiation Britain and China reached agreement on the financial support for the airport and airport railway project, which is underway.

- **Obtaining Chinese Approval for Current Hong Kong Legislators to Complete Their Term Periods.** After much negotiation, the Chinese accepted that legislators elected before 1997 could complete the remainder of their terms after the take over (referred to as the "through train").

Governor Patten, who assumed his position in 1992, proposed a series of political reforms that, according to critics, contravened the Joint Declaration and the Basic Law, complicating the reapportion for sovereignty in 1997 and making it more difficult to run the territory. In response to Patten's reform, China set up its own advisory body, the "Preparatory Committee," and in February 1994, ended the "through train" agreement and vowed to dismantle the current legislative structure of Hong Kong. Currently, Chinese officials are continuing discussions with British officials, but they have isolated Governor Patten from important events.

To facilitate the transfer of sovereignty, the Sino-British Joint Declaration established the ***Sino-British Joint Liaison Group*** for the purpose of facilitating and discussing matters related to the transfer of government, and the effective implementation of the Declaration. This group has been reviewing bilateral and multilateral agreements to which Hong Kong is a party, and has participated in the negotiations on the financial arrangements of the new airport project and the establishment of the Court of Final Appeal.

The establishment of the Hong Kong based ***Court of Final Appeal*** was agreed to by the Chinese and British government in June 1995. This will allow Hong Kong's citizens and business community to appeal any decision to a court with the power to make final decisions. This court begin operation after June 1997, and consists of one Chief Justice (who should be a Chinese citizen/permanent resident of Hong Kong), three Hong Kong-based judges, and one judge who can be invited from any common law practicing country.

The Preparatory Committee is responsible for preparing the establishment of the Hong Kong Special Administrative Region and deciding the specific method of formation of the first government. It was appointed in January 1996. This Committee is composed of 150 members, with 94 drawn from Hong Kong. The Committee has its headquarters in Beijing, and a liaison office in Hong Kong.

The Preparatory Committee decided that a provisional legislature will be established in July 1997 as part of the transition, and the first Chief Executive should be elected by an Election Committee of 400 members. Members of the Election Committee include 300 members from the private sector, 40 former political figures, 26 Hong Kong deputies to the National People's Congress, and 34 representatives of Hong Kong members of the Chinese People's Political Consultative Conference.

The first Chief Executive was selected by the Election Committee and the 60 members of the Provisional Legislative Council who were elected in December 1996. The first ***Chief Executive*** elected was Tung Chee-hwa who will replace Hong Kong's last British Governor, Christopher Patten, on July 1, 1997. Mr. Tung, a shipping magnate, is regarded by many as being selected by China. The press has also reported that Mr. Tung has been warmly received by Hong Kong businessmen who believe Tung's good relations with Beijing will give them a stable environment in which to operate. However, some of Mr. Tung's declarations to the press, such as his opposition to the media's criticism of some officials for their advocating freedom for Hong Kong and Taiwan, have made journalists nervous.

THE HONG KONG ECONOMY

The economies of Hong Kong and China are very interdependent. One-third of all of China's exports flow through Hong Kong on their way elsewhere, and 25 percent of China's imports come via Hong Kong.

Hong Kong's Economy is Growing Very Rapidly. Hong Kong's economy is characterized by high rates of real growth (4.7 percent annual rate increase in gross domestic product during 1995 and 1996), low unemployment (3.2 percent), and rising wages. Investment increased by 11 percent in 1996. Hong Kong has one of the highest per-capita gross domestic product (GDP) levels in the world. Economic growth may actually be higher because gross domestic product data do not include Hong Kong production activities in South China, which include manufacturing, services, trade, and property development.

This year Hong Kong's economy is expected to grow even faster. As a consequence of rapid growth, inflation may increase. High growth has gone hand-in-hand with an expansion of the middle class, and the creation of large attractive markets for exporters.

Over three quarters of Hong Kong's gross domestic product (GDP) derives from the service sector, much of it dependent on China. Tourism and other professional and business services have accounted for a major part of the growth of Hong Kong economy.

Hong Kong government spending has increased proportionally with to its economic growth. Despite low taxation, the Hong Kong government annually runs budget surpluses and has accumulated large fiscal reserves. The growing economy has produced substantial tax revenues while excise, real estate, and business profits taxes have been increasing slowly. Hong Kong has a simple low-tax structure. Interest, royalties, dividends, capital gains, and sales are not taxed. However, there is a property tax, a corporate tax, and a personal income tax.

In general, the Hong Kong government pursues policies of noninterference in commercial decisions. Market forces usually determine wages and prices. However, Hong Kong's industries have indirect support from quasi-governmental organizations that are equivalent to subsidies. Price controls apply only to some government-sanctioned monopolies in the service sector.

Since 1993, Hong Kong's economy has suffered from inflation. However, this trend has been decreasing since the second half of 1994. The 1995 rate of inflation was 8.7 percent and last year the inflation rate was 6 percent.

Hong Kong remains firmly committed to ensuring currency stability through its exchange rate policy. The Hong Kong Monetary Authority is responsible of the financial and monetary policy of Hong Kong. There is a single exchange rate and no foreign exchange controls. The Hong Kong dollar is linked to the U.S. dollar at HK$ 7.8 = U.S.$1. The link was established in 1983 to encourage stability and investor confidence during the unification of Hong Kong with China.

HONG KONG'S INTERNATIONAL POSITION

Hong Kong is a Major Regional and International Trade and Investment Center. It is the main gateway for trade and investment with China and East Asia. Hong Kong's port is the world's largest container port, and Hong Kong's airport is the fourth largest in terms of passenger traffic. Major new infrastructure replacement is needed to ensure continued competitiveness of Hong Kong as a center for trade.

Hong Kong Belongs to Major International Organizations. Hong Kong ratified the Uruguay round agreements and became a founding member of the World Trade Organization (WTO) in 1995. Hong Kong is also a member of Asia Pacific Economic Cooperation (APEC), an international trade agreement between Pacific countries including the United States, Canada, Australia, New Zealand, Mexico, Chile, and several Asian countries. In 1994, APEC countries' merchandise exports totaled U.S.$1.8 trillion (nearly half of all world trade), about three-quarters of which was sold within APEC.

