



Red Capital in Hong Kong

The invisible hand transforming the city's politics



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CONTENTS

Executive Summary	p.4
Recommendations	p.6
Introduction	p.8
Chapter 1: The rise of red capital and its scope in Hong Kong	p.11
Chapter 2: The Hong Kong government and the rise of red capital	p.17
Chapter 3: Party Cells, Politics and Protest – life inside red firms	p.29
Chapter 4: Red Capital and the Hong Kong business elite	p.34
Chapter 5: CASE STUDY: Red Capital and the Media	p.46
Conclusion: Red Capital and Western policy responses	p.52
References	p.58

EXECUTIVE SUMMARY

Hong Kong is China's cash machine. It sits outside of mainland capital controls, its currency is pegged to the US dollar, and it shares its common law system with other key financial centres. 'Red capital' – shorthand for the investments of state-owned enterprises and 'private' Chinese firms – has flooded into the city for these reasons.

The scope of red capital in Hong Kong

60% of companies listed in Hong Kong were mainland companies at the start of 2020.

Red Capital accounted for 82% of IPOS in Hong Kong.
35% of media outlets have a major mainland stake.

Red Capital makes up 40% of the insurance market.
57 percent of the government residential sites up for tender in the first half of 2019 were sold to mainland developers and their consortiums.

The invisible hand transforming Hong Kong's politics

- Ever since the Closer Economic Partnership Agreement (CEPA) was signed in 2003, activists have been powerless to stop Beijing quietly taking control of Hong Kong's most vital organ – the economy.
- With a Communist party cell on the board of every mainland company, employment practices have changed. Dr Law Ka-chung, an economist at the Chinese State-Owned Bank of Communications was the only economist at a state-owned bank to deviate from party dogma during protests: his subsequent sacking demonstrates why others choose to toe the line.

“Around 2012, after the financial crisis in the US and Europe, the strategy changed. They no longer sent people here to learn about Western market economics, instead they wanted the West to follow their rules. They no longer wanted to learn, they wanted to rule.”

“They started to fill top management positions. They are trying to fill every tier of the company with loyal people. Everyone who acts as a spokesperson should conform strictly to the party line.” (A Senior Executive at Chinese State-Owned Bank)

- Employees of red firms are expected to support the government line on contentious issues. In 2016, some at certain firms were instructed who to vote for. During the anti-extradition bill protests, others were banned from attending protests, with registers of attendance taken at the office in order to curtail protest activity. Employees at many of the leading red firms have been expected to sign petitions in support of the National Security Law. At one bank, employees were told they must sign a petition and screenshot their signature, sharing it with senior executives.

A new environment for business

- Historically, international and local Hong Kong business leaders held the key to power in Hong Kong, and the alliance between ‘the Hongs’ and Beijing formed the basis for the ‘blue’ coalition which was opposed by Hong Kong’s ‘yellow’ democratic movement.
- But the growing presence of red capital has changed the power dynamics, leaving Beijing less dependent on Hong Kong’s elites to act as powerbrokers.
- This has led to multiple confrontations. A notable example was the appointment as Chief Executive of the Hong Kong Special Administrative Region (SAR) of CY Leung, who was Beijing’s preferred candidate and backed by the red capitalists, but not the preferred candidate of the Hong Kong elite.
- More recently the extradition bill and the National Security Law run directly counter to the interests of international businesses which want to see Hong Kong retain its competitiveness and global reputation. But the government in Beijing has ploughed on regardless, increasingly demanding that firms like HSBC proactively demonstrate their support for policies which are universally acknowledged to be destructive to their direct interests.

The greatest threat to press freedom

- Red capital is reshaping the media environment in Hong Kong. Over one-third of the major media organisations in the city now have a major mainland stake. This is influencing the editorial line and has ensured that the diversity of views has been restricted.
- Economic coercion is also a central part of the strategy to limit the success and spread of pro-democracy outlets. The Chinese Government have instructed red firms, as well as many local Hong Kong businesses, to boycott advertising with the prominent pro-democracy news-outlets.
- The implications of these boycotts are that it is far harder to sustain a viable pro-democracy news business. Alongside litigation, this type of economic coercion is at the heart of the strategy to suffocate opposition media. The arrests or intimidation of individual journalists make headlines, but in the long-run, the greatest threat to press freedom in Hong Kong is found in the ownership structures of the varying outlets and the targeted attacks on the owners of pro-democracy news.

RECOMMENDATIONS

This project has been designed first, and foremost, as a means of bringing to light the importance of red capital in understanding Hong Kong. In areas, it begs more questions than it answers, and so one of our key recommendations is that further studies are needed into the behaviour and profile of red capital both in Hong Kong and further afield. Hong Kong is a canary in the coalmine, and policy makers in London, Canberra, Ottawa, Brussels, Berlin and Washington should heed the lessons about the implications of the dominance of red capital.

However, one insight which clearly comes through is that Hong Kong is highly valued as a capital conduit for mainland China, and red capital plays a critical role in Beijing's future ambitions. The policy recommendations and the concluding chapter of the report therefore focus in on ways that tighter controls could be placed on investment in mainland companies that are complicit in gross violations of human rights, either in Hong Kong or the mainland. Restrictions on investment are one area of leverage where policy makers are able to demonstrate that they are serious about facing the challenge China poses to the international rules-based order, democratic values, and human rights.

Taken separately governments might consider looking the other way but taking this behaviour together with increasing concerns over gross human rights violations, policymakers cannot ignore the danger at hand.

The following recommendations offer a series of tangible policy steps lawmakers can take in beginning to reassess their relationship with red capital.

Recommendations to researchers, think tanks and journalists

- Investigate the role of red capital in Hong Kong politics in greater depth.
- Investigate the depth of influence of red capital in the City of London, New York, Frankfurt, Sydney, Toronto, Tokyo and elsewhere.

Recommendations to international policy

- Consider policy solutions and regulations which will ensure complicity with the gross abuse of human rights in mainland China and Hong Kong is viewed by investors and financial institutions as an Environmental, Sustainability and Governance (ESG) issue.
- Consider enacting legislation similar to the US Hong Kong Autonomy Act and Uyghur Forced Labor Protection Act.
- Ensure that no state-pension funds invest in the stocks or bonds of firms complicit in gross human rights violations.
- Bar investors from purchasing the stocks and bonds on firms complicit in gross human rights violations.

Recommendations to the US Government

- Make greater use of the powers in the Hong Kong Autonomy Act to increase pressure on the city's leaders.
- Take executive action to blacklist firms complicit in the ethnic cleansing of Uyghurs in Xinjiang.

Recommendations to international fund managers

- Use leverage as shareholders in major mainland firms to underline that complicity with gross human rights abuses is a contingent factor in future investment.
- Stop investing in companies that are complicit in human rights violations.
- Stop passive investing in index funds which include companies that are complicit in gross human rights violations.

Recommendation to index providers

- Remove firms complicit in gross human rights violations including the ethnic cleansing of Uyghurs in Xinjiang from all major indices, including ESG indices.



Introduction

Mr Wong¹ was a senior executive at a Chinese State-Owned bank. His insider's view of the changing behaviour of one of China's SOEs in the Special Administrative Region brought with it a simple insight: "everything changed with the rise of Xi Jinping."

Chairman Xi came to power in the wake of the 2008 recession, when Western economies were pummelled, and China remained resurgent. Mr Wong saw the bank's personality change as the humility of the 'reform and opening up' era was replaced by the domineering confidence of the China dream.

"After 2012, they no longer sent people here to learn about Western market economics, instead they wanted the West to follow their rules. They no longer wanted to learn, they wanted to rule."

The bank's employment strategy changed with it. "Ten years ago, they were sending very junior people here to learn. After 2012, they sent very senior people, starting to fill top management positions. They are trying to fill every tier of the company with loyal people. Everyone who acts a spokesperson should conform strictly to the party line."

This report is an in-depth examination of the way that red capital has fundamentally shaped Hong Kong's politics. We consider the history of the rise of red capital, the way that the Chinese government and its counterparts in Hong Kong have deliberately encouraged the exponential growth of red capital, the size of the presence of red capital in Hong Kong, as well as the way that the behaviour of these firms has changed with time. We then turn to consider the implications this has had in Hong Kong politics, as well as the media and for the city as a business hub. The report concludes by zooming out and examining measures which could be taken by international policy makers to tighten pressure on red firms that are complicit in human rights abuses.

Defining red capital

Before considering these issues, it is important to define terms. The most simplistic definition of red capital is:

money originating in the People's Republic of China; the capital of state-owned enterprises and private firms.

But this definition does not fully encapsulate the unique characteristics which distinguish red capital from other forms of capital. Chinese firms, whether state-owned or privately owned, must behave in a distinct way if they are to survive, or better thrive, in the Chinese Communist state.

The reason for this is that the hybrid Chinese state capitalist system which combines 'Leninist control' with intense capital accumulation (McNally, 2012: 751), creates a unique set of incentive structures for state and private firms. For economic elites, the cultivation of political connections is of paramount importance in a context where state intervention, rather than free markets and transparent competition, is the norm (Nolke et al., 2015).

¹ This is a pseudonym for the sake of anonymity

There is an imperative on red capitalists to turn relationships with political elites into profit (Dickson, 2003). Political patronage is a precious resource which business elites in the mainland must prioritise. The CCP continues to control the capital market on the mainland (Walter and Howie, 2011) meaning that ‘national champions’ flourish under the beneficent hand of the CCP, while outsiders flounder. Elites foolish enough to challenge the status-quo are liable to find themselves in the court facing corruption charges.

It is wrong to consider red capital as a homogenous entity. Just as the Chinese Communist Party is not monolithic, ‘red’ firms have diverging interests and character. A state-owned enterprise with ties to the Chinese military is likely to behave differently to a Shenzhen-based private technology firm. However, due to its dependency on Beijing, the institutional incentives and pressures structuring the behaviour of red firms differ to that placed on international capital.

Naturally the CCP can co-opt red capital to pursue political ends. Heidi Wang-Kaeding and Malte Kaeding (2019) note that red capitalists are mobilised as a part of broader United Front strategies. One primary distinguishing feature which marks out red capital is the ‘synergy between economic measures and political will...’ This can be observed domestically, across the Belt and Road, as well as in sensitive contexts such as Taiwan, Hong Kong or in the case of technology firms such as Huawei. For instance, in Taiwan: ‘through economic integration, the Chinese authorities cultivate local agents (Taiwanese business and political elites), purchase Taiwanese media to manufacture public opinion, and create Cross-Straits interest groups to influence legislation and policy implementation.’



Chapter Structure

This report is structured in six parts.

In chapter 1, we consider the rise of red capital and its scope in Hong Kong. The chapter contains a thorough examination of the scope of red capital in finance, real estate and the media. It also examines the history of red capital's rise. This is partially an inevitable corollary of China's economic growth, but it has also been a matter of government policy with the Closer Economic Partnership Agreement one example of proactive measures which have been taken to further integration of the mainland with Hong Kong.

The proactive preferment of red capital is the subject of chapter 2. In this chapter we examine in depth the full range of Hong Kong government policies which privilege red capital. This ranges from the design of the Greater Bay Area programme through to regulatory tweaks relating to the Belt and Road Initiative.

Chapter 3 turns to the internal politics within red firms. Beijing's active cooption of these firms for political goals has increased with time. The activity of party cells and the changing demands of the central government have led to reshaped employment practices and a growing political role for red capital.

This has knock-on implications for other businesses, both local and international. **This is the subject of chapter 4.** Hong Kong's business leaders have found that they are increasingly walking a tightrope if they want to continue to access Chinese mainland markets. Where once their interests closely aligned with Beijing, now they are finding that punishment awaits if they fail to kowtow, and that the goals of Chinese nationalism do not always align with the desire for rule of law and free information flows which are the priorities of business leaders.

Chapter 5 zones in on an industry specific case-study: the media. Nearly 35% of the media in Hong Kong now has a major mainland stakeholder. Meanwhile, the pro-democracy news outlets are finding that their business model is increasingly under threat as a result of red capital advertising embargoes. This twin strategy exposes the full economic coercion arsenal at Beijing's disposal. The greatest contemporary threat to press freedom in Hong Kong is economic.

Finally, **chapter 6 considers what all of this means for Western policy makers.** Given the fundamental significance of red capital for Beijing's designs for Hong Kong, this chapter takes a broader look at ways of tightening pressure on red capital, particularly considering what targeted measures could be adopted to tighten capital flows to companies complicit in egregious human rights violations.

Chapter 1:

The rise of red capital and its scope in Hong Kong

Summary of key insights

- **The increased presence of red capital in Hong Kong has followed a similar trajectory to the Chinese economy in the last 3 decades. As China has grown in power and influence, the presence of red capital in Hong Kong has correspondingly increased.**
- **The current US-China tensions have led to an uptick in mainland Chinese IPOs in Hong Kong. In 2019, 82% of IPOs in Hong Kong were by mainland companies.**
- **In October 2020, mainland equities made up 57.3% of the Hang Seng Index by weight.**
- **At the beginning of 2020, around 60% of the companies listed in Hong Kong were mainland companies, and they account for about 70% of the market capitalisation.**
- **Similar trends are seen in other strategic industries including media, insurance, and real estate.**

The rise of red capital in Hong Kong

There has been a steady rise of red capital in Hong Kong. Up to 1978, red capital had little influence in colonial Hong Kong. A small number of state-owned enterprises such as the Bank of China had offices there, mostly to procure embargoed goods and hard currency (Lian, 2017b: 22).

The situation changed during the ‘reform and opening up’ era under Deng Xiaoping. This was the period when Hong Kong’s fortunes started to become increasingly tied to that of the mainland, as the rapid growth of the mainland economy became the major driver of growth in Hong Kong. Simultaneously, local tycoons shot to great wealth, largely riding the wave of China’s rise and pledging allegiance to the Chinese Communist Party (see chapter 4).

In the late 1980s and 1990s, an increasing number of state corporations began registering offices in Hong Kong. A common strategy was to buy up shell companies on the Hong Kong Stock Exchange and link them to assets in China. These companies, known as ‘Red chips’, were owned by the Chinese government but registered in Hong Kong. (Lian, 2017b: 22). Later on, SOEs began to list their shares directly in the Hong Kong Stock Exchange (HKSE), these shares were known as ‘H-Shares’. The reason for registering on the HKSE was primarily to raise capital, which was then to be sent back to the parent company.

Simultaneously, another type of red capital started to flood into Hong Kong, the private wealth of princelings. Amidst intense factional infighting, wealthy party elites would funnel money via relatives (‘princelings’) to Hong Kong, and sometimes from there to other offshore havens. Lian (2017b: 23) notes that the city is a ‘centre for money laundering of China’s rich and powerful.’

‘Paradoxically the presence of such wealth may ‘have been giving a layer of protection to Hong Kong’s long-term viability in the face of increasingly strident acts of intrusion into the affairs of the city by Beijing with the aim of undermining the ‘colonial’ institutions of rule of law and the various political freedoms. It is not difficult to see why. With Hong Kong as a safe haven for the wealth and lifestyles of these ‘princelings’, they are naturally disinclined to any further dismantling of the ‘one country, two systems’, which protects them at times from the anti-corruption campaign carried out by Xi and his allies.’

Post-handover economic integration

The handover led to an exponential rise in red capital's footprint in Hong Kong. The signing of the 'Closer Economic Partnership Agreement' (CEPA) in 2003 between Beijing and Hong Kong was a catalyst. Between 2003 and 2013, Hong Kong's trading volume with China tripled, and there was a disproportionate increase of both inward and outward investment from China vis-à-vis other jurisdictions (Yuen, 2014: 72). CEPA allowed the United Front a more open role in Hong Kong, it increased the city's dependency on China, and perhaps most significantly it encouraged a major influx of red capital.

Although initially, Chinese firms and Princelings used Hong Kong either as a conduit for capital raising or as a shelter for wealth, CEPA and the Great Recession of 2008 encouraged the arrival of another type of red capital investment as Chinese firms began to more actively participate in the local economy and politics. In the words of Lian (2017b):

“This new wave of Red Capital consists of new money from China, but also includes reinvigorated old-timers such as the Bank of China and China Resources. It is the result of Chinese elites becoming aware of the political leverage of China's new-found wealth, particularly after 2007, when China's economy reached peak growth.”

“It has since made its presence felt in insurance, retail and corporate banking, construction, real estate development, energy, tourism, local and regional transportation, and many other lines of business that relate to the livelihood of ordinary Hong Kong people, and together employs a lot of locals.”

