

## Hong Kong: Irresponsible Inheritances

In the good old days, Hong Kong only had to worry about inheriting one country's irresponsible monetary policy. These days, the SAR has to worry about two. And a combination of the US setting Hong Kong's price of money and China increasingly setting its supply has, not unexpectedly, been a recipe for rampant asset price speculation, especially in luxury property.

**In the good old days, Hong Kong only had to worry about inheriting one country's irresponsible monetary policy**

With the PRC looking to rein in its monetary excesses in the coming months, this process risks being rudely and painfully, yet ultimately temporarily, interrupted. Medium-term though the SAR's continued adherence to its USD linked-rate exchange mechanism still argues strongly for bubble like conditions should, as we expect, American interest rates remain extremely low, and China succeed in slowing its economy without crashing the whole shebang.

**These days, the SAR has to worry about two**

We always have to declare a couple of interests when writing about the Hong Kong dollar. First of all, we were originally brought out to the region by John Greenwood OBE, the architect of Hong Kong's (serially modified) currency board and therefore risk being accused of apostasy if we ever question its continued utility (sorry John). Second, we would stress that we have zero input or insight into the HKMA's monetary policy deliberations, although we have served for many years on the Council of Advisors of the monetary authority's Institute for Monetary Research.<sup>1</sup> To dispel any possible misunderstandings though, these are own opinions, etc. etc.

**A combination of the US setting Hong Kong's price of money and China increasingly setting its supply has, not unexpectedly, been a recipe for rampant asset price speculation, especially in luxury property**

It should be stated at the outset that the "peg" remains technically as robust as ever. However, it has become clearer and clearer that as China's economic and monetary activities have become increasingly integrated into the global economy, so Hong Kong's economy has become increasingly hostage to a volatility buffeting from both the Mainland and America. The SAR continues to have some of the most flexible factor markets in the world, skilfully regulated financial markets,<sup>2</sup> and a population that is

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<sup>1</sup> See <http://www.hkimr.org> for a sample of the excellent research on regional and global monetary policy matters carried out by the Institute.

<sup>2</sup> Principally its banks, supervised by the HKMA. While the SFC is generally staffed by high quality functionaries, its job is hampered by the oversight for company listings afforded to the self-listed stock exchange. Having a rotten borough financial sector Functional Constituency – more on FCs later – represented by a convicted felon who waltzed back into his seat on his release, is hardly assuring either. The end result is that stock and bond market oversight can be highly politicised as the fun and games of the recent Rusal listing saliently illustrate. Our understanding is that Hu Jintao gave an

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generally accepting of the benefits of asset boom and the costs of asset bust cycles. With a few noisy exceptions who generally get very little public sympathy, people here rarely if ever expect (nor get) a government bailout when their p.a. investments go awry. Hence, one can argue that Hong Kong is more than capable of dealing with such swings and therefore the monetary regime should be left well alone.

As it happens, we think it will be, at least for the next couple of years. First, while it has been rumoured that Hong Kong officials raised with Beijing the issue of exploring de-linking a few years back, they were swiftly knocked back based on the somewhat flawed logic that any such move would put the RMB even more into international play.<sup>3</sup> Second, the HKMA's long-standing and internationally-respected Chief Executive, Joseph Yam stood down at the end of last year. His replacement, Norman Chan, is now in the process of establishing his own credibility with the markets which argues against any imminent change to the currency regime. Nobody doubts Mr. Chan's technical credentials or his intellect but having headed up the Chief Executive of the SAR, Donald Tsang's, Bauhinia Foundation think-tank, and then having run Sir Bow-Tie's "re-election campaign", he is perceived, rightly or wrongly, to be more politicised than his predecessor.<sup>4</sup>

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assurance to Vladimir Putin that China would help out his old mate Oleg, and the SFC's only defence when faced by a company that would not have got anywhere near the SAR's normal criteria for listing was to slap a HKD1 million minimum board lot stipulation on the stock in order to deter the retail punters. In theory all the great and good who signed up for the Rusal listing are under water now but doubtless, they were offered enough ancillary inducements to write their cheques. Generally the SFC and even the HKEx listing committee are sensible enough though to know when to knock back the shonkiest companies, especially those from the Mainland. After all, Singapore will always be there to offer a home to these dregs....

<sup>3</sup> This would be true if a link to the USD were to be replaced by a link to the RMB as one cannot link a convertible to a non-convertible currency without making the latter *de facto* convertible. But this sort of simple change has never, ever been on the agenda. More on more realistic exchange rate alternatives in due course.

<sup>4</sup> Central bank governors are always battling politicisation problems but this is especially important in Hong Kong these days since the public's trust of many of the other arms of government has been seriously eroded by more than a decade of inept political leadership. The HKMA has consistently been one of the few institutions of state to be afforded high public opinion status but this has to be continually earned and cannot be inherited. We are

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Nevertheless, near-term political obstacles aside, we do believe it is time for Hong Kong to have a deeper debate as to whether a move to a Singapore-style managed exchange rate mechanism would not be more appropriate going forward. As a quick recap, the MAS manages the SGD against a nominal trade-weighted basket of currencies, whose weights can be roughly backed out but are never fully fixed or revealed. It also moves the path of the SGD's appreciation (and far more rarely depreciation) up or down against this basket as well as periodically re-centring/re-defining the bands within which the TWI fluctuates. The principal aim is to head-off inflationary/deflationary excesses in order to maintain broad real trade-weighted exchange rate (REER) stability. However, the system also in theory creates enough uncertainty in near-term exchange rate fluctuations so as to deter more extreme levels of speculation. Our own opinion is that the MAS's system is more optimal than a single country peg for a small open economy like Hong Kong. Moreover, there are few technical obstacles preventing the HKMA from shifting to such a system. The question as we have already noted is largely a political one.

