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Hong Kong: Inevitably irrelevant to China?

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Abstract

The protests in Hong Kong that took place in 2019 and are still ongoing in 2020 have attracted worldwide attention. This article presents an analysis of the relationship between Hong Kong and Mainland China through a number of different lenses, including past economic relations in financing, trade, capital flow, and renminbi (the Chinese currency) internationalisation, future economic relations against the background of China's growth model transition and global investment environment, and future political relations against the background of the China model under the leadership of President Xi Jinping. This article finds that Hong Kong has in the past mattered to Mainland China, may in the present matter to Mainland China to some extent, but in future may matter less or become irrelevant.

KEYWORDS

China model, foreign direct investment, Hong Kong, Mainland China, portfolio investment, renminbi (RMB) internationalisation, Xi Jinping

JEL CLASSIFICATION

F15; F21; O2; P26; P3; R11

1 | INTRODUCTION

The 2019 Hong Kong protests have attracted attention from a global audience. The 9 June 2019 rally attracted over one million people, which may be the largest ever in Hong Kong's history (Fowler, 2019). One week later, almost two million people, or 30 per cent of Hong Kong's population, came out in protest against the Fugitive Bill (SCMP, 2019). After a series of protests, general strikes and escalations, sieges of the universities, and casualties on both sides, the pro-democracy camp won a landslide victory in the District Council election on 24 November 2019 (Graham-Harrison & Yu, 2019). However, this is not the (happy) end of the story. The tense relationship between Hong Kong and Mainland China continues, and this relationship has entered an unprecedentedly difficult period (Liu, 2019c).

The direct cause of this protest movement is the Fugitive Offenders and Mutual Legal Assistance in Criminal Matters Legislation (Amendment) Bill, 2019, which was first proposed by the Hong Kong government in February 2019. If enacted, the bill would allow the extradition of criminal fugitives who are wanted in territories such as Mainland China with which Hong Kong does not currently have extradition agreements. Pro-democracy advocates are concerned that this would erode the 'one country, two systems'[1] principle that has operated in Hong Kong since it was returned by the United Kingdom to Chinese rule in 1997. The indirect cause of the movement is Hong Kong's recently rising localism in the form of a political movement that focuses on the preservation of Hong Kong's identity and autonomy. The protesters generally object to the growing political encroachment by the Beijing government in Hong Kong's political, economic, and social affairs. Trust in the Beijing government among Hong Kong's citizens has dropped significantly since 2008 (Kwong, 2016; Liu, 2019c).

There has been widespread speculation that the Beijing government may choose to impose a military crackdown on Hong Kong (Carpenter, 2019; *Daily Mail*, 2019). The main consideration that deters military intervention is that China still has many material interests in Hong Kong (*Financial Times*, 2019). Many commentators also argue that Hong Kong still matters a lot to China. For example, Bird (2019) and García-Herrero and Ng (2019) argue that Hong Kong is a goose that lays golden eggs. Since 1997, Mainland Chinese firms have raised US$335bn by floating in Hong Kong. Foreign companies and state investors have long used Hong Kong as a staging post for investing. Besides being economically important,*The Economist* (2019) argues that Hong Kong's economy is disproportionately useful to China because it hosts a body of international law and rules. The *Washington Post* argues that, as a global city and a global financial centre, Hong Kong gives China a kind of valuable soft power (Whalen, 2019). Thus, Hong Kong remains a vital economic asset for China. The Peterson Institute for International Economics argues that since Hong Kong's handover to China in 1997, China has developed massive economic and business interests in this territory (Huang, 2019). Thus, China still needs Hong Kong. But while these arguments are not groundless, they fail to look at the full, big picture. For example, that fact that Hong Kong did and does matter to China does not mean it will matter to China in the future. Furthermore, these arguments do not take into account the future of the Chinese economy and its politics.

By examining the past relationship between Hong Kong and China and making forecasts about its future, this article makes a further contribution to the debate, which will surely benefit global investors and policymakers. Section 2 looks closely at the evolving relationship between Hong Kong and China by examining a series of indicators measuring Hong Kong's contribution to China, and concludes that that contribution is generally shrinking. Section 3 explores the future role of Hong Kong against of the background of China's growth model transition and global investment environment. Section 4 looks at the broad background of the China model under the leadership of President Xi Jinping, and the future role of Hong Kong. Section 5 concludes the article.

2 | THE PAST: THE SHRINKING STATUS OF HONG KONG

This section examines a number of time series economic indicators of Hong Kong's economic contribution to Mainland China, including GDP, financing (equity, bond and loan), cross-border capital flows (foreign direct investment [FDI] and outward direct investment [ODI]), bilateral trade, and renminbi (RMB, the Chinese currency) internationalisation.

2.1 | GDP

Figure 1 shows the evolving relation between Hong Kong and Mainland China in terms of economic output. Before 1981, that is shortly after the reform and opening up policy implemented by Chinese leader Deng Xiaoping in 1978, Hong Kong's economy accounted for as much as 16.6 per cent of China's total economic output. From 1982, this share has been dropping continuously. In 2018, Hong Kong's output accounted only for around 2.7 per cent of China's total output. In fact, the output of Shenzhen, a Chinese city bordering Hong Kong, surpassed that of Hong Kong in 2017 (Liu, 2019c). In terms of economic output, Hong Kong has gradually become less important to Mainland China, if not wholly negligible.

China's rapid economic growth was enhanced by the removal of institutional constraints, factor accumulation, and improvements in resource allocation (Cai, Garnaut, & Song, 2018). China's economic structure has also undergone drastic changes. For example, in 1982 the primary, secondary, and tertiary sectors accounted for 32.8 per cent, 44.6 per cent, and 22.6 per cent of the economy respectively; in 2018 these shares had changed to 7 per cent, 39.7 per cent and 53.3 per cent.[2] At the same time, Hong Kong's economic structure has remained almost unchanged. For example, among the four key industries, the total share of trade and logistics, tourism, real estate, and professional service was 38.1 per cent in 1996, and 37.6 per cent in 2018. The only major difference is in the financial service industry, whose share of the economy increased from 10.4 per cent in 1996 to 19.7 per cent in 2018.[3]

