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Why China No Longer Needs Hong Kong

The mainland Chinese economy now dwarfs the city's, and rivals are usurping its status as a hub of global finance.

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The national flag of China, left, and the Hong Kong flag this week. The size of China's financial markets now dwarfs that of Hong Kong's.
Vivek Prakash/Agence France-Presse — Getty Images

For many years after regaining control of Hong Kong from Britain in 1997, China mostly respected the territory's institutions. That is no longer the case, as Beijing's heavy hand during the recent protests in the city has made obvious.

So what changed? In 1997, China needed Hong Kong. China had not yet been allowed to join the World Trade Organization, so Chinese exporters had limited access to the global market. Hong Kong was the solution: It served as a channel for entrepôt trade — goods from China could enter the territory's ports and then be sent as exports from Hong Kong to the rest of the world, thus evading the trade restrictions imposed by member nations on nations outside the organization.

When China became part of the trade organization in 2001, entrepôt trade through Hong Kong lost its importance. By some estimates, nearly half of China's trade went through Hong Kong in 1997, today that figure is less than 12 percent.

In terms of total size and wealth, Hong Kong has also shrunk relative to China, which has experienced more than three decades of astoundingly high economic growth. In 1997, Hong Kong's economy was one-fifth the size of China's, and its per capita income was 35 times higher. By 2018, Hong Kong's economy was barely one-thirtieth the size of China's. Hong Kong is still richer, but the gap is narrowing, with its per capita income now five times higher than China's.

In the period right after 1997, China wanted to strengthen Hong Kong's reputation as an open and market-oriented economy governed by the rule of law. This was a large part of its appeal as a major international financial center, a status that benefited the mainland economy.

Hong Kong was also used as a controlled testing ground where China's currency, the renminbi, could find its feet as an international currency. Hong

Kong had the trust of international investors, and the renminbi could trade more freely there than in China, where capital controls restricted the movement of financial capital across China's borders. China's dependence on Hong Kong is a thing of the past. The size of China's financial markets now dwarfs that of Hong Kong's. China's four largest banks have become the four largest in the world in terms of their assets. In 1997, China's stock markets were barely half the size of Hong Kong's stock markets. Today, the capitalization of China's stock markets stands at nearly $8 trillion, among the largest stock markets in the world, and about double that of Hong Kong's.

It is not that Hong Kong's markets have shrunk — the value of new public listings in Hong Kong was higher than any other exchange worldwide last year. Rather, it is simply that China's financial markets, like its economy, have expanded so fast they have left Hong Kong in the dust.

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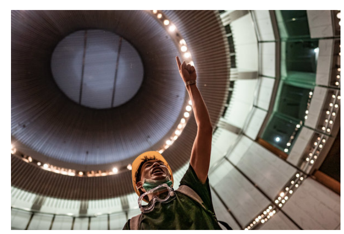

China now has enough clout that investors around the world are willing to overlook deficiencies in its corporate and public governance. The renminbi is on its way to becoming a significant international currency, with Hong Kong just one of many financial centers where trading in the currency is authorized. And China has ambitions of promoting Shanghai as an international financial center, which makes Hong Kong a rival.

In short, China no longer needs Hong Kong the way it once did.

In the aftermath of the global financial crisis and with political upheaval facing the United States and other major democracies, China has come to envision an entirely different purpose for Hong Kong. It is to show that its vision of rule by the Communist Party, with some economic freedoms but restrictions on political and social freedom, might be preferable to the chaos of liberal Western democracies. Beijing also wants to use Hong Kong to showcase the efficacy of China's version of the rule of law, in which the legal system serves the economy by enforcing property and contractual rights but is ultimately subservient to the Communist Party.

The troubles in Hong Kong go directly counter to Beijing's narrative that its citizens are more than willing to give up personal and political freedom so long as the government delivers stable economic growth and maintains law and order. And Beijing's actions there, including a controversial extradition bill, could eventually undermine international investors' confidence in Hong Kong's legal system. But the economic consequences for Beijing are modest, especially relative to the benefits of making a clear political point.

China may briefly loosen its chokehold on Hong Kong. But there is no mistaking Beijing's plans for Hong Kong, which do not include preserving what its people and international investors once cherished — the value placed on free enterprise along with democracy, freedom of expression and the rule of law. The protesters are right to fear what's coming.

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