Hearing Before the Congressional-Executive Commission on China

"How China Uses Economic Coercion to Silence Critics and Achieve its Political Aims Globally"

December 7, 2021

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Chairman Merkley, Chairman McGovern, and respected members of the Commission.

It is my honor to have this opportunity to contribute my expertise and testify before the Commission on China's Economic Coercion. My testimony will draw from the findings of my ongoing research and publications about Hong Kong business and politics. It will focus on the challenges that US corporations and investors face under the new political environment in Hong Kong after the implementation of the National Security Law in July 2020.

Since the 1980s, Hong Kong has been an indispensable offshore financial center of China while China's financial system was closed to the world. One purpose of Beijing's One Country, Two Systems design is to maintain such a role of Hong Kong after the sovereignty handover.

After China acceded to the WTO, China has continued to keep strict foreign exchange control and refused to liberalize its capital account. Hong Kong has been the only financial market under Chinese sovereignty that maintained a free financial system open to the world and a freely convertible currency of its own. It is a unique gateway where Chinese corporations raised capital from international investors, borrowed in USD, and channeled their investment to other parts of the world. As my forthcoming book *City on the Edge: Hong Kong under Chinese Rule* shows, as of 2019, among the 1,738 Chinese companies listed in overseas markets, 1,331 were listed in Hong Kong.[1] In 2018, 67 percent of FDI going into China originated from Hong Kong, and 57 percent of China's outgoing FDI was destined in Hong Kong. Hong Kong is still an indispensable doorway through which money goes in and out of China.

Such a special status of Hong Kong under China's sovereignty turns Hong Kong into an ideal destination for the Chinese political elite to hide their wealth and conduct shady international financial and commercial deals violating international sanctions. With the tightening of political control in Hong Kong across the board, foreign companies which used to operate in a liberal and open environment have started to face unique and mounting political and economic risks.

Hong Kong status as a free offshore financial center with enthusiastic participation by investors and corporations worldwide hinges on its rule of law, freedom of the press, the transparency of its corporate governance, and neutrality of its business regulators. These

[1] Ho-fung Hung. 2022. *City on the Edge: Hong Kong under Chinese Rule.* Cambridge University Press. Ch. 3

foundations for Hong Kong's financial centrality are now being threatened in the new political landscape. Despite their economic significance, these foundations have been thorns on the back of the CCP. For example, the presence of a free press presents a constant threat that the Chinese political elite's private wealth in Hong Kong would be exposed and create embarrassment for them.[2] Hong Kong-based Chinese front companies that helped North Korea and other unruly regimes to evade international sanctions are often exposed by journalists working in Hong Kong.[3]

While the National Security Law itself poses a threat to the civil liberty, free flow of information, and private property in Hong Kong, it also profoundly transforms Hong Kong's political climate. It opens the door for the HKSAR and Beijing governments to pass new laws in the name of national security that worsens Hong Kong's business environment for foreign corporations and investors.

The Anti-Foreign Sanctions Law

For example, in this summer (2021), Chinese official media and establishment political figures in Hong Kong have been citing authoritative sources to indicate that the anti-foreign sanctions law, passed in China in June this year, would be made applicable to Hong Kong in the NPCSC meeting in August. If it becomes a reality, any corporations, foreign or Chinese, operating in Hong Kong will face an impossible dilemma. If they abide by US sanctions on Chinese or Hong Kong entities and officials, they will be violating China's anti-foreign sanction law and penalized. If they comply with China's anti-foreign sanction law, they will be violating the many US and international sanctions. Facing this impossible choice, many corporations would have to consider leaving Hong Kong.[4] Against this backdrop of a looming anti-foreign sanction law besides tightening repression in many other realms of Hong Kong, the US government issued an official warning to US businesses operating in Hong Kong on July 16.[5]

As it turns out, Beijing's political elite are seemingly still divided on how much economical price to pay for continuing to tighten its screw on Hong Kong. Presumably, certain factions of the powerful elite still worry about the loss of Hong Kong as an offshore market. When the market was worrying about the inevitable application of the Anti-Foreign Sanctions Law to Hong Kong in late August, the NPCSC surprisingly announced it would delay the decision to obtain more time to assess its economic impact. [6] Despite this temporary backpedaling, establishment figures do express the confidence that the application of the law to Hong Kong will be back on the agenda sooner or later.[7] But this episode also manifests the soft spot and limits of Beijing's crackdown on Hong Kong and US continuous leverage over Beijing's Hong Kong policy.