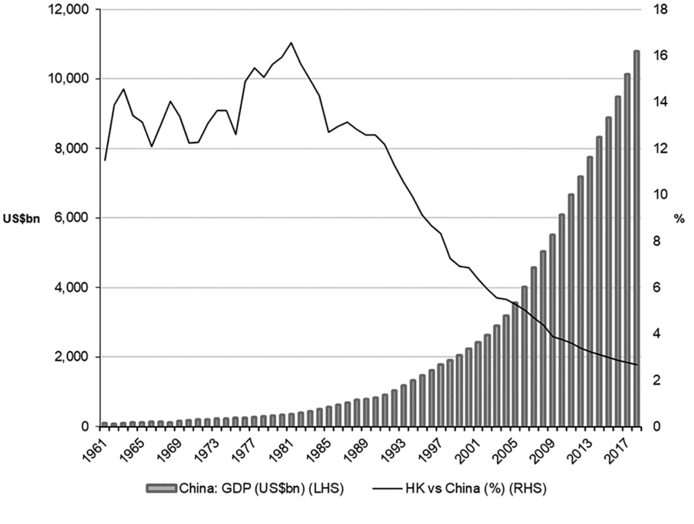

FIGURE 1 Hong Kong's share of China's total output, 1961– 2018 (%).
Source: World Bank Open Data (https://data.worldbank.org/).
Note: GDP is in constant 2010 US$.

TABLE 1 Hong Kong's contribution to Mainland China as a financing centre, 2003–2018

	Equity financing			Bond financing			Loan financing		
	Amount raised by Chinese firms in HK (US$bn)	Amount raised in Mainland China (US$bn)	Share of HK in Mainland China (%)	Amount raised by all firms in HK (US$bn)	Amount raised in Mainland China (US$bn)	Share of HK in Mainland China (%)	Loans to Mainland China from HK (US$bn)	Loan in Mainland China (US$bn)	Share of HK in Mainland China (%)
2003	6.8	8.4	81.3	5.6	251.9	2.2	n/a	n/a	n/a
2004	11.2	8.0	138.7	13.6	338.1	4.0	n/a	n/a	n/a
2005	23.1	0.7	3,415.2	7.9	535.7	1.5	n/a	n/a	n/a
2006	45.1	28.4	158.7	8.3	744.8	1.1	n/a	n/a	n/a
2007	25.2	101.3	24.9	7.5	1,073.3	0.7	n/a	n/a	n/a
2008	33.0	41.7	79.2	5.4	1,052.8	0.5	n/a	n/a	n/a
2009	25.8	66.8	38.6	6.1	1,272.3	0.5	n/a	n/a	n/a
2010	43.9	148.1	29.6	18.5	1,381.6	1.3	n/a	n/a	n/a
2011	18.9	108.7	17.4	19.6	1,212.4	1.6	n/a	n/a	n/a
2012	21.1	70.6	29.8	44.0	1,283.5	3.4	n/a	n/a	n/a
2013	26.1	74.8	34.9	74.3	1,472.8	5.0	337.9	11,809.2	2.9
2014	71.6	144.6	49.5	124.0	1,977.1	6.3	415.8	13,282.4	3.1
2015	63.0	256.0	24.6	96.9	3,686.9	2.6	429.9	14,689.2	2.9

(Continues)

TABLE 1 *(continued)*

	Equity financing			Bond financing			Loan financing		
	Amount raised by Chinese firms in HK (US$bn)	Amount raised in Mainland China (US$bn)	Share of HK in Mainland China (%)	Amount raised by all firms in HK (US$bn)	Amount raised in Mainland China (US$bn)	Share of HK in Mainland China (%)	Loans to Mainland China from HK (US$bn)	Loan in Mainland China (US$bn)	Share of HK in Mainland China (%)
2016	31.3	316.4	9.9	99.9	5,470.4	1.8	459.4	15,571.1	3.0
2017	28.4	255.0	11.1	152.4	6,053.4	2.5	536.5	18,173.3	3.0
2018	27.3	182.9	14.9	134.5	6,622.7	2.0	542.9	19,695.0	2.8
TOTAL	501.7	1,812.3	27.7	818.4	34,429.7	2.4	2,722.4	93,220.2	2.9

Sources: Wind; Hong Kong Exchange (https://www.hkex.com.hk/Global/Exchange/FAQ/Getting-Started/Overview-of-the-listed-market?sc_lang=en); Hong Kong Monetary Authority, People's Bank of China; China Securities Regulatory Commission.

Notes: Equity finance raised by Chinese firms in HK includes both red chip and H-share companies. Red chip companies are enterprises that are incorporated outside Mainland China but controlled by Mainland government entities. H-share companies are companies incorporated in Mainland China and whose listings in Hong Kong are approved by the China Securities Regulatory Commission. Shares in these companies are listed in Hong Kong, subscribed for and traded in Hong Kong dollars or other currencies, and referred to as H shares (H stands for Hong Kong).

Since Hong Kong Exchange does not classify the identities of bond issuers, the bond financing data in Hong Kong include bond issuances from all firms. Bond financing in Mainland China includes all types of bond financing such as government bonds, local government bonds, central bank bills, negotiable certificate of deposits, finance bonds issued by financial institutions, corporate bonds, commercial papers, and so on.

Loan financing to Mainland China includes trade finance.

2.2 | Finance

Hong Kong's role as a financial centre has also contributed to Mainland China but less than the public believes. Table 1 shows Hong Kong's contribution to Mainland China through various avenues such as equity financing, bond financing, and loan financing. As widely discussed by market economists and commentators, Hong Kong is in a strong position in terms of equity financing. For example, during 2003–18 Chinese firms, including both red chip firms and H-shares,[4] have raised as much as US$501.7bn from Hong Kong's stock markets. During the same time period, Chinese firms have raised US$1,812.3bn from domestic stock markets (Shenzhen Stock Exchange and Shanghai Stock Exchange). Hong Kong's contribution is not negligible. However, Table 1 also shows that during 2016–18 its contribution dropped significantly, mainly because of the changing institutional arrangements for Mainland Chinese stock markets. Chinese domestic stock markets were mainly vehicles for equity financing to help state-owned enterprises. Recently, they have focused more on innovation and emerging industries, including the launch of the Chinese Depositary Receipt[5] in April 2018 (Tan, 2018) and the Science and Technology Innovation Board in June 2019 (Liu, 2019a). Accordingly, the functions of resource allocation and financing of Mainland Chinese stock markets have been enhanced (Liu, 2019b).

