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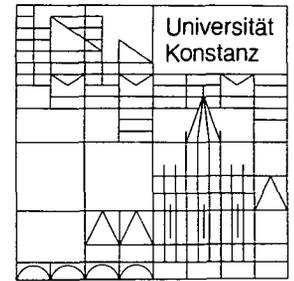
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Sonderforschungsbereich 178
„Internationalisierung der Wirtschaft“

Diskussionsbeiträge

Juristische
Fakultät

Fakultät für Wirtschafts-
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CHINESE INVESTMENTS - "HOSTAGES" FOR HONG KONG?

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Serie II - Nr. 163

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Abstract

It is argued in this paper that China has invested heavily in the Hong Kong economy to build trust in its intentions to maintain the present course of economic policy. The investments have the character of hostages because their payoffs depend on a functioning Hong Kong economy. This increases the stake for the Chinese to keep their promise. The paper also provides considerable empirical support for the claim that the engagement of Chinese investors in Hong Kong had a significant effect on economic confidence and the Hong Kong stock market.

Chinese Investments - "Hostages" for Hong Kong?

1. Introduction

Hong Kong is the last country with an economic system based on laissez-faire capitalism. Its economy has been one of the fastest growing ones in the world over the past decades. However, after 1997, its economic fate will be determined by the People's Republic of China. China has promised that it will not change the nature of the economic system in Hong Kong for another 50 years. It profits from significant trade with Hong Kong and investment spillovers into the bordering provinces. Nevertheless, the question remains whether China will keep its promise or whether it will change Hong Kong's economic regime for predatory or ideological reasons.

It is argued in this paper that China has invested heavily in the Hong Kong economy to build trust in its intentions to maintain the present course of economic policy. The investments have the character of hostages because their payoffs depend on a functioning Hong Kong economy. This increases the stake for the Chinese to keep their promise. The paper also provides considerable empirical support for the claim that the engagement of Chinese investors in Hong Kong had a significant effect on economic confidence and the Hong Kong stock market.

2. The "Hostage" Character of Chinese Investments

In autumn 1984, the Chinese government agreed to maintain the capitalist regime in Hong Kong after 1997. From the beginning, the credibility of the promises made by the Chinese has been reduced by the asymmetric information between Hong Kong and China on the future course of politics. The threat of opportunistic behaviour on the side of the Chinese government undermined investors' confidence. The Chinese government, for instance, can break the agreement through regulation, taxation or expropriation of Hong Kong businesses.

New institutional economics literature has identified several instruments which are used by parties to discourage ex-post-opportunistic behaviour and to commit themselves to fulfilling a contract (Williamson, 1987). Credible commitments can take the form of hostages, both monetary and non-monetary, which parties lose if they renege their promises.

Chinese investments have most of the features of a hostage as defined in the context of firms. Investments in Hong Kong have to be paid for in hard currency, increasing China's international financial obligations. Under the current regime, the returns from the investments pay for the credits. If China breaks its promise and changes the economic policy regime in Hong Kong, businesses including China's own investments will become less profitable. Buildings, infrastructure and manufacturing plants are particularly

vulnerable because of their immobility. The long payoff period normally associated with such investments and the specificity of these assets increase long-term credibility of the Chinese economic policy promises.

Two factors distinguish this type of government commitment from inter-firm commitments: Debts from Hong Kong investments are not personal liabilities for Chinese politicians. Dependence on public support and personal profit opportunities, however, provide an incentive for politicians not to forfeit investments in Hong Kong by changing the economic policy regime. Those politicians and business leaders who gain from the involvement in Hong Kong constitute vested interests in a functioning Hong Kong economy. They would try to defend their investments against destructive Chinese policy changes.¹

In the same way as managers of firms are induced to fulfill their contractual obligations through hostages, Chinese politicians have a stronger incentive to keep their promise because of Chinese stakes in the Hong Kong economy. However, the commitment is more complex than between firms. Normally, hostages compensate one party for the losses incurred by a breach of contract. Here, they would not make amends to the Hong Kong community but they would be devalued by a regime change.

