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Hong Kong-U.S. Economic Relations

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Summary

Hong Kong is described by many observers as having the world's freest economy due to its low tax, free trade, and strong rule of law policies. Hong Kong is an important U.S. trading partner and serves as a gateway for many U.S. companies doing business in China. As such, the continued economic autonomy of Hong Kong is of concern to Congress, as are a variety of trade issues such as the effectiveness of Hong Kong's export control regime on dual-use technologies, and protection of U.S. intellectual property rights. China. This report will be updated as events warrant.

Hong Kong is often characterized as the "world's freest economy" due to its strong rule of law, low tax and tariff rates, and minimal government interference in the economy.[1] Once a colony of Great Britain, Hong Kong was returned to Chinese sovereignty in July 1997 under an agreement that made it a "Special Administrative Region" (SAR) of China, a status that basically guarantees Hong Kong's economic and political autonomy for 50 years. Most observers contend that, to date, China has generally refrained from interfering in Hong Kong's economic affairs.[2]

Hong Kong's Economy

With a population of 6.8 million, Hong Kong is one of the world's most vibrant economies and a major center for international banking and foreign trade. It is utilized by many foreign companies as a gateway to markets in mainland China. With a per capita GDP of $27,700 on a purchasing power parity basis in 2003, Hong Kong maintains the second highest standard of living in Asia (after Japan); it is higher than that of many West European nations, including Germany and the United Kingdom. Hong Kong is a member of a variety of multilateral economic organizations, such as the World Trade Organization (WTO) and the Asia Pacific Economic Cooperation (APEC) forum.

[1] See the Heritage Foundation *2003 Index of Economic Freedom*, available at [http://www.heritage.org/index].

[2] However, some analysts contend that, in some instances, China has attempted to interfere with certain aspects of Hong Kong's political and judicial systems.

Hong Kong's economy is heavily dependent on trade. In 2003, Hong Kong's exports and imports were $223 billion and $232 billion, respectively. A large share of Hong Kong's trade consists of entrepot and processing trade, much of it involving China.[3] About 30% of China's trade passes through Hong Kong. Taiwan, which does not maintain direct commercial links with China, ships most of its exports to, and imports from, China via Hong Kong. A large share of China's exports also pass through Hong Kong before being re-exported to other destinations. Some of this trade consists of products made by Hong Kong firms in the Mainland, which are sent to Hong Kong for further processing before being re-exported elsewhere. Hong Kong has transferred a large share of its manufacturing base to the Mainland. In the Pearl River Delta region (Guangdong Province, China), 50,000 Hong Kong firms employ about 6 million Chinese workers, 20 times the size of Hong Kong's manufacturing workforce. As a result, the importance of manufacturing to Hong Kong's economy has diminished in recent years, while that of services (especially those relating to trade, such as banking and financial services) has increased sharply. In 2003, services exports and imports totaled $45 billion and $24 billion, respectively.[4]

Recent Economic Challenges

Hong Kong has enjoyed relatively healthy growth over the past several years. However, in 1997 Hong Kong's economy was hit by the Asian financial crisis. Beginning in July 1997, speculative pressures on the Hong Kong dollar (which has been pegged to the U.S. dollar since 1983) caused the Hong Kong Monetary Authority (HKMA) to spend $1 billion to prop up the currency. These pressures continued, leading the HKMA in October 1997 to raise interest rates (to stop capital flight), which subsequently led to a nearly one-quarter drop in the Hong Kong stock market (the Hang Seng Index) over a four-day period. In late August 1998, the Hong Kong government intervened in the stock market's decline by spending $15 billion to purchase shares from 33 blue-chip companies that make up the Hang Seng Index, which helped raise the value of the shares by 24%. Several analysts criticized the government's intervention, arguing that it violated Hong Kong's free market principles by increasing the government's role over the economy. The Hong Kong government maintained that its intervention was a one-time event, intended to halt speculation and stabilize the stock market.[5] The effects of the Asian economic crisis on Hong Kong were significant. The economy fell into a major recession in 1998: real GDP fell by 5.0%, the unemployment rate rose from 2.2% to 4.7%, and exports and imports declined sharply (see **Table 1**).