As for debt financing, Table 1 shows that Hong Kong's contributions to Mainland China have been very marginal, both in individual years and in aggregate. Moreover, even when equity financing, bond financing, and loan financing are combined, its overall contribution remains very marginal (at most, 3.1 per cent[6]), mainly because of the bank-centric financing model (indirect financing) of Chinese corporates.

2.3 | Bilateral trade

Hong Kong's role in China's foreign trade has also declined. Figure 2 shows the share of Hong Kong in China's imports and exports. Since the monthly or even quarterly data are volatile, the Hodrick–Prescott filter technique[7] is used. There are discrepancies in bilateral trade data between Hong Kong and Mainland China sources, but since this study adopts the perspective of Mainland China, the data from China are used.

Figures 2a and 2b show that Hong Kong's position in Mainland China's foreign trade has been generally declining for both imports and exports (see trend data). For example, Figure 2a shows that Hong Kong's share in Mainland China's imports has been continuously falling from 7.2 per cent in Q1, 1995 to 0.4 per cent in Q3, 2019. Figure 2b shows that Hong Kong's share in Mainland China's exports has fallen from 28.5 per cent in Q1, 1995 to 11.0 per cent in Q3, 2019. The temporary rebound in 2012–13 was mainly the result of trade-related arbitrage activities for RMB appreciation.

Since Hong Kong as a city with a population of fewer than seven million cannot consume such a large amount of goods, its role is mainly one of re-exporting goods from Mainland China to the rest of world. Under this arrangement, traders in HK import goods from China and then distribute them to a final destination. Goods for re-export can go through simple processing, such as sorting or packaging, or service activities including marketing or transport (Feenstra & Hanson, 2004). Over the period 1988–1998, 53 per cent of Chinese exports were shipped through Hong Kong in this manner, and the average mark-up on Hong Kong's re-exports of Chinese goods was 24 per cent (Feenstra & Hanson, 2004). In Q1, 2019, 66.7 per cent of Chinese

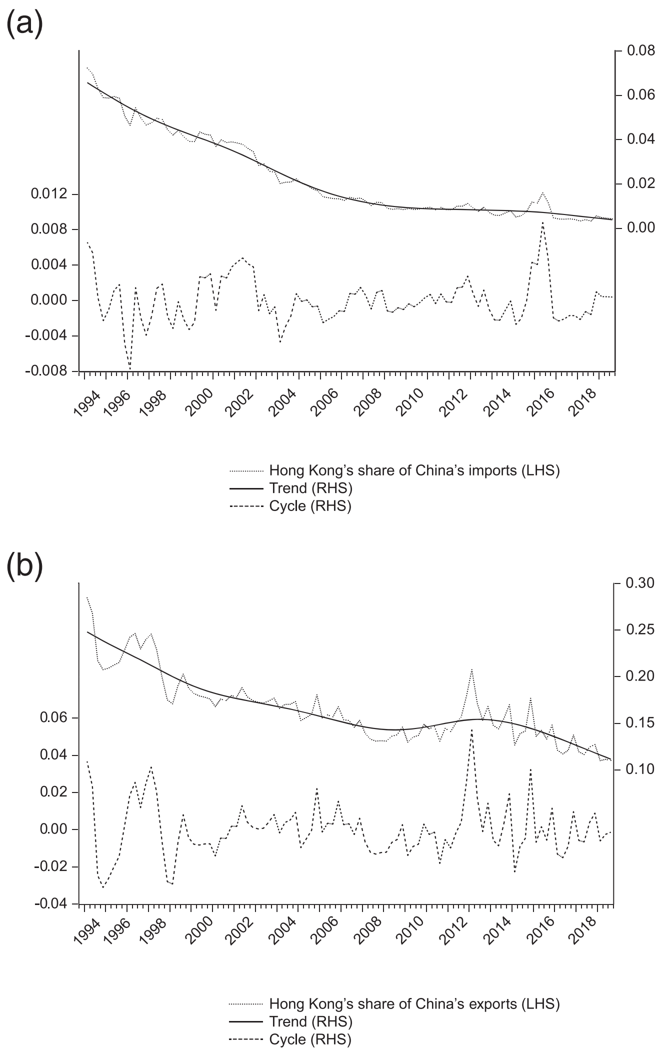

FIGURE 2 (a) Share of Hong Kong in China's imports: Q1, 1995–Q3, 2019. (b) Share of Hong Kong in China's exports: Q1, 1995–Q3, 2019.
Sources: Wind; General Administration of Customs of China.
Note: Hodrick–Prescott filter (lambda = 1600).

exports were for re-export.[8] The inter-agency report from the US Joint Commission on Commerce and Trade estimated the mark-up as 40.7 per cent for 1992 and 1993 (Feenstra, Hai, Woo, & Yao, 1999). The main theory explaining Hong Kong's role as the middleman highlights search and intermediation and information costs, that is, Hong Kong traders have an informational advantage in trade between China and the rest of the world. The declining share of Hong Kong may reflect the fact that Mainland Chinese producers have begun to know their final buyers better as China's reforms and opening-up continue and the Chinese economy has become more integrated into the world economy.

Furthermore, Hong Kong traders are often more than middlemen. Many firms that import goods from China for re-export are engaged in outward processing (Song & Sung, 1991). Before importing goods from China, they may buy raw materials on the world market, process these materials in Hong Kong or elsewhere, and export the unfinished goods to China for further processing. In 1998, outward-processing trade accounted for 48 per cent of Hong Kong exports to China and 83 per cent of Hong Kong imports from China (Feenstra & Hanson, 2004). In Q1, 2019, these shares were 25.7 per cent and 36.9 per cent respectively.[9]

However, the structure of China's foreign trade is changing. As the initial objective of China's processing trade policy was to attract foreign investment to boost exports, a series of preferential policies were implemented. Certain external and internal factors, including rising trade disputes with trade partners, excessive energy and resource consumption, environmental pollution, and imbalances in regional development, had driven the change in the preferential treatment to processing trade (HKTDC, 2007). In September 2006, China's Ministry of Finance, the National Development and Reform Commission, the Ministry of Commerce, and other government agencies jointly issued the Regulations on Adjusting the Tax Refund Rates for Certain Products and Adding the Catalogue of Prohibited Products for Processing Trade. This policy shift, together with the reform of China's exchange rate system and the global financial crisis, has contributed to a decline in the share of China's processing trade in total trade (Li & Jiang, 2018). The share of China's processing trade reached a peak of 56.9 per cent in 1999, and since then has been continuously falling, to 34.1 per cent in 2016.[10] This factor has also contributed to the fall in Hong Kong's share in China's trade.