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[2] E.g. "Luxury Homes Tie Chinese Communist Elite to Hong Kong's Fate" *New York Times.* August 12, 2020; "The Times, Bloomberg News, and the Richest Man in China" *New Yorkers.* May 5, 2015.
[3] "How Hong Kong Makes Evading North Korea Sanctions Easier." Wall Street Journal. March 16, 2018.
[4] "China's planned anti-sanctions law for Hong Kong unsettles financial sector," *Reuters*, August 19, 2021
[5] "Biden Administration Warns Against Doing Business In Hong Kong." NPR. July 16, 2021.
[6] "China Delays Anti-Sanctions Law for Hong Kong" *The Wall Street Journal.* August 20, 2021
[7] "人大暫緩《反外國制裁法》在港實施　劉兆佳：或因西方關注　中央認為要再探討" Standnews. August 20, 2021.

Declining Corporate Governance Transparency

When the Hong Kong authorities are expanding their control of the media in the name of safeguarding national security, it also expands its power in a way that jeopardizes the very transparency and integrity of the Hong Kong business environment. For example, in March 2021, the HKSAR government announced it would start restricting public access to information of directors and executives of registered companies.[8] For decades, journalists in Hong Kong took advantage of public access to such information, including name, HKID number, and addresses of directors of registered companies, to identify who is truly behind some important business transactions and property holdings. It is the channel through which journalists expose many corruption cases and unfair business transactions (e.g., government officials with insider information sell or buy a property through a company they hold). It is also the channel through which the Chinese elite's property ownership in Hong Kong, usually owned in the name of companies set up to hide the identities of the true owners, was discovered.[9] Labeling journalists' access to the board of directors' information as unduly "privilege," the HKSAR government is transforming the Hong Kong business environment into one rife with mysterious companies with secretive, powerful owners behind the scene, somewhat like money laundering centers and tax havens in the Caribbean. Journalists would also find it more difficult to discover problems with publicly listed companies if the identities of their bosses were shrouded in the dark.

Also, it has been an established practice that powerful Chinese companies set up front companies in Hong Kong to conduct international transactions that violate international sanctions. If one of such front companies were exposed and backlisted internationally, the powerful company behind would move on to establish a new front company in its place. If the new ban on public access to companies directors' information had been in place earlier, the world would have never known that Skycom, a Hong Kong-registered company that violated US sanction and sold restricted computer equipment to Iran illegally, was controlled by Huawei.[10] Powerful Chinese companies would have tricked more foreign banks operating in Hong Kong to violate international sanctions inadvertently, like the example of HSBC in the Huawei case.[11] This new restriction on disclosure of company information muddles the environment for foreign corporations operating in Hong Kong.

The Anti-doxxing Law

Another troubling development is implementing the anti-doxxing law amendment in October this year. The amended law criminalized unconsented disclosure of private information,

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[8] "Hong Kong Limits Public Information as China Exerts Control" Bloomberg March 30, 2021; "HK bankers and lawyers win right to apply for access to corporate registry" Reuters. June 12, 2021. Journalists will be barred access to the information. Lawyers, accountants and bankers could apply for access, and the application would be granted on a case-by-case basis by the authorities.

[9] "Hong Kong defends plan to reduce corporate database transparency" HKFP. April 9, 2021.

[10] "Exclusive: Top Huawei executives had close ties to company at center of U.S. criminal case" Reuters September 16, 2020.

[11] "Meng Wanzhou can return to China, admits helping Huawei conceal dealings in Iran." Washington Post. September 24, 2021.

vaguely defined, without the need for proof of the harm done. It hands the authorities vast new authorities to prosecute dissidents and journalists who disseminate information about the powerful elite and expands the authorities' power to request local and foreign media and internet platforms to remove contents deemed violating the law. It also gives authorities the power to access electronic devices and search premises without a warrant. [12]

This law will significantly impact US social media companies operating in Hong Kong, as the law's most draconian measures can be applied to them if one of their users is deemed to violate the vaguely defined offense. To try to maintain Hong Kong's financial center status, the Hong Kong government has not yet banned US social media and internet browsing platforms. The continuous presence of US social media companies in authoritarian Hong Kong poses a unique challenge. Under the anti-doxxing law, the social media companies could be forced to comply with the HK authorities to delete posts or surrender users' information out of the HKSAR government's request with a threat of heavy penalty. The law could effectively turn those companies into the enforcers of the government's efforts to stifle the free speech of their users, including US citizens inside or outside Hong Kong. The law would also force those companies to surrender users' data.