CEPA and the Great Recession are not the only factors in the proliferation of Red Capital in Hong Kong. Since 2011, the mainland government, and their counterparts in Hong Kong, have actively pursued a range of policies designed to entrench the influence of red capital in Hong Kong.

This has been part of a wider strategy to deepen Hong Kong's integration into the mainland. Beijing's 'comprehensive jurisdiction' (BBC, 2014), not Hong Kong's autonomy, has been named as the priority by the Chinese Communist Party. The 2014 White Paper on Hong Kong policy stated that:

'As a unitary state, China's central government has comprehensive jurisdiction over all local administrative regions, including the HKSAR,'

This policy statement has translated into a more interventionist approach everywhere from the law courts to the Legislative Council to the response to protests. Taking economic control of strategic industries along with the expansion of red capital has been a crucial pillar of the strategy.

Chapter 2 considers in greater depth the ways that the Hong Kong Government have actively encouraged the spread of Red Capital, even sometimes compromising the integrity of the city's financial regulations or reputation in order to ensure that mainland firms are given priority. Examples considered in Chapter 2 include the actions of the Hong Kong Government, and their counterparts in Beijing, to prioritise red capital through the Greater Bay Area plan, the Belt-and-Road Initiative, and the expansion of the West Kowloon high-speed rail terminus. This has contributed to the depth of influence that mainland firms have in the city.

2019-2020: Red Capital IPO boom in response to the US-China Trade War and National Security Law

The political turmoil of 2019-2020 has catalysed a further boom in red capital. The US-China Trade War and the National Security Law have together contributed to red capital influxes into Hong Kong. Firms which previously would have listed in the New York Stock Exchange have responded to the growing international tension by choosing to raise international capital in Hong Kong. US-China decoupling appears likely to set in motion a trend where major firms like Chinese fintech giant Ant Group choose Hong Kong over foreign financial centres. In addition, the international uproar over the National Security Law led Beijing to issue a directive to mainland companies to support the Hong Kong economy.

Chinese companies that have listed their IPOs in the city in 2020 include JD.com Inc., Netease Inc., Evergrande Property Services Group, the property management unit of China's largest real estate developer Evergrande Group. The figures would have been even larger had Jack Ma's fintech giant Ant Group planned \$35 billion dual listing in Hong Kong and Shanghai gone ahead, but this was pulled following regulatory difficulties (Nikkei Asia, 2020; McMorrow and Lockett, 2020).

Over 2020, more than \$40 billion has been raised in mainland IPOs (Prasso, 2020). A total of 99 IPOs listed in Hong Kong in the first three-quarters of 2020 (Cheng, 2020). In turn, the exchange's shares have surged in the same period.

The steady flow of listings has been driven by three factors. First, in 2019 Beijing called on its biggest state firms to take a more active role in Hong Kong, by stepping up investment and asserting more control of companies in the financial hub (Zhai, 2019; see chapter 4).

The second driving factor is the fact that little pressure has been brought to bear on capital flows during the US-China Trade War (Mitchell, Hale, Lockett, 2020). While there has been a trade and technology supply chain decoupling, Beijing and Wall Street have deepened their ties as China has sought to open-up further and investors have looked for opportunities during the global pandemic. Hong Kong's role as a capital conduit has therefore increased in importance.

Simultaneously, Chinese companies have increasingly become spooked by concerns that US-China tensions will lead to the tightening of regulations on the US stock exchanges and make it harder for them to attract Western investors. This has led to a growing number of companies being advised to hold secondary offerings and list on Chinese stock exchanges as a fail-safe against the worsening of relations between China and the West.

There is some basis for these concerns. In April 2020, three US-listed Chinese companies faced fraud allegations. Nasdaq-listed Luckin Coffee was found to have exaggerated sales by \$310 million. Days later, NYSE-listed TAL Education Group admitted fraudulent sales. Then short-sellers Muddy Waters and Wolfpack accused Nasdaq-listed video-streaming site iQiyi of fraud, a claim it continues to deny. These fraud allegations prompted Nasdaq to propose new rules that would make it harder for foreign firms to launch on the market (Barrett et al., 2020).

On 20 May 2020, the US Senate passed new legislation which would give the Securities and Exchange Commission greater leverage to remove Chinese firms from US stock exchanges (Congress.gov, 2020). The US House of Representatives has yet to schedule a further vote on the legislation, citing concerns that threats to de-list Chinese firms could lead to US investors being subject to retaliatory measures on Chinese stock exchanges (Weizhen, 2020).

In November 2020, the U.S. Securities and Exchange Commission pushed ahead with a plan that threatens to kick Chinese companies off U.S. stock exchanges, setting up a late clash between Washington and Beijing as the Trump administration winds down (Schmidt and Bain, 2020).

As Chinese firms continue to weigh up the likelihood the continuation of the US trade war, or worse of the trade war turning into a capital war, many have opted to take out secondary listings as an insurance policy against further restrictions in the US. Technology firms NetEase and JD.com, which both trade in New York, made clear in corporate filings this year that they think the United States is becoming more hostile toward Chinese companies. Both now hold secondary listings in Hong Kong.

Hong Kong as a global financial hub is well situated to benefit from this new approach by Chinese firms, especially since the Hong Kong Government has announced reforms to the Hang Seng Indexes to change the rules to allow companies that have chosen Hong Kong for their secondary listing to appear on the city's benchmark index and in July launching a Nasdaq-like technology index to track the largest tech firms that trade in the city. These reforms paved the way for the index to add Alibaba and Xiaomi as Hang Seng constituents in September 2020 (He, 2020).

While the political situation in Hong Kong continues to unravel, the Hang Seng Index is peaking in unprecedented ways. How things pan-out will largely depend on the state of US-China relations going forward. Hong Kong could find itself the beneficiary of a further deterioration under a Biden administration, but there are a range of ways that US pressure might be applied on Hong Kong's financial system itself which we discuss in the concluding chapter. These are unlikely to be sufficient to meaningfully undermine the city's role as a key cashpoint for mainland firms. Having said that, the more Hong Kong's system is undermined, the more likely it is that cities like Shanghai may be able to compete for the city's status in the mid-to-long run.

The scope of red capital in Hong Kong

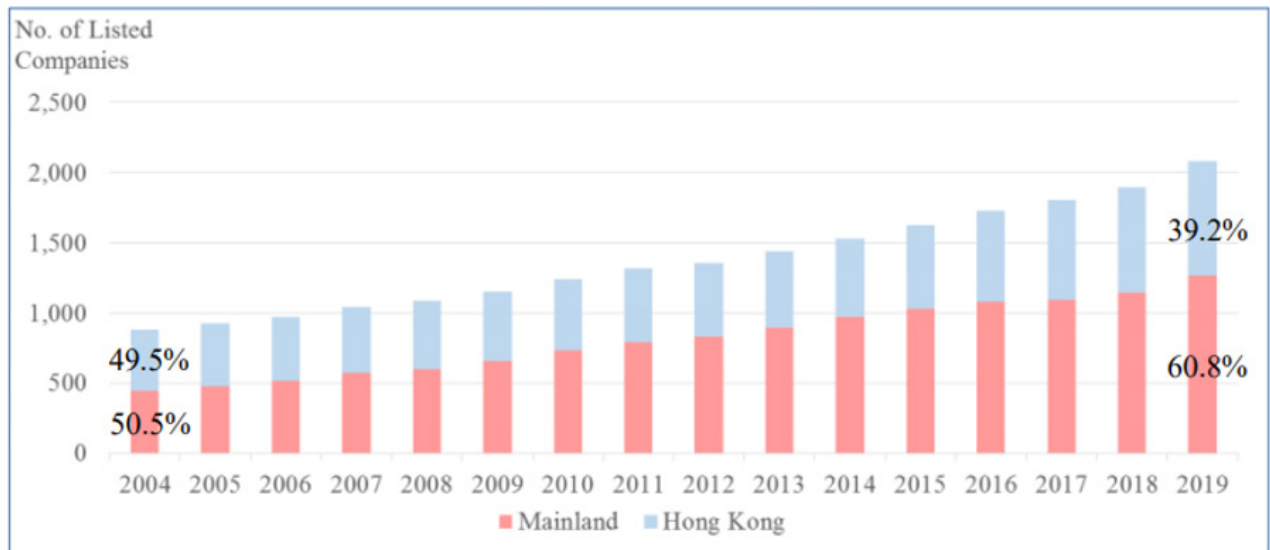
These trends have contributed to the size and pervasive influence of red capital in Hong Kong.

In this section, we lay out the data, focusing on the market capitalisation of Chinese companies, and the market share of red capital in real estate and insurance sectors.

The Hang Seng Index, the Hong Kong Stock Exchange and capital markets

- In October 2020, Mainland companies (H-Share + Red Chip + other mainland companies) accounted for 57.3 percent of the Hang Seng index by weight. The Hang Seng index is a market capitalization-weighted index that is made up of the 50 largest companies that trade on the Hong Kong stock exchange. Tencent Holdings Ltd was the largest equity on the Hang Seng Index (Hang Seng Indexes, 2020b).
- Hong Kong capital markets are dominated by Chinese corporations. In 2019, China-related IPOs accounted for 82% of such funds raised in Hong Kong (Reuters, 2020a; Weinland, Leahy, Sender, 2019; HKEX, 2020).
- At the beginning of 2020, around 60% of the companies listed in Hong Kong were mainland companies, and they account for about 70% and 80% of the market in terms of market capitalisation and trading respectively (Hang Seng Indexes, 2020a).

Graph 1: Number of listed companies by geographical classification (2004-2019)



Source: Hang Seng Indexes (2020a)

Graph 2: Market Capitalisation by Geographical Classification (2004-2019)



Source: Hang Seng Indexes (2020a)

Media

- In their 2017 Annual Report, the Hong Kong Journalists Association calculated that 35% of the traditional Hong Kong media outlets had major Chinese mainland stakes. Among them are TVB, that controls over 90% of the broadcasting industry, as well as the city's only major English-language newspaper the South China Morning Post.
- In a 2018 investigative report, Radio Television Hong Kong uncovered Chinese mainland ownership of Hong Kong's three major publishing companies, dominating over 70% of the market.

Insurance

- Among the ten largest insurance companies in Hong Kong, three are from China and make up 40 percent of the market (Apple Daily, 2019a).
- China Life Insurance (Overseas) takes up 25.2 percent of the market's share, Bank of China Life makes up 9.6 percent and China Taiping Life Insurance (Hong Kong) makes up 5.3 percent.

Real Estate

- Red Capital investment in real estate has risen significantly. 2016 was a particularly important year when Chinese buyers accounted for 53 percent of the \$12.2 billion in Hong Kong's government land sales (Bloomberg, 2017).
- This investment has fluctuated, with Chinese investment in Hong Kong property dropping in 2018, but then spiking again in the first half of 2019. 57 percent of the government residential sites up for tender in the first half of 2019 were sold to mainland developers and their consortiums. (Gerrity, 2019).

Conclusion

This chapter has demonstrated the scope of red capital in Hong Kong. The city's financial markets are now dominated by mainland firms, and red capital investment is reshaping a range of strategic industries. This process is partially a natural corollary of the growth of China's economy, and Hong Kong's place as the mainland's ATM. However, geopolitical push factors including the unrest in Hong Kong's local politics and the US-China trade war have placed political imperatives on the influx of capital. The following chapter will also consider how these trends have been furthered due to conscious Hong Kong government policy. Of course, as will be discussed in chapter 4, China's influence strategies in the region do not only depend on red capital. Many of the local Hong Kong tycoons and international firms in the city have their fortunes tied up with their ability to access the mainland and are therefore reliable partners for the Chinese Communist Party in the city.

Chapter 2:

The Hong Kong Government and the rise of red capital

Summary of key insights

- **Expanding the presence of red capital, and the integration of Hong Kong into the mainland economy, has been a conscious matter of Chinese and Hong Kong government policy in recent years.**
- **This has led to breaches of, and changes to, Hong Kong's regulatory framework in order to accommodate the role of red capital in the Belt and Road, Greater Bay Area and elsewhere.**
- **Hong Kong government policy has often focused on white elephant projects which appear to primarily benefit mainland capital rather than Hong Kong's people. Contracts for key projects are frequently offered to Chinese State-Owned Enterprises without going out to public tender.**

Introduction

The Closer Economic Partnership Agreement (CEPA) was a major turning point in the rise of red capital in Hong Kong but under Chairman Xi Jinping and recent leaders of the Hong Kong government including C Y Leung and Carrie Lam, there has been another concerted push to further the integration of Hong Kong into the mainland economy.

In recent years, the Hong Kong Government has consistently worked with the mainland Government to ensure that there are incentives for mainland firms, and firms with significant red capital stakes, to invest in Hong Kong's strategic industries.

To do this, they have both amended regulations to make them more favourable to firms with major red capital stakes, as well as offering major subsidies to mainland firms and developing policy which favours mainland companies. Significant funds have been spent on a range of 'white elephant' projects which primarily serve the interests of red capital rather than local Hong Kongers.

Corruption and graft have a long history in Hong Kong which precedes the large influx of mainland money into the city. Since 1997, one chief executive and one chief secretary have been imprisoned, and this doubtless only scratches the surface (Wordie, 2019). The process by which government officials hand out contracts has always been opaque. What has changed in recent years is the increased privileging of red capital. This chapter considers a range of case studies which illustrate this process.

The Belt and Road, Red Capital and Hong Kong's regulatory environment

Rule bending to accommodate red capital is common in Hong Kong's financial sector. From rule changes to the Hang Seng Index to ensure the incorporation of Chinese internet giants like Alibaba, Xiaomi and Meituan Dianping (Reuters, 2020b), to Citic Group entering the Hong Kong Stock Exchange through a 'backdoor listing' via Citic Pacific in 2014 (Yam, 2014), Hong Kong's financial rules are increasingly frequently bent to give discretion to red capital.

Perhaps the most notable example of this has been seen in the case study of the Belt and Road Initiative, as well as the Greater Bay Area. The city's position as a key hub in both schemes has resulted in regulations being glossed over or ignored.

The roll-out of Xi Jinping's Belt and Road Initiative (BRI), as well as the Greater Bay Area plan (GBA) have increased the interconnections between the mainland and Hong Kong economy, increasing the presence of red capital in Hong Kong's economy and illustrating the way that red capital is reshaping the city's financial regulations.

The Hong Kong Government describes the city as a 'super-connector' in the BRI (NewsGov.HK, 2017). The city boasts of the ways that its capital flows, currency convertibility and simple low tax regime allow it to facilitate belt and road investment.

While Government officials are correct to underline that these reasons allow the Special Administrative Region an important role in the Chinese Communist Party's marquee project, another important reason Hong Kong is able to be a super connector is because of the ways that red firms seeking to invest in the BRI are given a leg-up by governing officials and regulators.

The Hong Kong government have actively sought to facilitate BRI investment. A key Hong Kong initiative aimed at facilitating this was the establishment of the Infrastructure Financing Facilitation Office (IFFO) (Charltons Law, 2017). The IFFO provides a platform aimed at helping facilitate infrastructure projects and their financing. The HKMA signed a Memorandum of Understanding with the Export-Import Bank of China and the China Development Bank Corporation to establish a framework to facilitate the financing of projects through this platform.

Taken alongside the stock connect schemes that connect Shanghai and Shenzhen with Hong Kong, and the establishment of the China Exchanges Services Company Belt and Road Index, there has been a concerted effort by the financial sector, the authorities in Beijing and the Hong Kong government to ensure Hong Kong plays a key role in the BRI, and that it is an easy place for red firms to operate, acting as a springboard for investment elsewhere.

These trends may be profitable in the long-term but they carry clear risks. In order to make the regulatory environment more favourable to red capital, the Securities and Futures Commission has had to compromise the rigour of its listing standards.

In April 2017, Hong Kong's Securities and Futures Commission, under pressure from the Chinese Government, announced that it was willing to be more flexible when it comes to approving "One Belt, One Road" initiative-linked companies to be listed on the stock exchange (SFC, 2017).

Previously, the Securities and Futures Commission would require main board constituents to have a HK\$50 million profit before listing. Under its new flexible guidance, any company located in a country tied to the Belt and Road can list in Hong Kong, as long as the risk levels are considered acceptable.

Outlining the new guidance detailing the factors which it considers when assessing risk levels of Belt and Road companies listing, the SFC includes the following mitigating factors:

- a large shareholding by a relevant Mainland state-owned enterprise, sovereign wealth fund, substantial listed company or substantial and globally-active institutional investor;
- a sizeable Mainland, Development or International Bank committed to providing ongoing project finance;
- and a direct involvement or shareholding by the relevant state government (i.e. where the project assets are located).