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[3] In 2003, 93% of Hong Kong's exports were re-exports, i.e., products that were imported into Hong Kong and re-shipped elsewhere.

[4] According the Hong Kong Trade Development Council, Hong Kong is currently the world's 10^{th} largest trading economy and the 10^{th} largest exporter of services.

[5] In October 1999, the Hong Kong government began to divest itself of the shares it had purchased in 1998 during the stock market crisis.

Table 1. Selected Economic Data for Hong Kong: 1997-2003

	1997	1998	1999	2000	2001	2002	2003
Annual Real GDP Growth (%)	5.1	-5.0	3.4	10.2	0.6	2.0	3.3
Unemployment rate (%)	2.2	4.7	6.2	4.9	5.1	7.3	7.9
Nominal GDP ($billions)	174	165	161	165	164	162	158
Merchandise exports ($billions)	191	173	173	202	190	200	223
Merchandise imports ($billions)	209	183	179	213	201	208	232

Sources: Hong Kong Trade Development Council, Hong Kong Census and Statistics Department, and Economist Intelligence Unit.

Hong Kong's economy showed some signs of recovery in 1999 — real GDP grew by 3.2%. However, the unemployment rate grew to 6.2% and trade flows were relatively unchanged. In 2000, real GDP grew by 10.2%, unemployment fell to 4.9%, and exports and imports rose sharply. However, Hong Kong's economy barely grew in 2001 (up 0.6%), due largely to economic slowdowns in the United States and other major trading partners. The September 11, 2001 terrorist attacks against the United States led to a further weakening of Hong Kong's economy, particularly its export and tourist sectors. While Hong Kong's economy recovered somewhat in 2002, growing by 2.0%, unemployment rose to 7.3. Hong Kong's economy also suffered from weak consumer demand and deflation (caused in part by falling property values).

Hong Kong' economy was further weakened by the outbreak and spread of a new and deadly virus called Severe Acute Respiratory Syndrome (SARS) in 2003. According to the World Health Organization, 1,755 people in Hong Kong were infected with SARS and 300 people died , making Hong Kong one of the hardest hit areas from SARS. The virus drastically reduced tourism and other service industries in Hong Kong during the second quarter of 2003. By the end of June 2003, the unemployment rate rose to a record high 8.7%. The SARS outbreak was eventually brought under control in Hong Kong, and several sectors of the economy showed improvement in the later half of 2003. GDP grew by 3.3% for the full year. Unemployment averaged 7.9% in 2003; however, it fell to 7.3% during the last three months of 2003.

Hong Kong-U.S. Economic Ties

The United States is one of Hong Kong's most important economic partners. In 2003, the United States was Hong Kong's largest market for domestic exports (i.e., products made in Hong Kong) and its fourth largest supplier of imports. There are over 1,000 U.S. businesses represented in Hong Kong, including over 400 regional operations; over 50,000 U.S. citizens reside in Hong Kong. Cumulative U.S. foreign direct investment (FDI) in Hong Kong at the end of 2002 was $35.8 billion.[6] Many U.S. firms and investors seeking to do business in China have used Hong Kong as a base for their

[6] The American Chamber of Commerce in Hong Kong argues that this figure significantly understates the actual level of U.S. FDI in Hong Kong because it reflects only FDI reported by U.S. parent companies of subsidiary corporations in Hong Kong but not individual U.S. investors.

operations, frequently relying on Hong Kong partners to obtain the "guanxi" (connections) that are often needed to gain access to China's markets.