Other multilateral organizations of which Hong Kong is a member are the Pacific Economic Cooperation Council (PECC), Pacific Basin Economic Council (PBEC), Pacific Trade and Development Conference (PAFTAD), and the Asian Development Bank.

Hong Kong Has Liberal Trade Policies. Hong Kong is a duty-free port with no quotas, anti-dumping laws, or other barriers to the importation of U.S. goods. There are no restrictions on foreign capital or investment, except for some limitations in the media sector. There are no export performance or local content requirements.

Hong Kong is virtually a free market for food, and health certification requirements and documentation are minimal. Phytosanitary standards are generally compatible with U.S. exports of agricultural products. Hong Kong labeling requirements are generally not restrictive.

Hong Kong' s Intellectual Property Laws and Their Enforcement are Among the Best in the World. Hong Kong has acceded to the Paris Convention for the Protection of Industrial Property, the Bern International Copyright Convention, and the Geneva and Paris Universal Copyright Conventions, and also enacted laws covering trademarks, copyright for trade descriptions, industrial designs, maskworks, and patents. The Customs and Excise Department is responsible for enforcing the criminal aspects of intellectual property rights.

Hong Kong is an Important Asian Banking and Financial Center. Hong Kong's stock market is highly internationalized with many international stock-brokers. Banks specialize mostly in the financing of trade and investment in China and Southeast Asian countries.

Hong Kong is also the second largest source of venture capital in Asia, after Japan. More than half of the funds have as their goal investment in China. As the government in Beijing has relaxed its control over the economy, starting with the privatization of state-owned companies, the demand for venture capital funding has burgeoned.

In Hong Kong, There are Virtually no Restrictions on Foreign Capital or Investment. There are no export performance or local content requirements. There are some exceptions however, in the media sector. In some service sectors, such as medicine, law, and aviation. There are also some barriers to entry.

Overseas direct investment in Hong Kong amounted to almost $100 billion at the end of 1995. Japan accounts for 25 percent of this investment, the United Kingdom accounts for 21 percent, China for 19 percent, and the United States for 12 percent. Most of these investments are in banking and manufacturing of electronic products.

In 1995, Hong Kong was the fourth largest source of funds for foreign direct investment in the world. Investment outflows from Hong Kong totaled U.S.$25 billion in 1995. China and other Southeast Asia developing countries are receiving an increasing amount of capital from Hong Kong. Hong Kong is the largest investor in China, second largest in Indonesia, and the third largest in Taiwan, Thailand, Vietnam, and the Philippines. ***Hong Kong investment in California is about $2 billion, or 2 percent of total foreign direct investment in California.***

Chinese Investment Policies are More Restrictive Than Hong Kong's Policies. In China, there remain several areas in which foreign investment is restricted or prohibited, such as telecommunications and insurance. Foreign enterprises are generally not allowed to import and resell goods without some processing, or they are subject to specific local content requirements when they want to avoid tariffs on imports.

Some investors and businessmen have pointed out recently that, although there have been positive actions to protect foreign-invested ventures, the enforcement of China's laws is usually more a function of the political environment than it is of the legislature or the judiciary having enacted it. Thus, many investors are still uncertain about the future of their investments due to the political environment and poor implementation of laws and regulations. In 1994, The Joint Commission on Commerce and Trade, a ministerial-level forum for discussion of investor and business concerns, established working groups on trade and investment in a number of sectors. Those groups provide forums to discuss specific investor and business problems.

Hong Kong is Negotiating Bilateral Agreements with Various Countries to Give Assurance to Overseas Investors That Their Investments will be Protected After July 1997. These Investment Promotion and Protection Agreements (IPPA) seek to create a stable climate for the investment from the countries involved, by:

- defining investment
- extending most-favored-nation (MFN) or national treatment to investment of the parties[1]
- prohibiting performance requirements (restrictions on investors such as requiring them to sell all or a portion of their goods for export)
- requiring that expropriations meet international standards
- requiring adequate compensation in the case of expropriations
- consenting to binding international arbitration for investor-State disputes
- allowing unrestricted transfer of investment-related funds.

U.S. ECONOMIC TIES WITH HONG KONG

Hong Kong is a major platform from which Americans can develop their economic and cultural ties with all of East Asia. It also plays a pivotal role in the development of Southeast China, and is a major transshipment point for Chinese products exported to and imported from the United States.

Hong Kong has Asia's Largest Proportion of American Businesses. As of January 1997, 37,000 Americans resided in Hong Kong and over 1,200 U.S. firms have located their corporate offices there. Most of these offices are financial and marketing operations for manufacturing facilities in mainland China and headquarters for business activities in Asia. Total U.S. foreign investment was $13.8 billion at the end of 1995, or 12 percent of Hong Kong's foreign investment. Total U.S. manufacturing investment in Hong Kong represents 27 percent of all foreign industrial investment in the territory.

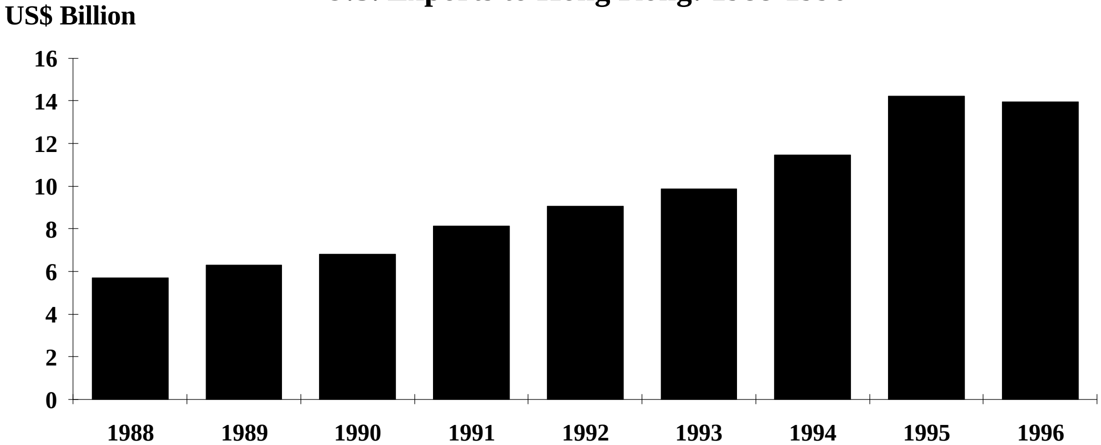
U.S. investment in Hong Kong is concentrated in the manufacturing of electronics and electrical products industries, wholesale trade, finance, insurance, real estate, and banking. Other important manufacturing industries are textiles and clothing, metal products, food and beverages, chemicals, and printing and publishing.

