The U.S. Might Revoke Hong Kong's 'Special Status.' Here's What That Means For Business in the Global Financial Hub

BY **AMY GUNIA / HONG KONG** MAY 29, 2020 2:44 AM EDT

Secretary of State Mike Pompeo announced on Wednesday that Hong Kong was no longer sufficiently autonomous from mainland China — an assessment that could threaten the city's trading relationship with the U.S. and deal a blow to both American and Chinese companies operating there.

The news comes following Beijing's decision late last week to draw up a national security law for Hong Kong. The move came after Hong Kong's Legislative Council failed in its obligations to enact such a law since the former British colony was handed back to China in 1997. Critics say, however, that the Chinese government's bypassing of the local legislature undermines the "high degree" of autonomy promised to Hong Kong when China resumed sovereignty over the territory of 7.4 million.

"No reasonable person can assert today that Hong Kong maintains a high degree of autonomy from China, given facts on the ground," Pompeo said in a statement.

That autonomy matters because Hong Kong's trading privileges with Washington depend on it. It's up to the White House to decide what action it will take following Pompeo's assessment, but options include tariffs, visa restrictions, export controls and freezing the U.S. assets of Hong Kong and Chinese officials deemed to be aiding Beijing in its encroachment on Hong Kong's freedoms.

Officials made clear that the move is not intended to target Hong Kong citizens. The U.S. will try "to ensure the people of Hong Kong are not adversely affected to the best we can," David R. Stilwell, assistant secretary for East Asian and Pacific affairs, said during a media teleconference on May 27.

Businesses, however, are nervous. Almost 300 U.S. companies base their regional headquarters in Hong Kong and more than 1,300 have operations in the city — from 3M to Goldman Sachs to the insurer AIG. There are also an estimated 85,000 U.S. citizens living in Hong Kong.

An American Chamber of Commerce spokesperson spoke last week of a "fear factor developing in the business community." Business confidence was already shaken by the six months of often violent protests sparked last year by a contentious extradition bill, in the wake of which some companies started making plans to shift their operations. Now experts say that Beijing's growing control over Hong Kong, and potential trade restrictions by Washington, could further diminish business confidence and compromise Hong Kong's importance as an international business center.

"Businesses will inevitably change their perceptions of Hong Kong as a gateway to China that is protected by rule of law," says

Benjamin Quinlan, CEO and managing partner of strategy consultancy Quinlan and Associates, who also sits on the board of a fintech association.

"If you remove [Hong Kong's special status], there will be foreign companies that say 'we'll just enter China directly, I've got no one-up going via Hong Kong,' or they'll just exit China completely," he tells TIME. "It doesn't bode well for Hong Kong's position as a global financial hub."

What is Hong Kong's 'special status'?

Although Hong Kong is a part of China, under the terms of the Hong Kong Policy Act of 1992 the U.S. treats Hong Kong as distinct from the mainland when it comes to economic relations, applying a different set of rules from the rest of China on things like export controls, customs and immigration.

The continuance of this special status is predicated on Hong Kong remaining distinct from mainland China. The "one country, two systems," framework, a political formula that has been in place since the 1997 handover, affords the city plenty of leeway to run its own affairs, including an independent judiciary and freedoms of assembly, the press and speech. The enclave has its own currency, Olympics team and seat at the World Trade Organization.

Business groups say that these characteristics are an important driver of the city's commercial success. "It would be a serious mistake on many levels to jeopardize Hong Kong's special status, which is fundamental to its role as an attractive investment destination and international financial hub," the U.S. Chamber of Commerce said in a statement on Tuesday.

The Hong Kong Human Rights and Democracy Act—passed in November 2019 following months of protests in Hong Kong—requires the State Department to complete an annual assessment to determine if Hong Kong remains sufficiently different from China. That assessment is needed to justify Hong Kong's unique treatment under U.S. law.

What happens next?

Scott Kennedy, senior adviser and trustee chair in Chinese business and economics at the Washington D.C.-based Center for Strategic and International Studies (CSIS) tells TIME that while President Trump "has a menu of things he could choose to do" it was "an a la carte menu as opposed to on or off."

According to Kennedy, it's likely that things like export controls on sensitive technologies would be adopted first, with more punitive measures like tariffs coming later on.

In his May 27 teleconference, Stilwell said actions would be "as targeted as possible to change behavior."

Sanctions on Chinese officials or entities could damage the ability of Chinese companies to transact in the city, which in turn impacts China's ability to do international business in U.S. dollars. But the Hong Kong government warned in a May 28 statement that, "any sanctions are a double-edged sword that will not only harm the interests of Hong Kong but also significantly those of the U.S."

Eswar Prasad, a professor of economics and trade policy at Cornell University and the former head of the IMF's China Division tells TIME that the revocation of Hong Kong's special status will have a significant negative impact on trade and financial flows between the U.S. and Hong Kong. In 2018, U.S. foreign direct investment in the territory was $82.5 billion and U.S. goods and services traded with Hong Kong totaled an estimated $66.9 billion. Hong Kong is one of the few jurisdictions to maintain a trade surplus with the U.S., to the tune of $26.4 billion in 2019.

Key to Hong Kong's success is the rule of law, but its longevity is doubted many businesspeople say. "If the Chinese legislature can start doing things like this and overriding Hong Kong legislature, can they start doing similar things on issues other than national security?" asks Kevin Yam, a financial regulatory lawyer based in Hong Kong.

A lawyer at one global law firm tells TIME that she has received inquiries from nervous clients over the last few days who want to move commercial contracts away from Hong Kong law.

"For U.S. businesses and financial institutions operating in Hong Kong this would herald a period of great uncertainty," says Prasad, "especially as they can no longer count on Hong Kong's much-touted rule of law and at least modest independence from China."

Kennedy believes that companies with operations in Hong Kong will likely leave if the situation continues to deteriorate.

"If Hong Kong loses its independent judiciary, freedom of the press, and all those things it has treasured, then Hong Kong is not going to be seen as a safe harbor within China and the region for American companies to base their regional headquarters, have most of their capital and large staff, and base their contracts there," he says.

One Hong Kong hedge fund executive tells TIME that he is "definitely concerned" about the news. His firm started considering alternative office locations in Asia because of events in Hong Kong last year, but hadn't made any meaningful decisions. Depending on how the situation pans out, it may "speed up," the process of getting a contingency plan in place.

Better for business?

Hong Kong officials have attempted to allay the concerns of international investors, saying that national security legislation is needed to ensure there is no repeat of the mass demonstrations that paralyzed Hong Kong for the second half of 2019. The protests plunged Hong Kong into its first recession in a decade. Protests raged in the financial district for several weeks late last year.

During lunchtime on Wednesday, riot police fired pepper balls to dispel a crowd that had gathered to protest the national security law in the Central area, which is home to the headquarters of several international banks and law firms.

"As the implications of China's recent direction on Hong Kong start to sink in, there is a growing possibility that investors will lose confidence in Hong Kong's unique legal construct, of British law operating on Chinese soil," says Kurt Tong, the former U.S. Consul General in the territory, who is now a partner at consultancy the Asia Group. "As that happens, the movement of people and money out of Hong Kong could start to snowball."

Others say that it may take a while to see the consequences the national security law has on business in the city. Some are even guardedly optimistic.

"If the process is purely confined to addressing mass protests and what not," Quinlan says, "then you could argue the opposite point, that businesses will see this as a better place to do business, particularly ones that will be more impacted by protest movements like retail or restaurants."

WRITE TO AMY GUNIA AT AMY.GUNIA@TIME.COM.