Out of Shanghai's Shadow: Why Hong Kong Is Becoming China's New Financial Services Center

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It's a city-state of seven million people, with skyscrapers wrapped around a picturesque harbor and an in-your-face brand of capitalism. But it wasn't long ago that economic obituaries were being written about Hong Kong: A June 1995 story in *Fortune* magazine was titled, not-too-subtly, "The Death of Hong Kong."

As the reasoning went, Hong Kong would fade in economic dynamism when the British lease expired and the island reverted to Communist control in June 1997. Under an agreement between Margaret Thatcher's government and China, Beijing vowed to give Hong Kong substantial freedoms, except in foreign and defense affairs, until 2047 -- 50 years after the handover. Observers doubted the hands-off promise, fearing that Hong Kong would become "a captive colony of Beijing ... just another mainland city, governed by corruption and political connections rather than the even-handed rule of law," as the*Fortune* piece stated.

At the same time, Beijing's patronage shifted to Shanghai, the gateway to China's interior. According to John Zhang, professor of marketing at Wharton, Shanghai had been the preeminent financial and commercial center in China in the 1920s and 1930s before the Communists came to power, and the city aspired to return to the role. "China had every intention of building up Shanghai as the financial center for all of Asia," he says.

Yet reports of Hong Kong's death were greatly exaggerated. In a resurgence noted recently by *Time's* Asia edition and others, Hong Kong has emerged as the financial intermediary through which foreign investors seek to invest tens of billions of dollars into mainland China. Meanwhile, Shanghai's star has started to fade. What happened? According to Wharton faculty and other experts, while Hong Kong was crafting a strategy to position the city as both a legal and financial services center for China, Shanghai was weighed down by corruption and a largely state-run financial services sector.

The Favored Child

As China entered the 1990s, Shanghai was largely untouched by modern ideas of capitalism and political freedoms, thereby making it a more amenable place than Hong Kong for national leaders and economic growth policies. Shanghai also had a powerful political clique pulling strings with Communist bureaucrats. Massive public works projects were started, including a shipping port to rival Hong Kong's. An international crowd gathered in this most Western of mainland Chinese cities, while foreign money in factories, real estate and tech centers flowed in. As one major U.S. newsweekly noted, "Shanghai was the favored child.... Hong Kong was in the shadows."

"[Shanghai] was the place where capital was to be raised in China," says Marshall W. Meyer, professor of management at Wharton. "In the mid-1990s, there was an assumption that Shanghai would absorb the Hong Kong stock exchange.... Shanghai was allowed to develop its own self-contained economy, like Singapore. Tax policies favorable to Shanghai were developed, and Shanghai boomed."

In response, Hong Kong officials worked to bolster the city's position by emphasizing Hong Kong's rule of law and its British-based court system, anti-corruption measures and U.S.-like securities laws. Officials like Justice Secretary Wong Lan Lung lobbied to make Hong Kong the place to resolve business disputes on both the mainland and in the city itself, an effort that has produced some results.

Ingratiating itself in Beijing, Hong Kong made an all-out effort to influence Communist leaders so that its needs weren't neglected. And where laws permitted, Hong Kong attempted to integrate itself with mainland China. For instance, Hong Kong officials say they allow thousands of pregnant mainland Chinese women to enter Hong Kong each year to give birth in the city's well-run hospitals. Mainland Chinese banks have expanded in Hong Kong, and both Hong Kong and Chinese currencies are accepted in Hong Kong businesses. Meanwhile, China has scheduled polo events for the 2008 Beijing Olympics in Hong Kong.

Private groups, such as the Better Hong Kong Foundation and the Vision 2047 Foundation, were organized by businesspeople, bankers, asset managers, real estate tycoons and local leaders to promote Hong Kong and address negative perceptions in the West. "The fear was that Hong Kong would be marginalized. At this stage, I can [guarantee] that Hong Kong will not be marginalized," says Vision 2047 member David Dodwell, chief executive of Strategic Access, a Hong Kong consulting company, and co-author of the book *The Hong Kong Advantage*. Stephen Brown, another Vision 2047 member, in a breakfast meeting with foreign journalists, added: "Shanghai's star is not shining as brightly as it was a few years ago."

Indeed, billions of dollars in foreign investment that might have gone directly to China are now being funneled through Hong Kong, in part because of the Closer Economic Partnership Arrangement, or CEPA, a free trade agreement signed in 2003 between Hong Kong and the mainland. English is widely spoken in Hong Kong, so doing business there is easier for Western companies than in China. In addition, Chinese corporate executives are now seeking to tap robust international capital markets in Hong Kong instead of Shanghai's weaker capital markets.

One example: In mid-October, China's largest bank, the Industrial and Commercial Bank of China, raised $19 billion in the world's largest initial public offering, dividing the offering between Hong Kong and Shanghai. The share that went to Hong Kong: $13.9 billion. The share that went to Shanghai: $5.1 billion. Other large mainland China banks that have listed on the Hong Kong exchange include the Bank of China and the China Construction Bank. They are among dozens of mainland Chinese companies -- called "Red Chips" -- listed on the Hong Kong exchange, which has internationally recognized regulations.