It is time for Hong Kong to have a deeper debate as to whether a move to a Singapore-style managed exchange rate mechanism would not be more appropriate going forward

Theoretical discourses aside, what is the evidence that the China is indeed adding to local economic and asset price volatility? When we discussed such issues with a friend at the HKMA a few weeks back we were given an understandably elegant yet obtuse brush-off that there was no evidence through the banking system of excessive and destabilising Mainland capital inflows. And of course they would not be since the PRC in theory maintains tight capital controls over the movement of funds out of the country by its own citizens.

What is the evidence that the China is indeed adding to local economic and asset price volatility?

The reality though is that such capital controls (on both the inflow and outflow side) have become increasingly leaky over the years. Indeed, various statements over the past year from Chinese government officials suggest that up to a third (which probably means more like a half) of the USD1.4 trillion of loans disbursed last year have been diverted to speculative purposes. For sure a decent chunk of this has found its way to Mainland property and share markets but a fair amount has also likely been spontaneously privatised and diverted to Hong Kong assets, Macau gaming tables (casino revenues were up 63% YoY in January), south-east Asian brothels, and luxury properties in Australia, the UK and America. And of

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sure Mr. Chan is patently aware of this and will hence not seek to rock the boat until he is comfortably settled into his new position.



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course the HKMA cannot admit as much or even publish estimates on such a politically sensitive subject.

But we can as can others in what is still one of the region's freest media. The term "money laundering" is inflammatory and can certainly get its users into hot water in other jurisdictions in Asia. Moreover, the EU's attempt to get the SAR branded as an outpost for such activities clearly hit a raw nerve and it was gratifying to see Beijing instantaneously coming to Hong Kong's defence. While it is safe to say that some unsavoury characters do bring questionably legitimate funds into the SAR – Robert Mugabe's purchase of a villa in Yuen Long and his daughter's enrolment at one of our local universities is one of the most offensively obvious cases in point – the vast majority of people who bank in Hong Kong do so because of its open capital account, its low taxes, and its rock solid financial institutions. Moreover, to open a bank account here requires the applicant to jump through the same global practice know-your-client (KYC) hoops as one does in every other serious jurisdiction. That is why Hong Kong, along with Singapore and Japan, is the region's only Financial Action Task Force (FATF) compliant "country".<sup>5</sup> In essence, Monsieur Sarkozy's whinge was more to do about his dislike of competitive taxation policies....

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Anyway, leaving aside inflammatory monikers, is it possible to make any sensible estimates of the size of capital flows buffeting Hong Kong, and specifically those emanating from China, directly and indirectly? In the following charts and comment, we have a go.

This is as attractive to Mainlanders as anyone else

Let us start with the narrow assessment of inflows coming in through the official banking sector (see the top chart overleaf). The HKMA publishes detailed breakdowns of Hong Kong bank's external assets and liabilities and as our friend at the monetary authority indeed noted, there are few signs of a major surge in external and/or Chinese claims on local financial institutions. We can also look at flows into the Hong Kong banking system from other offshore centres – traditionally a conduit for disguised Chinese funds.<sup>6</sup> Same result. Yet at the same time, the HKMA has been accumulating foreign exchange reserves at a 50% annualised rate.

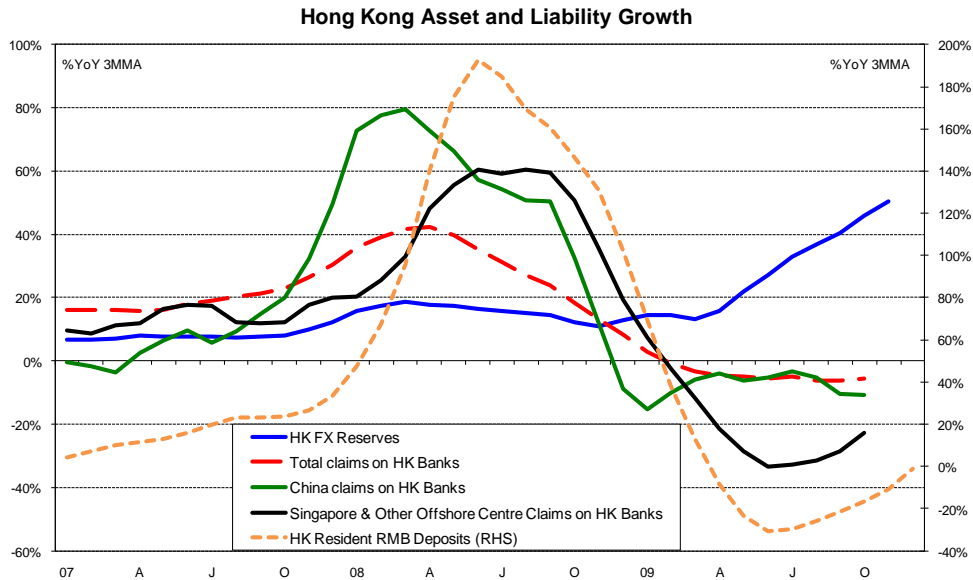
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<sup>5</sup> As are Australia and New Zealand if Asia is more widely defined.