Hong Kong still consumes more U.S. goods per capita than almost any other world economy. In 1996, the United States was the fourth largest source of imports for Hong

[1] Most-favored-nation treatment requires that individuals from another country be treated the same as individuals from all other countries. National treatment requires that citizens of all countries be treated the same as domestic individuals.

Kong. Hong Kong was the 11th largest market of U.S. exports. Chart 1 shows U.S. exports to Hong Kong. U.S. exports totaled $14.0 billion in 1996, a 1.8 percent decrease from the 1995 level. This decline is explained in part by last year's increase in the value of the U.S. dollar.

Chart 1
U.S. Exports to Hong Kong: 1988-1996



Source: Massachusetts Institute of Social and Economic Research.

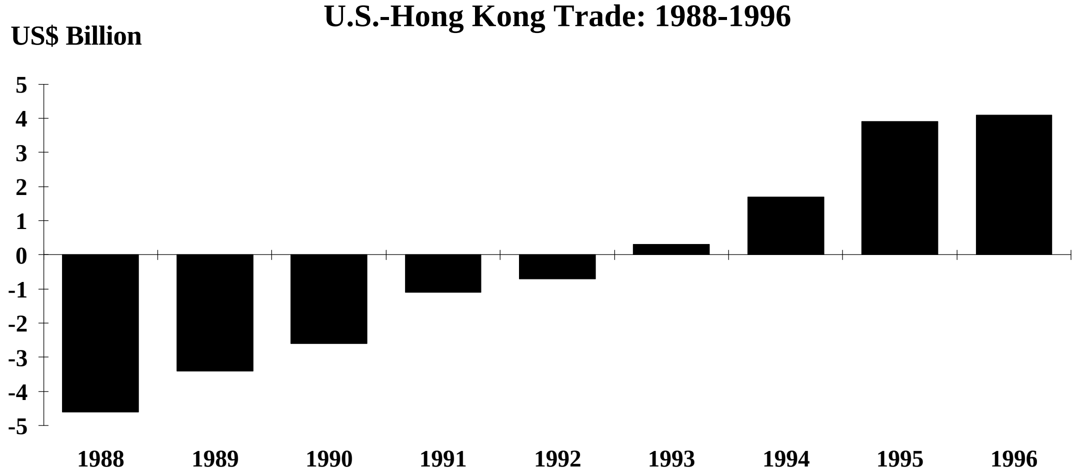
Hong Kong's most important exports to the United States are electrical machinery, office machines and computers, telecommunications equipment, audio and video equipment, and plastics in primary forms.

Hong Kong is not only one of the largest markets for U.S. agriculture, but also is one of the markets with the greatest potential for future growth, given its strategic economic positioning as one of the three major cities in the Pearl Delta River Triangle. This is a highly populated region that is developing rapidly. Hong Kong is also a major transshipment point for Chinese agricultural products exported to the United States and for U.S. farm products imported by China.

Hong Kong is completely dependent on agricultural imports. Its main imports from the United States are poultry, meat, oranges, fresh fruit, vegetables, and tobacco. Hong Kong is among the top three U.S. export markets for oranges, apples, grapes, tomatoes, celery, lettuce, peppers, and onions. It also demands a significant amount of U.S. cotton, soybeans, wheat, and fibers, and is a leading market for U.S. cigarettes. Main U.S. competitors for Hong Kong agricultural and food markets are China, Thailand, Australia, Singapore, and Netherlands.

Chart 2 shows the U.S. Trade Balance with Hong Kong. The trade balance with Hong Kong has improved from a $4.6 billion deficit in 1988 to a $4.1 billion surplus in 1996. U.S. imports from Hong Kong have decreased because many imports that once came from Hong Kong now come from China. Some of these Chinese imports are manufactured by Hong Kong-owned enterprises in China. During the same period, the U.S. trade deficit with China increased from $3.5 billion in 1988 to $39.5 billion in 1996.

Chart 2
U.S.-Hong Kong Trade: 1988-1996



Source: Massachusetts Institute of Social and Economic Research.

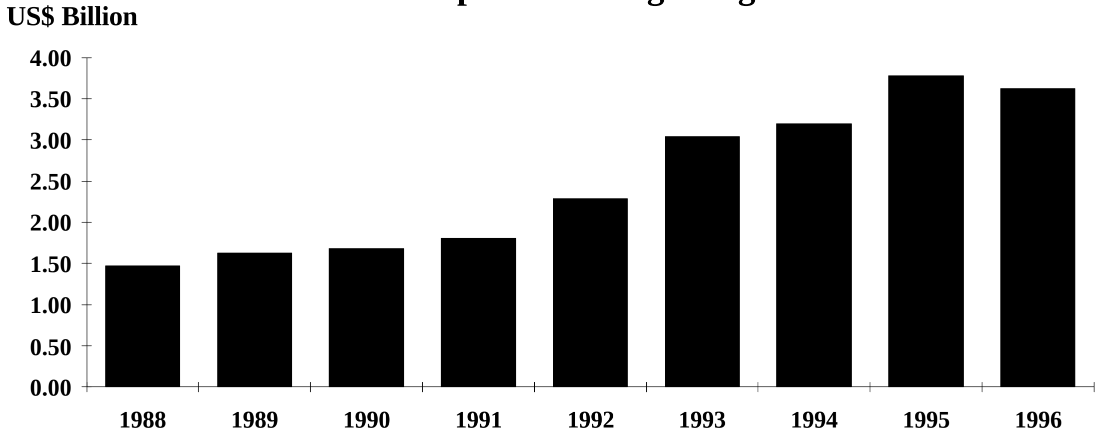
CALIFORNIA ECONOMIC TIES WITH HONG KONG

California produces a significantly higher proportion of U.S. exports to Hong Kong (27 percent) than its total share of U.S. exports of 17 percent. In 1996, Hong Kong was the ninth largest buyer of California exports, and China was the sixteenth. About 3.5 percent of California exports with a value of $3.6 billion went to Hong Kong last year, while California exports to China totaled $1.9 billion. Last year exports to China increased by 39 percent, after a fall of 13 percent in 1995.