BRI listings are therefore one of the clearest examples of Hong Kong's markets being rigged in favour of red capital, with political projects taking priority over strict financial regulation.

Case Study: Chinese auditors and the Hong Kong market

A powerful example of the impact of red capital on the Hong Kong regulatory regime is seen through changes to the city's auditing industry. Recent years have seen policy changes to open the door to mainland audit firms, as well as behind the scenes interference within individual companies and the backdoor acquisition of audit firms in Hong Kong by mainland corporations. While some of the evolution is motivated by business drive, Beijing's determination to expand its influence in the industry and its overwhelming power over Hong Kong are the prime causes.

Top-down policy to open the door to Chinese audit firms.

Despite widespread reservations about the quality of mainland audit firms, the Hong Kong Stock Exchange have chosen to allow mainland auditors to audit the mainland incorporated companies listed on the Stock Exchange.

The process by which mainland audit firms came to be accepted in Hong Kong began in 2007, following the Ministry of Finance and seven other mainland government departments issuing a policy declaration to encourage its auditors to expand overseas. Within months, the Hong Kong Institute of Chartered Accountants signed an accord with the Ministry, promising to explore the acceptance of mainland auditors in the city.

In 2009, the Hong Kong Stock Exchange issued a consultation paper on opening its doors to mainland auditors for the mainland incorporated firms listed (HKEX, 2009). Under the proposals, these auditors would be subject to the accreditation and censure of Mainland regulators, meaning that the Hong Kong regulators would have zero power over them.

Critics expressed concerns on the professional ethics of mainland auditors as well as the Hong Kong regulators' lack of power over them. The Big Four accountancy houses and industry bodies, however, supported the change. Beijing had offered them reciprocal treatment that would allow them to work on Hong Kong companies listed in the Chinese stock market. Though they may well have realised at the time that this carrot was beyond their reach, given China's tight control on listing, they would not take the business risk of antagonizing Beijing. At the same time, the Big Four and other key auditors had been assured that their Mainland joint ventures would be accredited.

The policy change was delayed for a year due to strong reservations expressed by the Hong Kong Securities and Futures Commission. The watchdog questioned how Hong Kong regulators could protect investors when they have no jurisdiction over mainland accountants and therefore no access to audit papers. However, its leverage was limited. In December 2010, twelve mainland audit firms gained access after the Mainland authorities agreed to investigate matters raised by the Hong Kong Financial Reporting Council and to advise their Hong Kong peers of the outcome (Jacob, 2010). By early 2015, of the 204 mainland-incorporated companies listed in Hong Kong, more than 25% was audited by mainland accountants or their Hong Kong subsidiaries (Xiao et al. 2016).

Acquisition of Hong Kong peers

From 2004 onwards, Mainland auditors have been expanding into Hong Kong via mergers and acquisitions. These trends have occurred despite requirements in two laws that accountancy firms be owned by Hong Kong certified public accountants (CPA) only. The laws also allow for no partnerships with non-CPAs.

No party involved has discussed how the acquisition can reconcile with the legal requirement. A veteran in one of the merged firms who spoke on condition of anonymity said:

“There are various ways to handle the law. Let’s not forget many mainlanders have been accredited as CPA in Hong Kong over the years. Or you have a Hong Kong CPA owning the firm but the Chinese controlling the management. Some use a special purpose vehicle to control the Hong Kong audit firm.”²

Some local accountants initially resisted red capital, but this principled stance has too often given way to pragmatism. The fate of Grant Thornton’s Hong Kong team is a telling case. In 2010, this 500-strong force rebelled against the head office’s decision to put them under the directive of the Chinese member firm and joined its rival BDO instead. They preferred the BDO model that ran Hong Kong and China teams independently. Their so-called independence did not last long as the Chinese market continues to expand. In 2015, BDO HK accepted the fate of a takeover by a Chinese team via capital injection. Several of the PRC controlled auditors managed to break into the dominance of the Big Four and enter the international league table. Shinewing International, which acquired a Hong Kong peer in 2005, is now ranked 19th in terms of fee income in 2019. Others, however, are more associated with small and dodgy listed companies. PRC controlled auditors accounted for a third of the 65 listed companies that have had their financial numbers questioned by short sellers and the 35 cases of audit firms reprimanded by the HKICPA since mid-2015.

Example: The Financial Statements of China High Precision Automation

An example of how red capital auditor firms have eroded Hong Kong’s regulatory regime is seen in the case study of the financial statements of China High Precision Automation (CHPA).

In October 2011, KPMG expressed concerns over the claim in CHPA’s financial statement that the organisation had notched up a 33% profit increase.

The auditor said it had identified “inconsistencies” between the information contained in the Group’s accounting records and information independently obtained from relevant government departments, and that the company had failed to provide any supporting proof.

Citing a legal opinion, the company explained that the information required by the auditor could not be provided because it could run afoul of the ‘Law of the PRC on the Guarding of State Secrets’. The organisation’s trading was suspended after this refusal to provide information (Steger, 2011).

² Interviewed on 21 January 2021

In August 2012, CHPA disclosed that the Fujian state secret authority had confirmed that its business involves state secrets; and should not be disclosed to the auditor. Its claims were backed by the Hong Kong subsidiaries of two Chinese accountancy firms. One of the firms explained the inconsistencies in numbers with the requirements under the Secrecy Law that governmental departments must process the information involving state secrets before disseminating that on its platforms. The other firm gave the company an unqualified audit opinion, adding that a relevant tax bureau official had verbally confirmed the company's sales and profit data. Neither firm provided any information on whether they had seen any supporting documents on the sales in question.

The day after, the Hong Kong Stock Exchange approved the resumption of trading, causing grave market concerns on whether state secrets have been endorsed as an exemption from audit rules. Independent commentator David Webb said a company that refused to put its numbers up for audit in the name of state secrets should have never been allowed to list. The bourse, which rarely made case specific comments, emphasized that CHPA's auditor had managed to verify the numbers via other sources and denied any rule bending.

Within days, the local media reported that officials from The Liaison Office of the Central People's Government in Hong Kong had met the Exchange Chief Executive Charles Li to raise concerns over CHPA's prolonged suspension (Apple Daily, 2012). An exchange spokesperson did not comment on the meeting but emphasised that all regulatory requirements have been made before CHPA resumed trading. The Securities and Futures Commission disagreed with the Exchange's decision. On 23 August 2012, the company announced that the commission has directed the Exchange to suspend its trading (Yiu, 2012). CHPA remained suspended as of the date of publication. The Exchange has exercised its discretion not to delist the company despite its nine-year long suspension.

Beijing's tight control on audit papers

In 2014, China's Ministry of Finance banned foreign auditors from auditing the books of mainland IPO hopefuls, including Hong Kong auditors. International auditors were required to work with domestic partners, and all papers were potentially subject to claims of being state secrets (Yiu, 2014). Without the audit papers, the Securities and Futures Commission have been unable to pursue criminal litigation against Chinese businessmen in certain widely reported fraud cases (Yam, 2017). This has severely damaged the city's regulatory regime.

Growing linkages between Hong Kong and the mainland via Stock Connect schemes has seen the policy relaxed somewhat. In May 2019, the Ministry of Finance agreed in a memorandum of understanding that the Hong Kong Financial Reporting Council "will be able to make request" to the Ministry "for assistance in gaining access to audit working papers of Hong Kong audit firms located in the Mainland". In late 2020, the Council finally laid hand on the first batch of papers.

However, the Hong Kong authorities remain reliant on the Ministry of Finance to reach audit papers. Moreover, the memorandum did not specify whether works done by mainland audit firms would be covered. It also continued to bar Investment banks working on the listing of their clients from accessing these audit papers despite their due diligence responsibility and legal liability in the case of foul play by their clients.

The impact

Professional audit is the backbone of the integrity of any financial market. While the issues listed above are not unique to Hong Kong, the impact is. As Chinese firms account for more than 60 percent of the listed companies, the highly restricted access by watchdogs to audit papers compromise the regulatory regime. As an increasing number of local accountancy firms have fallen into the hands of Chinese counterparts with doubtful standards, the city's professional ethics have become at risk.

Policy changes to facilitate integration of the Greater Bay Area

Since April 2017, Beijing has focused its efforts on integrating Hong Kong into the Greater Bay Area (GBA), which consists of nine mainland cities and the two special administrative zones on the Pearl River Delta, including Guangzhou, Shenzhen, Zhuhai, Foshan, Dongguan, Zhongshan, Jiangmen, Huizhou, and Zhaoqing, Hong Kong and Macau.

The principal aim is to integrate the semi-autonomous regions of Hong Kong and Macau into the nine neighbouring mainland cities to create a powerhouse of innovation and economic growth to rival San Francisco, New York, or Tokyo.

In Hong Kong's case, this means integrating the special administrative zone economically and eventually politically into the GBA by removing the current regulatory and legal barriers that exist between the mainland and Hong Kong. The most noticeable part of the wider GBA strategy has been the investment by the Hong Kong Government and Beijing in large-scale infrastructure projects that link Hong Kong to the mainland and primarily benefit red capital businesses. However, there have also been technical announcements of pilot schemes which have for the most part fallen under the radar of international observers.

Wealth Management

For example, a recent announcement in July of the opening of a pilot Wealth Management Connect scheme which would spur cross-boundary wealth management has largely gone unnoticed. Under the scheme residents of Macau and Hong Kong would be able to buy offshore wealth management products sold by mainland Chinese banks and residents in the GBA would be able to invest in products sold in Hong Kong and Macau. As with previous attempts at stock and bond connect schemes between the mainland and Hong Kong, there would be a closed loop capital flow system reflecting the fact that China's capital account is not fully liberalised (Tudor-Ackroyd and Yiu, 2020).

Rather than bolstering Hong Kong's status as a wealth management hub, financial analysts have speculated that if the pilot scheme is successful it could lead to substantial 'northbound traffic' as investors tap into the higher yields of wealth management products in mainland China. This would in turn increase the demand for offshore Renminbi, making it a more profitable and active currency (Hong, 2020).

Legal profession

In October, Hong Kong authorities announced a three-year pilot scheme for legal professionals which would allow them to practice in any of the nine cities within the GBA, by providing legal services regarding specified civil and commercial affairs, including litigation and non-litigation businesses, using the mainland's applicable laws in the Bay Area.

Internships

Outside of the legal sector, the Hong Kong Chief Secretary has announced more government support to encourage young Hong Kongers to take up internships or set up businesses in the neighbouring cities in the GBA. He announced that the GBA will be a springboard for many young Hong Kongers, with more than 60,000 Hong Kongers being granted opportunities every year to gain experience on the mainland through internships and exchange programs (Ng, 2020b).

Education & Housing

As part of a set of 57 measures agreed by the Hong Kong Chief Executive and the Guangdong provincial governor, Hong Kongers will be encouraged to open bank accounts, buy property, and send their children to schools in the neighbouring mainland cities.

Under a set of joint initiatives Hong Kongers will be allowed to open bank accounts in the Greater Bay Area without having to visit mainland China. The measures agreed also include simplifying loan procedures for residents seeking to purchase homes in the region (Cheung, Wong, Sito, 2020). Previously, Hong Kong buyers could only apply to mainland Chinese banks for mortgages. But since July 2020, at least six local lenders have offered cross-border mortgages, with buyers applying at the branches and allowed to pay in Hong Kong dollars.

Both authorities are also working to refine policies which will allow Hong Kong children to access examinations and free education if their parents move to Guangdong.

Spending on major infrastructure projects

As part of the Greater Bay Area plan, another feature of the development of red capital in Hong Kong has been the growing amount of spending by the Hong Kong Government on large-scale infrastructure projects which primarily benefits mainland Chinese businesses.

This spending has increasingly by-passed the Legislative Council and has been announced as part of Beijing's plans to integrate Hong Kong into its plans for the Greater Bay Area and spending related to the Belt and Road Initiative.

Hong Kong Government officials have often presented these projects to the public as win-win scenarios, but closer analysis shows a preference for mainland businesses and that these projects overwhelmingly cater to Beijing's overall aims.

Hong Kong-Shenzhen technology park

In the case of the Hong Kong-Shenzhen technology park in the Lok Ma Chau Loop, the Hong Kong Government has spent HK\$20 billion (\$2.58 billion) for the first phase of its development since 2018, and the first plot of land in its section is expected to be ready in 2021 (Yau, 2018).

The shared project has been billed by Hong Kong Government as a key part of plans to turn the city into an innovation and technology hub, which will have overwhelming benefits for local residents. However, lawmakers in the Legislative Council have criticised the lack of consultation and the involvement of the Shenzhen Government, as the technology park is being constructed within the city's borders and is fully funded by the Hong Kong Government (Van Der Kamp, 2018).

Concerns over the benefits for Hong Kong have been exacerbated by news that two-thirds of the board that oversees the technology park will be appointed or co-appointed with Shenzhen and worries that Shenzhen based-businesses will dominate the park (Cheng, 2017b). Shenzhen has announced that it has already recruited over 100 companies to its part of the park. The remote location is less appealing to Hong Kongers and has drawn questions about why the Hong Kong government is paying for the project.

The Hong Kong-Macau-Zhuhai Bridge

The bridge connecting Hong Kong and Macau via Zhuhai is at the heart of Beijing's plans to integrate Hong Kong into Beijing's plans for the Greater Bay Area. Hong Kong's bill for the bridge came to \$HK 120 billion (\$15.4 billion), despite there being little demand from Hong Kongers for greater transport links with Macau and Zhuhai (Leung, 2018). In April 2020, nearly a year and a half after its opening, the Transport and Housing Secretary Frank Chan Fan admitted that traffic on the bridge was 4,000 vehicles below what the Government had expected, even with a relaxation of the bridge's vehicle quota (Yau, 2020).

Considering the minimal use of the bridge and its substantial cost, running over budget several times, the greatest beneficiaries have been the businesses rewarded with large contracts to build it. This includes the Chinese Harbour Engineering company, which was one of the main contractors on the bridge, responsible for providing concrete (Siu, 2018). The Chinese Harbour Engineering Company is a subsidiary of China Communications Construction Company, a Chinese state-owned enterprise which was listed by the US Department of Defence in August 2020 as a 'Communist Chinese military company' and sanctioned by the US Government for its construction work in helping to militarise artificial islands in the South China Sea.³

The Kowloon West high-speed rail terminus and the third runway at the Hong Kong International Airport

The Kowloon West high-speed rail terminus which connects Hong Kong to the neighbouring city of Shenzhen has been the source of much controversy, not least because its co-location arrangements allow mainland Chinese police officers to operate and enforce national laws in parts of the station. Pro-democracy opposition lawmakers in the Legislative Council and the Hong Kong Bar Association launched an unsuccessful legal challenge to block its construction, claiming that the co-location arrangements contravened Hong Kong's Basic Law.

The Hong Kong Government shouldered the full cost of the new terminus which stood at HK\$86.4 billion (\$11.1bn) (Cheng, 2018). As with other infrastructure projects, mainland Chinese companies appear to be some of the biggest beneficiaries. The construction project was divided into a Southern and Northern part, with the Northern part awarded to Gammon Construction, a subsidiary of Jardine Matheson and Leighton Contractors, a subsidiary of China Communications Construction Company, which as previously mentioned is a Chinese state-owned enterprise involved in work to militarise artificial islands in the South China Sea (SMH, 2011).

The Hong Kong airport authority's ongoing plans for a third-runway has been a source of much debate in the city, with many Legislative Council members fearing that the decision for the expansion to be self-financed through bank loans and a passenger levy would leave the city liable for bailing out the airport authority.

³ See Concluding chapter

The new runway is expected to expand air routes for Chinese airline carriers and develop Hong Kong as an air transport hub, as the airspace will be shared with neighbouring mainland cities in the Greater Bay Area (Dodwell, 2016).

As with other large-scale infrastructure projects in Hong Kong, mainland Chinese state-owned enterprises have substantially benefited from construction contracts regarding the new runway (NEC Contract, 2020):

- In June 2017, China State Construction Engineering, the largest state-owned construction company in the world headquartered in Beijing, secured a HK\$2.37 billion (£235 million) contract to build the first section of the passenger and baggage tunnels.
- In April 2019, the Airport Authority announced that the third-runway and associated taxiways contract, worth HK\$6.27 billion (£621 million), would be awarded to a joint venture including Sinohydro Corporation Limited, a Chinese state-owned hydropower engineering and construction company and Powerchina Airport Construction Company Limited, a state-owned electricity company.
- In May 2019, the Airport Authority also announced the awarding of a tripartite agreement for the supply of sand and dredging works for the third runway to two mainland state-owned enterprises, Guangxi Beibu Gulf International Port Group Company and China Communications Construction Company.