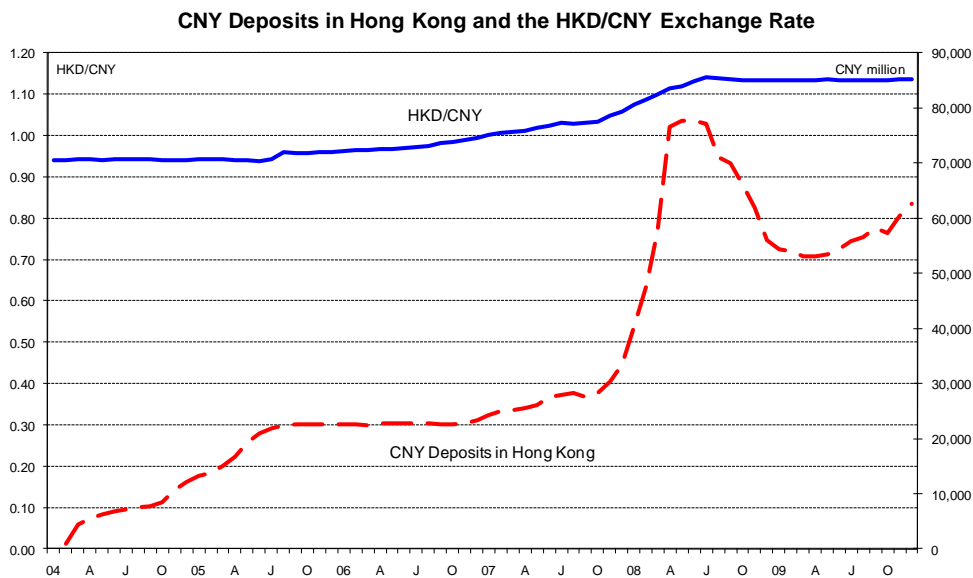
<sup>6</sup> Traditionally, many Mainland entities have set up associated companies in the BVI and the like in order to make FDI re-investments in Hong Kong and China in order to garner tax benefits.

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As a digression, you will also note on the first chart that Hong Kong resident holdings of RMB have also been relatively stagnant as is also illustrated by the levels chart below. Buying and selling a maximum of CNY20,000 per day does allow retail investors to build up decent personal positions in CNY cash or locally-offered bonds over time, but hardly poses a huge monetary risk to overall Mainland liquidity management.

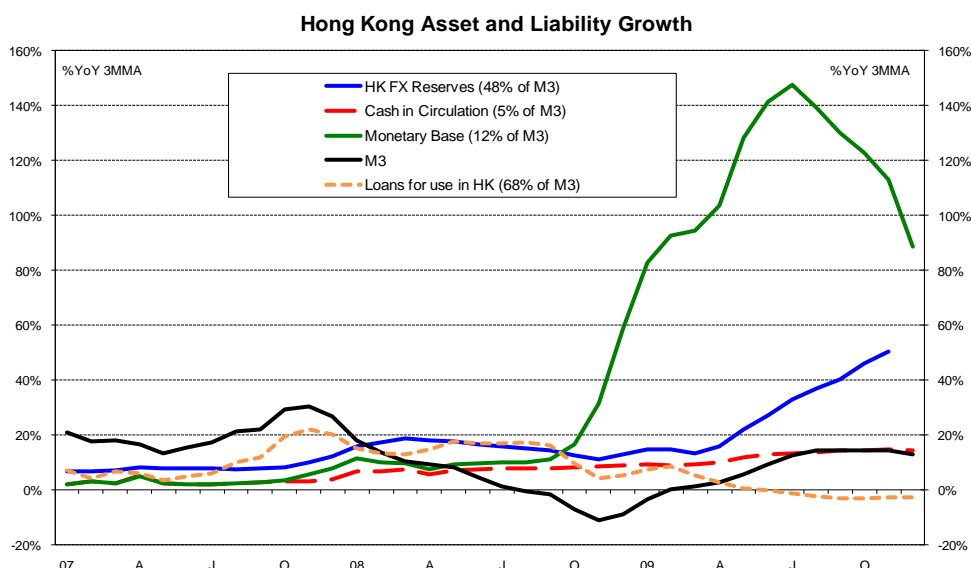
**The HKMA has been accumulating foreign exchange reserves at a 50% annualised rate**



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And while we are on this subject, it may be useful for CCP officials to cite the wish to discourage short-term capital flows into the RMB as an excuse to not move the currency. However, the reality is that domestic credit creation, not balance of payments flows, remains the principal driver of Chinese monetary expansion. China's M2 money supply expanded around 27% during 2009 and over 20% of this 27% was driven by bank lending growth. Meanwhile, of the 6.4% contribution resultant from balance of payments sources, 3.7% was a function of the current account surplus, itself significantly a function of ingrained exchange rate mercantilism. Net capital flows contributed only 2.7 percentage points to the PRC's broad money supply growth and of these, 0.9% were FDI-related. In essence, the contribution of portfolio and other unaccounted for capital flows was a mere 1.8%.

The contribution of portfolio and other unaccounted for capital flows to China's M2 explosion last year was a mere 1.8%



So Hong Kong and other foreign sources may not be principally responsible for Chinese monetary incontinence, but when it comes to the SAR, the reverse is far more likely to be true. As the chart above shows, Hong Kong's broad M3 money supply has recovered steadily since the end of 2008 and has been expanding in the mid-teens since the middle of 2009 – admittedly well above the rate of nominal GDP which was contracting for much of the year. Nevertheless, domestic credit demand remained moribund throughout the whole of last year with only really mortgage lending, around a quarter of total loans for use in Hong Kong, in expansion territory. And even here, residential property loan growth has only recovered from 1.3% YoY in April 2009 to 9.1% YoY in December – hardly evidence of rampant local