Fluctuations in exports to Hong Kong and China are largely explained by changes in purchases of products from the transportation equipment industries, mainly aircraft and aircraft-related products such as engines and parts. For instance, in 1996 there was a decline in Hong Kong's demand for aircraft equipment, while China increased its demand for California products from both the transportation equipment and electronics industries.

Chart 3 shows California exports to Hong Kong. Since 1990, California exports to Hong Kong have doubled, and between 1994 and 1996, exports to that country increased by 13 percent. However, in 1996, exports to Hong Kong decreased by 4 percent, due mainly to new tax and customs measures in China and the strong U.S. dollar that affected Hong Kong's international trade.

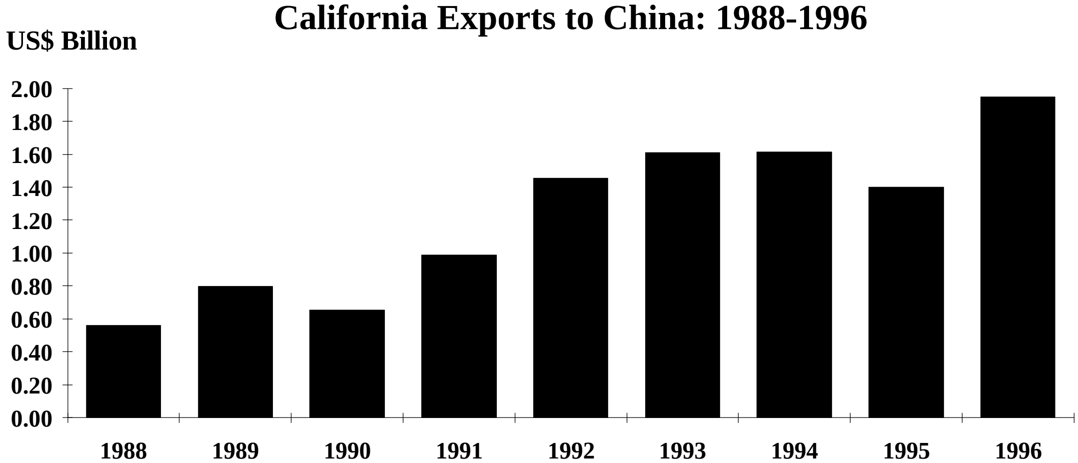
Chart 3
California Exports to Hong Kong: 1988-1996



Source: Massachusetts Institute of Social and Economic Research.

Chart 4 shows that since 1992, exports to China increased significantly. California exports to China tripled since 1990, and increased by more than 20 percent between 1994 and 1996, largely due to an increase in the amount of exports of transportation equipment and electronic products to that country.

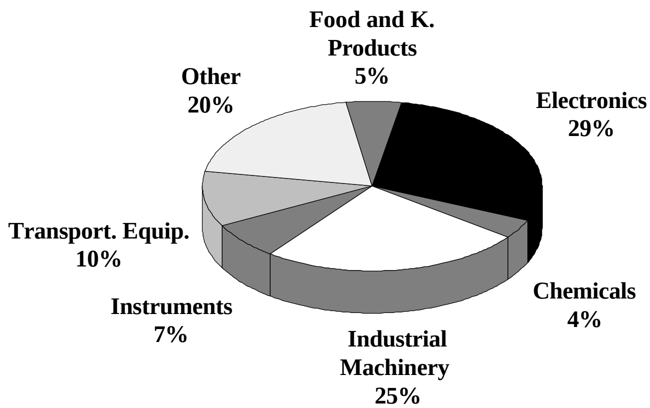
Chart 4
California Exports to China: 1988-1996



Source: Massachusetts Institute of Social and Economic Research.

Chart 5 shows the composition of total 1995 California exports by industrial group. The leading merchandise exporting industries in California are machinery, electronics, transportation equipment, precision instruments, chemicals, and agriculture. These categories represented more than 80 percent of California total exports. Furthermore, California produces a relatively large proportion of U.S. exports from these industries.

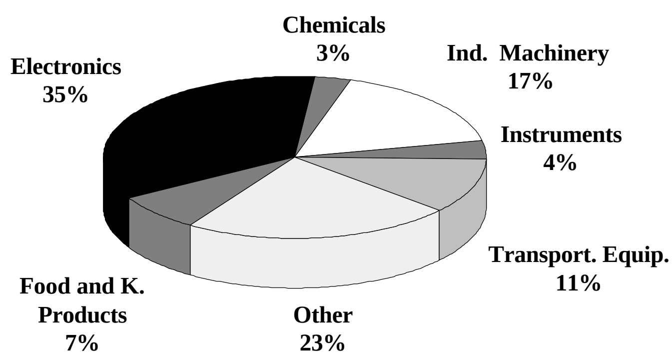
Chart 5
Total California 1995 Exports by Industrial Group



Source: Massachusetts Institute of Social and Economic Research.

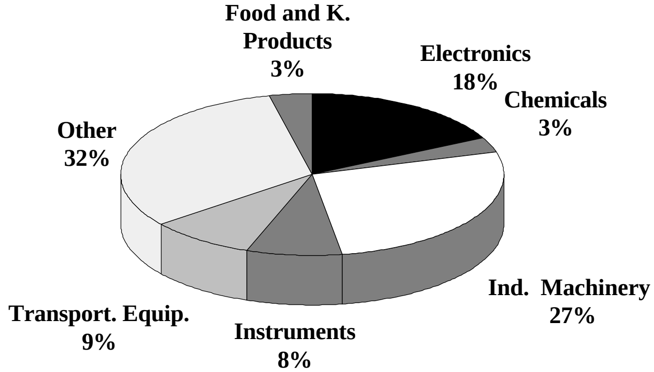
Chart 6 shows that Hong Kong imports from California a relatively higher proportion of electronics, food, and transportation equipment products compared to the rest of the world (Chart 5). In contrast, China demanded in 1995 more transportation equipment, instruments and other products (Chart 7). A comparison of the composition of demand for exports from China and Hong Kong must be viewed cautiously, since it is difficult to separate their demand due to the economic ties between them, and because Hong Kong re-exports a large amount to China. This is particularly true for agricultural and food products.