2.4 | Cross-border capital flows

Hong Kong's role as a major source of foreign direct investment (FDI) and a major destination of outward direct investment (ODI) has been evolving. Figure 3 shows the evolution of Hong Kong's shares in China's FDI and ODI during 1986–2018. Its share in China's FDI is defined as the share of the FDI that has come from Hong Kong to invest in Mainland China over the total FDI Mainland China has attracted. Hong Kong's share in China's ODI is defined as the share of ODI that has come from Mainland China to invest in HK over total ODI that has come from Mainland China to invest overseas.

Figure 3 shows that Hong Kong has been a major source (in fact, it is the number one source) of FDI in Mainland China. Zhang (2005) identified four determinants of the dominant role of Hong Kong in Mainland China's FDI, namely China's export-promotion FDI strategy, its large pool of cheap labour, Hong Kong's specific advantages in export-oriented FDI, and its unique links with China. Zhang argued that FDI from Hong Kong was primarily motivated by low labour costs. Zhang and Yuk (1998) found that most of Hong Kong's manufacturing investments in Mainland China are labour-intensive and export-oriented, and the primary

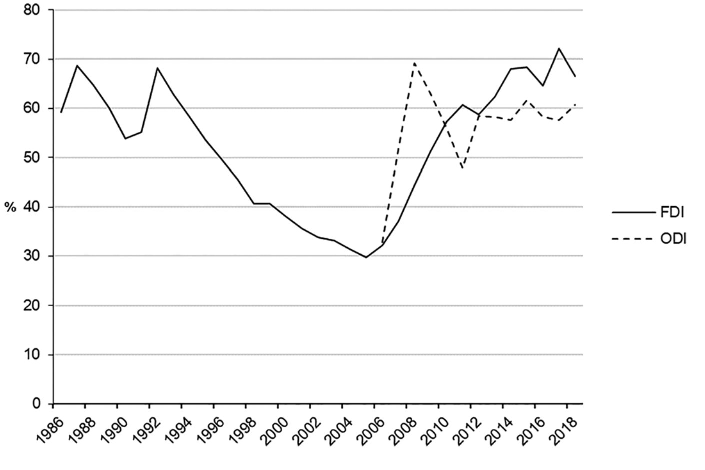

FIGURE 3 Hong Kong's shares in China's foreign direct investment (FDI) and outward direct investment (ODI), 1986–2018. Sources: National Bureau of Statistics; Ministry of Commerce; Wind.

determinant of Hong Kong's manufacturing investment in China is cheap labour and land. As the Chinese population is aging and the demographic dividends are diminishing (Liu, 2018), the share of Hong Kong in China's FDI is falling. The pickup since 2006 is primarily the result of two reasons. First, the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA), a free trade agreement covering trade in goods, trade in services, investment, and economic and technical cooperation, together with other supplements signed in 2003 and afterwards, has helped attract Hong Kong FDI to Mainland China. Second, this pickup may represent significant 'round-tripping' of investment from Mainland China through this offshore location (Lovely & Huang, 2018; Ramasamy & Yeung, 2016).

Figure 3 also shows that Hong Kong has been the major destination of Mainland China's ODI. While it is argued that the middleman services of Hong Kong have attracted Mainland Chinese ODI, from the viewpoint of Mainland China there are also costs such as loss of control, especially as a result of evasion of foreign exchange and trade controls (Sung, 1996). After the August 2015 improvement in China's mechanism for setting the RMB central parity rate against the US dollar (Liu, 2016), there was a mass underground capital flow (Cai, 2017). In 2016 Chinese ODI in Hong Kong reached US$114.2bn,[11] the largest amount ever. As a result, Chinese authorities began to revise their policies towards Chinese ODI from encouragement to restriction. In August 2017, China's National Development and Reform Commission together with the Ministry of Commerce, People's Bank of China, and Ministry of Foreign Affairs issued the Guidelines on Further Guiding and Regulating the Direction of Overseas Investment (State Council, 2017). This document classified three types of ODI: encouraged, restricted, and forbidden. Encouraged investment includes: infrastructure investment in One Belt One Road countries; cooperation on production capacity, high-quality equipment and technical standards; establishing overseas research and development centres; resources including oil and mines; agri-food; and establishing overseas branches of domestic financial institutions. Restricted investment especially includes real estate investment, which has been the main asset class of Chinese ODI in Hong Kong. In short, the Chinese authorities' recent strengthening of regulation of Chinese ODI has had a negative effect on Chinese ODI in Hong Kong.

2.5 | Renminbi internationalisation

Hong Kong has been playing a significant role in the process of RMB internationalisation since 2009. For example, based on SWIFT data, during October 2010–October 2019 the share of Hong Kong in RMB international payments was between 70 and 80 per cent. As of Q3, 2019, Hong Kong's share in offshore RMB deposits is around 61.7 per cent.[12] Hong Kong is undoubtedly the largest offshore RMB centre. However, this position should not be simply taken for granted, for several reasons.

First, the City of London was the first foreign international financial centre approved by the Chinese government to become an offshore RMB centre (Töpfer & Hall, 2018). Besides having a track record of foreign exchange expertise and acting as a 24-hour bridging point for trade between East and West, Töpfer and Hall (2018) argue that whether a place has strong political relations with China also matters a lot. Unlike Hong Kong, foreign RMB hubs such as London are not directly controlled by the Chinese authorities, Eichengreen (2015) also recognises the importance of Beijing's political control of Hong Kong in promoting Hong Kong rather than other global cities as an offshore RMB centre.

Second, studies also show that economic fundamentals matter more than government policies. Based on comprehensive data from the Triennial Central Bank Survey of Foreign Exchange and Over-the-Counter Derivatives Market Activity, Cheung, McCauley, and Shu (2019) find that trading seems to be converging to the geographical pattern of all currencies, and conclude that Hong Kong may well have started to become the major offshore RMB centre, but market forces, not policy, will determine where the RMB is traded.