¹ Furthermore, millions of Chinese in the border region live off an economy which is dependent on Hong Kong. Politicians will be reluctant to risk support from these if the Hong Kong economy is ruined.

Summarizing, we hypothesize that China stepped up investments during and after the negotiations about the future of Hong Kong because it wanted to commit itself in a credible way to the British-Sino accord. The investments increase confidence in the economic future because they raise the stakes for the Chinese government in a capitalist Hong Kong.

3. An Empirical Investigation of the "Hostage" Hypothesis

The Hang Seng stock market index is representative of Hong Kong's economic situation and also reflects expectations about the future. Up to 1981, the Hang Seng seems to have been influenced more by Hong Kong's economic situation than by scepticism about the political future. Hong Kong became one of the famed "four little dragons" of Asia (Jao, 1987) with strong international market orientation. As a result of this, the Hang Seng index is closely related to the Dow Jones index. During and after the second oil crisis, however, Hong Kong managed to achieve significant growth rates and a boom in the stock market despite the beginning world recession.

At the end of 1981, the Hang Seng started to decline. This was partly caused by the world recession, which finally reached Hong Kong. (The growth rate of Hong Kong's GDP fell from 9.4 percent in 1981 to 3.0 percent one year later). But another more striking reason was public concern about the Chinese position with respect to the future of Hong Kong (and its "New Territories") when it could be foreseen that British

land leases in the New Territories would expire in 1997. In January 1982, China requested authority over Hong Kong after 1997. Margaret Thatcher's visit to China in September 1982 and her recognition of China's demands shattered public confidence in future political stability. In the course of negotiations in 1983 it became clear that the British administration of Hong Kong could not be continued after 1997. In spring 1984, both sides came closer to a settlement, which included both the integration of Hong Kong into China and the British request that basic parts of the Hong Kong economic system should exist beyond that date. This made up the basic content of a White Paper, published in September 1984 by the British and Hong Kong governments, which included and explained the draft Sino-British agreement on the future of Hong Kong.

Various Chinese activities furthered stability in Hong Kong during the confidence crisis in the early 1980's: China provided short term credits, it took over two major industrial firms in 1984, and it bailed out the Ka Wah Bank in June 1985 (Jao, 1987).

Chinese stakes in the Hong Kong economy have increased remarkably: China expanded its manufacturing investments in Hong Kong significantly, starting in 1983. Figure 1 shows that the number of these investments increased from one single project in 1981 to ten projects in 1987 (Hong Kong Industry Department, 1987, 1990). Other remarkable investment projects with significant Chinese participation were the Bank