Chart 6
California 1995 Exports to Hong Kong, by Industrial Group



Source: Massachusetts Institute of Social and Economic Research.

Chart 7
California 1995 Exports to China, by Industrial Group



Source: Massachusetts Institute of Social and Economic Research.

California Exports a High Proportion of U.S. High Tech Products to Hong Kong. The leading exporting industries in California also lead U.S. exports since California produces a relatively large proportion of U.S. exports from these sectors.

In 1996, almost 17 percent of U.S. exports originated in California. However, California dominates the exports of high tech products. For instance, California produced more than 30 percent of all U.S. electronics exports; almost one-fourth of U.S. industrial machinery and computer equipment exports; more than one-fifth of American instruments exports, and more than one-fifth of U.S. exports of food products.

An even larger proportion of American exports of these high-tech commodities to Hong Kong are produced in California. Table 1 shows a comparison between the proportion of U.S. total exports, U.S. exports to Hong Kong, and to U.S. exports to China that originates in California.

Table 1

Proportion of 1995 American Exports Originated in California, by Industrial Group

	All U.S. Exports	*Hong Kong Exports*	*China Exports*
Electronics	30.4%	35.3%	18.9%
Industrial Machinery	22.6%	30.4%	18.3%
Transportation Equipment	11.5%	45.5%	10.0%
Food And Kindred Products	18.6%	27.5%	7.9%
Instruments	21.3%	24.6%	25.0%
Chemicals	6.0%	8.1%	2.0%
Other	10.7%	19.3%	11.5%
All 1995 Exports	**16.6%**	**26.6%**	**11.9%**

Source: Massachusetts Institute of Social and Economic Research

Hong Kong and China, are Important Markets for Electronics, Industrial Machinery, Transportation Equipment, and Agricultural and Food Products.

Electronics. In 1996, Hong Kong purchased U.S.$1.2 billion of electronic products from California, more than 4% of California total exports of electronic products. Almost 26,000 jobs are tied directly or indirectly to these exports, and 39,000 are dependent on exports to Hong Kong and China combined. Last year imports of electronic goods from California decreased by 7 percent. However, China imports of these goods increased by 134 percent. The outlook for electronic products is very favorable for U.S. businesses, particularly those related to telecommunications equipment.

Telecom services in Hong Kong are open to competition. Telecommunications is one of the most vital sectors that will sustain economic growth in East Asia. Reflecting the extraordinary economic growth in South China, two-way telephone traffic between Hong Kong and China is the busiest international calling route, higher than the number of calls between the United States and Japan.

The demand for telephones is expected to rise substantially. Cellular, paging, fixed radio, and new services are experiencing fast growth. Hong Kong, Singapore, Australia and Japan are competing intensely to attract foreign investment for start-up network carriers and restructured state monopolies. An explosive growth in satellite and cable capacity has transformed television systems, leading to new regulatory issues.

China is investing enormous sums in energy, telephones, and other basic services to upgrade its industrial infrastructure. Over the next six years the country is expected to spend $40 billion just to upgrade its telecommunications network. In April 1996, ATT signed a $150 million deal with China.

However, some public services are provided under an exclusive license to Hong Kong Telecom International who is required to provide a range of international telephone services until the year 2006. This arrangement has constrained U.S. companies from offering their full range of services in Hong Kong.

Industrial Machinery. Commodities from this sector, such as computer equipment, were the second most important export to Hong Kong. Nearly 16,700 jobs are supported by exports from this industry to Hong Kong, and 9,100 are supported by exports to China.

Transportation Equipment. In 1995, almost half of the U.S. transportation equipment exports to Hong Kong originated in California. Since orders of aircraft are included in this category, exports in this industrial group are subject to major annual fluctuations. About 5,200 jobs depend on exports of transportation equipment to Hong Kong, and 11,000 depend on exports of these commodities to Hong Kong and China combined.

China represents a growing important market for transportation equipment, particularly aircraft. China projects to increase its purchases of planes.

Agricultural Products. California exports a high proportion of U.S. food exports to Hong Kong. Some of the exports to Hong Kong are re-exported to China. Important markets for California are oranges, apples, grapes, tomatoes, celery, lettuce, peppers, and vegetables, and nuts.

Since 1992, California agricultural exports to Hong Kong have been increasing at an average rate of 10 percent. Exports to China have more than tripled. Hong Kong bought $727 million of California agricultural exports in 1995, becoming the fifth most important market for the state’s agricultural products. California agricultural exports to China totaled $258 million in 1995, when China was the tenth most important agricultural market for California.

Trade with Hong Kong and China Supported 120,000 California Jobs in 1996. According to our calculations based on data from California Trade and Commerce Agency, in 1996 exports to Hong Kong supported 78,000 California jobs, and exports to China supported 42,000 California jobs.

REGIONAL SIGNIFICANCE OF CALIFORNIA EXPORTS TO HONG KONG

Changes in Hong Kong's (and China's) Imports from California will Impact the Various Regions in the State Differently. Although export data at the regional level are not available, it is possible to infer the effect on various California regions by relating the composition of exports to Hong Kong (and China) with the main economic activities of each region.

Bay Area Region. In the Bay Area, there is a high concentration of the following industries which export heavily to Hong Kong: multimedia industries, computer and office equipment, transportation equipment manufacturing, such as guided missiles, space vehicles, and parts, electronic components, communication services, and measuring and controlling devices. These industries provide almost 40 percent of the region's manufacturing jobs. Within the Bay Area, manufacturing is most prominent in the South Bay (Santa Clara, San Mateo, Santa Cruz counties). These industries are also the main payroll generators in the region, paying 65 percent more than the regional average industry.