Third, much evidence shows that the RMB internationalisation has recently stalled. For example, the RMB's share in global payments reached a peak of 2.8 per cent in August 2015, then dropped to between 1.5 and 2.0 per cent during February 2016–October 2019.[13] Zhang and Zhang (2017) attribute this stagnation to cross-border arbitraging activities. Also, in view of the relatively dim prospects for capital account liberalisation, RMB internationalisation may remain on hold at least in the near and medium terms (McDowell, 2019).

In this section, the status of Hong Kong vis-à-vis Mainland China has been examined through various indicators. The conclusion is that Hong Kong's status has been generally declining during recent decades. For example, in terms of economic output, Hong Kong has become relatively irrelevant. Hong Kong has played a significant role in equity financing for Mainland Chinese firms, but this role has been weakened recently. At the same time, Hong Kong's role as a debt financing source has always been insignificant. Bilateral trade, including imports and exports, is also becoming relatively weaker. Although the data show that Hong Kong was, and is still, playing a significant role in capital flow in and out of China, the overall relationship is more complicated. The positive aspect is that Hong Kong has been playing a major role in RMB internationalisation. However, this role cannot be simply taken for granted.

3 | HONG KONG'S FUTURE ROLE: CHINA'S ECONOMIC TRANSITION AND THE GLOBAL INVESTMENT ENVIRONMENT

In this section, two issues, the internal environment and the external environment of the Chinese economy, are discussed. The internal environment is related to the transition of the Chinese economy from the old growth model to the new growth model. The external environment is related to the global economy characterised by the ultra-expansionary monetary policies adopted by major central banks since the 2008 global financial crisis. Their effects on the role of Hong Kong vis-à-vis the Chinese economy are analysed.

3.1 | China's growth model transition

The performance of the Chinese economy has been much discussed among academics, investors, policymakers, and China watchers. The central topic is the continuous decline in the growth of its economic output. Since 2010, the Chinese economy has been continuously decelerating. The annual growth rate in 2018 was 6.6 per cent, the lowest since 1990. The more sensitive quarterly data further confirm this trend. The Chinese economy grew by only 6.0 per cent in Q3, 2019.[14] Certain cyclical factors may be involved, but the primary factor is structural and fundamental (Wei, Xie, & Zhang, 2017).

The key factors that drove China's rapid economic growth during 1978–2013 have fundamentally changed. The first factor is market-oriented institutional reforms, including reforms of township and village enterprises and the state-owned enterprise sector, fiscal reform, opening up to foreign direct investment through establishing special economic zones and special development zones, and entry into the World Trade Organization (Wei et al., 2017). As argued by Liu (2018), institutional reforms, which are assumed to improve total factor productivity, are proceeding very slowly. For example, in November 2013 Chinese leaders held a summit meeting, known as the Third Plenum, to construct a master plan for putting the economy on a sustainable growth path (China.org.cn, 2014). The Decision on Some Major Issues Concerning Comprehensively Deepening Reform provided a road map for change that would span 15 broad areas and 60 specific tasks including economic, financial, social, and environmental policies. While abolishing the one-child-per-couple policy to increase labour supply and further opening up China's domestic market are positive initiatives, overall progress is very slow (Liu, 2018).

The second factor is low wages and a favourable demographic structure, including a favourable dependency ratio and the gender ratio imbalance of the premarital cohort (Wei et al., 2017). During 1980–2011, China's economy was relatively low-wage, with a large workforce with a favourable dependency ratio, and an increasingly unbalanced sex ratio in the premarital cohort. Things changed from 2012, since when China's working-age population has been shrinking. Chinese wages are now higher than in a majority of non-OECD economies. For example, China's wages are almost three times as high as those in India, an economy with a labour force of almost the same size (Liu, 2018; Wei et al., 2017). Thus, China needs a new growth model which relies less on industries that are resource- and pollution-intensive, such as steel and construction, and on labour-intensive and low-quality manufacturing, and instead shifts to an economy driven more by consumption, services, higher value-added manufacturing, and innovation (Song, Cai, & Johnston, 2017). Specifically, China's foreign trade and FDI policies need to be adjusted accordingly.

The main factor that affects foreign trade is the rising cost of manufactured goods. As discussed at the beginning of subsection 3.1, a growth model that is based on low labour costs, and thus the low cost of manufactured goods, is no longer feasible. Together with rising protectionism on international trade (Liu, 2019b), China's international trade (exports) has fallen from double-digit growth to single-digit or even zero growth. Figure 4 shows the growth of China's exports during 1980–2018. The Hodrick–Prescott Filter method is used to obtain the trend date.

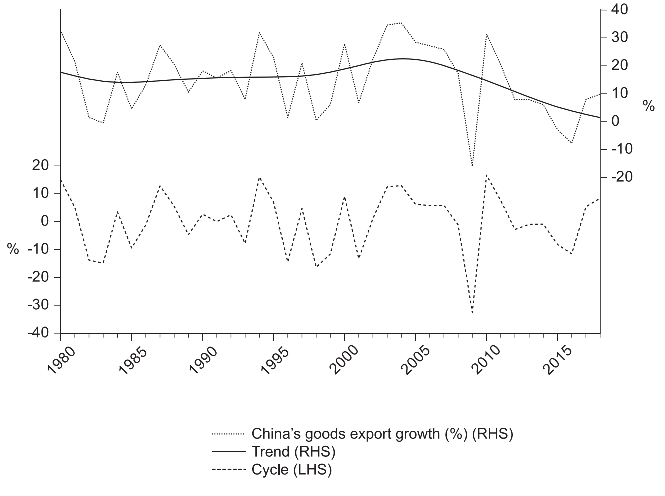

FIGURE 4 China's goods export growth, 1980–2018 (%).
Sources: Wind; General Administration of Customs.
Note: Hodrick–Prescott filter (lambda = 1600).

Furthermore, the trend data also show that the growth of China's goods trade surplus has entered negative territory (not reported, but available upon request).

Regarding the role of Hong Kong, first, as argued by Athukorala (2017), before 2000 China's exports were heavily concentrated on traditional labour-intensive manufactures such as apparel, footwear, toys, and sporting goods; and Hong Kong manufacturing firms played a pivotal role. As China moves away from its old labour-intensive and low-quality manufactured exports, the role of Hong Kong has become less important. Second, as discussed above, Hong Kong manufacturing firms were heavily involved in the processing trade. After more than two decades of rapid growth since the 1990s, China's processing trade is now under stress. As argued by Pei, Yang, and Yao (2015), rising labour costs are driving foreign-funded processing firms to other cheap developing countries or even back to their home countries. China's policies of encouraging indigenous innovation have also helped domestic production of R&D-intensive parts and components, which are increasingly replacing imported intermediates. Lemoine and Unal (2017) also argue that the driving force of foreign trade has become ordinary trade, which is based mainly on local inputs. Thus, the role of Hong Kong is becoming less important.