A Window to the World

What caused the reversal of fortunes? Shanghai wasn't ready for the big time, say experts. Its financial services companies -- typically state-run -- and stock brokerages were unsophisticated. Shanghai stock brokerages went bankrupt after promising returns on stocks that tanked. Big-money investors weren't comfortable with weak accounting rules and Chinese market regulation. Chinese laws, meanwhile, restrict the granting of stock options to executives and directors. This has partly encouraged Chinese companies to float stock in Hong Kong through Hong Kong-registered holding companies.

"Most of the listed companies are state-owned. If you are a state-owned company listed in Shanghai you can't give your executives or directors [stock] options," Meyer says. "The Shanghai stock market has been on a long downhill slope for some time ... it also almost looks as if China has outsourced its capital markets to Hong Kong." He notes that the amount of capital raised on the Hong Kong stock exchange in the first half of 2006 -- fueled by Chinese company listings -- was greater than the amount raised in New York.

Shanghai faces other problems as well. A political backlash in the form of an investigation into local corruption has snared local political bosses. In September, the central government fired Shanghai Party Secretary Chen Liangyu for his alleged involvement in the mismanagement of the city's Social Security fund. Many others are being investigated. It was a stunning political move by President Hu Jintao, who is not from Shanghai and is consolidating national power. "No matter who, no matter how high their post, those who violate party discipline and state laws will receive serious investigation and severe punishment," the state-controlled news agency Xinhua quoted the Community Party Central Committee as saying.

The investigations "already show that Shanghai will not receive the favorable treatment it has in the past," Meyer notes, adding that Beijing wants to prevent endemic corruption. The government has proposed moving local officials around the country to prevent them from building individual political networks.

Yet according to Zhang, Shanghai still has a big part to play in China's economy. Multinational companies have invested billions in factories and research centers there. Some investment is export-oriented and some is focused on developing local products for the Chinese market. But Beijing also has learned in the last decade that "Hong Kong is a window to the rest of the world.... There is an advantage to keeping Hong Kong prosperous and not overshadowing it." Hong Kong has a deep talent pool of lawyers, accountants, traders, analysts and economists that can't be easily replicated in Shanghai, he adds.

Mike Rowse, Hong Kong's director general of investment promotion, can barely contain his glee over the Hong Kong bounce. "We found a new lease on life," he says, noting that last year $35.9 billion in foreign direct investment came into Hong Kong, making it one of the world's largest recipients of FDI. Hong Kong doesn't track exactly where all this money goes, but it's believed that a healthy portion is eventually funneled into mainland China, with Hong Kong businesses acting as intermediaries. According to government statistics, Hong Kong entities are the largest external investors in mainland China, accounting for 43%, or $245 billion, of cumulative foreign direct investment.

Hong Kong's economy grew at about 8% last year -- not bad for a mature economy that lost nearly all its manufacturing base over the last 15 years as businesses sought dirt-cheap factory labor on the Chinese mainland. "We don't need the manufacturing," Rowse says. "We do manufacturing where it makes sense to do it.... The manufacturing is never coming back. I have to be careful where I say this in Hong Kong because there are some who still think it will. But it's not." As for Shanghai, he says China is a big country and there is room for both cities to succeed. At the same time, he adds, "people are getting a bit more realistic about what you can do in Shanghai."

With about 90% of its economic output in services, Hong Kong has other issues to deal with. One of its biggest current problems didn't even exist five years ago -- pollution. Favorable breezes act like "down" escalators transporting the smoke of about 200,000 factories in the Pearl River Delta into Hong Kong. American executives complain that they have trouble recruiting and keeping talented managers there because of the smog and air pollution. The 2,000-member American Chamber of Commerce in Hong Kong says U.S. companies have invested $30 billion in Hong Kong, but families don't want to put their kids through a childhood of toxic air.

Todd Hodgson, a vice president with Time Warner, recently recounted to a *Wall Street Journal* reporter how he relocated his family to Australia from Hong Kong in August. He said his two young children, ages three and six, were constantly in the doctor's office in Hong Kong for asthma and lung ailments. "The money and perks just weren't enough to keep us there anymore," Hodgson said. "You can drink bottled water. But with the air -- you have to breathe it."

Environmental officials in Hong Kong have begun working more closely with mainland Chinese authorities and are posting pollution data on public access web sites. They have also sharply criticized Exxon Mobil for failing to install equipment to clean the smoke from dirty coal-burning electric units that supply Hong Kong with electricity.

"This is part of economic development," Rowse says. "Forty years ago, there were oxygen tanks on the streets in Tokyo. They cleaned it up." Hong Kong can't point its finger at China for air pollution "because much of it is coming from Hong Kong-owned factories. We're not innocent here." As for the threat of pollution to the city's growth, "Individual executives are very critical of the air, but the companies still know they have to be in Hong Kong to earn a profit."