Figure 1: Chinese Manufacturing Investments in Hong Kong, 1972-1989

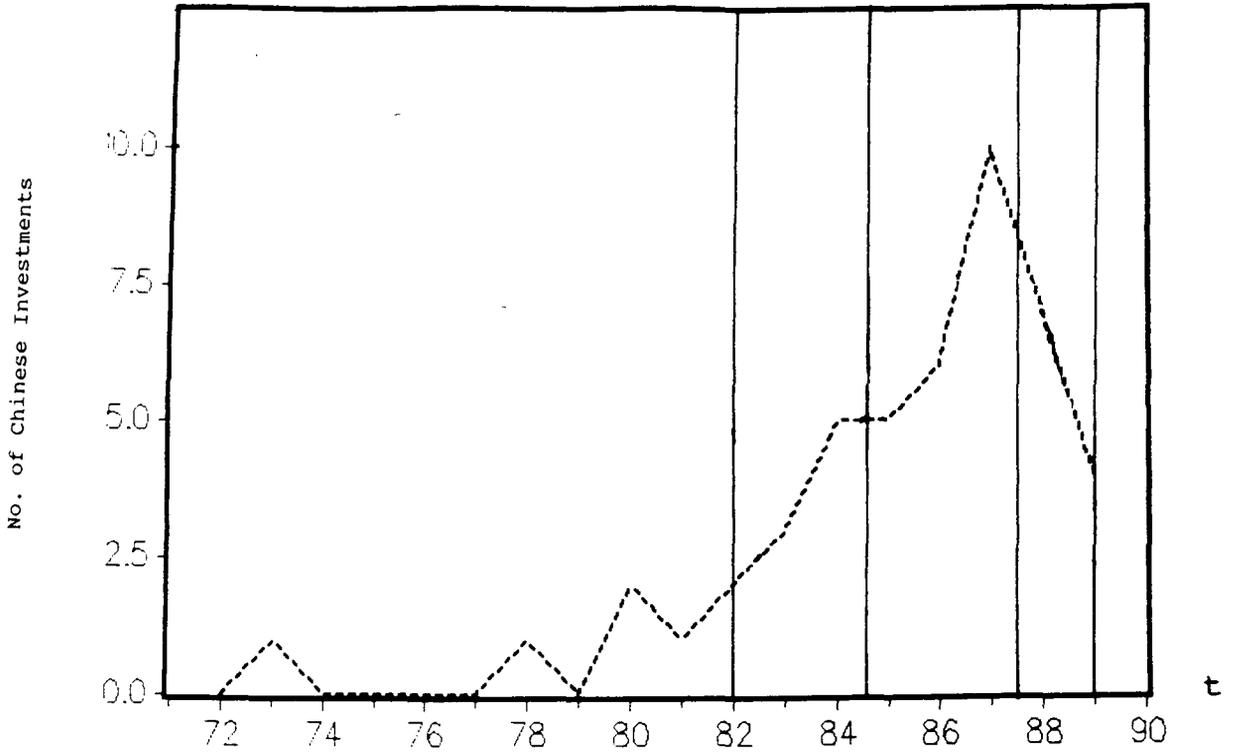
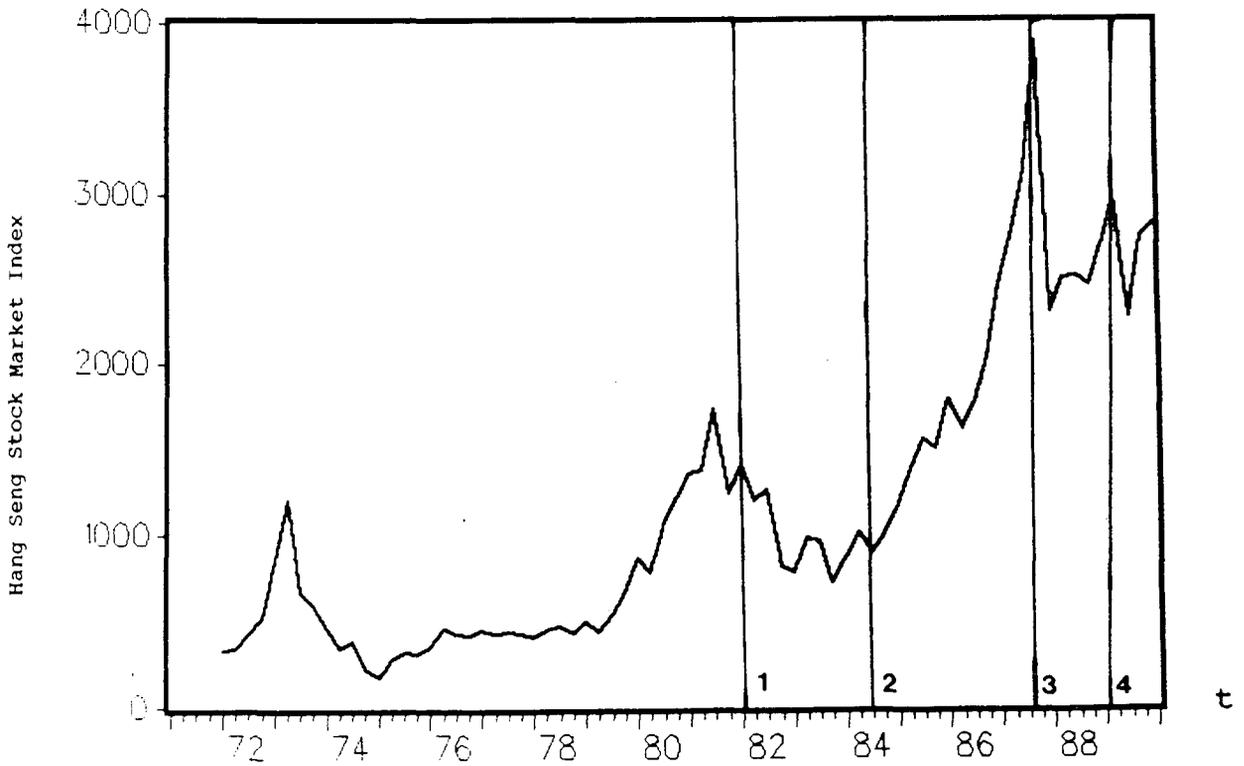