Lantau Tomorrow Project

The Lantau Tomorrow Vision project has been vaunted by the Hong Kong Government as the solution to Hong Kong's housing crisis for several years. The project aims to reclaim up to 17,000 hectares (4,200 acres) of land out at sea to house up to 1.1 million people on artificial islands.

Currently the reclamation work is scheduled to begin in 2025 with 1,000 hectares of land around the island of Kau Yi Chau in the central waterway east of Lantau, with the first residents moving in by 2032. Once completed, the reclaim land is expected to have up to 400,000 houses, which will have a 70/30 split between public and private housing. The project is estimated to cost at least HK\$624 billion (US\$80 billion), a sum equivalent to the entire GDP of Ethiopia in 2017 (Keegan, 2019).

Critics have attacked the project, citing environmental concerns and the growing cost to the Government and taxpayer, claiming that “pouring money into the sea” will wipe out the city's fiscal reserves. Arguing that the only beneficiaries of the new islands will be engineering and construction firms that will come mostly from mainland China.

Former lawmaker Eddie Chu Hoi-dick, who is also a surveyor, said the Government had underestimated the cost, as interest on loans to complete the project could total at least HK \$150 billion. He has also said that the estimate ignores the fact that building costs will increase every year. At a conservative rate of 20 per cent over the minimum 14 years building period, Chu Hoi-dick estimates that it could rise by up to HK \$900 billion in total (Cheng, 2019).

Environmental campaigners also oppose the building of artificial islands which they argue will destroy natural habitats, negatively impact marine ecology, and harm the livelihoods of local fishermen. Environmentalist Angel Lam has urged the government to adopt a “brownfield first” policy instead. This would involve developing more than 1,000 hectares of existing brownfield land in the city’s New Territories area. Greenpeace believes that by spending less money, the government could gain large tracts of land for development while solving planning problems in rural areas (Lung, 2019).

The Lantau Tomorrow Project is not simply about land or housing. The Hong Kong Chief Executive Carrie Lam has insisted that the project could see Lantau become the third core business district and an aerotropolis given its proximity to the international airport and the recently opened Hong Kong-Zhuhai-Macau Bridge, which will serve to connect Hong Kong further to the wider Greater Bay Area.

There remain concerns over the role of developers in the project, after the Government recently floated the idea of allowing private developers to pick up contracts for land reclamation and development. A land concern group has argued that this would mean house prices stay at high levels and do little to resolve the housing shortage which the scheme is designed to address. They point to the example of the private-public partnership for the City One residential project in Sha Tin in the 1980s which did little to address the housing crisis (RTHK, 2020).

Similarly, the question of who is likely to benefit from any new housing built in Hong Kong remains a contentious topic. A steady flow of mainlanders to the city has increased housing demand, with nearly one-fifth of public housing applications in the first quarter of 2018 coming from new arrivals from the mainland (Lung, 2019).

Red Capital and the Covid-19 pandemic

Like other governments across the world, the Hong Kong authorities have relied heavily on private sector outsourcing to manage the spread of COVID-19. As with other sectors of Hong Kong’s economy, the largest beneficiaries of increased government spending in response to COVID has been Chinese state-owned enterprises.

In March 2020, the Hong Kong Government took decisive action to limit the spread of COVID through the creation and construction of a network of government run quarantine facilities for those suspected to have been infected with the virus.

Quarantine Camps

The awarding of the first-phase of a contract to build a 600-room quarantine camp at Penny’s Bay on Lantau Island worth HK \$194 million (US\$25 million) to state-owned China Harbour Engineering without a formal tender process has been a source of criticism by opposition lawmakers. News of the decision to award the contract was broken by the China Harbour Engineering on 17th February on WeChat, with the company writing that it had received a call from the Civil Engineering and Development Department and the contract was signed two days later (Zhang, 2020).

A separate decision to award a HK \$70 million (US \$9 million) contract for another quarantine camp at Lei Yue Mun Pak and Holiday Village to the state-owned China State Construction Engineering has also drawn opposition, particularly as following the award of the contract, the Director of Beijing’s Liaison Office, Luo Huining, visited the construction site for a photo-op. Some members of the public questioned the discrepancy of construction cost between the two quarantine sites, particularly as the projects are being directly funded through the Social Welfare Department’s Lotteries Fund.

Under pressure to justify why it had awarded these contracts to companies funded directly by the Chinese Communist Party state, the Hong Kong Government conceded to a transparent open tender bidding process for the second phase of the site at Penny's Bay on Lantau Island (Ting, 2020). The second-phase contract worth HK \$418 million (\$US 53.9 million) was eventually awarded to Gammon Construction owned by Jardine Matheson and Balfour Betty.

Mass testing

Efforts by the Hong Kong Government to mass test the whole population of Hong Kong have been the source of great controversy, not least because many residents have raised privacy concerns and pro-democracy politicians have asserted that the involvement of mainland companies could see DNA leaked from labs and used to track participants.

HybriBio's Hong Kong Molecular Pathology Diagnostic Centre and two other subsidiaries of mainland Chinese companies BGI and Kingmed Diagnostics helped conduct the mass testing, which initially cost the Hong Kong Government HK\$530 million (US\$68.4 million) (Ji, 2020).

A total of 1.78 million people were tested under the Universal Community Testing Programme and 42 COVID cases identified among those that were tested. The numbers were far below the Government's estimates of a take up of five million, leaving the companies involved in the testing underwhelmed.

Health experts also have questioned the effectiveness of mass testing, reporting low levels of cases prior to the scheme and whether it would prove an effective tool in containing the spread of COVID-19. The effort uncovered just 42 infections, or two per 100,000 people.

The full cost of the scheme is still unknown and will not be confirmed until the mainland biotechnology companies involved disclose how much they spent.

Investment in the mainland

The Mandatory Provident Fund

The Mandatory Provident Fund (MPF) is Hong Kong's compulsory pensions scheme (MPFA, 2020). Like other schemes around the world, it exists to ensure that Hong Kongers are provided for in retirement. The 20-year-old MPF had HK\$967.76 billion assets under management in the end of June 2020 (Hui, 2020).

In 2020, the 10% cap on MPF investment in Chinese A-shares was dropped, and the Shanghai and Shenzhen bourses were added to the list of approved stock-exchanges for the MPF scheme. The Hong Kong government said that 'it was heeding the call to invest more in China.' (Hui 2020) Pretty much all of the major MPF investors have funds which are devoted to investing in red capital, predominantly through H-shares, Chinese equities listed in Hong Kong. The allocation of Hong Kong pensions to red capital will only increase following the addition of A-Shares listed in Shanghai and Shenzhen (Yiu, 2020b).

A recent Apple Daily investigation found that Hong Kongers planning to relocate to the United Kingdom with their British National (Overseas) passports this year will not be allowed to withdraw their Mandatory Provident Fund savings even if they plan to leave the city permanently. The MPF normally prevents withdrawals until the account holder reaches the retirement age of 65. However, those who plan to leave Hong Kong permanently can withdraw their contributions early.

But the exception to early withdrawals is BN(O) holders planning to settle in the U.K. this year. Customer service officers at several MPF trustee companies – including Manulife, HSBC, AIA and BOCI-Prudential Trustees – said the BN(O) is considered only a travel document rather than proof of residency outside of Hong Kong (Apple Daily, 2020).

The Hong Kong Future Fund: Furthering integration?

On 1 January 2016, the Hong Kong Government created the Future Fund with an initial endowment of HK \$219.7 billion. Operating as a sovereign wealth fund, the logic behind its creation was to invest the city's financial reserves, with the money being placed with the Exchange Fund for an initial 10-year investment period (Gov.hk, 2015). The Future Fund posted an annual return of 4.5% in 2017, 9.6% in 2018, and 6.1% in 2019.

Hong Kong Financial Secretary Paul Chan announced in February 2020 that the Government would start drawing down HK \$22 billion (US \$2.82 billion) from the Future Fund to create a new growth portfolio which will focus on domestic investments, possibly including non-mainstream assets such as private equity (Asia Asset Management, 2020).

In September 2020, the Hong Kong Government announced the establishment of a Governance Committee to oversee investments of the Hong Kong Growth Portfolio. Chaired by Financial Secretary Paul Chan Mo-po, the committee's membership comprises: Victor Fung Kwok-king, group chairman of trade multinational Fung Group; lawyer and venture capitalist Victor Chu Lap-lik; banker Chen Shuang; venture capitalist Herbert Chia Pun-kok; Hong Kong Science and Technology Parks Corporation Chairman Sunny Chai Ngai-chiu; and Cyberport non-executive chairman Lee George Lam (Gov.hk, 2020).

The Committee's terms of reference states that its aim is 'to provide strategic steer on the establishment and development of the Hong Kong Growth Portfolio under the Future Fund with a view to achieving an enhanced return whilst consolidating Hong Kong's status as a financial, commercial and innovation centre and raising the productivity and competitiveness of Hong Kong in the long run.'

Critics have argued that the Hong Kong Growth Portfolio will likely be used to further integrate Hong Kong into the Greater Bay Area by using the city's sovereign wealth fund to primarily benefit Chinese state-owned enterprises and members of the local and foreign business community who align themselves with the aims of the Chinese Communist Party.

As the Hong Kong Growth Portfolio comes online, its investments will serve as an important indicator in the continued influence of red capital in Hong Kong.

Conclusion

This chapter has sought to demonstrate the diverse ways that the Hong Kong government have actively sought to encourage and expand the presence of red capital in the city. Integration with the mainland has been a matter of government policy and continues to remain a priority. The rise of red capital must be understood in this context: it has been a conscious matter of government policy.

Chapter 3: Party Cells, Politics and Protest – life inside red firms

Summary of key insights

- **Since Xi Jinping became General-Secretary of the Chinese Communist Party, there has been a wide range of changes in the behaviour of red firms in Hong Kong.**
- **Beijing’s control of firms has grown as the mandate of party cells has expanded. This has shaped employment practices, as well as the behaviour of these firms.**
- **Red capital has been coopted to influence the local politics including by firms instructing their staff on how to vote or not to attend protests.**

Introduction

As mentioned in the introduction, Hong Kong Watch spoke to a senior executive at the Hong Kong branch of a Chinese state-owned bank while researching this report. Mr Wong’s⁴ insider view of the changing behaviour of one of China’s State-Owned Enterprises (SOEs) in the Special Administrative Region brought the insight that Xi Jinping’s rule has led to a step change in the behaviour of red firms.

One senior media executive agreed that 2011-2012 was the most significant turning point. However, he underlined that it was not only Xi’s accession which was relevant. “Everything changed once CY Leung turned up. The Mainland Affairs Office changed; a lot happened.”

Whether it was local personnel or central government, the turn of the decade clearly marked a turning point in the assertiveness of Beijing in Hong Kong. This carried with it two consequences. First, as described above, the influx of red capital increased as a policy priority.

A second consequence of the changes is that the behaviour demanded of businesses has changed with time. Mr Wong described changes in the bank’s strategy:

“Around 2012, after the financial crisis in the US and Europe, the strategy changed. They no longer sent people here to learn about Western market economics, instead they wanted the West to follow their rules. They no longer wanted to learn, they wanted to rule.”

The bank’s employment strategy changed with it:

“Ten years ago, they were sending very junior people: here to learn. After 2012, they sent very senior people, starting to fill top management positions. They are trying to fill every tier of the company with loyal people. Everyone who acts a spokesperson should conform strictly to the party line.”

⁴ We have given the interviewee a pseudonym for the sake of anonymity

The senior media executive saw a similar trend:

“Beijing’s primary tool for getting people to do things in Hong Kong was never the stick at first, it was always the carrot.

“Up to 2002, it was all about the carrot. Charles Ho, if you buy Singtao for us, we will open up China for you.”

However, successive political crises, particularly the Article 23 debate in 2003, and the universal suffrage debates in 2009 and 2014, saw things change: “the line was firmly drawn, if you do something wrong, you’re going to be punished.” With greater numbers of red firms in Hong Kong, this kind of compliance is now far easier to demand.

Party cells

Beijing has consolidated control of red firms through the incorporation of party cells. In the mainland, private firms, SOEs and even joint ventures must incorporate party-cells in decision making (Hornby, 2017; Michael, 2017; Yan and Huang, 2017), while a panoply of laws provide license for the state to control sensitive data and other key assets (McGregor, 2019). While there is a certain flexibility inherent in the relationship between the state and private firms, the blurring of lines is significant.

The mandatory inclusion of party cells into the decision making of red firms extends beyond the mainland into Hong Kong. In 2017, more than 30 Hong Kong-listed SOEs added lines to their articles of association – the governing document of any corporate - which mandate that party cells must be at the heart of the business (Hughes, 2017).

The new phrases inserted into the articles of association include describing the party as having a core role in “an organised, institutionalised and concrete way” and “providing direction [and] managing the overall situation”.

These changes are important. The China Construction Bank amended its constitution to state that “(The party committee) instructs and promotes the Senior Management to implement the decisions of the Shareholders’ General Meeting and the Board”. The Bank of Chongqing changed its constitution to allow the party committee to vet the senior management candidates nominated by the board and propose its own candidates. Shirley Yam reported that in 2017, the China Railway Group had “708 party committees at different levels of its corporate structure, while Sinopharm Group has 91, excluding party committees at the bottom most level.” (Yam, 2017b).

Mr Wong noted that in what he termed ‘strategic sectors’ such as finance, real estate, education and the media, there has been considerably expanded party membership since 2012.

‘Previously there would have been one-or-two party members in each firm, now they expanded to ensure there were party members at every level of the organisation.’

If there has been any resistance to the resurrection on party cells within corporations, Xi Jinping’s ‘anti-corruption’ campaign and the purge which followed has eliminated that. Xi cited the weakness of Party committees as a reason for corporate corruption. This is seen in the case of the Citic Group. Citic Group was supposed to be a leading light in planned reforms to give private capital and the market economy a larger role in China’s economy by opening-up the activities of SOEs. In 2014, it underwent major restructuring to make these reforms possible.

Yet in 2016, the ‘Central Commission for Discipline Inspection’ slammed Citic’s Party Committee because it ‘mainly talked business with little or no mention of the Party and politics.’ The crime was limiting the activities of the party committee to the appointment of key officials, the demand was that the committee would be consulted on all significant policy changes, investment strategies and personnel appointments (Yam, 2016). The promised reforms never happened, and its reform-oriented chairman was subsequently replaced by an outsider. The change reflects the fact that there is usually only one winner when party priorities compete with market considerations.

It is worthwhile noting that the introduction of party cells was not confronted with the scrutiny that might have been expected in a city like Hong Kong whose international reputation is paramount (Yam, 2017d). Party committee members were not asked to sign any undertakings that their actions would comply with the standard financial regulations and laws, despite their insider information and powerful role. Beijing demanded that Hong Kong listed SOEs be audited by mainland firms, and this has been deemed acceptable despite it reducing the transparency of the accounting and the ability of the Hong Kong authorities to monitor their activities.

Employment

The tightening of Beijing’s control of red capital has played a role in ensuring that red firms are now more frequently co-opted for political and cultural ends as part of Chinese Liaison Office in Hong Kong’s United Front strategy. This is seen in recruitment practices where from board level downwards, mainlanders are being privileged above Hong Kongers.

Despite the economic slowdown in Hong Kong and the on-going global pandemic, global recruiters and red capital are choosing to actively hire bankers from mainland China to help global banks leverage their contacts in mainland China, particularly within the Chinese Communist Party. J.P Morgan has a specific ‘Sons and Daughters Program’ which over recent years has provided dozens of jobs in New York, Shanghai, and Hong Kong, to the children of the Chinese Communist Party elite in the hopes that their employment will further the American investment bank’s business in mainland China.

Reflecting the changing recruitment processes in the financial industry in Hong Kong, speaking Mandarin has become a pre-requisite qualification for most jobs. Few client-facing jobs in Hong Kong now go to workers who do not speak Mandarin. 78% of the Hong Kong based Mergers and Acquisitions professionals in Hong Kong speak fluent Mandarin according to eFinancialCareers data (eFinancial, 2020).