The East Bay (Alameda and Contra Costa counties) and San Francisco contain a high proportion of the multimedia sectors. Monterey and San Benito contain significant multimedia activity in two areas: communication equipment and software development.

In addition, trade with Hong Kong and China is important for port activity. About 16 percent of Oakland port waterborne trade traffic is with Hong Kong and China.

Sacramento Valley Region. This region includes Butte, Colusa, El Dorado, Glenn, Placer, Sacramento, Sutter, Tehama, Yolo, and Yuba counties. Three industries are the engine of growth in this region: 1) food processing, 2) electronic components, and 3) medical equipment manufacturing. More than one-third of manufacturing jobs in the region depend on these activities.

Hong Kong, China and other Asian countries represent a growing demand for processed food and other agricultural goods. Exports to the Pacific Rim are key in the expansion of the industries in this area.

This region also produces a high proportion of electronic components (such as computer terminals, semiconductors and related devices, electrical equipment, and space propulsion units and parts) and medical equipment. These products are in high demand in Asian markets.

The Southern California Region includes the counties of Ventura, Los Angeles, Orange, San Bernardino, Riverside, and Imperial. Southern California has three leading manufacturing industries that produce commodities highly demanded by Hong Kong and China: aircraft and parts, search and navigation equipment, and electronic components. Plastics products and women's and misses' outwear are also attractive commodities for Asian markets. More than one-fourth of the regional manufacturing jobs depend on these five industries.

Trade with Hong Kong and China is important for Los Angeles and Long Beach ports, since most trade with China that comes through California is handled by the Los Angeles and Long Beach ports. About one-fourth of the employment related to waterborne trade traffic in these two ports is supported by trade with Hong Kong and China (See Table 2).

San Diego Region. Aircraft and parts, electronic components and accessories, guided missiles, space vehicles and parts, and medical instruments, California's main exporting commodities to Hong Kong, are also produced in this region. More than one-fourth of manufacturing jobs are engaged in these industries.

Table 2

California Port Activity in 1996

	Exports US$ Million	Port % Share	Imports US$ Million	Port % Share	Traffic US$ Million	Port % Share
Port Hueneme						
China	3.00	1.04	0.58	0.87	4.00	0.14
Hong Kong	0.10	0.04	0.00	0.11	0.00	0.00
Total	**3.10**	**1.08**	**0.58**	**0.98**	**4.00**	**0.14**
Los Angeles						
China	870.00	5.50	13,381.00	25.80	14,251.00	21.06
Hong Kong	1,108.00	7.01	1,614.00	3.11	2,722.00	4.02
Total	**1,978.00**	**12.51**	**14,995.00**	**28.91**	**16,973.00**	**25.08**
Long Beach						
China	1,692.00	7.26	13,515.00	23.48	15,207.00	18.81
Hong Kong	2,029.00	8.71	1,993.00	3.46	4,021.00	4.97
Total	**3,721.00**	**15.97**	**15,508.00**	**26.94**	**19,228.00**	**23.78**
Oakland						
China	516.00	4.72	2,158.00	14.69	2,674.00	10.43
Hong Kong	706.00	6.45	347.00	2.37	1,053.00	5.96
Total	**1,222.00**	**11.17**	**2,505.00**	**17.06**	**3,727.00**	**16.39**

Source: Global Trade Information Services. WaterBorne Trade Atlas

CHALLENGES TO INTERNATIONAL TRADE POSED BY THE REVERSION

A high degree of openness has been a major contributor to Asia's high growth economies, allowing a variety of external influences in the development of new technologies and business innovation. These factors have played a key role in the strong economic performance achieved by these economies. Low inflation and macroeconomic stability have been very important for attracting foreign investment and developing financial markets. The fundamental question is whether, after the unification with China, Hong Kong will be able to maintain its autonomy in economic decisions given China's largely planned and highly-regulated economy.

U.S. CONCERNS REGARDING FUTURE DEVELOPMENT IN HONG KONG

Hong Kong's transition to China sovereignty is important to the United States because of the significant economic presence of the United States in Hong Kong, and because adverse developments in Hong Kong are likely to lead to deterioration of U.S.-China relations. The U.S. government has a variety of concerns that relate mostly to international trade and investment. These include:

- the enforcement of contracts
- protection of individual and property rights
- maintenance of a reliable system of commercial dispute resolution, and
- the stability of the political system.

Furthermore, Hong Kong and China have very different policies. American exports confront a range of barriers in China, from high tariffs and intellectual property theft to outright quotas on imported goods set at annual planning sessions by the government. Investment in China is very regulated and their not-fully-convertible currency makes it very difficult to repatriate profits.[2] In Hong Kong, by contrast, economic, investment, and trade policies are very liberal. There are concerns that the integration of both territories may change the character of Hong Kong's economy, adversely affecting American businesses.

Individual Rights. Concerns exist about the possibility that companies and individuals may be subject to arbitrary rule changes, difficult to understand laws, and unenforceable contracts, since:

- There have been recent complaints that this situation is already the case in China.
- Some Hong Kong groups believe that despite the agreements already in place, some concepts may mean different things to the Chinese government, to the British, and to Hong Kong residents.

[2] A not fully convertible currency is a currency that cannot be readily exchanged for other currencies in the world money markets.

- Beijing's decision to dissolve the elected Legislative Council on July 1, 1997, and replace it with an appointed temporary body (a provisional legislature) has created uncertainty. This decision is seen as an interference with Hong Kong's promised autonomy. Many Hong Kong residents think that this decision will allow Beijing to redefine or reduce the legislature's function.
- According to some groups, routine statements from Chinese officials suggest that Basic Law provisions on freedom of speech, of press and publication, of association, of assembly, of procession, of joining unions, of striking and of demonstration may prevail with restrictions, or may not prevail at all. For instance, there are declarations from some Chinese authorities that rumors, lies, or personal attacks on Chinese leaders published by journalists should not be tolerated.

Freedom of Speech and Press. In Hong Kong there is a tradition of free speech and press as practiced in Great Britain. International media organizations operate freely. However, according to poll results published by the University's Social Sciences Research Center, most journalists believe that self-censorship is a problem in Hong Kong. In China, media and general public access to government information is strictly controlled. The Chinese government opposed freedom of information legislation as proposed by the Legislative Council, and instead decided that an administrative code of practice on access to government information should be developed.