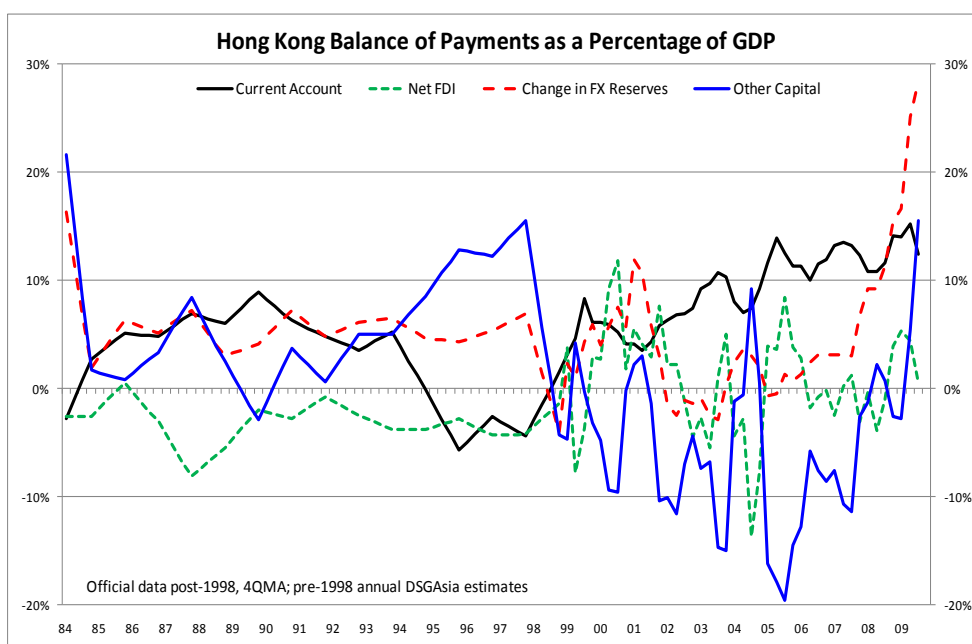
Hong Kong's broad M3 money supply has recovered steadily since the end of 2008

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real estate speculation. By contrast though, the HKMA has been heavily and regularly intervening to maintain the HKD from breaching strong-side parity and accordingly the growth of the monetary base and FX reserves has surged.

The next chart below decomposes the balance of payments to back out a non-FDI net capital flow number. What it suggests<sup>7</sup> is that the HKMA is accumulating foreign exchange reserves at a rate unprecedented since the linked rate mechanism was instituted in October 1983. While some of this is attributable to an abnormally large and persistent current account surplus, note that the blue line, our other capital flows estimate, is hitting levels only seen twice in the past quarter century. These incidences were in the immediate aftermath of the HKD's peg which resulted in a massive restoration of local confidence, and more ominously, in the run-up to the Asian crisis.

Domestic credit demand has been steady but the HKMA has been accumulating foreign exchange reserves at a rate unprecedented since the linked rate mechanism was instituted in October 1983

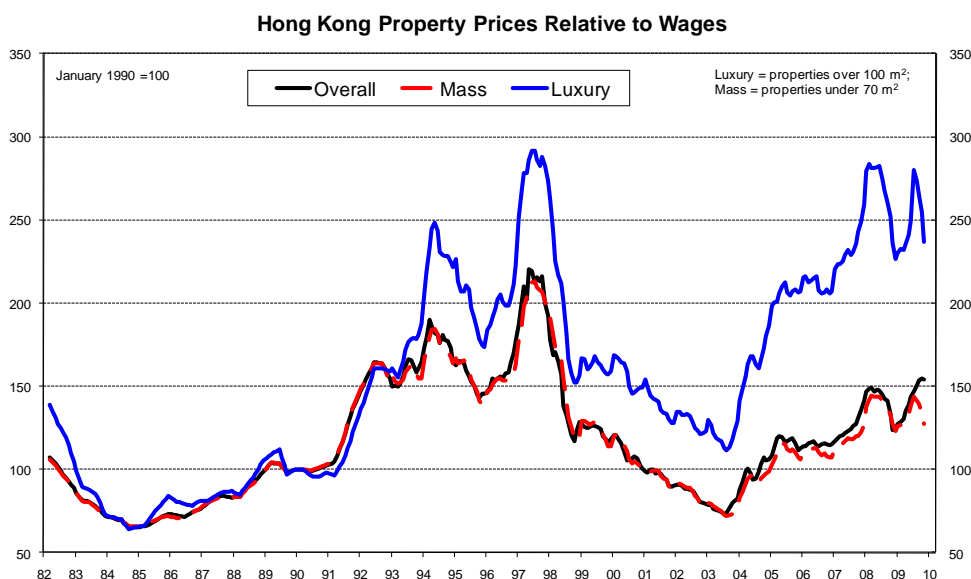


<sup>7</sup> We should caveat our comments by saying that a system that has historically never had capital controls, and serves as an entrepôt for trade and service flows that dwarf the size of the domestic economy, has severe logistical difficulties collating accurate BoP numbers. On the capital controls (or lack of) front, Hong Kong is as far as we are aware the only place in the British Empire to have never suspended convertibility into gold, the period of the Japanese occupation aside. Singapore may have a similar record but its importance as a financial centre in Imperial days was far, far lower.

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So where is all this money going and what is its source? Chief Executive Donald Tsang was quoted the other week as saying that in the last sixteen months, HKD600 billion had flowed into the SAR of which HKD400 billion had gone into local stocks. We might respectfully argue that his factotums have fed him the wrong column to cite. Although the HKD600 billion total inflow number roughly accords with the balance of payments as reported from Q4 2008 to Q3 2009 (official Q4 2009 numbers have not been released), the HKD400 billion equity figure Tsang cites is nearer the HKD470 billion *outflow* recorded by the SAR over the same period. Cumulative inflows, by contrast, have been far more modest at around HKD60 billion yielding a net outflow of HKD410 billion. Eliminate this line item and we come up with a figure of HKD590 billion (USD75 billion) of unaccounted for inflows – 36% of local GDP!

So where is all this money going and what is its source?