This trend reflects the growing importance of mainland relationships and expertise in the Hong Kong economy, and is not only seen in ‘red capital’, but other businesses too. However, the changing recruitment practices are also a corollary of the changing demands of the political situation. Mr Wong noted that this trend has been particularly pronounced since the Umbrella Movement: ‘After the Umbrella Movement, they started to insert more of their people into firms here. At least all the Chinese firms are now ruled by party members. We saw the mainland proportion of staff getting higher and higher, from very junior positions to very senior positions.’

‘They sent their people to sit in top positions. Top management started changing more and more rapidly.’ Firms with significant red capital stakes are opting to recruit mainlanders who are prominent Communist Party members to be board members. Sun Hung Kai Properties, MTRC, HK Electric, TVB, and PCCW have all in recent years hired mainlanders onto their board of directors (Apple Daily, 2019b).

In the case of the Hong Kong media-based company TVB, the company recently appointed Chinese media mogul Li Ruigang as its vice-chairman, citing the need to improve their business (Sito, 2016). Dubbed the ‘Rupert Murdoch of China’, Li previously headed the office of the Shanghai Municipal Party Committee.

But it is not only top management where recruitment practices have begun to see the prioritisation of mainlanders. Increasingly Chinese companies based in Hong Kong have introduced advanced screening processes when it comes to recruitment, which are designed to favour the hiring of mainlanders over their local counterparts.

Following the anti-Extradition protests last year, senior figures from financial institutions including banks, asset management firms, accounting firms and law firms have expressed fear that hiring Hong Kongers may send the wrong message to China and damage their relationship with Chinese customers. Three unspecified Hong Kong hedge-fund managers told the Financial Times that the company's unspecified rules now barred them from hiring Hong Kongers (Riordan, Lewis, Woodhouse, 2019).

Hong Kong students are worried that links to the pro-democracy movement will have a negative impact on their ability to gain employment when they graduate, particularly within the finance industry where there is a perception that any past opposition to the Chinese Government will bar them from jobs.

Hong Kongers have also found their jobs under pressure. The most high-profile case-study was the case of Ka-chung Law, a senior economist at Bank of Communications, a state-backed Chinese bank, who was asked to leave during the extradition protests. Mr Law was told by senior management not to talk about the role that the political chaos was having on the local economy. In early October 2019, Mr Law emailed an article to his team that was critical of China and discussed ways in which the United States could punish Beijing economically. He was subsequently called in by his bosses, asked if he had shared the article with colleagues, and then asked to resign (Riordan, Lewis, Woodhouse, 2019).

Red capital and politics

The inter-connection between red capital and politics goes beyond the employment sector. It is only one part of the Chinese Liaison Office in Hong Kong's United Front work to influence elections, culture and politics in the city.

In the 2016 Legislative Council election, the Bank of China and China Resources Land Limited instructed recruits to vote for candidates that 'love China and love HK'. The Hong Kong Chinese Enterprise Association distributed voting instructions to its 1000-member companies. Chapter 4 considers in greater depth how red capital has changed the balance of power in local politics, shifting control away from the established property tycoons and towards Beijing loyalists. Arguably the elections of pro-Beijing hardliners like Junius Ho and CY Leung are a result of this process.

During the Umbrella Movement, Beijing exerted pressure on protestors using local business groups with financial ties to the Mainland. For example, Chun Wo Development Holdings Limited withdrew its scholarship sponsorship from four universities which supported protestors.

A similar pattern can be traced throughout the 2019 protests (Wang Kaeding and Kaeding, 2019). In August 2019, Apple Daily reported that the Bank of China, the Industrial and Commercial Bank of China, China Construction Bank and the Agricultural Bank of China took a register of attendance and refused to grant staff leave during the city-wide strike over the Extradition Bill under the direction of the central government of Beijing. In the same month Haitong International reminded its staff that they were banned from any unapproved political activities in office hours other than those stated in the employee handbook.

As the anti-Extradition protests continued into late 2019, there were reports that Chinese banks required staff to report their movements outside of work to verify that they were not participating in protests. The Agricultural Bank of China required its Hong Kong staff to volunteer their time outside of work to clean up roadblocks at Hung Hom.

Red capital and the National Security Law

Since the Chinese Communist Party announced its intention to enforce national security legislation on Hong Kong, employees at red firms have increasingly found themselves under pressure to support the new law. Some were encouraged to sign a petition in the case of the Hong Kong staff for the Bank of Communications, ICBC International, Haitong International, Guotai Junan Securities, and SPDBD International. In the case of China Mobile, the company's staff committee simply endorsed the law on behalf of all employees in Hong Kong (Chan, 2020).

Managers at Chiyu Banking Corporation, a local bank owned by Xiamen International Bank, sent a WhatsApp message to employees asking them to sign a petition, according to a complaint filed by the Hong Kong Financial Industry Employees General Union. Once they had done so, the complaint said, they were told to screenshot their signature and share it. Similar instructions were sent to employees at Wing Lung Bank, according to the union.

Civil servants and office workers have also been encouraged by employers and teachers to remove protest related posters, stickers, and other material from their desks in the wake of the new law, with those refusing being invited for “friendly chats” with senior managers.

Conclusion

This chapter is only a preliminary exploration of life inside red firms. The National Security Law has limited the range of people that we, as a foreign human rights organisation, have been able to interview inside state-owned enterprises and other major firms. However, the combination of publicly available information, our interview with Mr Wong, and existing academic studies provide a compelling snapshot which points to the changing role that red capital plays in Hong Kong.

The National Security Law marks the latest development in a growing culture of businesses in Hong Kong pressuring their staff to either curtail individual political activism or to endorse an overall stance taken by the company. These trends are only set to deepen. Further academic studies, as well as investigative journalism, on this would be invaluable to better understand the relationship between the communist party, state-owned enterprises, and local politics in Hong Kong. On these matters, Hong Kong is something of a canary in the coalmine, and should provide a warning for governments around the world considering strategic partnerships with Chinese state-run entities.

Chapter 4:

Red Capital and the Hong Kong business elite

Summary of key insights

- **The rise of red capital is changing the relationship between the authorities in Beijing and their international and Hong Kong business allies.**
- **Historically, Beijing relied on Hong Kong's business leaders to control the city's politics. An alliance of mutual interest between 'blue' businesses and 'red' authorities acted to marginalise the 'yellow' camp: i.e. the democrats.**
- **The rise of red capital changes the power dynamics, meaning that Beijing is now less reliant on Hong Kong, and less reliant on the Hong Kong business elites in order to pursue its ends.**
- **This has led to Beijing more proactively pursuing policies, including the National Security Law and Extradition Bill, which are counter to the interests of the international business elites and local tycoons.**
- **Red capital has also modelled a new ideal for the behaviour of firms operating in Hong Kong. This means that increasingly other firms operating in the city are expected to demonstrate political loyalty to Beijing. This has put firms like HSBC and Cathay Pacific in a difficult position.**

Introduction

In this chapter, we consider the implications of the rise of red capital in Hong Kong for the city's established business elites.

Hong Kong's business elites and Beijing have historically worked closely together to govern the city. A combination of Cantonese and international business leaders were Beijing's key allies in the city, helping to maintain the pro-establishment status quo in the aftermath of the handover. These business leaders were conservatively minded and deferential towards Beijing, acknowledging that their fortunes are dependent on access to the mainland. But they also tend to be in favour of the small state, rule of law, low tax status quo. The relationship between key business leaders like Li Ka-shing and Beijing has been a chequered marriage of convenience.

The privileged position of these elites is simultaneously under pressure, because of the growth of red capitalists who are more actively dependent on the Chinese Communist Party for their legitimacy, and perhaps has been consolidated by the effective removal of political opposition by the National Security Law which has historically acted as something of a check on the worst excesses of the tycoons.

The new political environment ensures that the survival of the existing international and local business elites increasingly depends on taking a more subservient posture towards Beijing. This can leave some international businesses treading a tight rope if regulators in their home jurisdiction, or local Hong Kong consumers, start taking issue with Beijing's more controversial political demands.

The Business-Beijing partnership: Hong Kong's social contract in the aftermath of the handover

Studies show that Hong Kong's business elites and the government in Beijing have worked hand-in-glove together to govern Hong Kong (Fong, 2014; Wong, 2015). Hong Kong's politics since the handover has been embroiled in conflict between the 'blue' camp, business-led and sympathetic to Beijing, and the 'yellow', pro-democracy, camp.

This was a legacy of pre-handover politics. Prior to the handover, Hong Kong's business elites had worked closely with the colonial government to ensure that the city remained a stable business environment and that Beijing was receptive to investors from Hong Kong on the mainland. This alliance was mutually beneficial, ensuring that neither group had to succumb to the interests of Hong Kong's burgeoning democracy movement. As Martin Lee marched for democracy, tycoons were quietly encouraging a slower pace of political change.

These alliances were consolidated after the handover as Beijing realised that both Hong Kong's success and stability relied on the compliance of business elites. Economic turbulence caused by capital outflows of major British firms at the time of the handover convinced Beijing that it was vital to win over the firms in Hong Kong (Fong, 2014: 197).

Beijing saw the business elites as their clients in Hong Kong and understood that the future stability of the city relied on them. They also knew that Hong Kong was a critical financial conduit for China, a key source of capital inflows. As a result, leading figures in the business community were guaranteed to receive a sympathetic hearing in Beijing when they had concerns (Fong, 2014: 195). An informal political alliance was established in which, the shared interests of business leaders and the central government united them against the city's democrats, whose anti-authoritarian and social democratic policy platform could potentially have undermined the direct interests of both camps.

During the transition period, business tycoons were appointed to the bodies which determined the nature of the transition including the Basic Law Drafting Committee, Basic Law Consultative Committee, and others. 44% of the Hong Kong representatives in the National People's Congress and 71% of the representatives Chinese People's Political Consultative Committee were from big business families, providing unprecedented institutionalized channels through which to gain direct access to Beijing's top leaders (Fong, 2014: 199).

Interaction between the business community and Beijing was consolidated through the united front work of the Chinese Liaison Office in the city. The academic Brian Fong (2014) analysed the membership lists of the Hong Kongers invited to be involved in the planning and implementation of national day celebrations. The business community, and particularly the most influential capitalists, were consistently the most important stakeholders in the Liaison Office's United Front work.

In a controversial 2008 (Cas, 2008) document, the head of the Liaison Office stated that the Liaison Office should operate as the second 'governing' team in Hong Kong. With the business lobby as the key stakeholders in interaction with the Liaison Office, this meant that the business leaders had direct access to the Hong Kong government, but were also able to go to Beijing for recourse if the SAR government made a decision which countered their interests.

Of course, this did not mean that the interests of business elites always countered those of the pro-democracy movement. For instance, the protests of 2003 over national security legislation saw their interests coalesce. Nor does it mean that their interests are homogenous – the tycoons frequently have competing and diverging interests (Wong, 2015: 17).

But it is safe to say that Hong Kong's business elites and the Chinese state have had a cosy and mutually beneficial relationship since the handover which serves to protect both, sometimes to the detriment of campaigners of reform. The 'blue' and 'red' camps have been working together to marginalise 'yellow.'

'Red' trumps 'blue': Red capital's growing influence on Hong Kong politics and the waning influence of the old Hong Kong establishment

The situation has changed due to red capital's growing role in the economy. There has been a shift in the social contract, as red capital grows in strength. The interests of 'red' business and 'blue' business differ, and the future looks red. Time and again in recent years, international and local Hong Kong firms find their interests are now second-tier priorities for the Hong Kong government, and that they are under pressure to emulate red capital in their politics.

This is most obviously seen in the changes to the regulatory environment and the ways that mainland capital is being subsidised, but there are many other signs of the changing business environment. It is observable in the political struggles, where Beijing's interests and the interests of Hong Kong's leading tycoons frequently diverge, and the growing – if infrequent – public disgruntlement of the city's tycoons. Five examples are illustrative: the sanctioning of Moody's for a report critical of red capital, the 2012 Chief Executive Election, the 2016 Legislative Council election, public statements from property tycoons, and Li Ka-shing's investment strategy.

Moody's sanctioned for report critical of red capital

One area of potential conflict lies in the area of financial analysis. There are a range of possible examples of this, but one striking case study is the Securities and Futures Commission's decision to fine the credit ratings agency Moody's for a report critical of some mainland companies (Webb, 2016).

The report, published on 11 July 2011 and titled 'Red Flags for Emerging Market Companies: A focus on China', included a few minor inaccuracies, but was largely accurate. The Securities and Futures Commission fined HK\$23 million for the error, and this was reduced to HK\$11 million on appeal.

While certainly parts of the report merited correction, the serious fine was not only disproportionate, but it could also have carried a chilling effect. The message sent by the judgement was clear: that negative forecasts which are contrary to the interests of the central government and red capital are not wanted and carry a potential penalty.

In the words of financial analyst David Webb,

'What licensed firm will now dare to publish such a report if the regulator is going to pick it apart afterwards and then slam them with a fine and potential loss of licenses for the individuals involved?' (Webb, 2016)

Henry Tang versus CY Leung

The 2012 Chief Executive election was the first time that the leading tycoons and Beijing backed different candidates. Henry Tang Ying-yen had the support of the most influential of Hong Kong's property tycoons including Li Ka-shing, Lee Shau-kee, Robert Ng, and Gordon Wu. But he was defeated by Leung Chun-ying, the candidate backed by Beijing.

The unprecedented decision by Beijing to ignore the wishes of the tycoons was widely taken as a sign that the business-Beijing alliance was strained (Fong, 2014: 212).

Wong (2015: 17) notes that this cannot be simply explained with reference to the rise of red capital, as some of the less prominent members of the real estate elite, such as Ronnie Chan and Vincent Lo backed Leung Chun-ying. Fong further notes that the election was scandal ridden, and that Beijing swiftly sought to patch up relationships.

But such an outcome would have been inconceivable even ten years previously. The rise of red capital in the territory had reduced Beijing's dependency on local Hong Kong and international business leaders, and it showed.

The 2016 Legislative Council elections, the marginalisation of the Liberal Party and the rise of Junius Ho

In the 2016 Legislative Council elections, the Liaison Office expanded its involvement in the political campaigns, handpicking candidates. Certain candidates including Eunice Yung and Junius Ho ran in the New Territories by challenging Heung Yee Kuk candidates. The Heung Yee Kuk is a pro-establishment advisory board made up of members of rural committees. Allied with the Liberal party, they represent the pro-establishment local Hong Kong elite.

Yung and Ho won the seats at the expense of the Heung Yee Kuk candidates. Ho was swiftly fast-tracked to a position of influence by CY Leung, while Yung was a new ally of the Liaison Office whose family had close links with Chinese SOEs. Their success reflects 'the weakening of elites with local interests' and the rise of the prominence of red capital (Wang Kaeding and Kaeding, 2019).

Hong Kong's real estate elite

Chapter one considered the significant increase in the presence of red capital in real estate. Chinese companies bought less than 6% of property in 2009. This increased to 30% in 2016, and 50% in the first half of 2017 (Lian, 2017b).

The purchase of properties by the HNA group provides a helpful case-study. Their ability to significantly outbid the wealthiest Hong Kong tycoons, paying far above the normal market rate, was an enormous shock which signalled that red capital looks likely to transform the real estate market. (Gopalan, 2019). Yam (2016b) writes: 'HNA, a Hainan-based conglomerate, is sitting on a 145 per cent net gearing while its Hong Kong competitor CK Hutchison is at 1.2 per cent. HNA is borrowing at 8.15 per cent, which is four times of what CK Hutchison is paying. Yet, it outbid local developers by almost a 100 per cent.' The implication: red capital is able to play by different rules (Yam, 2017d), meaning that Hong Kong's real estate elites may find their days are numbered.

Another interesting case study is the property investment by the Chinese Liaison Office. Bloomberg reported that:

'The Liaison Office and its subsidiary companies have received more than HK\$206.5 million (\$27 million) of stamp-duty exemptions on at least 91 property deals, according to data provided by Hong Kong's Inland Revenue Department on deals dating to 2012. This includes a record value of exemptions this year for the Liaison Office—HK\$80.4 million on 22 transactions, most of which were approved after pro-democracy protests started in June.'

'But real estate is the most valuable piece of the Liaison Office's portfolio. A Bloomberg examination of hundreds of Hong Kong Land Registry documents found that the office owns properties in more than 20 buildings across the city, with an estimated value of more than \$1.5 billion. The figure is likely conservative, given that the Liaison Office doesn't publicize its transactions and there's no straightforward way to conduct a comprehensive search of its holdings (Schmidt, Kwan and Dormido, 2019).