As for investment, Wei et al. (2017) argue that China's future growth has to come mainly from the growth of labour productivity. The main reason is that China's investment–GDP ratio is already very high, and the returns from continued physical investment will be declining. Based on provincial panel data from 1978–2013, Bai and Zhang (2014) found that the growth in the investment rate and the expansion of government size are major contributors to the recent decline in China's returns to capital since 2008. In fact, the trend data show that China's capital formation's contribution to GDP growth has been continuously declining since 2008 (see Figure 5).

As a result, the Chinese government has revised its policies towards FDI. As is clear from the 2007 Catalogue for the Guidance of Foreign Investment Industries (NDRC & MoC, 2007), labour-extensive manufacturing and export-oriented projects are no longer encouraged. Instead, the emphasis is now on new material production, high-end equipment, modern agriculture, and high-end services such as modern logistics (Chen, 2011). In April 2010, China's State Council (China's cabinet) issued new guidelines on using FDI (State Council, 2010) stipulating that foreign investment in high-end manufacturing, high-tech industries, modern service industries, new energy, and energy-saving and environmental protection industries will be encouraged,

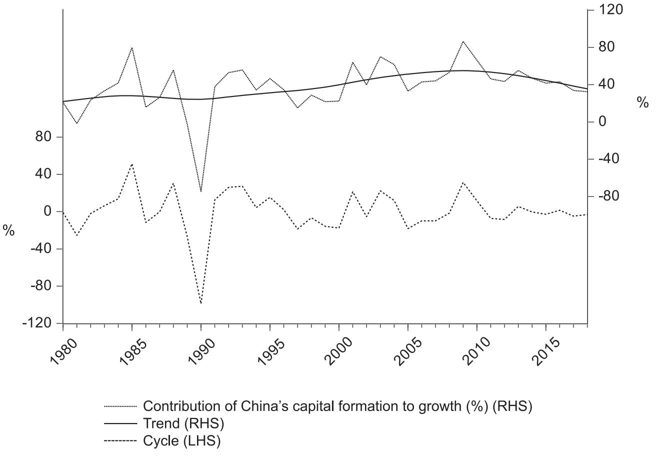

FIGURE 5 The contribution of China's capital formation to GDP growth, 1980–2018 (%).
Sources: Wind; National Bureau of Statistics.
Note: Hodrick–Prescott filter (lambda = 1600).

while high–energy consumption, high pollution, and overcapacity projects will be discouraged (Chen, 2011). This selective FDI policy had been reflected in successive Catalogues for the Guidance of Foreign Investment Industries in 2011, 2015 and 2017. In 2018 and 2019, the lists of industries where foreign investment is discouraged and directory of encouraged foreign investment industries were issued, which also reflect the selective nature of China's FDI policy. China's selective FDI policy is supported by academic studies. For example, Zhang (2015) found that FDI contributes more to export capacity than to export upgrading, especially in labour-intensive and low-tech products; and high-tech FDI from the Western world is more conducive to export upgrading than is low-tech FDI from developing economies. In short, as argued by Zheng (2019), China still needs FDI, but will be more selective in order to facilitate the growth-model transition. Hong Kong's role as a major source of labour-intensive FDI has become less important if not insignificant.

3.2 | Global ultra-low interest rates

As argued by Juselius, Borio, Disyatat, and Drehmann (2016), real interest rates, short-term and long-term alike, have long been on a downward trend and have remained exceptionally low since the global financial crisis. A few central banks have even adopted negative policy rates. For example, since 2014 the European Central Bank, together with five other central banks, including Danmarks Nationalbank, Sveriges Riksbank, the Swiss National Bank, and the Bank of Japan, cut its policy rates to below zero (Bech & Malkhozov, 2016). The reasons for this range from stabilising inflation expectations and supporting growth to relieving currency pressures (Arteta, Kose, Stocker, & Taskin, 2016).

Since the People's Bank of China (China's central bank) completed its interest rate liberalisation process only in October 2015 (Liu, 2017), and then began to focus more on price indicators, it would be more appropriate to compare China's policy rate with others from 2015. China's policy rates and ten-year government bond yields have recently been generally much higher than those in other major economies. From this point of view, Chinese assets are attractive in that they yield a higher rate of return.

Furthermore, Chinese assets traditionally display a low correlation with global markets, thus providing a good diversification effect and enhancing the rate of return. For example, in terms of bond markets, Hu, Lau, Hu, and Ding (2016) conclude that Chinese onshore bonds have historically displayed extremely low correlations with other bonds. Based on data between 31 December 2010 and 31 December 2015, the correlation with bonds in the USA, Europe, and emerging markets was in the range 0–0.2. As for portfolio management, Chinese onshore bonds can potentially help reduce portfolio volatility. Fan, Jiang, and Zhou (2015) also found that investors who held bond portfolios diversified across China and the USA were likely to perform better than they otherwise might. As for equity markets, Shan, Tang, Wang, and Zhang (2018) find that China's stock markets have a low correlation with global markets, and are resistant to international financial contagion. These diversification benefits can be explained by the unique features of China's stock markets including frequent government interventions, disconnection with the real economy, and low levels of foreign ownership.

In short, Chinese assets are attractive to international investors in both providing a higher rate of return and enhancing the rate of return by diversification effects. Since 2017, global index providers have also included Chinese onshore stocks and bonds in their indices. For example, some Chinese onshore bonds have been included in the Bloomberg Barclays Global

Aggregate Index, FTSE Russell World Government Bond Index, and JP Morgan EM Global Diversified. Some Chinese onshore stocks have been included in MSCI Emerging Markets Index and FTSE Russell Global Equity Index. Lien and Sunner (2019) estimate that the total potential inflow of capital would be around US$387bn.