Figure 2: The Hang Seng Stock Market Index, 1971 - 1989



- 1 First demands of the Chinese
- 2 Publication of the results of the agreements in the 'White Paper'
- 3 Stock market crash
- 4 Massacre in the Tiananmen Square

of China Building, the second harbour tunnel, and the partial takeover of Cathay Pacific, the Hong Kong airline. On the other hand, no desinvestments have been reported. The number of Chinese run companies in Hong Kong is estimated at around 4000.

Figure 2 shows the Hong Kong Stock Market Index Hang Seng for the 1971-1990 period. It fell between 1981 and 1984 reflecting the confidence crisis in the country's economic future. It rebounded after September 1984, indicating that confidence was rising again. This period of new confidence is also the period of the major Chinese investments in Hong Kong. It was interrupted by a sharp decline in the Hang Seng in autumn 1987 which reflected the world stock market crash, and the drop in summer 1989 caused by the bloodshed in Tianaman Square.

To follow on from this brief historical scetch, the following two studies provide more empirical evidence on the effect of Chinese investments on the Hong Kong economy.²

A Simple Test of the "Hostage" Hypothesis with Data on Chinese Manufacturing Investments in Hong Kong

The Hang Seng stock market index mirrors the expected returns for investors and is therefore the dependent variable

² The Far Eastern Economic Review (5/7/1987) and the Frankfurter Allgemeine Zeitung (10/21/1991) also casually observe that the Chinese investments contributed to rebuilding confidence in Hong Kong without providing theoretical arguments or empirical evidence for their claims.

in a simple OLS regression for the period 1972-1989.³ The crucial independent variable here is the number of Chinese manufacturing investments in Hong Kong which approximate the degree of commitment through investment "hostages".

The Hang Seng is expected to correlate with the Dow Jones index positively, reflecting the strong dependence of Hong Kong on the world economy. After the second oil crisis, however, the performance of the Hong Kong economy was still excellent while Western economies struggled with stagflation. An oil crisis dummy variable taking the value of one for the years 1979-1981 captures the difference in performance between the world economy and the Hong Kong economy. A positive sign is anticipated.

The variable reflecting the distrust in the future of Hong Kong's economic policy (economic confidence) is specified as presented in the appendix. As long as policy expectations seemed to be unimportant to investors (until 1981 as discussed before) the variable takes the value of zero. Chinese demands and British acknowledgement of these demands led to a confidence crisis culminating in 1983. The "distrust" variable takes the value of 0.5 in 1982 and 1 in 1983. The accord in September 1984 partly reestablished trust

³ Data on manufacturing investments is drawn from the Hong Kong Government Industry Department's report on the survey of Overseas Investment in Hong Kong's Manufacturing Industries, 1987 and 1990. The Hang Seng stock market index and the Dow Jones Industrial average were provided by the Far Eastern Economic Review and the *Wirtschaftswoche*. Growth rates of the Hong Kong GDP were provided by Ho and Chau (1989) and comparative figures for western economies were provided by the OECD.

although some uncertainty remained. The variable takes the value of 0.75 in 1984 and 0.5 thereafter. In 1989 when the democratization ended in the bloodshed at Tianamen Square, confidence in the credibility of Chinese politics declined again. The "distrust" variable takes the value of 0.75 for 1989.

The pattern of these variables seems plausible from the previous description of events; the exact quantification, however is ad hoc out of necessity. Alternative values are applied to test for robustness: 1983: 1.25, 1984: 1 in estimation (2), and 1985-1988: 0.25 in estimation (3). The first variation puts more emphasis on the confidence crisis in 1983/84, the latter suggests that the agreement reestablished confidence in a better manner. A negative sign of the coefficients is expected.

