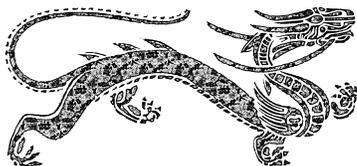


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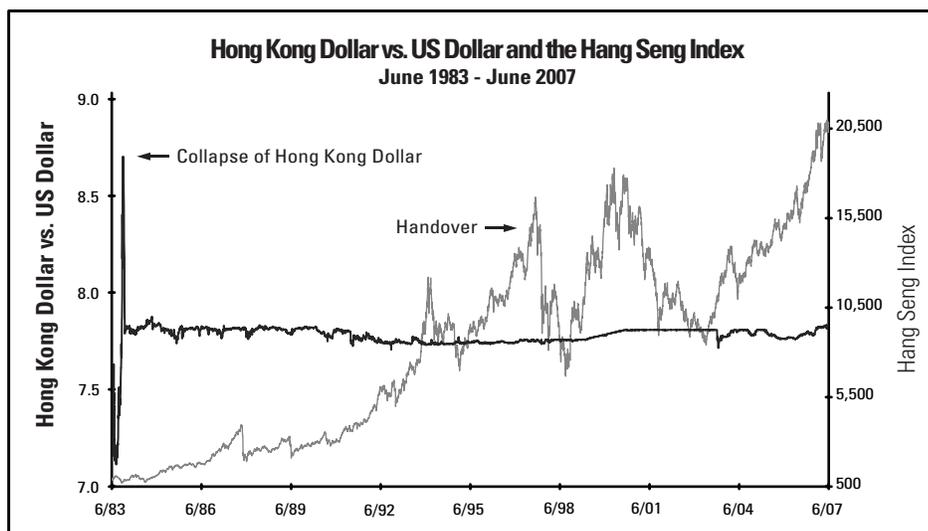


Hong Kong's Handover: A Look Back

as of 6/30/07

One Friday afternoon in early-1983, I left my office in Hong Kong's central district to spend a long weekend with friends in the Pratas Islands. It was a wonderful weekend of sailing and diving, which my wife and I enjoyed enormously. However, on our return late the following Monday, we were astonished to find Hong Kong in the grips of a crisis. Over the course of the weekend, the Hong Kong dollar had collapsed—losing some 15% of its value—and supermarket shelves were being emptied as shoppers rushed to stock up before prices jumped. The dramatic breakdown in negotiations between British Prime Minister Margaret Thatcher and her Chinese counterparts over the future of Hong Kong after 1997 caused this sudden crisis. Until that weekend, the issue of “1997” while widely discussed, had not been taken too seriously as it was commonly assumed China would simply extend the lease. A period of enormous uncertainty and tension ensued in Hong Kong as it was many months before the two sides reached a tentative agreement over the lease extension.

This month marks the tenth anniversary of the official handover of Hong Kong from Great Britain to China on June 30, 1997. As a British colony for 150 years, Hong Kong pre-



Source: Bloomberg

1997 was a shining example of free market economics at work—allowing its small population to enjoy a uniquely high standard of living when compared to the rest of Asia, particularly China. Many thought it highly unlikely that this status would be preserved under Chinese rule. Following the signing of the Sino-British Accord in 1984, the prospects of post-1997 Hong Kong under the agreed “one country, two systems” formula invoked mostly fear and alarm. The

idea that China would allow Hong Kong to remain unchanged for at least 50 years seemed little more than a pipe dream. Many forecasters expected that Hong Kong would rapidly lose the freedoms it had enjoyed under the British and enter a period of long-term decline. The worst predictions included a mass exodus of those with access to foreign passports, a swift end to laissez-faire economic policies, a clamp down on free speech and the free press and general

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economic malaise. Ten years later, these predictions have not only proved false, but Hong Kong is thriving as a key player in China's extraordinary economic rise. So far so good, but is ten years long enough to declare victory? Or is Hong Kong's future still subject to the same uncertainties that were so widely discussed in the pre-handover period?

The last thirty years of Hong Kong's history could be broadly divided into three periods: the years leading up to the 1984 Sino-British Accord; the intervening years between then and 1997; and finally the post-handover period. A look back at some of the key issues faced in each of these periods suggests that a number of key challenges still confront the city-state. That said, the most surprising findings are not the changes that have impacted Hong Kong, but rather those that have taken place on the mainland itself.