In 2003, Hong Kong was the 13th largest purchaser of U.S. exports ($13.5 billion) and the 27th largest supplier of U.S. imports ($8.9 billion). The top three U.S. exports to Hong Kong in 2003 were electrical and electronic machinery and parts (mainly electronic integrated circuits, micro-assemblies, and semiconductors), non-electrical machinery (such as computers and computer parts), and miscellaneous manufactured items (mainly diamonds and jewelry). The top three U.S. imports from Hong Kong were apparel and clothing, miscellaneous manufactured commodities, and electrical and electronic machinery (see **Table 2**).

Table 2. Major U.S.-Hong Kong Trade Commodities: 1999-2003
($ in billions)

Year	1999	2000	2001	2002	2003
Total U.S. Exports to Hong Kong	**12.6**	**14.6**	**14.1**	**12.6**	**12.5**
Major U.S. Exports to Hong Kong					
Electrical and electronic machinery, equipment and supplies	3.3	3.9	3.2	3.3	3.8
Non-electrical machinery (e.g., computers)	1.6	2.0	2.0	1.4	1.3
Miscellaneous manufactured articles (mainly jewelry)	0.7	0.7	0.8	0.8	0.8
Total U.S. Imports From Hong Kong	**10.5**	**11.4**	**9.6**	**9.3**	**8.9**
Major U.S. Imports From Hong Kong					
Apparel and clothing products	4.3	4.6	4.3	4.0	3.8
Miscellaneous manufactured commodities	1.4	1.6	1.4	1.5	1.4
Electrical and electronic machinery, equipment, and supplies	1.8	1.8	1.1	0.9	0.6

Source: U.S. Commerce Department.

The United States continues to treat Hong Kong as a separate economic territory for such purposes as trade data, export controls, and textile quotas. U.S. officials continue to work with Hong Kong officials to ensure that Hong Kong is not used by China to illegally circumvent U.S. controls on exports of dual-use and other high technology products and U.S. textile quotas, as well as to combat violations of U.S. intellectual property rights (IPR) in Hong Kong.[7]

Export Controls. The United States seeks to control exports of dual-use technologies for a variety of national security and foreign policy purposes through a complex regulatory system of export license requirements. Despite the reversion of Hong

[7] U.S. and Hong Kong officials also cooperate on a variety of other matters, such as terrorism, alien smuggling, money-laundering, counterfeiting, organized crime, and drug trafficking.

Kong to Chinese sovereignty, the United States continues to treat Hong Kong separately from the Mainland for export control purposes (i.e., controls of U.S. exports of dual-use items to Hong Kong are far less restrictive than those to China). Some Members of Congress have raised concern that China may be using Hong Kong to acquire dual-use items that cannot be obtained directly from the United States, and have called for tighter controls on U.S. exports to Hong Kong.

The United States-Hong Kong Policy Act of 1992 (P.L. 102-383) requires the U.S. State Department to report periodically to Congress on conditions in Hong Kong and its relations with the United States, including cooperation in the area of export controls. In its most recent report (April 2004), the State Department stated that "Hong Kong maintains an effective, highly autonomous, and transparent export control regime that the U.S. government has encouraged others to emulate." However, the report stated that the growing economic integration between China and Hong Kong has presented new challenges to ensure effective compliance with export control regimes, and noted that over the past two years, inspections have uncovered an increase in instances of illegal re-exports of U.S. dual-use technology to China. Hong Kong and U.S. officials have agreed to boost cooperation on the sharing of licensing and enforcement information and to education the Hong Kong public of export control laws.[8]