Workers Rights. Hong Kong law provides the right of association and the right of workers to establish and join labor organizations (trade unions). A fifth of the workers in Hong Kong belong to a trade union. Work stoppages and strikes are permitted but the Employment Ordinance also permits firms to deduct wages from staff who are absent on account of a labor dispute. In practice, collective bargaining is not widely practiced and unions are not powerful enough to force management to engage in collective bargaining.

There is no minimum wage except for foreign domestic workers. Restrictions on hours of work only apply to women and young people aged 15 through 17. The government is also committed to human rights and welfare of children. Child labor is reported not to be a serious problem. The Department of Labor sets basic occupational safety and health standards. However, there are some complaints that government enforcement and inspection is not strong enough. Hong Kong minors are allowed to work part-time beginning at age 13 and to engage in full-time work at age 15. Employment of females under 18 in establishments subject to liquor regulations is prohibited.

China's laws regarding these issues are different. For instance, China's 1982 Constitution provides for freedom of association, but this right is subject to the interest of the State and the leadership of the Chinese Communist Party. The All-China Federation of Trade Unions, the country's sole officially-recognized workers' organization, is controlled by the Communist Party. Independent trade unions are illegal. In China it is forbidden to hire workers under 16 years of age.

Economic and Political Stability for Investment

Hong Kong needs to continue implementing economic policies that are similar to it's current ones in order to keep its position as a key Asian financial center. An international financial center like Hong Kong needs a currency that is freely convertible, a working legal system to solve disputes, and a financial infrastructure to make it all work.

Under the terms of Sino-British agreements, after the reunification, Hong Kong will retain the status of a free port, and be able to continue its free trade and liberal investment policies. Hong Kong will also be able to continue to formulate its own monetary and financial policies, maintaining its own currency and foreign reserve exchanges. It is expected that Hong Kong will maintain a currency pegged to the U.S. dollar.

China does not have a fully convertible currency. Although The People's Bank of China began to allow the convertibility of the renminbi, the country's currency, for limited commercial trading purposes, it may take five years for China's currency to become fully convertible.

Foreign Investment and Distribution of Traded Goods. Despite the recently improved access to the Chinese market, state control is still exerted in various forms. Foreign companies are not permitted to directly engage in trade in China, other than direct marketing of goods they have manufactured in China. Thus, U.S. exporters need to use a domestic Chinese agent for both importation into China and marketing within the country. Only those companies that are authorized by the central government are permitted to sign import and export trade contracts.

China's government has various barriers to foreign investment. Foreign investment is encouraged in priority sectors such as energy production, communications, and transportation. Although lately there has been greater flexibility in approving investments, some investors are still hindered by the lack of transparency of laws and regulations.

China's economic reforms in the 1980's greatly increased the role of market forces, international competition, and technology in the development process. However, China still needs to establish and maintain a more friendly environment for investors to achieve Hong Kong's investment status.

Trade Issues with the United States

Barriers to Trade. China continues to impose barriers to U.S. exports, despite its stated goal of reforming and liberalizing its trade regime. In addition to prohibitively high tariffs in many sectors, China relies on multiple, overlapping nontariff barriers, administered at the national and provincial levels by various bureaus or ministries, to limit imports. Barriers to trade include import licensing requirements, import quotas, restrictions and controls, standards and certification requirements, and scientifically unjustified sanitary and phytosanitary measures.

In 1992, the United States and China signed a Memorandum of Understanding on Market Access that commits China to dismantle most of these barriers and gradually open its markets to U.S. exports. The actions to be taken by China could be considered sufficient for the consideration of China's membership to the World Trade Organization.

Most-Favored-Nation Treatment. The problem over renewal of China's most-favored nation status by the United States always casts a shadow over the economy of Hong Kong. The United States has applied most-favored-nation (MFN) treatment in trade generally to all its trading partners. In 1951, this status was suspended to all countries in the then Sino-Soviet bloc. MFN status can be restored to any of the suspended countries only by specific law, setting out the conditions and procedures for its restoration. Since 1979, MFN status to China has been renewed every three years. Since 1993, new conditions have been imposed, and MFN status has been renewed annually. After long discussions, China's MFN status was renewed again on May 31, 1996. The denial of MFN status to China would have a detrimental effect on the Hong Kong economy. U.S. exports to and imports from these regions would decrease. Both effects would have negative consequences for the economy and for consumers, who would have to pay significantly higher prices for their imported products. Revoking MFN status would raise average tariffs on Chinese imports from 5 to 45 percent.

Maintenance of Trade Agreements

Hong Kong's reversion to China raises a number of concerns regarding the future status of existing bilateral and multilateral agreements to which the United States, China and Hong Kong are parties.

All treaties to which Hong Kong is a party (including those that Great Britain extended to Hong Kong) will no longer be in effect as of July 1, 1997. At the same time, treaties to which China is a party will apply to Hong Kong. However, parties involved can agree to a different arrangement. Much of current U.S. policy concerning the Hong Kong transition is in the ***Hong Kong Policy Act of 1992*** that authorizes the U.S. government to continue treating Hong Kong as an independent legal entity after its incorporation into China.

One of the key trade issues is whether the United States will be able to maintain its currently close working relations with Hong Kong trade officials on commercial issues, including the exchange of information and cooperation on enforcement. Currently a bilateral investment treaty is being negotiated between the United States and Hong Kong, in consultation with China. This treaty extends the most-favored-nation treatment to investments of the parties, requires that expropriations meet international law standards, prohibits restrictions on investors such as requirements to sell all or a portion of their goods for exports, and consents to use international arbitration for investor-State disputes. Since other countries have already signed investment promotion and protection agreements with Hong Kong, U.S. investors may be placed at a competitive disadvantage relative to other investors if the United States cannot conclude its discussions prior to July 1, 1997.

Membership in WTO. Hong Kong is a member of the World Trade Organization (WTO), while China is not. After the reversion, Hong Kong's membership in the WTO is expected to continue. If the PRC becomes a WTO member, the precise legal relationship of the PRC and Hong Kong Administrative Region will need to be defined.