Finally, the number of manufacturing investments in Hong Kong serves as an approximation for the hostages provided by the Chinese government. Hong Kong statistics are very rudimentary and do not supply continuous figures for the value of Chinese investments. From the previous hypothesis, we expect manufacturing investments to reestablish business confidence and to have a positive effect on the Hang Seng.

The following equation is tested:

$$\begin{aligned} \text{Hang Seng Index} = & \alpha_0 + \alpha_1 \text{Dow Jones} + \alpha_2 \text{Oil Crisis} \\ & + \alpha_3 \text{Distrust} + \alpha_4 \text{Investment Hostages} \end{aligned}$$

Table 1: Determinants of Economic Confidence in Hong Kong:
Manufacturing Investments as Hostages

OLS: Dependent variable is Hang Seng stock market index				
Sample: 1972-89				
Variables	Expected Sign	Results - Estim. Coefficients (t-statistics)		
		(1) ^a	(2)	(3)

Constant		-741 (-7.55)	-749 (-7.9)	-771 (-8.2)
Dow Jones Ind. Average	(+)	1.33 (12.2)**	1.35 (12.8)**	1.38 (13.1)**
Second Oil Crisis	(+)	692 (10.8)**	689 (10.1)**	702 (10.0)**

Distrust in future Chinese policy	(-)	-213 (-1.9)*	-168 (-1.99)*	-179 (-1.88)*
Hostages: Manuf. Investments	(+)	79 (3.41)**	74 (3.56)**	65 (3.37)**

R ² adj.		0.976	0.977	0.976
DW stat.		1.91	1.87	1.86
F-statistic		130	135	131
No. of Obs.		17	17	17

*(**): rejection of H_0 at the 10%(5%) level

^a The three estimations only differ in their specifications of the distrust variable to test for robustness. For the specifications see the appendix.

Results: The main hypothesis of the paper is supported by the estimation results presented in table 1.⁴ The confidence crisis of 1982-1984 and the continuous uncertainty about the trustworthiness of the Chinese depressed the Hang Seng index. This is true for all of the distrust variable specifications. As hypothesized, however, the results for the investment "hostage" variable indicate that the stock market rebounded with increasing Chinese manufacturing investments in Hong Kong.

The strong correlation between the Dow Jones and the Hang Seng as well as the different performances after the second oil crisis were anticipated. Although we do not claim that manufacturing investments are mainly responsible for the reemergence of business confidence, it is one element of the Chinese efforts to build up belief in Hong Kong's stability and continuity.

An Event Study on the Effect of the Chinese Cathay Pacific Engagement

If the cumulative effect of investments on the Hang Seng is significant it should be possible to detect such an effect by the most important single investment projects as well. We apply the event study technique with daily stock market data. It is argued that the Hang Seng reacts positively to the announcement of Chinese investments. Since the building of trust and credibility is not an instantaneous event but a

⁴ The Cochrane-Orcutt-technique is applied to correct for autocorrelation.

process, and since the details of the deals have to be known and interpreted, it is unlikely that the full impact is felt on the day of announcement but is rather spread over the following days of trading.

Three large Chinese investments attracted public attention in the 1984-1987 period. On August 18th 1984, the Bank of China announced a major office building project worth 1 Billion HK\$ (approximately 130 Mill.\$US). Unfortunately, the announcement was made in the middle of various statements by policy makers on the future of Hong Kong during the final stage of the Sino-British negotiations. Although the project was widely perceived as confidence-building, the effect of its announcement can not be disentangled from the policy statements.

Chinese investors also have a significant share in the second harbour tunnel project estimated at three billion Hong Kong Dollars. It is not expected to pay a profit before 2007 which would make it an ideal candidate for an event study of our "hostage" hypothesis. Upon announcement of the project, however, its financing and the extent of Chinese involvement were not known and one week after the announcement the financing of the project was still unsettled. A clearcut event can therefore not be identified.