Recently, international investors have significantly increased their exposure in Chinese financial markets. At the same time, the majority of these investments come through Hong Kong. For example, since the launch of Bond Connect[15] programme in July 2017, international investors have increased their investments in Chinese bond markets from almost zero to RMB 2.2trn (equivalent to US$312.5bn) as of November 2019.[16] Since the launch of Shanghai–Hong Kong Stock Connect[17] in April 2014 and Shenzhen–Hong Kong Stock Connect[18] in December 2016, international investors' holdings of Chinese stocks through HK–Connect (consisting of these two channels) has increased from RMB128bn (equivalent to US$18.4bn) in June 2016 to RMB1,255.1bn (equivalent to US$178.5bn) in November 2019.[19] The share of the HK-Connect channel among all international investments in Chinese stock markets has increased from 55.1 per cent to 88.9 per cent during the same period.[20] However, this mainly demonstrates Mainland China's favourable policy towards Hong Kong, whose role in international portfolio investments is significant but not indispensable. Furthermore, given the attractiveness of Chinese assets, Hong Kong mainly plays a facilitating role rather than a decisive one.

At the same time, Mainland China is further opening its domestic markets. For example, equity shareholding restrictions for fund management firms will be lifted from 1 April 2020. The Shanghai–London Stock Connect programme is under the way (Baili, 2019). In January 2017, Fidelity became the first wholly foreign-owned asset manager in China that can issue investment products targeting domestic investors. As of November 2019, 25 wholly foreign-owned asset managers, including Invesco, Blackrock, Bridgewater, and Schroders, have been licensed for such a business (*Securities Times*, 2019). While their investments are still smaller than those from the HK–Connect channel, they show that Hong Kong is not a must-go channel. Hong Kong's role will be less efficient or less necessary in the future. The other scenario is that Chinese assets will become less attractive in the future – in which case Hong Kong's role would be even less necessary.

In summary, Section 3 has set out the role of Hong Kong vis-à-vis China's growth model transition and global investment environment. As China is in the process of transition from emphasis on labour-intensive exports and investment to emphasis on consumption and innovation, Hong Kong's role as a re-exporter and processing trader and a major source of labour-intensive and exported-oriented FDI has become, and will continue to become, less important. While at present Hong Kong plays an important role in helping international portfolio investments in Chinese financial markets, this role is facilitating rather than decisive, and may be less necessary in future.

4 | HONG KONG'S FUTURE ROLE: THE CHINA MODEL AND PRESIDENT XI JINPING

In this section, another perspective – that of the China model and President Xi Jinping – is discussed. Since Hong Kong's handover to China in 1997, Hong Kong has officially fallen under Chinese sovereignty. Hong Kong's future is closely related to the future of China, while the latter is also the topic of heated debated among policymakers and investors worldwide.

First, the China model is strongly characterised by state control and intervention (Liu, forthcoming). The China model is closer to the new authoritarianism than to neoliberalism (Dirlik, 2012). Strong government, stability, and partial economic liberalisation without fundamental democratisation and political liberalisation together form the political basis of the China model (Breslin, 2011).

Second, since President Xi's ascent to power 2013, the China model has developed emerging characteristics that go against the decentralisation trend of the past three decades (He, 2018); for example, the establishment of the National Security Commission; an intensified penetration of society by the state; controlling non-government organisations and citizens through the new social credit system; the creation of a virtual wall of regulations and restrictions that more tightly control the flow of ideas, culture, capital, and scientific exchange; strengthening the Great Firewall; and a significant and accelerated projection of Chinese power in the world (Harnisch, 2018). In particular, the Chinese Communist Party has singled out civil society as one of the most threatening agents of destabilisation (Lam, 2020). President Xi proclaimed that the China model "(is) blazing a new trail for other developing countries to achieve modernization" (Denyer, 2017). Some scholars argue that this mainly reflects the Chinese leadership's desire to secure its position at home and abroad (Weiss, 2019) and that China would rather strive for reforms from within the existing system than fundamentally change it (Rühlig, 2018). Kevin Rudd, the Mandarin-speaking former Prime Minister of Australia, has dismissed these arguments and claimed that China in fact has presented the most direct, unqualified, and expansive statement on China's intentions (Rudd, 2018). In addition, some studies (Economy, 2018; Klimeš & Marinelli, 2018) have found that China (President Xi) has eliminated the dividing line between domestic policy and foreign policy, that China is exporting its political values, and that China's governance model is front and centre in its foreign policy. President Xi is in effect asserting that his ultimate goal is a Chinese-led global order. Consequently, China's revival is destined to challenge Western liberal democratic systems in the long term (Kallio, 2018). While some studies (Garrick & Bennett, 2018; He, 2018) have also noticed that China under the leadership of President Xi has various weak spots, there is little compelling evidence showing that President Xi's revival of China is in danger of being reversed, and, in fact, many of his accomplishments have earned him widespread support (Economy, 2018). The China model under the leadership of President Xi is still gaining strength.

Third, Hong Kong's role vis-à-vis Mainland China will be further overshadowed. As argued by Lo (2018), ideology is arguably the most important factor shaping Mainland China–Hong Kong relations. For example, rights protection and heritage preservation activism and the enormous growth of its civil society are unique facets of Hong Kong, and Hong Kong's civil society has become an offshoring space of Mainland China's civil society (Duara, 2016), whereas in Mainland China, as discussed above, civil society has been regarded as one of the most threatening destabilising agents. Furthermore, the rule of law is widely considered as very important for Hong Kong's free society and dynamic economy (House of Commons Foreign Affairs Committee, 2019), whereas in Mainland China the essence of China's neo-socialism under Xi Jinping is a stratified political order led by the Communist Party of China (Erik, 2018). Hong Kong observes the free market principle of a small state (Shackleton, 2018), while, as discussed above, Mainland China prefers state control and intervention.

This deep ideological conflict has made Mainland China–Hong Kong relations far more turbulent and unstable (Lo, 2018). There are a number of cases regarding Mainland China's political encroachment on Hong Kong's affairs such as the Standing Committee of the Chinese National People's Congress's interpretations of Hong Kong's Basic Law and Beijing's concept of comprehensive jurisdiction, the use and adjudication of the Public Order Ordinance, several ongoing cases and controversies involving the eligibility of candidates for office (including the banning of the Hong Kong National Party under the Societies Ordinance), the potential implementation of new national security laws, the disappearance and abduction of Hong Kong residents by Chinese agents, the legal controversy over the deployment of Chinese officials at a new high-speed rail terminal in Hong Kong, and the adoption of extradition legislation including to Mainland China (House of Commons Foreign Affairs Committee, 2019; USSC, 2019). As Chris Patten, who served as the 28th and last Governor of Hong Kong from 1992 to 1997, claimed, the Mainland Chinese government's crackdown in Hong Kong mirrored President Xi Jinping's approach to governance on the Mainland China (House of Commons Foreign Affairs Committee, 2019).