Further changes in the real estate market have arisen as a result of the squeeze on the private wealth of ‘princelings’ by Hong Kong regulators. Tightening restrictions and monitoring in Hong Kong on foreign wealth, as a result of the introduction of the Common Reporting Standard (CRS), could have exposed mainlanders using the city to hide wealth. These tighter regulations did not apply to property investment, increasing private investment by mainlanders in real estate (Yam, 2017e).

Red capital’s aggressive participation in the city’s real estate market, in particular government land auctions, signifies a lifting of the ban that was imposed by Beijing after 1998. Following the 1998 financial crisis, Hong Kong developers are understood to have successfully lobbied Beijing to stop mainland rivals from entering the market. The major loss suffered by mainland companies in this period added weight to the lobbying and ensured that red capital had largely disappeared from land auctions until 2013 when China Vanke won a large bid (Yam, 2013).

Hong Kong’s real estate elite have expressed alarm at transformations in the sector, and the entrance of mainland capitalists who are willing to pay above market rates.

During an interview with Professor Yi-zheng Lian (2017a), Lui Che-woo, the chairman of the Hong Kong conglomerate K. Wah Group, said that Hong Kong developers stand little chance against investors from the mainland, many of whom are backed by powerful Chinese government entities, central or local. James Tien Pei-chun — a former legislator, a former chairman of the pro-business Liberal Party and a tycoon in his own right — turned heads at a public forum in April when he said: “Chinese money buying up land in Hong Kong at sky-high prices has left many local developers with no standing room. In the future, Chinese capital will seep into many livelihood sectors in our city.”

“When a country can fully control our main economic arteries, when the boss has full say,” he added, “the kind of good life and democracy that we all yearn for will be much more difficult to attain.”

Li Ka-shing’s investment strategy and the extradition protests

Another sign of the shifting economic power balance is seen by examining the investment strategies of Li Ka-shing. Known as ‘superman’, Mr Li has long been the city’s wealthiest man. But in recent years, he has chosen to diversify his wealth outside of Hong Kong as the influence of red capital and the Chinese Communist Party has increased in the economy.

Mr Li’s property arm has diversified (Yam, 2017a), as have most other branches of his business. Hong Kong accounted for just 3 per cent of core earnings at CK Hutchison, the Li family’s holding group, as of mid-2019. By contrast, Europe contributed 54 per cent and Canada 10 per cent (Weinland and Lewis, 2019).

Evidence of a growing schism between Mr Li and the CCP is seen through his treatment during the extradition bill saga. From the superman of investment, he became known as the ‘cockroach King’ on Chinese social media after he called for dialogue between the protestors and the government. The Central Political and Legal Affairs Commission in Beijing said his remarks were akin to “harbouring criminals” (Vines, 2019). This led to three of the four companies that dominate Hong Kong’s property market to offer up land for housing.

Pressure to conform to a Communist ideal. The influence of red capital on international and local firms since 2018

Li Ka-shing is not alone in coming under increased political pressure. With the interests of Cantonese tycoons and international business leaders now a lower priority for Beijing, these business leaders are finding themselves under increasing pressure to conform politically – modelling their behaviour on their ‘red’ counterparts. The extradition bill, the protest movement and the enactment of the National Security Law have all exposed the growing fissure between the priorities of the old Hong Kong establishment and Beijing, but also that Beijing is increasingly demanding the type of political loyalty expected of red capital from all major firms acting in Hong Kong.

Extradition bill and protests

The extradition bill was a critical watershed. In the run-up to the outbreak of protests, there was widespread concern expressed by the international and local business community about the implications of the bill for the city’s rule of law.

The statements of the American Chamber of Commerce, Hong Kong General Chamber of Commerce and others stood in stark contrast to the message from the chambers affiliated with red capital that expressed support for the bill (Patterson, 2019). In previous years, the opposition of the international business community would have been enough to create Hong Kong government doubts about the legislation, but instead Carrie Lam and the Hong Kong government chose to push ahead.

It was one of the first occasions in recent years when the priorities of local business elites, particularly of political stability and the robust rule of law, came into conflict with Beijing’s nationalist agenda. The Chinese government’s course of action showed that the latter will always trump the former under Xi Jinping.

This course of action eventually sparked protests from the Hong Kong public. The anti-extradition bill movement presented a new range of challenges for the city’s business elite which found itself caught between the democracy movement and Beijing. A range of case-studies during this period show that these elites are now required to meet a new set of standards by Beijing.

The shifts in Hong Kong’s economic circumstances, with the rise of red capital, leave Beijing less dependent on the established Hong Kong elites. This has given the freedom for Communist cadres to behave in a more bullying and intimidating way towards the other businesses in the city.

Table 1 shows a range of case-studies of this kind of pressure taking place during the extradition protests.

TABLE 1: Examples of economic coercion during the extradition protests			
Firm	The problem	Pressure by Beijing	Response
Yoshinoya	Employees satirized the Hong Kong Police Force in drawings found on Lennon Wall and social media (Hinata, 2019).	The company was pressured to take disciplinary action.	In July 2019, Mr Yoshino fired employees in Yoshinoya’s Hong Kong advertisement department
TVB	Employees posted political slogans in support of the anti-Extradition protests on an internal company message board (AsiaE-News, 2019).	The company was pressured to take disciplinary action.	In August 2019, TVB announced the firing of twenty staff who posted messages on an internal company message board, accusing them of ‘interfering with work of the Department of Information.’

Firm	The problem	Pressure by Beijing	Response
Sage Group	Machine engineering employees were pressured not to participate in anti-Extradition protests and strikes in August 2019.		This included management recording any staff submissions for annual leave, summoning staff, and refusing to offer permission for them to participate in political activities.
PwC, Deloitte, KPMG and Ernst & Young	PwC, Deloitte, KPMG and Ernst & Young, distanced themselves from a front-page ad in Apple Daily signed anonymously by employees of the four accounting firms in support of the anti-Extradition protests (Toh, 2019).	The Global Times, a tabloid controlled by the Chinese Communist Party, urged the firms to “fire employees found to have the wrong stance on the Hong Kong situation.” Mainland Chinese internet users also warned executives against “becoming the next Cathay Pacific.”	This is not the first time that the Big Four accounting firms have disagreed publicly with their employees taking public stances. In 2014, during the Occupy Central protests, the companies published an ad saying the protests would harm Hong Kong’s status as a financial center. The employees responded with another ad in the Apple Daily that said, “Hey boss, your statement doesn’t represent us.”
First Pacific Co.	A board member of First Pacific Co. was barred from entering Hong Kong for a board meeting in June 2019 (Reed, 2019).	The man in question, former Philippines Foreign Affairs Secretary Albert del Rosario, was barred because of his resistance to China’s expansive claims in the South China Sea.	He resigned from the board shortly afterward.
Health Staff & Circle K	In February 2020, health workers in Hong Kong went on strike to encourage the Government to close the city’s borders with mainland China and limit the spread of the coronavirus.	The Hospital Authority was pressured to threaten action against striking workers.	In response the Hospital Authority wrote to absent health workers reserving the right to take action against them, including deducting their salaries. On 13th February an “Ok Convenience Store” worker was also fired for striking in solidarity with health workers.
YMCA	Staff were accused of attending pro-democracy protests, organising as part of trade unions, and not doing enough to deter young people from joining social movements.	Pressure to stop young people joining the pro-democracy movements and limit the influence of trade unions.	In March 2020, the YMCA in Hong Kong fired 28 staff, including two trade union organisers, who were accused of supporting pro-democracy protests and not doing enough to deter young people from joining social movements.

Firm	The problem	Pressure by Beijing	Response
Google and Apple	Both American tech giants Google and Apple have found themselves increasingly under pressure from Beijing to delete and restrict apps in Hong Kong in response to the pro-democracy movement in the city (Nicas, 2019).	Last year both tech companies removed several apps from their online stores associated with the Hong Kong protests, after pressure from Chinese authorities.	<p>Apple, for example, banned a crowdsourced map service that allowed protesters to track police activity, while Google removed a mobile game that permitted users to roleplay as Hong Kong demonstrators, stating that it has a policy that prohibits “capitalizing on sensitive events.”</p> <p>In July 2020, ahead of the pro-democracy party primaries, Apple appeared to exclude PopVote, a voting platform used by primary organisers from its store. The company refused to comment on its decision, although primary organisers speculated that the tech firm was hesitant to include the app following the passing of the National Security Law.</p>

In-depth Case Study: Cathay Pacific

Cathay Pacific remains one of the principal examples of the consequences that can befall a international company operating in Hong Kong that fails to comply with the wishes of the Chinese Communist Party.

Cathay found itself under pressure after its Chief Executive backed staff members who joined the anti-Extradition Bill protests in 2019. In response up to thirty Cathay Pacific airline staff were fired for their participation or support for the protests. The Civil Aviation Administration of China also pressured their parent company Swire to sack senior management of Cathay including removing its chief executive, Rupert Hogg, and Lu Jiawei, its chief customer and commercial officer, or risk losing access to China’s commercial airspace (Branigan and Hale, 2019).

Beyond sacking staff, the airline was forced to recant its earlier support for the anti-Extradition protests and released a statement in favour of the Hong Kong Chief Executive, Carrie Lam, and was required to put in place an updated and strict employee code of conduct stating that employees are not allowed to post anything on social media that damages Cathay’s reputation, and encourages employees to report suspected code violations.

As a result of this, Cathay found itself subject to a boycott by Hong Kongers who were angry at the airline for its compliance. Facing economic coercion from both Beijing and local Hong Kongers ensured that the airline’s finances came under significant pressure.

After the onset of the Coronavirus pandemic, Cathay appealed for a bailout from the Hong Kong government. The \$5 billion bailout from the Hong Kong Government prevented the airline from collapsing or falling under majority control of Beijing, but guaranteed the Hong Kong authorities ‘unprecedented access to the inner workings of Cathay’ (Horton, 2019).

Some have speculated that rather than a helpful intervention that will maintain the airline carrier's independence, the bailout instead will suck Cathay and its parent group Swire Pacific closer into the orbit of China. From Beijing's perspective, the Hong Kong Government is seen as the ideal shareholder who will be hands off and always go along with furthering the Chinese Communist Party's interests.

Some are concerned that the bailout could potentially mark the beginning of the Hong Kong Government using its foreign reserves to intervene in the market on behalf of the China's wider interests. Spending which is often presented as a win-win for both the city and Beijing masks the larger truth that Hong Kong's dwindling reserves will make the territory and currency even more reliant on the Chinese Government for its future economic development.

The National Security Law

The trends which emerged during the extradition bill protests have been exacerbated since the passage of the National Security Law (NSL). The NSL has forced many of Hong Kong's leading corporations into more explicitly pro-communist party positions.

The nine richest Hong Kong real-estate tycoons with a combined worth of US \$140 billion endorsed the National Security Law in June 2020, either personally – as was the case with Li Ka-shing and Michael Kadoorie – or through one of their businesses or relatives.

A developer association representing firms including Lee Shau-kee's Henderson Land Development and the Kwok family's Sun Hung Kai Properties said it backs the law because it will guarantee stability and prosperity. The families behind Swire Pacific, Galaxy Entertainment Group and Jardine Matheson Holdings have issued similar endorsements.

The general consensus is that Hong Kong business leaders had little choice in backing the law, the only other alternative being relocating themselves and their businesses. There is a concern that if they do not publicly back the law, then Beijing would assume that they opposed it. There are few better case studies of this than the example of HSBC.

In-depth Case Study: HSBC

Since last year's anti-Extradition Bill protests, Beijing has increasingly coopted financial institutions to target funds which support the pro-democracy movement in Hong Kong.

British-based bank HSBC, which makes two-thirds of its profits in Hong Kong, has found itself particularly vulnerable to direction from the Chinese Communist Party.

HSBC sees itself as a conduit for capital from East to West and vice versa and has arguably been one of the greatest beneficiaries of the close ties between China and America since the rise of Deng Xiaoping. Decoupling and growing geopolitical tensions has shown the bank that it is hard to serve two masters.

The extradition case against Huawei's chief financial officer Meng Wenzhou was the first illustration of this. The US authorities accuse Meng of lying to HSBC regarding the company's relationship with Skycom, an affiliate that was doing business in Iran which put HSBC at risk of breaching US sanctions on Iran. This led to accusations that HSBC is 'betraying the Chinese tech company Huawei' by cooperating with US authorities. The bank's reliance on Hong Kong as a profit-hub means that it can ill afford such ire, and has led to a series of decisions where it has been forced, or chosen, to explicitly endorse the Communist Party line.

A critical example is the case of Spark Alliance. Spark Alliance was launched in 2016 to support protesters on a number of fronts including legal fees. A crowd-funding platform, it raised HK\$ 70 million (\$10 million). In December 2019, the Hong Kong Police Force arrested four individuals responsible for running the Spark Alliance fund, accusing them of money laundering. Under direction from the Hong Kong Government, HSBC suspended the Spark Alliance account and has subsequently refused to release the money in the account (Saito and John, 2019).

The seizure of Spark Alliance's funds has significantly damaged the pro-democracy movement in Hong Kong, as many young protesters who have been arrested rely on money raised from crowd-funding platforms to help pay their legal bills. The Spark Alliance alongside the 612 Humanitarian Relief Fund created by Margaret Ng accounted for 70% of the money raised to support the pro-democracy protests in 2019.

Following the suspension of Spark Alliance's account, the 612 Fund become one of the last places that protestors can receive financial support for legal bills. In March 2020, the fund showed signs of financial strain after reporting a 39% dip in disposable funding to HK\$32.2 million as the group said legal cases connected to protests had surged by 75% in a month (Wong, 2020b).

In May 2020, the 612 Fund was replenished after a crowd-funding push, bringing in HK\$24 million in 20 days. However, since the introduction of the National Security Law in July, there has been increased speculation of how long the fund can be sustained, as the new law criminalises anyone who uses funds to assist those guilty of 'succession', 'subversion', 'colluding with foreign forces', and 'terrorism'.

The case of Spark Alliance is not the first instance of HSBC being accused of targeting the pro-democracy movement in Hong Kong. The pro-democracy activist Joshua Wong in April 2016 accused the bank of refusing to allow him to create a bank account for his political party Demosisto.

The National Security Law looks set to bring further changes. Following the announcement by Beijing of plans to unilaterally introduce national security legislation in Hong Kong in direct breach of its obligations under the Sino-British Joint Declaration, the CCP moved quickly to shore up the support of the business community. HSBC, with its reliance on Hong Kong, was considered an easy target to elicit support for the law.

After criticism from Leung Chun-ying, Hong Kong's former chief executive and Chinese state media, Peter Wong Tung-shun, the Asia-Pacific chief executive of HSBC, took the unusual step of publicly backing the National Security Law. Despite this public endorsement which faced heavy criticism in the UK and other parts of the world, the bank still found itself attacked by Chinese state media and academics for "being late" in its endorsing the law and for its colonial past.

Since the National Security Law came into force in July 2020, HSBC have become a major enforcer of the new status quo. They have come under sustained pressure around the world after freezing the assets of a church pastor, Roy Chan, and an exiled former lawmaker, Ted Hui.

Other international firms under pressure

HSBC are not alone in ceding to pressure. Table 2 demonstrates a range of other case studies.

Table 2: Examples of economic coercion following the National Security Law

Company	Pressure from Beijing regarding NSL	Outcome
H&M	The Swedish multinational fashion label faced pressure from authorities regarding the need for a new staff code of conduct to limit their involvement in the pro-democracy protests.	In June 2020, H&M announced a new code of conduct for staff in Hong Kong, which included banning employees from expressing political opinions or wearing clothing with political slogans.
BNP Paribas	Last year Jason Ng, a former lawyer for BNP Paribas, the French bank, was forced to resign by the bank for writing his political views on his Facebook page, using the phrase “monkey see, monkey do” to complain about pro-Chinese demonstrators. The comments, which were later taken down, were heavily criticized in China’s state media and on the Chinese internet.	BNP apologized and pledged to take immediate action, forcing Mr Ng to leave the bank.
Chambers of Commerce	Since the National Security Law came into force on 30th June, various chambers of commerce in Hong Kong have been warning millions of businesses of the consequences of violating the law, which range from financial penalties to companies being barred from operating in the city.	Joe Chau Kwok-ming, president of the Hong Kong General Chamber of Small and Medium Business has warned that companies may inadvertently violate the law and “may step on land mines without realising it.” Over eight in ten Japanese companies in Hong Kong are concerned or very concerned about the impact the National Security Law will have on their business in the city.
Siemens	The German industrial conglomerate Siemens found itself under pressure after its CEO Joe Kaeser was quoted in the German newspaper Die Welt saying that “as long as Beijing adheres to the One Country, Two Systems agreement, German businesses can handle it. But it is indeed unusual that this understanding has not been clearly confirmed by China for some time.”	Kaeser’s comments led to criticism of the firm in China, with calls for it to be blacklisted. Siemens responded by releasing a statement reaffirming its respect for China’s sovereignty and territorial integrity which remained unchanged.