Before the law was enacted, Singapore-based Asia Internet Coalition (AIC), which represents Apple, Facebook, Google and Twitter among other members, warned that "introducing sanctions aimed at individuals is not aligned with global norms and trends," and that local staff in Hong Kong handling the day-to-day operations for these tech giants does not have the access rights or ability to remove content if so demanded by the local government. The anti-doxxing law could place members in an untenable position that could force them to "refrain from investing and offering their services in Hong Kong." [13]

Deteriorating Regulatory Environment

Independent and respected institutions that have been instrumental in safeguarding the reputation and integrity of the Hong Kong business environment have been under threat even before the National Security Law. Some of them appear to face increasing political pressure and start to behave like a political tool of the authorities. For example, it is unclear whether Hong Kong's independent financial regulator, the Securities and Futures Commission, could uphold its independence. In 2014, the SFC took action against an American short-seller for publishing a negative research report about a powerful property developer (Evergrande!) from mainland China. It also fined and reprimanded credit rating agency Moody's for a report that warned about

[12] "Hong Kong passes new anti-doxxing law – violators face HK$1m fine and 5 years jail" HKFP September 30, 2021.
[13] "Big Tech Lobby Makes Noise About Pulling Out of Hong Kong Over "Doxxing" Privacy Law" CPO, July 13, 2021. "Hong Kong's anti-doxxing law comes into force despite human rights criticism" The Daily Swig. Oct 8, 2021.

corporate governance irregularities of 49 mainland Chinese companies listed in the Hong Kong market. [14]

These may be isolated cases, but they already raised the fear that the regulatory body would increasingly favor mainland companies, creating a chilling effect on financial analysts who do research that was critical of them. This summer, the *Economist* warned that "[g]lobal banks say that practices from mainland China are seeping into the city. These include a shift in the way ipos and bonds are underwritten. Where banks' roles were once clearly defined early in the process, now a handful of institutions, many of them mainland-Chinese, fight for top spots in transactions. Many are accused of inflating their orders for the securities in order to impress clients. This has reduced the transparency of the process and disrupted price discovery. …. bankers fear that Hong Kong's standing as a global financial centre will suffer. Moreover, the situation mirrors the city's greater dilemma. A cosmopolitan society with globally recognised norms is rapidly losing ground to a Chinese way of life."

Risks to US Investors

With China's economic slowdown and brewing economic crisis over the last decade, Chinese entities have been increasingly eager to raise debt in the international financial market via the Hong Kong platform. Hong Kong is already a unique global platform for Chinese corporate bond offshore sales. It also started to emerge as a platform for Chinese government bond sales. Just this October, the debut of the Shenzhen government bond in Hong Kong – the first-ever offshore sale of Chinese government bonds – attracted USD 775 million worth of global subscriptions.[15] US institutional and individual investors' involvement in these financial products could effectively tie their financial fortunes to Chinese companies and Chinese government action that violate international sanctions and human rights.

As independent and critical research, including financial analysis, academic research, and journalistic report, of Chinese business and government in Hong Kong became increasingly difficult, and as Hong Kong regulators become ever more biased toward the mainland Chinese firms and government, investment into these corporate and government bonds in the Hong Kong market will become increasingly risky. While US institutional investors may feel the urge to follow the herd of global high finance to pile into such an exotic bond market, individual contributors to investment funds will always have to bear the heaviest loss when anything bad happens. The explosion of the debt crisis of Evergrande and other major Chinese property developers recently is the best indication of such risk to US investors.

My new book about the corporate origins of deteriorating US-China relation shows US businesses in mainland China have been complaining about the lack of rule of law, lack of free flow of information, bias of regulators against them, unpredictability (or politicization) of law

[14] " Evergrande's crisis was 'a long time coming,' says banned short-seller Andrew Left" CNBC. Sept 24, 2021. "Moody's Loses Appeal Over Research Critical of Hong Kong" *Wall Street Journal.* Sept 3, 2018. "Hong Kong's regulator rightly resists the bad habits of mainland finance" Economist. July 3, 2021.
[15] "Global investors hungry for Shenzhen's US$775 million dim sum bond, the first mainland Chinese local government debt issued in Hong Kong" SCMP. Oct 12, 2021.

and regulations enforcement there for a long time. These problems have created an unleveled playing field in which US corporations compete with domestic Chinese ones at a disadvantageous position.[16] But at least for financial deals, US corporations could rely on the Hong Kong financial market, which did not share many of the shortcomings in the mainland Chinese environment. However, under the new political climate of Hong Kong, the institutional foundations of the fairness and transparency of Hong Kong's financial market erode rapidly, making the Hong Kong business environment converge with the mainland.