So why have we not seen a rampant local property market? If you read the local press and the average blurb from the sell-side analysts, you could be fooled into thinking that it was 1997 times a thousand.<sup>8</sup> However, the reality on the ground (charted above) is that while mass residential volumes, prices and loan demand have all ticked up, the excitement has largely passed the plebs by. Indeed the argument that local property is becoming unaffordable does not really hold too much water – at least in comparison to the mid-

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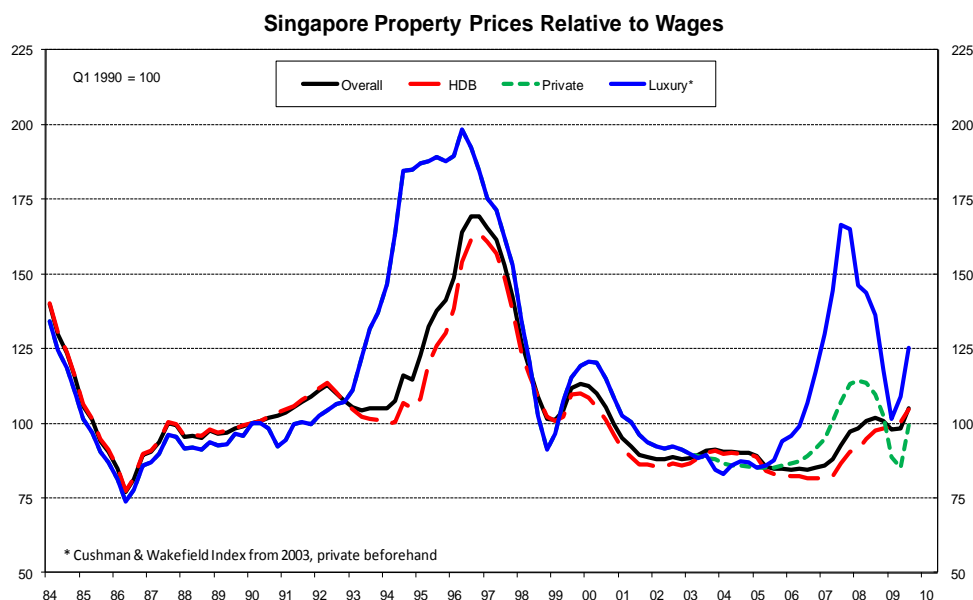
<sup>8</sup> And what is 1997 times a thousand? Why 1,997,000 of course.

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1990s. Luxury property<sup>9</sup> affordability is back near its peaks but the mass market seems averagely valued.

By way of comparison, Singapore has exhibited similar dynamics albeit the round-trip in luxury property has been more severe, notwithstanding the recent bounce. The Lion City's supply dynamics continue to look inferior to the SAR's while the extent of luxury demand from places such as Indonesia and India, not to mention expats of other hues and flavours, is unlikely to be quite as torrid as that from China hitting Hong Kong – for now at least anyway.

Singapore has exhibited similar dynamics

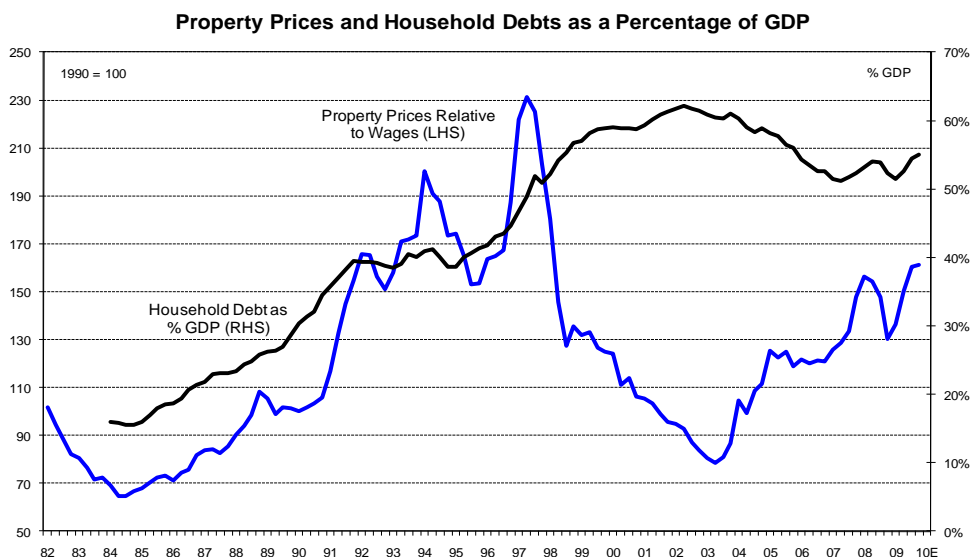


<sup>9</sup> Even here we have to be careful about how we define luxury. We are using in the chart the Hong Kong government's Class E property index but in practice, there has been a marked shift in preference for what is being bid up. While traditional areas such as The Peak and Mid-Levels remain popular with the new strain of PRC buyer they have also been bidding up the prices of new developments in densely populated Kowloon, near the rail links and shopping centres. All the better to park your mistress in you see while allowing you to make a quick getaway back across the border to see other assorted wives and concubines. By contrast, your correspondent's neighbourhood, hitherto one of the hottest in the last decade, has not moved nearly as much over the past year. The space and cleaner air afforded by the rural Eastern New Territories has been extremely attractive to the white trash (who are now in somewhat shorter supply) but do not appear to be of much interest to your average Mainland punter.