Conclusion

This chapter has described the ways in which Hong Kong is changing as a business environment for local and international businesses. The process began before the extradition bill protests and reflects the rise of red capital and the corresponding decline in political leverage that these groups carry in Hong Kong. The extradition bill protests and the National Security Law have supercharged pre-existing trends. Beijing, and their Hong Kong government clients, are now far more politically assertive than they were previously in demanding political compliance from the business sector. From Cathay Pacific to HSBC, this has left leading firms – which historically have been key powerbrokers in Hong Kong – facing tough political choices that have resulted in costly consumer boycotts or worse.

Looking forwards there are question marks about how these firms will walk the tight-rope if the Chinese government or consumers, and the United States government or consumers make mutually incompatible demands. We are already seeing cases like this: HSBC is a fine example of a previously ‘apolitical’ firm is being forced into political choices on issues ranging from the sanctions on Meng Wenzhou or the freezing of assets of the Spark Alliance. How businesses will respond to the growing matrix of sanctions and competing demands of differing jurisdictions is one of the dilemmas in a more divided world and perhaps the inevitable outcome of the Chinese government’s decision to flagrantly violate international law in Hong Kong through the passage of the Sino-British Joint Declaration. Red capital is part of this story because it leaves Beijing less reliant on international or local Hong Kong firms, strengthening their ability to flout international conventions and demand the loyalty of firms seeking to profit from Hong Kong.

Chapter 5: CASE STUDY: Red Capital and the Media

Summary of key insights

- **One of the strategic industries which has been a focus of Beijing's attentions has been the media.**
- **There are two dimensions to the relationship between red capital and the media:**
 - o **The Communist Party has sought to ensure that a significant proportion of Hong Kong's media organisations are owned by reliable allies. In its 2017 Annual Report, the Hong Kong Journalists Association calculated that 35% of the traditional Hong Kong media outlets had major Chinese mainland stakeholders.**
 - o **Advertising embargoes, often through the co-option of red capital in other industries, ensure that it is increasingly difficult to sustain a 'pro-democracy' news model.**

Introduction

The expansion of Chinese Communist Party influence in the media sphere in Hong Kong must be understood in the context of a global trend. While the global propaganda department declined in influence during the 1990s and was a lower priority, the early 2000s saw a shift in emphasis. Since 2003, when official documents were revised to outline 'media warfare' as a political goal of the People's Liberation Army, it has been an increased priority for the Chinese government (Lim and Bergin, 2018). Billions of yuan have been pushed into the roll-out of a 'Great External Propaganda plan' (Qinglian, 2010; HKJA, 2016).

External image has been a major preoccupation for Beijing in the last decade and a half, with propaganda efforts accelerating and broadening since Xi Jinping took power. The tactics and activities used to extend Chinese influence in media abroad have been wide-ranging, from the purchase of foreign media outlets to the co-option of foreign elites to the use of litigation or intimidation to force editors to self-censor. These strategies are being adopted everywhere from Hungary to Vietnam, throughout Africa, the Belt and Road Initiative countries and across the Western world (Cook, 2020).

Hong Kong provides an excellent case study for three reasons: it is of central strategic importance to Beijing, it has a key position as the only Chinese city where freedom of the press is purportedly protected, and Beijing's influence runs deep.

Growth of red capital in the media

Co-opting media outlets has been one of the most important strategies by which the Chinese government has sought to pacify the Hong Kong media (Lee, 2018).

The Hong Kong Journalists Association has conducted multiple in-depth studies of these trends (HKJA, 2014, 2015, 2016, 2017, 2018). It observes that many of the largest media groups have been bought up by red money, and once this has happened this has shaped the editorial tone:

“Therefore, mergers and acquisitions as well as investment moves by Beijing and its followers not only represent an expansion of its speech territory but also an increase in its power to control the media. It is also worth noting that in recent years pro-establishment people have been flexing their muscles in online media, as well as traditional media.” (HKJA, 2018: 31)

As in other sectors, the role of red capital has changed over time in the media in Hong Kong. A sector which was once predominantly sympathetic to Hong Kong’s democrats, has steadily become increasingly ‘blue’ or ‘red’ – in other words in favour of the interests of the city’s establishment elites or the Chinese Communist Party. By the mid-2000s, most media organisations were owned by business leaders with heavy business interests in the mainland (Lee, 2018).

Anne-Marie Brady, an expert on Chinese influence strategies abroad and United Front strategies, wrote in a 2017 paper that two policies are adopted in tandem (Brady, 2017). Under the policy known as to ‘borrow a boat to go out on the ocean’, the CCP has set up strategic partnerships with foreign newspapers, TV, and radio stations to provide free CCP authorised content – this was seen notably with the insertion of China Daily supplements in newspapers like the Daily Telegraph. Alongside this, increasingly the CCP have chosen to adopt a policy of ‘buy a boat to go out on the ocean’, with red capital takeovers of firms. In Hong Kong, where CCP has more levers of control than abroad, the two pillars of the strategy might better be described as ‘buying the boat’ and ‘bullying the captain’. A dual strategy of ensuring that state actors and their allies own the bulk of the media, and ramping up the cost for opposition, has been adopted to squeeze the media space.

In their 2017 Annual Report, the Hong Kong Journalists Association calculated that 35% of the traditional Hong Kong media outlets had major Chinese mainland stakes, a serious increase. These include those with deep ties to the state like Ta Kung Pao, Wen Wei Po, and China Daily, as well as more commercial organisations such as Hong Kong Commercial Daily, Sing Pao, South China Morning Post, Phoenix Satellite Television, Television Broadcasts (TVB), and iCable News (HKJA 2017: 6). Alongside these firms with ‘red’ funding, Sing Tao is owned by Charles Ho – a loyal ally of Beijing with significant business exposure in mainland China, and the Oriental Press Group is owned by the family of Ma Sik-chun whose wealth was raised through drug trafficking and continues to have significant ties with mainland China.

There is a considerable portion of the online and digital media space which has similar ownership structures. There is an ecosystem of online outlets, such as HKGPao and Speakout, which are funded by red capital and have become significant backers of pro-establishment politicians in Hong Kong (HKJA, 2018). They work together to shape the narrative around key political events.

Equally importantly, there are a number of leading online outlets with Hong Kong owners who are close allies of the Communist Party. Yu Pun-hoi, the owner of HK01 media, owns a chain of cinemas in mainland China. He professes admiration for Xi Jinping, holds senior positions in Tsinghua and Peking Universities, and holds a PhD from Peking University in Marxism. The Taiwanese Ministry of Economic Affairs ordered a halt on a US\$32 million property development by Mr Yu’s ‘Nan Hai Corporation’ on the basis of the fact that the firm and its proprietor ‘have extremely deep connections’ with mainland China and ‘could easily be influenced by mainland policies’ (Xie, 2019). Similarly, the Apple Daily has reported that one of the key investors in Inimum Media previously worked at the Supreme People’s Court in Beijing, and has close ties with Xi (Chen, 2016).

Another related area of funding has been for social media. The Chinese government has also ploughed money into developing twitter bots to shape the narrative. In August 2019, Twitter announced that it had taken down over 900 accounts that were used as part of a Chinese state-directed disinformation campaign to undermine the credibility of anti-government protesters in Hong Kong, and that it had also removed 200,000 new accounts associated with the network. Facebook and YouTube announced similar account takedowns, but on a smaller scale (Cook, 2020).

Trends which began to emerge in organisations with significant red capital stakes include the end of contracts for politically sensitive commentators, the self-censorship of employees, and visible changes of coverage following take-overs by red media.

One of the most famous examples of this process was the takeover of TVB. In 2015, China Media Capital (CMC), bought controlling shares in TVB. CMC Chairman Li Ruigang, a former top party person and bureaucrat in the mayoral office of Shanghai, widely known as ‘Murdoch of China’, became its vice-chairman (Lian 2017b).

Lian (2017b) notes that:

‘In a highly controversial move in 2016, the government allowed Li to exercise control over TVB even though he remained a person “not qualified to wield a broadcasting license” under Hong Kong’s law due to his non-Hong Kong Chinese citizenship. Since then, the political stance of TVB has become no different from CCTV, the state TV of China, a fact that earned for it the nickname CCTVB.’

TVB’s ownership has shaped the way that the organisation covered news stories and protests. Notably, normally loyal tycoons and media outlets more or less unanimously opposed the extradition bill when it was tabled by Carrie Lam in 2019 (Patterson, 2019). TVB were one of the only media organisations to back the bill from its inception and towed the government narrative for the entire period. One senior media executive said to us: ‘Beijing lost control of the press. Everyone except TVB was against it.’ TVB taking this controversial editorial line demonstrates the ability of red capital to reframe the editorial tone of a newspaper.

Following a change of management at the Sing Pao Daily News, a veteran Xinhua News Agency journalist was appointed as publisher. According to the HKJA, at three particularly pro-Beijing newspapers (Ta Kung Pao, Wen Wei Po, and the Hong Kong Commercial Daily), special internal groups were established. Their members are mostly from the mainland and are tasked with vetting the publications’ articles (Cook, 2013).

Another often cited example is the South China Morning Post (SCMP). SCMP was purchased by Jack Ma of Alibaba in 2015 who said the purchase was: “fuelled by a desire to improve China’s image and offer an alternative to what it calls the biased lens of Western news outlets” (Lian 2017b: 24). The organisation had already been influenced by Beijing under the previous Malaysian-Chinese owners, with the appointment of China Daily veteran Wang Xiangwei as Editor-in-Chief drawing significant question marks. The new ownership has consolidated this editorial shift.

The SCMP’s approach is more subtle than state owned mouthpieces like China Daily, and much of the organisation’s journalism and content remains of a high standard. However, employees of SCMP testify about the way editorial decisions are being dictated to determine a pro-government political stance (McLaughlin, 2020; Hernandez, 2018; Vines, 2018).

Notable examples include the language used in print to describe the police officers who attacked commuters in the Prince Edward train station on 31 August 2019. Early drafts described the scenes as ‘chaotic’, with commuters ‘cowering’ in the face of officers. The final draft presented an image of the ‘elite Hong Kong Police Force’ dealing with ‘radical protestors’ (McLaughlin, 2020). This was typical of protest coverage, where the editorial weighting tended to be in line with the official government narrative, even if individual journalists were trying to tell a different story.

Famously, and perhaps most controversially, SCMP provided coverage of the government-arranged forced confession of Gui Minhai. This led veteran journalist Steve Vines to stop writing for the newspaper (Vines, 2018).

Similarly, in a 2018 interview with *The Guardian*, an SCMP journalist (Lim and Bergin, 2018) described “a veneer of press freedom”, noting, “It’s not so much that pieces are pulled and changed. It’s where they’re positioned, how they’re promoted. The digital revolution has made that all very easy to do. You write whatever you want, but the people control what we see!”

Shrinking space for pro-democracy media: advertising embargos and red capital

Beijing have used allies to acquire key media outlets and shape the media environment through censorship and editorial control. However, when Hong Kong was handed over to China, there was a vibrant group of pro-democracy media outlets in the city. Beijing have not been able to fully silence this group but have used a range of strategies to intimidate and suffocate these outlets. This has not yet been fully successful, but red capital has also been a part of this story, and therefore it is worth examining in greater detail.

Beijing’s strategy in response to these outlets has involved a combination of litigation, physical intimidation and advertising boycotts (HKJA, 2018: 31). The three are used in concert with each other to increasingly shrink the space for pro-democracy media. All strands of this strategy have been used against *Apple Daily*, and other outlets like AM730, *Mingpao* or the *Hong Kong Economic Journal*. While *Apple Daily* continues to provide robust commentary from a democratic perspective, the *Hong Kong Economic Journal* and *Mingpao*’s editorial line has profoundly changed.

Advertising boycotts and the role of red capital

Red capital is coopted to enforce advertising boycotts. Mark Simon, who worked at Next Media as a senior aide to Jimmy Lai for nearly twenty years, underlined that initially it was more the ‘carrot’ than the ‘stick’ which brought compliance in Hong Kong’s media sector. But the role of the media during moments of major public mobilisation, particularly the Article 23 protests of 2003, opposition to proposed political reforms in 2009, the patriotic education protests in 2012 and the Umbrella Movement protests in 2014, led to a hardening of the Chinese Communist Party’s position and a central government decision to prioritise gradually taking control of major media platforms.

For *Apple Daily* this started fully in 2003. The major demonstrations in Hong Kong over Article 23 drew Beijing to examine the role of the media.

Mr Simon said:

“2003 changed everything. In 2003, I sat with the General Manager of all the major newspapers except Oriental Daily news and the Communist Party papers... we all got money from major tycoons to take out anti-Article 23 ads.”

“After the July 1 march of 2003, in the fall, that was when things change. The messages came out, and the message was that in the Fall of 2003, no more State-Owned Enterprises or property developers were allowed to take ads with us.”

“The Bank of China read it, and saw that in four months you won’t be allowed to take anymore ads out. They quickly took out four months’ worth of adverts.”

“They were all Hong Kong people at this point, all the guys working at these banks were Hong Kong people. The Bank of China, ICBC etc. all took out ads for four months.”

However, for Apple Daily and other groups, there were ways of working around these boycotts in the years after the Article 23 protests. Mr Simon described the way that the locals at mainland banks based in Hong Kong found workarounds, like working with credit card companies to advertise specific visa cards, which ensured that they could continue to advertise in Apple Daily. A similar United Front coordinated boycott campaign failed in Taiwan.

The situation changed in 2011-12 when CY Leung became Chief Executive of Hong Kong, and Xi Jinping took over as General-Secretary of the Chinese Communist Party.

In the words of Mr Simon:

“The line had been firmly drawn, if you do something wrong, you’re going to be punished. That was when TVB, and more importantly ATV, became very pro-government. That was all financial pressure which was shaping this. They would never write anti-China stories, they would cover everything but leave it to Apple.”

The pressure on Apple Daily ramped up. Other businesses, which were local to Hong Kong or international firms but with serious exposure in China, started to join the ad boycott. Cathay Pacific stopped advertising in 2012, and major banks like HSBC, Standard Chartered and the Bank of East Asia pulled their adverts in the run up to the Occupy Central protests of 2014 (HKJA, 2014: 13).

It was at this point that the pressure was also particularly brought to bear on the more moderate outlets such as the Hong Kong Economic Journal, AM730 and Mingpao. AM730 saw a total advertising boycott by red capital in late 2013 (HKJA, 2014: 14). In 2014, MingPao and the HKEJ both saw their leading editor reshuffled, people reshuffled out, as the ownership of the newspapers changed. In a sign that the pressure had existed long before then, the founder of HKEJ Lam Shan-muk wrote an article in Feb 2014 under a pseudonym saying that the paper had suffered an advertising boycott from red capital. He didn’t mention the timeframe, but he had sold the paper in 2006 (HKJA, 2014: 12). HKEJ Chief Editor Chan Kin-cheung, who resigned from the newspaper, revealed that executives had pressured him to drop a column by Benny Tai (HKJA, 2015: 4).

The situation worsened after the Umbrella Movement. Advertisers increased their boycott of funding post-Occupy (HKJA, 2015: 5). Organisations like House News shut down following intimidation and financial pressure (HKJA, 2015: 6). There were different responses to the pressure. The new management of the Hong Kong Economic Journal fired veteran editor and columnist Professor Yi-zheng Lian (HKJA, 2017). Apple Daily continued fighting on, but the pressure intensified and Oriental Daily had now got an entire team of reporters assigned to harass the owner of the newspaper, Jimmy Lai.

Whatever the political stance of the newspaper, the pressure was intense. Robert Kuok decided to sell SCMP to Jack Ma in order to get out. Mark Simon said that:

“Singtao was getting daily reviews from Beijing about what they are writing. Individual journalists are being named as problems. Editors were getting emails about which journalists are being rude to CY.”

“Since 2014, it’s been pressure, pressure, pressure on every front. Mingpao wants out, the MTR paper gets sold, the Economic Journal, the Lam family, pull out. There is an inflow, more and more, of mainland journalists into these publications. We went from carrot, to carrot and stick, to pure stick.”