The temporary stalling of applying the anti-foreign sanctions law to Hong Kong shows significant vested interests in the CCP still prefer not to destroy Hong Kong's financial center status too rapidly. But the development in the recent two years shows that Beijing's instinct for absolute control is so great that any internal check against the destruction of Hong Kong's financial centrality can at best be temporary. The HKSAR government's refusal to take any advice and complaint from AmCham Hong Kong and US financial firms to lessen the draconian and unscientific quarantine regime and border closure that hinders operations of global firms indicates that the authorities are ready to sacrifice Hong Kong's financial centrality for the sake of political control.[17] The recent denial of work visas to foreign journalists covering financial news in Hong Kong (like the rejection of visa renewal for the Hong Kong correspondent of the *Economist*) without giving any reasons is another indicator.[18]

For a long time, Beijing had adopted a "frog-cooking" approach to taking away Hong Kong's political freedom, adding the temperature gradually so we might not be alerted that the freedom is taken away. After a certain point, Beijing turns up the fire all the way to destroy whatever remains (via the imposition of the NSL new order). Now, Beijing has started to use this frog-cooking approach to slowly take away the institutional foundations of Hong Kong's status as a transparent, fair, and clean offshore financial center, turning it into a murky swamp where politically well-connected Chinese firms and their collaborators enjoyed outsized feasts whereas unsuspecting foreign investors are eaten. It also slowly pressures foreign corporations eager to make money in Hong Kong to become accomplices of its efforts to repress and surveil Hong Kong's civil society and subvert international order and rule.

Recommendations

In light of the above considerations, there are several things that the executive and legislative branches of the US government could do to protect US corporations and investors concerning the deteriorating business environment in Hong Kong.

(1) While most US social media and web browsing platforms cannot operate in China and nearly all other authoritarian states, their continuous operation in Hong Kong poses a unique challenge. The Hong Kong government has not yet banned them, but it has been trying to force them to comply and aid its efforts to stifle dissenting voices and collect users' information. The US government should find ways in existing laws or make new laws to regulate these companies and

[16] Ho-fung Hung 2022. *Clash of Empires: From "Chimerica" to the "New Cold War"*. Cambridge University Press. Section 3.
[17] "Hong Kong Rejects Plea From Global Banks to Scrap Zero-Covid" Bloomberg. Oct 25, 2021.
[18] "Hong Kong Authorities Deny Visa to Economist Journalist" Associated Press. November 13, 2021.

ensure that they will not become the accomplices of the crackdown in Hong Kong. Such measures would help US companies to resist the temptation of staying in Hong Kong and muddling through while slowly becoming enforcers of local repressive policies. Such cooperation with local authorities might yield short-term profit, but it will also create a huge risk to those companies and their investors in the long run.

(2) The US could allocate more resources to develop technology and tools that residents in Hong Kong (and elsewhere in China) could use to bypass internet censorship and suppression. The fund allocated to develop technologies and programs for an "open, interoperable, reliable and secure internet" for Hong Kong residents in the US Innovation and Competition Act of 2021 is a laudable first step.[19] While the Great Firewall of China is closing in on Hong Kong fast, time is running out for the US government to counteract the enclosure and help maintain internet freedom in Hong Kong. The USICA was passed in Senate earlier this year. It needs to be passed in the House and become law soon.

(3) Continue to monitor the political and economic risks that investment in Chinese stocks, corporate bonds, and government bonds could bring to US investors. Suppose the transparency and accountability of the Chinese issuers of financial products in Hong Kong continue to erode. In that case, the US government will be responsible for issuing warnings or even restrictions on US institutional investors' involvement in such products. It will be a necessary thing to do to protect the savings, investments, and pensions of millions of working Americans. There is a precedent in the Treasury sanction against investment in Russian sovereign bonds earlier this year.[20] Keeping this option open could also serve as a deterrent that shapes the Chinese and Hong Kong authorities' calculation about how fast and wide they would dismantle preexisting institutions that warrant the integrity of the Hong Kong financial market.

(4) For a long time, Hong Kong has been a base for journalists, analysts, academic researchers who might not be able to enter mainland China to investigate Chinese companies, Chinese political development, and the Chinese business environment. The knowledge generated in these endeavors is of utmost importance to US investors when making investment decisions. With the troubling new trend of expelling foreign journalists and the stifling of local media under the NSL, the US government needs to use whatever diplomatic tool available to ensure media organizations and personnel from the US and other like-minded countries can continue to operate freely in Hong Kong. They constitute an irreplaceable line of defense for a fair, transparent, and level playing field in the interest of many US companies operating in the Hong Kong market.

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[19] https://www.congress.gov/bill/117th-congress/senate-bill/1260/text

[20] "Treasury Sanctions Russia with Sweeping New Sanctions Authority" https://home.treasury.gov/news/press-releases/jy0127