IPR Protection. Over the past few years, the United States has pressed Hong Kong to improve its IPR protection regime. From April 1997 to February 1999, Hong Kong was designated by U.S. Trade Representative (USTR) under *Special 301*, (a provision of U.S. trade law dealing with countries that violate U.S. IPR) as *a watch list country* due to the widespread distribution and retail sale in Hong Kong of pirated compact discs.[9] Hong Kong was removed from the Special 301 *watch list* after the USTR determined that Hong Kong had made significant improvements to its legal regime and enforcement efforts. The 2001 and 2002 Special 301 reports listed Hong Kong as one of several trading partners in which progress in protection of IPR had been made. The USTR's 2003 IPR report praised the Hong Kong government for requiring government agencies to use only legitimate software and for its commitment to halt optical media piracy. The 2003 State Department report stated that Hong Kong had "shut down virtually all large-scale illicit manufacturing lines," but noted deficiencies in two areas: commercial end-use piracy and patent projection for pharmaceuticals.[10]

Hong Kong's Economic Future

Several international economic forecasting organizations contend that the long-term prospects for Hong Kong's economic future remain relatively positive, provided that it continues to employ free trade, market-oriented policies, and maintains its autonomy from

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[8] U.S. Department of State. *United States Hong Kong Policy Act Report*, April 1, 2004, p.7.

[9] Under the Special 301 provisions, the USTR annually issues a three-tier list of countries judged to have inadequate regimes for IPR protection or that deny market access: *priority foreign countries* (considered the worst violators of U.S. IPR and are subject to possible U.S. trade sanctions; *priority watch list countries* (considered to have serious deficiencies in their IPR regime, but do yet warrant trade sanctions); and *watch list countries* (identified because they maintain IPR practices of particular concern, but do not yet warrant higher level designations).

[10] Ibid, p. 6.

mainland China.[11] The *Economist Intelligence Unit* projects that Hong Kong's economy will grow by 6.5% in 2004 and 4.6% in 2005, while *Global Insight* projects real GDP growth at 4.9% and 5.1%.[12]

China's accession to the WTO (which occurred in December 2001) poses both opportunities and challenges to Hong Kong's economy. On the one hand, the removal of trade and investment barriers by China will likely significantly boost Hong Kong trade with, and investment in, the Mainland. Hong Kong is already by far the largest investor in China (and China is the largest investor in Hong Kong), and hence is likely to be in the best position to take advantage of a more open Chinese market. In addition, China's WTO accession is expected to sharply increase its trade flows, and much of that increased trade will likely take place via Hong Kong.[13] On the other hand, a more open Chinese market could diminish Hong Kong's role as a middleman for foreign firms wanting to do business with the Mainland, especially if foreign investors believe that the rule of law, rather than "connections," will be the primary factor governing business relations in China. Hong Kong's economy could also be negatively affected if China and Taiwan decide to establish direct trade links, which would likely reduce the level of trade that takes place via Hong Kong.[14]

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[11] A major area of contention concerning Hong Kong's autonomy arose in July 2003 when the government tried to pass an anti-sedition law (known as Article 23 proposals), which, many critics contended, was being pushed by Beijing in order to undermine civil liberties in Hong Kong. The relative secretness of the contents of the bill (and concerns over a number of other political and economic issues) sparked a massive demonstration in Hong Kong on July 1, 2003, with an estimated half a million participants, forcing the government to withdraw the bill. A second major autonomy issue arose in April 2004 after the Chinese government declared that political reforms in Hong Kong would have to meet Beijing's approval. See CRS Report RL31185, *China-U.S. Relations: Current Issues for the 108th Congress*, by Kerry Dumbaugh.

[12] Economist Intelligence Unit, *EIU Country Indicators*; and Global Insight, *Hong Kong: Interim Forecast Analysis*, March 4, 2004.

[13] In June 2003, China and Hong Kong signed a free trade agreement, a move that is likely to deepen their economic integration. In addition, the Chinese government in 2003 relaxed a number of restrictions on mainland residents wanting to visit Hong Kong, which has helped to boost Hong Kong's tourism industry. In 2003, more than half of all tourists visiting Hong Kong were from the mainland.

[14] Taiwan joined the WTO in January 2002. WTO rules may require Taiwan to end its ban on direct trade links with the Mainland.