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In both cases, the argument for mass residential property seems pretty solid. As our next Hong Kong chart below shows, household leverage is no higher than a decade ago. Singapore's household debt series (not shown) has exhibited a similar dynamic albeit its debt-disposable income ratios are significantly higher than the SAR's due to policies which systematically remove Singaporean's ability to spend their own money as they see fit. Another positive trend is that in contrast to 1997, interest rates have fallen not risen<sup>10</sup> while leveraged multiple ownership appears to be considerably less prevalent. In fact what seems to have held locals back is not affordability or a lack of credit but rather concerns over job security and stagnant middle and lower class incomes. We will return to this potentially socially explosive subject towards the end of this piece.

Luxury property affordability is back near its peaks but the mass market seems averagely valued



As noted earlier, conceivably around USD75 billion or 36% of GDP of unaccounted for capital has hit the local Hong Kong economy since September 2008. Anecdotal evidence in turn suggests that a decent chunk of this inflow has a Mainland Chinese complexion; unsurprising since if 30% of the credit pumped out by the PRC's banks has indeed been diverted to speculative purposes, this comes to a cool USD575 billion looking to play.

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<sup>10</sup> In Hong Kong, banks are engaged in a mortgage war which means that mortgage rates are either priced at considerable discounts – 3% or so – to prime rates or even off rock-bottom HIBOR. Those of you who have visited **DSGAsia**'s funky offices in Lan Kwai Fong will know our location is arguably second to none for the *bon viveur*. What you are probably not aware is that it is being funded at current interest rates not far north of 1%.

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Official estimates of such flows are neither available nor would be politically correct to publish. After all, these would controversially highlight the thorny issue as to how the original investment funds were sourced and spirited out of the country? As it happens, as we were putting this article to bed over the weekend, the South China Morning Post's Shirley Yam (no relation of Joseph as far as we are aware) published a related piece in her always interesting and well-researched *Money Matters* column. She was commenting on statement by the HKMA's Norman Chan that 77% of the HKD340 billion raised in the Hong Kong equity market last year by Mainland companies, has stayed in Hong Kong rather than being repatriated (as is stipulated) for use in China. As Yam notes:

*Keeping the money in Hong Kong provides the greatest flexibility. Fear is another reason. Over the head of almost every private entrepreneur [she adroitly avoids saying and "CCP cadres with overseas assets incommensurate with their public salaries" though the implication is there] on the mainland hangs the knife called "yuan zui" (cardinal sin). The issue is about how they got their first bucket of gold. Was it a loan secured by bribing a bank official? Did he or she buy a state-owned business at dirt-cheap prices plus bribes? It may be something that happens years or decades ago. But no one can be sure. It is politics, not law, that determine when the police will arrive at his or her doorstep. To these people, Hong Kong is a safe haven for their wealth. Even if their conscience is clear, they are well aware of the "red eye" syndrome, meaning the jealousy of others. Neither do they want the tax man to come after them.*

That Yam, as a Chinese national, can still write openly about such matters is a testament to Hong Kong's greatest strength that puts the SAR apart from just about every other place in the region and prevents us from becoming just another big city in China. Current and future leaders of the SAR would do to take note. Her analysis is also the reason why we remain deeply sceptical about the Taiwan-is-the-next-Hong-Kong-play argument. Nice enough though Taiwan is with its great food and friendly, engaging people, its legal system and capital control regimes are steeped in the same ersatz Leninist-Confucian mores that any Mainlander with any sense and money seeks to escape. For sure, this will not prevent PRC state-related companies buying Taiwanese assets at the wrong price for patriotic reasons, while Taiwanese on the Mainland, and perhaps their Fujian cousins, may be more minded to purchase properties in the Renegade Province. But in the end, Hong Kong is the Manhattan of China, and will remain so unless our amateurishly inept leaders descend to even greater depths of professional ineptness. Taipei by contrast – the Des Moines perhaps?

Anecdotal evidence in turn suggests that a decent chunk of this inflow has a Mainland Chinese complexion



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We would argue that Hong Kong property even more than Hong Kong stocks provides the safest store of wealth for the Mainlander seeking security over his assets.<sup>11</sup> This is because Hong Kong's property title registration system provides for maximum anonymity. It is our understanding<sup>12</sup> that if a property in the SAR is bought through a company, the beneficial shareholders need to be registered on the title deed. Subsequently though, this document is then sealed and lodged at the Land Registry but a court order is required to reveal this information, and such an order can be appealed all the way to the highest court. As far as we are aware, there has never been a successful revelation.

**Hong Kong property even more than Hong Kong stocks provides the safest store of wealth for the Mainlander seeking security over his assets**

Judging by the bottom up surveys of Mainland property purchases, the private entrepreneurs and cadres appear to agree. A recent Centaline Property Agency survey reported that PRC citizens bought 18.1% of the properties transacted in excess of HKD12 million last year compared to 11.2% in 2008 and 9.2% in 2007. However, in the mass market, Mainlanders comprised only 5.6% of buyers in 2009 compared to 4.3% in 2008. A separate survey by Nomura's Paul Louie reported that in Q4 2009, Mainlanders accounted for 27% of property purchases above HKD10 million but were also more becoming active in the lower price segments of the market. Such buyers accounted for 14% of total transactions. And stripping out corporate from individual purchases, PRC citizens as individuals – assumedly those who felt more confident that they had nothing to hide – accounted for 20% of non-corporate purchases.

**A recent Centaline Property Agency survey reported that PRC citizens bought 18.1% of the properties transacted in excess of HKD12 million in 2009**

Two further points to note. First, while we do not have the data, the anecdotes suggest that at the higher end of the market especially, Mainland buyers are cash buyers. Hence such purchases are not being matched by rapidly rising demand for mortgage financing. Second, defining who and what is a Mainland individual or entity is in itself tricky and the implication is that the numbers quoted above could still understate the influence of those from north of the border. For example, if a Chinese corporation sets up an associate company in the BVI or Cayman and then buys a Hong Kong property, how is this purchase accounted for in the domicile stakes? In a

**They are also becoming increasingly active in the lower price segments of the market**

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<sup>11</sup> If we were a Mainlander we would look to own property in Hong Kong and perhaps further afield, but we would bank elsewhere, most probably Singapore – the banking sector of choice for many Hong Kong residents and companies anyway.