He described one experience of a journalist at Mingpao who wrote a positive piece about the behaviour of the Umbrella Movement demonstrators.

“Their Malaysian editor called up and told them, I’ve just had the Chinese Ambassador on the phone, about the story. We can’t write pieces like that anymore.”

The situation since then has been increasingly difficult for media organisations like this, although the rise of digital online pro-democracy platforms has brought some breathing space.

However, since the National Security Law passed, other levers of control are being utilised. The space for digital platforms is shrinking as a result of the introduction of mandatory press credentials. The financial pressure on Apple Daily is greater than it has ever been. Meanwhile litigation against Jimmy Lai and others is proceeding through the courts.

Mark Simon said:

“The financial screws are down harder than ever before. They’re cutting off banking, they’re doing everything they can. It is hard to get the banks to work with us.

“They targeted Apple Daily’s CFO, and the administrative manager. The media executives and not the journalists.

“Now it’s full on pressure, and they’re trying to put people out of business. They want you to die, but they don’t want to pull the trigger.”

Conclusion

Beijing’s strategy for the media involves the twin strategy of ensuring that allies own the bulk of news outlets while also strategically co-opting red capital and businesses with major mainland exposure to turn the screw on their opponents. The greatest threat to press freedom in Hong Kong is that this kind of financial pressure is used alongside litigation to steadily suffocate pro-democracy outlets and encourage self-censorship.

We are already seeing this process in action. Apple Daily is the most notable example, but there is a sense that if they fold then the other smaller online outlets will have little chance. The one glimmer of hope in this context is that Hong Kongers continue to show an appetite to consume pro-democracy news. When Apple’s executives came under pressure, their stocks shot up as Hong Kongers signalled their support by investing in Next Media. These kind of small acts of protest may not be enough to preserve press freedom in the long run, but they show Hong Kong’s people remain committed to the principle.

Conclusion: Red Capital and Western policy responses

This report has found that the presence of red capital in Hong Kong has rapidly expanded in recent years. Red capital is not monolithic or homogenous, just as there is huge diversity everywhere, but the incentive structures which govern the behaviour of mainland firms are distinctive. From the media to real estate to finance, the transformation of the make-up of Hong Kong's economy has had a discernible impact on the society.

The behaviour of red capital has changed with time. The leadership of Xi Jinping and the increasingly assertive nationalism of the Chinese Communist Party has changed the relationship between state and capital. From 'bide your time and hide your strength,' the great China dream has become the goal of the Party. This has translated into the life and culture of firms with major red capital stakes where party cells are ensuring that political uniformity is the status quo and red firms serve the state's wider political interests.

There has been a corresponding change in the social contract between the Chinese authorities in Beijing and the city's local and international business leaders. Where once the Communist party looked to Hong Kong's business elites as their key partners in maintaining the status quo, there is a growing demand that they fall into line behind Beijing's agenda. This was seen most notably during the extradition bill protests and in the aftermath of the National Security Law. Both the extradition bill and the National Security Law run counter to the core interests of the city's established business elites. But where in 2003, they were able to say that Article 23 was bad for business, Beijing demanded compliance in 2020 or threatened economic coercion. This change in the power dynamics is best understood because of the reduction in the Chinese government's dependence on these business leaders, which itself reflects the steep rise in red capital.

Nowhere is this better seen than in the media. Red capital has been coopted in two ways to control the media. First, nearly 35% of the city's media organisations have significant red capital stakes. But perhaps more significantly, Beijing's business allies are being coopted to make pro-democracy news hardly viable as a business model. Advertisers are having their arms bent. Economic coercion is the greatest threat to press freedom in Hong Kong.

Western policy responses

What does this all mean for Western governments and policy makers? The purpose of this research is to deepen understanding about the economic drivers of change in Hong Kong. We have provided an overview but one key recommendation is that further academic study into the political implications of red capital is sorely needed if one is to fully understand Beijing's international influence strategies.

Outside of Hong Kong, the role of red capital more broadly presents a worrying picture for Western policymakers. Alongside human rights concerns, the behaviour of Chinese businesses and the Chinese state that backs them poses a threat to the current international rules-based system which has guaranteed peace, stability, and prosperity. This behaviour includes the areas covered in the report as well as others considered extensively elsewhere (e.g. USCC, 2020) including the regular flouting of international law and a failure to live up to previous commitments made by the Chinese Government including the guarantee that Hong Kong's autonomy and freedoms would remain unchanged for fifty years, the theft of intellectual property, attempts to undermine Western democracy, interference in academic institutions, and corrosive and unsustainable business practices that are destroying the environment and turbo-charging climate change. Hong Kong is a canary in the coal-mine, an excellent case study, but many of the insights within this report would be as applicable to red capital in cities around the world including New York, Toronto, London, Sydney, Frankfurt or Tokyo.

A second implication of the research is that international capital flows into, and out of, China deserve greater scrutiny. It is worth underlining that the rise of red capital, along with recent political developments, have not yet proven destructive to Hong Kong's prospects as a financial centre. In fact, as is noted in the second chapter, the Hong Kong government have made growing dependency on mainland capital a policy choice. Despite the events of 2019-2020, the Hang Seng Index and property prices are holding up relatively well.

Why is this? Partially because, while the US-China Trade War has put pressure on the city as a trading hub, there has been little pressure exerted on the city's capital markets which are the most important pillar in the city's status as an international financial centre.

A financial centre can function – up to a point - within a very repressive political environment. You need reliable contract law, proficient international language skills, freedom of information flows, an easy business environment, and preferably a sheltered silo for international bankers to mingle (Hong Kong Watch, 2020a). Some in the sector consider Singapore to be a good example of this. Hong Kong still has all these properties, although freedom of information flows are beginning to come under pressure. Life might feel increasingly restrictive, authoritarian and bleak for the average Hong Konger in Kwun Tong, but life for the investment banker at the private member's club in Central District or on the Peak carries on as normal providing they do not have children involved in protests. Hong Kong's political system is in ashes but this currently matters little to the city as a financial centre because mainland firms can continue to raise dollars in the city.

Hong Kong's instrumental value to red capital lies in its ability as a capital raising hub. This has been given little attention, even though Western policy makers hold meaningful leverage over the international financial system. From recent events in Hong Kong to atrocities in Xinjiang, from expansionism in the South China Sea to trade embargoes in Australia, Beijing are increasingly showing contempt for international norms. Policy makers should consider a suite of targeted measures to bring greater pressure to bear. The remainder of the report considers two possible areas that policy makers might consider:

1. Tighten pressure on the ability of red capital affiliated with human rights abuses to raise foreign funds.
2. Tighten pressure on Hong Kong as a capital raising hub, in view of China's breach of the Sino-British Joint Declaration and the promise of autonomy.

Policy responses which could tighten pressure on the ability of red capital affiliated with human rights abuses to raise foreign funds.

The importance of Environment, Sustainability and Governance (ESG) investing is increasingly widely accepted. As part of this, human rights due diligence must increase as a priority for firms, investors, and regulators.

There should be greater scrutiny of the complicity of red capital in human rights abuses. This is relevant both to Hong Kong and the Uyghur situation in Xinjiang. There are a range of ways that policy makers can practically turn up the pressure.

The targeted use of the Hong Kong Autonomy Act, and development of similar legislation around the world

Under the Hong Kong Autonomy Act, individuals, institutions, and banks that erode Hong Kong's autonomy through the National Security Law will face targeted financial sanctions. Under the act, financial institutions which assist sanctioned individuals in Hong Kong are liable to face US sanctions (Hong Kong Watch, 2020b).

This is powerful legislation which the US could make greater use of, laying out the financial institutions which are affiliated with those officials responsible for the assault on freedoms in Hong Kong.

Similar legislation, which strengthens the power of Magnitsky legislation, could be considered by other governments around the world.

China human rights and ESG investment: Curbs on investment in specific companies

Western governments and regulators are increasingly asking whether the status quo, whereby there are no meaningful regulations to stop investors from investing in companies complicit in the most egregious human rights abuses in China – including forced labour and ethnic cleansing in Xinjiang, is acceptable.

The United States has taken steps to curb specific companies that are complicit in such breaches. In November 2020, the United States administration issued an Executive Order which deters U.S. investment firms, pension funds and others from buying and selling the shares of Chinese firms with links to the military. Those included on the list include Huawei, The China General Nuclear Power Group and others. The Executive Order prohibits the trading of securities that would amount to investment into Chinese Communist military companies (The White House, 2020a). The executive order inhibits the actions of fund managers that have been investing in China, including those which passively track indices with strong China weighting. Several major indices including FTSE Russell and MSCI have chosen to drop a number of the blacklisted companies in response (Platt and Sevastopulo, 2020). By the end of the Trump administration, 44 firms were listed including Xiaomi, the Chinese National Overseas Oil Corporation (CNOOC), and China Mobile (Klein and Delaney, 2021).

Pension fund managers will have to change their investment strategies as a result of these policies. The Federal Thrift Board in the United States has been informed by the United States administration that it must not invest in Chinese stocks and bonds (Sevastopulo, 2020).

Similar policies ought to be considered for investment in any firm that is complicit in the oppression of the Uyghurs in Xinjiang. Complicity in gross human rights abuses must be a red line. Major emerging market indices include firms that have been shown to be involved in the creation of the Xinjiang surveillance state. Should that be the case? These firms should be blacklisted from pension investment. Greater scrutiny should be placed on this process, and corporate complicity in the situation in Xinjiang ought to be considered a red line similar to engagement in the tobacco industry.

Legislators should be considering strengthening the capital controls on firms implicated in gross human rights abuses. There is further to go in the United States where Congress should consider legislation, but these policies will be most effective if the UK, EU, Australia, Canada and other partners join the United States. One way of ensuring this takes place may be to strengthen international human rights due diligence frameworks and ensure that there are clear consequences for firms that choose to partner with human rights abusers. This may be more acceptable to EU policy makers who would prefer not to single out China.

China human rights and ESG investment: Curbs on Specific Companies

A second set of actions could incorporate curbs and sanctions on specific companies that are complicit in human rights abuses. The Hong Kong Autonomy Act provides one possible model. A second good example is the Uyghur Forced Labor Prevention Act which passed the U.S House of Representatives in September 2020. This would:

1. prohibit the importation of goods made wholly or in part in the XUAR or by persons working with the Chinese government for purposes of its "poverty alleviation" or "pairing-assistance" programs, which allegedly use forced labor from China's ethnic minority populations;
2. provide a mechanism to impose sanctions on foreign persons who knowingly engage in or facilitate forced labour in the XUAR and/or contribute to or provide support for efforts to contravene U.S. law regarding the importation of goods made by forced labour; and
3. establish new disclosure requirements for U.S.-listed companies that knowingly engage with entities involved in certain activities related to the XUAR. (Miller & Chevalier, 2020)

This kind of robust action is what is needed to fully signal that human rights matters to Western governments, and gross abuses of rights will not be tolerated. Similar policies should be considered elsewhere. Genocide and forced labour should be a red line when it comes to investment.

Policy responses which could tighten pressure on the Hong Kong Government

Alongside human rights specific regulations, there are certain regulatory shifts which might tighten the pressure on the Hong Kong government. The appeal of these policies is that they are Hong Kong specific, but the drawback is that they are perhaps less targeted at either red capital or the primary perpetrators of human rights violations. Nonetheless, policy makers may conclude that it is time for the financial markets and trade policy to signal that Hong Kong is no longer autonomous. We now turn to consider a range of policy options:

‘Made in China’ or ‘Made in Hong Kong?’

Should Hong Kong be considered different in terms of trade to the rest of China? With the revocation of the Hong Kong Policy Act in the United States, the US government has said no (The White House, 2020b). They have therefore started to list Hong Kong companies as ‘Made in China.’ This carries a range of implications from a trade perspective – including increased scrutiny on customs checks and greater barriers being placed on certain types of sensitive technology.

The reality of the depth of red capital influence in Hong Kong raises questions about whether the distinction is still justified. The National Security Law makes it clear that Hong Kong’s autonomy is of little meaningful significance. The risk that the city could now be used as a backdoor by Beijing for the import and export of sensitive technologies remains deeply relevant.

Increasing scrutiny on the disparity between Hong Kong’s rating and China’s rating

Our research shows that red capital dominates Hong Kong’s economy. The US government has affirmed that the city is no longer meaningfully autonomous from mainland China. Questions should be asked about the stark disparities in the credit ratings of bonds from Hong Kong and the mainland. While there are still clear differences in the legal system, contract law, and other key qualities, scrutiny should be placed on these disparities, particularly given the sheer size of red capital influence on the territory.

The credit ratings agencies Moody’s and Fitch downgraded Hong Kong’s rating in 2020, citing concerns about the city’s institutions, governance strength and constraints on the territory’s autonomy from mainland China. Currently, another ratings agency, S&P rates Hong Kong sovereign bonds as AA+ while Chinese bonds are A+; Moody’s rates Hong Kong bonds as Aa3, while Chinese bonds are A1; and Fitch rates Hong Kong bonds as AA- while Chinese bonds are A+ (Trading Economics, 2020a, 2020b). There are questions about whether this status quo is sustainable.

Fitch wrote that the “downgrade reflects Fitch’s view that Hong Kong’s gradual integration into China’s national governance system and associated rise in economic, financial, and socio-political linkages with the mainland justify a closer alignment of their respective sovereign ratings.”

The ramifications of growing dominance of red capital in Hong Kong’s economy are likely to be wide ranging and profound. As Hong Kong’s reliance on red capital grows, it will be harder to avoid the pitfalls which plague the mainland, whether that is the compromised corporate rule of law or an economy which is rigged in favour of mainland firms and those with CCP connections.

Increasing scrutiny on the ratings agencies’ decisions vis-à-vis Hong Kong is therefore apposite, but policy makers should bear in mind that a downgraded Hong Kong rating is not the most targeted means of restricting capital flow to problematic mainland companies. This is particularly the case as lowering Hong Kong’s sovereign rating is more likely to cap the rating of non-red Hong Kong companies than red Hong Kong companies.

MSCI incorporating Hong Kong into China’s weighting on the Emerging Markets Index

A similar set of questions may be asked of Hong Kong’s ongoing inclusion on the MSCI World Index (an index of developed country markets). The collapse of the city’s autonomy, and the heavy presence of red capital in Hong Kong, raises questions about whether the city justifies separate inclusion in the MSCI World Index or should be included as part of China in the Emerging Markets Index. Removing Hong Kong would wipe the c. \$400 billion USD index from Hong Kong’s current listing on the World Index. Of course, investors may just decide to invest more in the Emerging Markets Index to offset this (MSCI, 2020).

The inclusion of Hong Kong as part of China in the Emerging Markets Index would increase China's dominance of Emerging Markets indices. Exchange Trade Fund providers should consider providing more 'Emerging Markets ex China + HK' products and investors should be encouraged, in view of the ESG considerations, to consider these instead of those dominated by Chinese equities.

Blocks on US dollar clearing in Hong Kong

In an extreme scenario, the US could consider blocking access for Hong Kong financial institutions to dollar clearing through Swift.

Joseph Yam, the former head of the Hong Kong Monetary Authority described the fourth potential scenario as the 'nuclear option'. Given the sheer size of the US financial system and dominance of the dollar, Yam said the US "has a powerful arsenal at its disposal", but "deploying the powerful arsenal could well end up hurting itself badly." Hong Kong is the third largest US-dollar trading centre in the world, behind the US and the UK. If it lost this role, then there would be global repercussions (Yiu, 2020a).

Financial analysts generally view the use of the 'nuclear option' as an unlikely course of action. While hypothetically the US government could impose similar sanctions to those it levied at various points on North Korea, Iran or Myanmar, the linkages between the world's two largest economies are so much deeper and neither side would come out of this type of policy unscathed. Furthermore, Hong Kong's considerable US-dollar reserves makes this a difficult policy for the US government to enact.

In Summary

The world must take red capital more seriously. Firms tied to the Chinese state play a key role in their exercise of influence abroad. Nowhere is this demonstrated more clearly than Hong Kong, but it is a process which plays out around the world.

Hong Kong's value to China is best understood with reference to red capital. The city is China's top fundraising hub, providing safe access to foreign capital.

In view of the centrality of Hong Kong and red capital to China's geopolitical ambitions, the purpose of this chapter has been to examine what policy levers are available for those looking to hold China to account for gross human rights abuses. Our central recommendation lies in the strengthening of regulations on investment in rights abusing companies. This would be one economic measure with teeth which would signal that the West cares about human rights in Hong Kong and further afield.

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