China's entry into the WTO would require China to revise its position on issues such as market access and trade rules. Other issues such as human rights, threats to Taiwan, prison labor, and proliferation of nuclear weapons and missiles are also important in the discussion. Although China has taken some steps to meet WTO obligations, including lowering tariff rates, eliminating quotas on some imports and moving toward a convertible currency, they have not been enough. Furthermore, some Chinese industry officials favor a slower admission, fearing an open market would hurt domestic industries leaving many people unemployed. Recently China is promising to adopt broad-ranging economic reforms but only at a pace that will allow it to maintain employment levels and protect key industries.

Textile Agreement. The United States allocates different textile quotas to Hong Kong and China. However, the continuation of this policy raises concern because Chinese producers transship their products through third parties in order to avoid the quota limitations. Currently, tight enforcement of rules of origin have been implemented in order to avoid Chinese illegal textile transshipments through Hong Kong after the annexation.

Intellectual Property Rights Protection. A very important issue for the United States, and California in particular, is intellectual property rights protection. After July 1997, Hong Kong is expected to keep an independent intellectual property regime which will have authority over Hong Kong's intellectual property rights policies, laws, and enforcement efforts. Hong Kong will bring these laws into compliance with the Trade Related Aspects of Intellectual Property Rights agreement under the WTO.

The United States remains concerned over:

1) the rising piracy of U.S. software and compact disc music in Hong Kong, and
2) the high level of pirated products produced in China, many of which are produced by Hong Kong-owned firms in China and distributed in Hong Kong.

The fundamental question is the future ability of the Hong Kong government to prevent the introduction of illegally transshipped products from China through Hong Kong and to prevent intellectual property theft by China.

China has made significant progress in recent years in the enactment of laws and regulations to protect intellectual property. However, enforcement of these new measures has been extremely poor. Although not now a member of the GATT/WTO, China has declared its support of the Uruguay Round text on trade-related aspects of intellectual property protection.

Spread of Dangerous Weapons and Technology. Hong Kong, as a British territory, is part of the Wassenaar Agreement, a multilateral accord that regulates transfers of conventional arms and dual-use goods and technologies. China is not a participant in this Agreement. China has not been invited to join Wassenaar because of concerns regarding Chinese weapons exports to Iran and Pakistan and other shortcomings in its export control system.

As a participant of the Wassenaar Agreement, the United States allows Hong Kong to import, license-free, most controlled high technology dual-use items. Dual-use exports are commodities, processes, or technologies created for civilian uses which can also be used to develop or enhance military equipment. Hong Kong has been responsible and cooperative in working with other countries and multilateral groups in trying to prevent the spread of nuclear, chemical, and biological weapons and missile delivery systems. Even more, Hong Kong has helped identify and stop dangerous shipments to the Middle East. Concerns in this area relate to defense relations, intelligence sharing and operations, and proliferation controls, particularly the fundamental question of how to monitor Hong Kong's performance on export controls after the unification with China.

If Hong Kong officials are able to continue an autonomous export control regime after July 1997, the United States will likely continue to give Hong Kong separate export control treatment for advanced technology items. Otherwise, the United States may tighten control on exports to Hong Kong, which could have implications for the high-tech industries. Since California has a relatively higher share of these industries, California firms may be affected if new markets do not absorb the Hong Kong's current demand for these goods.

This issue is also important to Hong Kong for many reasons. For instance, major banks in Hong Kong use the highest level computer technology, a technology that would not be allowed to be exported to China. These computers have to be replaced once every four years. Hong Kong's role as the financial capital of Asia would be reduced if they could not import the computers they need to continue that business.

FUTURE OUTLOOK

It is impossible to determine in advance the consequences of Hong Kong's reversion to China on Hong Kong's economic autonomy. On the one hand, some think that China will not do anything to stall Hong Kong's prosperous economy because it has a significant vested interest there. On the other hand, others are concerned that looming restrictions on political activity could hurt the free flow of information, a crucial part of doing business.

While there is hope that Hong Kong will be autonomous, there is no certainty, since Hong Kong will be part of China and under its political control.

There are good reasons for China to maintain Hong Kong's current position as a trade and investment center.

1) The economies of Hong Kong and China are intertwined and it is in the interest of both sides to maintain the conditions that have brought growth in the region. China has become the principal engine of growth for the Pacific. Hong Kong has a large stake in the Chinese economy, and the Chinese economy has a large stake in Hong Kong. Hong Kong is the largest foreign investor in China, accounting for 60 percent of total foreign direct investment. Furthermore, Hong Kong has been acting as a middleman between Chinese and U.S. firms for trade and investment. Nearly half of China's exports are shipped to Hong Kong to be re-exported. A large share of China's imports are also distributed through Hong Kong. China has invested more than $25 billion in Hong Kong, with Chinese companies and banks assuming control or influence over major strategic industries, such as the local airlines and the power companies. Historically, Hong Kong has also been a conduit for trade between China and Taiwan. However, on January 22, 1997, these countries agreed to end a 48-year ban on direct shipping links, a decision that will have significant implications for Hong Kong.

2) With international competition, the production and research and development assets of the region are of vital importance to the key players in industries ranging from semiconductors to textiles. Regional cooperation may remain strong as growth depends on the ability of these economies to remain tied to the sources of new products and ideas. The development of the Asia-Pacific region relies heavily on intra-regional interaction and cooperation in science and technology. Through a vast array of manufacturing and R&D networks established by firms such as NEC in South China and Hong Kong, and Matsushita and SONY in Southeast Asia, the economies of the region are being linked together as never before. It is in China's interest to recognize.

After July 1997, U.S.-China Relationships will Have More at Stake. Hong Kong, China, and Southeast Asia are the fastest growing economies in the world, and it is to the benefit of the United States to capture a large share of these markets. California trade with these countries is important. In 1996, Hong Kong and China purchased more than five percent of total California exports. U.S. foreign investment in this region is also significant. These markets are growing rapidly and prospects for future demand for California products are excellent. Markets for high value products such as multimedia, aircraft, and other electronic products are just starting. Asian markets are particularly important for processed food and agricultural products. After the unification, the economic significance of the way U.S.-China relationships will be handled is extremely important for California.

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