<sup>12</sup> We are more than willing to be disabused of these notions by anyone with greater legal expertise.



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similar vein, is a Chinese citizen who has moved overseas and picked him or herself up a foreign passport truly a foreign buyer?

The latest report on Hong Kong's Capital Investment Entrant Scheme (CIES) offers some clues. This is a scheme implemented in October 2003 which grants Hong Kong residency to overseas individuals who bring in and invest more than HKD6.5 million in certain types of investible assets (including property). While the scheme explicitly excludes Chinese nationals living on the Mainland, it is open to residents of Taiwan, Macau and other Chinese nationals with right of abode in foreign countries. As at September 2009, 5,182 applications (with 9,495 dependents) have been approved bringing in a total of HKD36.6 billion to the SAR, of which HKD10.4 billion has been invested in real estate. And of the 5,182 approvals, only 843 have been true foreign nationals; 3,904 have been Chinese with overseas residency while the remaining 435 have been principally Taiwanese and Macanese.

**Hong Kong's Capital Investment Entrant Scheme has overwhelmingly attracted people of Chinese origin**

For the most part, Mainlanders buying luxury apartments should not impact on the life of the average Hong Kong citizen.<sup>13</sup> Indeed it can be argued that while there may be some spill over to lower segments of the property market, the investments should also boost general incomes and labour demand. However, Nomura's Louie also reports in his survey that Mainlanders in Q4 2009 also accounted for 10% of purchases of flats below HKD5 million, up from only 5% just a quarter previously. And while we are all for free markets, this is potentially more socially troubling.

**For the most part, Mainlanders buying luxury apartments should not impact on the life of the average Hong Kong citizen**

We promised earlier that we would conclude with some further colour on the subject of ordinary citizen stagnant living standards and growing popular resentment. We would suggest that perceptions, rightly or wrongly, that the northern country cousins are now coming in and pushing up the price of basic flats beyond levels that the locals can afford<sup>14</sup> are not helping such matters. A fuller polemic on Hong Kong's dysfunctional politics is perhaps on our agenda in the not too distant future. For now though we will

**Floods of Mainland capital into the mass residential markets are potentially more socially troubling**

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<sup>13</sup> Wealthier locals and expats may bitch that the places they want to live in are being priced out of their range; similar gripes can be heard in your correspondent's city of origin, London, about Arabs and Russians. However, given where relative rental yields are in Hong Kong, it makes sense to rent somebody else's opulent apartment and buy a couple of smaller ones for renting out.

<sup>14</sup> Leave aside the reality that the overwhelming majority of "locals" were Mainlanders once.

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finish with a few brief observations about the entangled nature of the aforementioned Functional Constituencies (FCs), democratic unaccountability, land and government expenditure policies, and inherited entitlement mentalities.

Hereditary dynasties have always come and gone throughout the ages though some have had more enduring qualities than others. In the modern world there are few societies where the divine right of kings still reigns even though some have managed to maintain a constitutional role for their royal families. Hence we are left with a few smaller, traditional states, largely in Africa and the Middle East, where the monarch's writ still looms large and where the mantle is passed onto the children, irrespective of their inherent talents. In Asia, Nepal's recent regicide has left Bhutan and less benignly North Korea carrying the mantle, and even in the case of the DPRK, Kim Jong-il will likely find it a lot harder to successfully and sustainably transfer power to Kim Jong-un, than Kim Il-sung found it to transfer power to Kim Jong-il.<sup>15</sup>

Hereditary dynasties have always come and gone throughout the ages

What has this to do with Hong Kong you may ask? The answer is that the SAR's property tycoons hiding behind a sham electoral process have been attempting to transfer their rent seeking privileges to an inbred, spoilt and out-of-touch younger generation in the context of a local population getting more and more frustrated with their meagre lot. Hong Kong is not by large a jealous place. If people here see a Rolls Royce drive by, their first instinct is not to reach for the Stanley Knife but to say, "I want to drive one of those one day." In a similar vein, while the locals may not quite buy into the fawning coverage afforded to Li Ka-shing, they also respect that he is broadly speaking a local boy made good (even if he is ripping them off at every turn). Such deference clearly does not extend to Li's kids and the assorted offspring of the other tycoons. Indeed with surreal shades of the Mainland's own princeling experience,<sup>16</sup> the public mood continues to get angrier and angrier at what is largely viewed as a parasite class. Most Hong Kong citizens are realistic enough to recognise that Leninist parties do not do democracy and would likely be more than happy to accept universal suffrage in terms of having a free vote for a selection of Beijing pre-

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<sup>15</sup> There is a delicious parallel of course playing out in an unnamed fictional state located somewhere in south-east Asia.

<sup>16</sup> Which is why what would seem to be an increasingly princeling dominated Chinese elite is likely to want to back their own kind.

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selected, pre-vetted candidates. However, the FCs, especially where they are clearly rotten boroughs whose incumbents are returned in ultra small-circle elections, are increasingly viewed as beyond the pale.

The FCs are in turn central to blocking any serious discussion of the SAR's increasingly distorted land policies and the related automatic hypothecation of all land revenues to infrastructure projects. Hong Kong residents are not seeking to put in place a high tax, European style, welfare state, but they are justified in asking for better schools, hospitals and basic social security, not to mention clean air. They would also quite like to be able to buy homes that are the actual size advertised, that you can swing more than a cat in, and that do not fall down due to shoddy maintenance (admittedly the last of these is thankfully rare).