When Prime Minister Thatcher visited Hong Kong for the first time in the early 1980s, she intended to negotiate an extension on Britain's lease over the New Territories. She was fresh off her military victory over the Falkland Islands, and apparently totally taken aback by the complete rejection of her proposals by her Chinese counterparts. At the time, Hong Kong was just recovering from a property slump and the news that she had been rebuffed had an immediate and devastating impact on Hong Kong's financial markets and currency. Over the next few weeks, Hong Kong's currency fell 20% and it was only the hastily installed peg to the U.S. dollar that prevented a further collapse. Looking back this was probably the most critical point, and had it been known then as it is today that China seriously considered a military invasion to settle the issue, not even the peg could have saved the currency. In recent interviews, Prime Minister Thatcher has revealed that she always knew she was powerless to do anything to stop such an action, and that her only weapon was "the eyes of the world." Against this background, it is understandable that the final signing of the Sino-British Accord was greeted with huge relief, if much skepticism. These revelations also underscore that the issue of Hong Kong was and is inextricably intertwined with that of Taiwan. All discussion about what might have happened in Hong Kong has potential repercussions for future negotiations with Taiwan, and in that context ten years is no time at all.

The years between the signing of the accord and the handover ceremony in 1997 were marked as much by economic change in China as anything that happened in Hong Kong. The Hong Kong economy grew steadily through the period, but suffered from the world economic cycles and the 1987 financial crisis along with the other Asian Tigers. Meanwhile across the border in China, the experiments with tax free zones, use of free markets to set prices, emergence of joint stock companies and establishment of crude markets in Shenzhen and Shanghai, all served to encourage the thought that China might abide by the terms of the accord after all. During this period some attempts were made in Hong Kong to establish democratic institutions; these efforts were encouraged by the last British Governor and resisted fiercely by China. Hong Kong businessmen who wanted to do business in China and support

political freedoms in Hong Kong found they could not do both. The Tiananmen Square protests in 1989 served as a horrific reminder that politically China was far from free. Even as political reform was quashed, economic reforms continued. While large numbers of Hong Kong's professional classes sought overseas passports and several companies de-listed in Hong Kong in favor of Singapore and other markets, optimism that Hong Kong could survive 1997 was slowly building. A new school of thought emerged, suggesting that some aspects of Hong Kong's economy would benefit from an influx of Chinese property buyers and that Hong Kong had a particularly bright future as a source of much needed foreign exchange. By the summer of 1997, property prices were at all time highs on the anticipation of Chinese buyers flooding the Hong Kong market.

The post-handover period saw Hong Kong almost immediately confronted with the Asian financial crisis. Property prices fell sharply and the Hong Kong economy flattened out but did not collapse. The currency peg defied the worst expectations and held firm. Under pressure, however, the Hong Kong government stepped in to support the stock market; a move they felt was necessary to maintain confidence in the currency, but suggested to many that "laissez-faire" was no longer a guiding principle. The new Chinese appointed governor of Hong Kong, Tung Chee Hwa was considered little more than a puppet and many felt Hong Kong had lost its way. Ironically it took another crisis, SARS, to wake the former colony up. Post-SARS, the people of Hong Kong realized that their future lay in doing business with the rapidly emerging mainland economy. With support from the Chinese government, trade and tourism with China became Hong Kong's most important growth drivers. Today under its new Governor Donald Tsang, Hong Kong is thriving again as the leading financial center for Chinese companies outside of the mainland itself. Tourist arrivals from China are up tenfold since 1997, the stock market value of Chinese companies listed in Hong Kong has soared from virtually nothing to over \$1.5 trillion. While the number of British and American ex-pats living in Hong Kong has fallen, the total expatriate population has grown significantly, and the numbers of Hong Kong citizens living and working in China has soared.

While Hong Kong is thriving today, history suggests many issues could still threaten its long term future. At the time of the handover, China promised that Hong Kong could "one day" enjoy universal suffrage, they just didn't say when. Taiwan's future remains extremely sensitive and "one country, three systems" does not yet appear to be a viable option. The environment and deteriorating air quality threaten to prompt the same population flight as did fears of post-1997 life. While Hong Kong's currency appears stable there is again talk of changing the peg, and the renminbi remains a quasi-fixed currency. Hong Kong citizens leaving for a long weekend today could find any one of these issues unsettling the financial markets on their return, but none seem as threatening as the issue of 1997 did in 1983.

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