5 | CONCLUDING REMARKS

The protests in Hong Kong that began in 2019 and are continuing in 2020 have attracted the attention of a global audience. This article has examined the role of Hong Kong vis-à-vis Mainland China through a range of different lenses including past economic relations in financing, trade, capital flows, and RMB internationalisation, future economic relations against of background of China's growth model transition and global investment environment, and future political relations against of the background of the China model under the leadership of President Xi Jinping.

Based on a variety of indicators, this article finds that Hong Kong has mattered to Mainland China, may still matter to Mainland China to some extent, but may not matter as much as now and may even be irrelevant in the future. For example, as the Chinese economy has been growing for four decades, Hong Kong's share in China's economic output has become insignificant. Hong Kong has played a significant role in equity financing for mainland Chinese firms, but this role has been weakened recently. At the same time, Hong Kong's role as a debt financing source has always been insignificant. Bilateral trade between Mainland China and Hong Kong is also becoming relatively weaker. Although data show that Hong Kong has played, and is still playing, a significant role in capital flow in and out of China, the overall relationship is more complicated. As China is in the midst of a growth model transition, Hong Kong's role as a source of FDI and a trading partner will be further weakened. At present, Hong Kong plays an important role in helping international portfolio investment in Chinese financial markets, but this role is facilitating rather than decisive, and may be less necessary in the future.

The positive aspect of the relationship is that Hong Kong has been playing a major role in RMB internationalisation. However, this role should not be simply taken for granted. Against mainstream analyses of RMB internationalisation, McNally and Gruin (2017) argue that China is adopting a unique, illiberal state-managed mode of monetary governance. One important consideration in choosing Hong Kong as a major offshore RMB centre is the emphasis on tight government control in Hong Kong (Töpfer & Hall, 2018). If the political and ideological clash between Mainland China and Hong Kong continues, Hong Kong's role in RMB internationalisation will be weakened. The Chinese authorities recently announced a series of policies to make the neighbouring but well-behaved special administrative region of Macau (Bird, 2019) a financial centre, including for expanding RMB businesses (Lee & Hong, 2019). Macau may not be able to compete with Hong Kong immediately, but Hong Kong's future role is overshadowed.

As this article focuses on the relationship between Hong Kong and Mainland China, it may be premature to draw a strong conclusion on the future of Hong Kong. We need additional analysis, for example of the resources Hong Kong owns. However, if Hong Kong's role vis-à-vis Mainland China is becoming less relevant, it would be difficult to argue that the future of Hong Kong is bright. After the pro-democratic Occupy Central with Love and Peace civil disobedience campaign in 2014, Scobell and Gong (2016) raised the important issue of 'whither Hong Kong?', and concluded that the mostly likely scenario was the *status quo ante*, that is, freedom without democracy. Now, it seems that this forecast needs to substantially updated.

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NOTES

[1] 'One country, two systems' is a constitutional principle that defines Hong Kong governance. Under this principle, Hong Kong retains its own political, legal, and economic systems, including trade relations with foreign countries, all of which are independent from those of Mainland China.

[2] Source: Wind (https://www.wind.com.cn/en/). Wind is the mostly widely used Chinese economic and financial data and information provider. It serves more than 90% of the financial firms in the Chinese market, and 75% of the qualified foreign institutional investors in China.

[3] Sources: Wind; Census and Statistics Department, Government of Hong Kong.

[4] See Table 1 notes for definitions.

[5] A Chinese Depositary Receipt (CDR) is a type of depositary receipt that is traded on a Chinese stock exchange. As China's tech giants have traditionally listed their shares in the United States or Hong Kong, the primary goal of issuing CDRs is to attract high-tech firms to Chinese markets.

[6] 'At most' because some bond financing in Hong Kong did not flow to Mainland China. The share of 3.1% is derived from the sum of 501.7, 818.4, and 2,722.4 over the sum of 1,812.3, 34,429.7, and 93,220.2.

[7] The Hodrick–Prescott filter is a mathematical tool to remove the cyclical component of a time series from raw data. After that, the smoothed-curve time series will be more sensitive to long-term than to short-term fluctuations.

[8] Source: Hong Kong Government, Statistics on trade involving outward processing in the mainland of China, first quarter 2019. https://gia.info.gov.hk/general/201906/11/P2019061100386_311904_1_1560238232041.pdf (accessed 21 January 2020).

[9] Source: as for note 8.

[10] Sources: Wind; General Administration of Customs of China. Note that as of 18 December 2019, China's customers had not yet reported the 2017 and 2018 data. It is expected that these data will show a continuation of the declining trend.

[11] Sources: Wind; Ministry of Commerce.

[12] Since the data on RMB deposits in the United Kingdom and Luxemburg are not available, this figure may be a little overestimated.

[13] Sources: Wind; Society for Worldwide Interbank Financial Telecommunication (SWIFT).

[14] Sources: Wind; National Bureau of Statistics.

[15] Bond Connect (https://www.chinabondconnect.com/en/index.htm) is a mutual market access scheme that allows investors from Mainland China and overseas to trade in each other's bond markets via the related Mainland China and Hong Kong financial infrastructure institutions. Northbound Trading commenced on 3 July 2017, allowing international investors from Hong Kong and other regions to invest in the China interbank bond market through mutual access arrangements in respect of trading, custody, and settlement.

[16] Source: Wind.

[17] Shanghai–Hong Kong Stock Connect is a cross-boundary investment channel that connects Mainland China's Shanghai Stock Exchange and the Hong Kong Stock Exchange. Under the programme, investors in each market are able to trade shares on the other market using their local brokers and clearing houses.

[18] Shenzhen–Hong Kong Stock Connect is a cross-boundary investment channel that connects Mainland China's Shenzhen Stock Exchange and the Hong Kong Stock Exchange. Under the programme, investors in each market are able to trade shares on the other market using their local brokers and clearing houses.

[19] Source: Wind.

[20] Source: Wind.

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