**Functional Constituencies are central to blocking any serious discussion of the SAR's increasingly distorted land policies and the related automatic hypothecation of all land revenues to infrastructure projects**

It is not as if the government does not have the cash to pay for this. Even during the savage of downturns seen in recent decades, the fiscal accounts have rarely spent much time in the red. Moreover, government debt, almost all of which is Exchange Fund paper issues for monetary management purposes is only 10% of GDP. There is just no truth to the assertion that there is no money in the kitty – after all over HKD60 billion is, controversially, going to be shelled out on the new Hong Kong-Guangzhou high-speed rail link, with billions more earmarked for our Y-shaped bridge to Macau and Zhuhai. The darker reality is that the property and construction cartels love this sort of things and a change in the rules that would allow greater government flexibility not to have to pure concrete hits at the heart of their basic prerogatives.

**It is not as if the government does not have the cash to pay for better social services**

The problem for the great and good is that they are being increasingly rumbled. The reason why increasing numbers of youngsters are taking to the streets in protest (in contrast to their more deferential parents) is that they see that their opportunities for advancement are being held back by a combination of an increasingly sub-standard education system and the restrictive practices of wide swathes of the business class. Moreover, they have no real democratic channels through which to make their demands heard, LEGCO having no real power to propose sensible, alternative legislation, and the government's (pre-decided) consultation processes being a complete joke. And when asked why FC's, a British colonial legacy only introduced in the 1970s, cannot be reformed, let alone abolished, the unbelievably weak and frankly offensive response is, "it is too complicated."

**The problem for the great and good is that they are being increasingly rumbled**



## Hong Kong: Irresponsible Inheritances

As things stand currently, Hong Kong is likely to be handed down yet another inept nonentity when Donald Tsang steps down on June 30<sup>th</sup> 2012.<sup>17</sup> In 1997, the SAR was bequeathed a nice-but-dim Shanghainese who owed myriad favours to the tycoon class and turned out to be thoroughly out of his depth. When the hapless Tung Che-hwa finally stood down, ostensibly for health reasons, Beijing swallowed its anti-colonial pride and went with a knighted (and benighted) civil servant who was viewed by most at the time as being both capable and decent. The latter description would still be accepted by all but the most bitter of Donald Tsang's enemies but his reputation for competence has subsequently taken a fearful battering and he has rapidly morphed into a lame (Donald) duck.

The front runner to succeed Sir Donald in 2010 is his current Chief Secretary, Henry Tang, yet another nice-but-arguably-not-that-bright Shanghainese who inherited the family jewels. The tycoons would of course love someone as non-threatening. And the odds for now remain tilted towards business as usual and Henry being given the nod. The emerging, intriguing wild card is Leung Chun-ying though, widely believed to be a card carrying CCP member and not hitherto much loved by anyone except perhaps his mother. Indeed, when we raised the possibility on Friday night at a dinner with a group of our local contemporaries, it was as much as many at the table could do to hold their food down at even the suggestion.

Irrespective, we are coming round to the view that C.Y. is probably the SAR's best bet. He is a good deal smarter than any of the safer, establishment choices. Moreover, as a property man – he is a surveyor by background – he knows how the rigged land system works and where the bodies are buried. Nevertheless, he is by all accounts not much in the favour of the majority of the tycoons and from what we can observe, their disdain is reciprocated. Being close to Beijing will also enable Leung to better argue the case for reform in areas such as the FCs, the land sale and revenue hypothecation system, and competition policy, should he truly wish to do so.

As things stand currently, Hong Kong is likely to be handed down yet another inept nonentity when Donald Tsang steps down on June 30<sup>th</sup> 2012

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Nonetheless, we are coming round to the view that C.Y. is probably the SAR's best bet

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<sup>17</sup> Complicating things further is the fact that in 2012, Barack Obama and Ma Ying-jeou are both up for re-election while the terms of Hu Jintao and Wen Jiabao also come to an end. We would refer you back to our friend Tim Summer's article for us on what potentially comes next: "China 2012 – the next generation of leaders", November 16<sup>th</sup> 2009.

## Hong Kong: Irresponsible Inheritances

The argument against is that he has as yet to develop any real grassroots popularity though a charm offensive has been launched to try to rectify this. Leung is also not particularly popular even amongst the local pro-Beijing lapdogs though given the way the CCP has serially abused their loyal support and failed to offer them any real power since the handover (thank heavens), who cares? His bigger task will be to garner definitive support from the senior leadership up north and as noted earlier, his background would seem to the outsider to fit more with that of Hu Jintao (who will be still in charge when the decision is made) than the Princeling faction who will likely come after and prefer a like-minded aristocrat.

Leung knows how the rigged land system works and where the bodies are buried. He is by all accounts no friend of the tycoons either

C.Y. Leung clearly comes with much baggage and myriad risks. Tung Chee-hwa and Donald Tsang assumed office being perceived as being fundamentally likable and honourable even though their competence (or lack of) was quickly revealed. By contrast C.Y. still has a great of work to do to win over hearts and minds. There is also a risk that he would likely to want to take a more hard line on national security issues and patriotic education (though he would be foolish to push this too hard as our early digression into freedom of expression matters discussed). Recall that it was the botched attempt to introduce Article 23 legislation that ultimately created a tipping point for Tung. The conclusion we have reached though is that any of the other plausible candidates just implies another half decade of dithering, drift and cossetting of a self-entitled, self-satisfied business elite. Hong Kong people have remarkably tolerant over the years but are becoming increasing less so. Its citizens truly deserve better!

But he clearly comes with much baggage and myriad risks

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