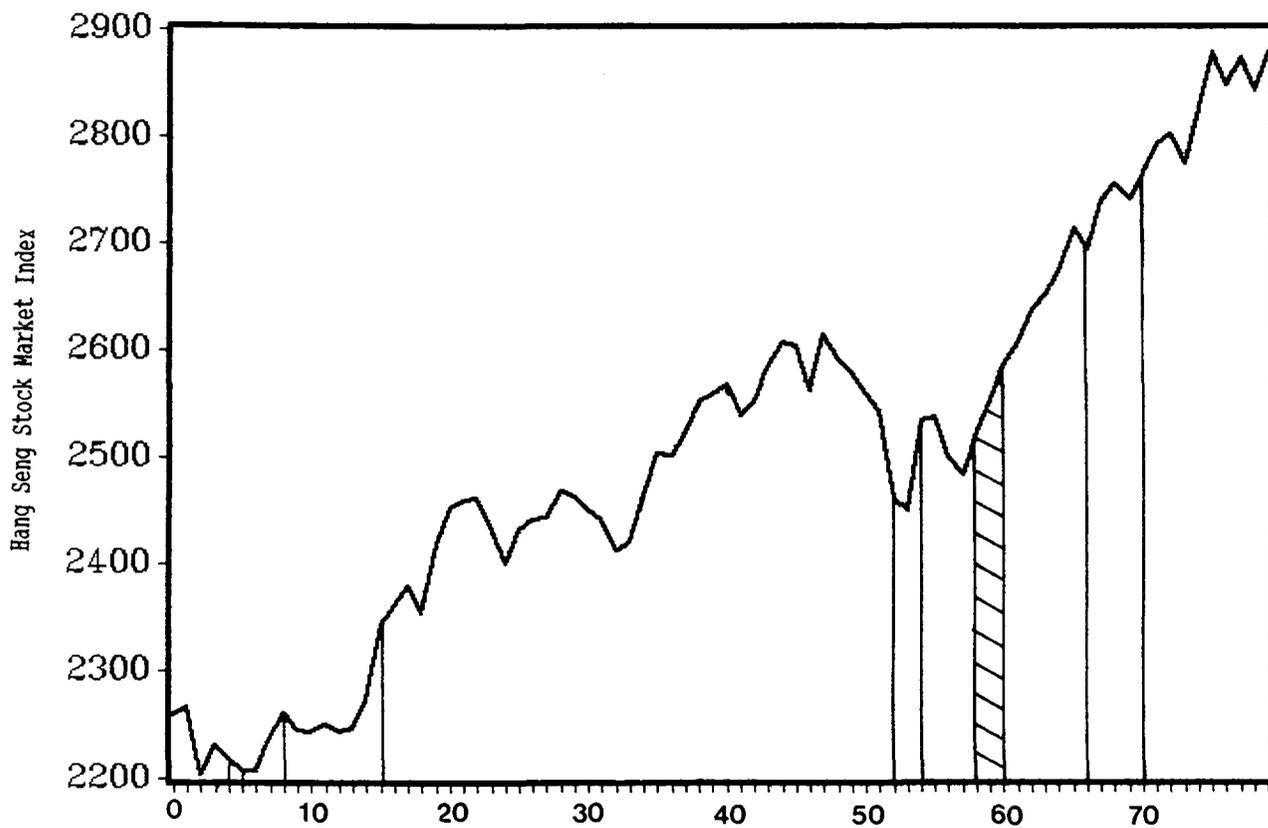
On January 27th, 1987, the Chinese International Trust and Investment Corporation (Citic) announced the purchase of a 12.5% share of the Hong Kong airline Cathay Pacific. This followed some political uncertainty regarding the resignation

of the general secretary of the communist party Hu Yaobang on January 19th. When the stock market fell by 4% following his resignation, Peking vowed on January 21st to keep its promise for the future of Hong Kong. After first rising, the stock market remained jittery and fell by 2% until the announcement of the Cathay Pacific deal on the 27th. During the rest of the trading week (the three trading days from January 27th to February 2nd), the stocks soared by 3.5% and in the following week by another 5%. Stocks continued to rise until the end of the month as illustrated in figure 3 which indicates the daily stock returns for our event study.

Unlike the other projects, the Cathay Pacific engagement is very suitable for an event study because the announcement date is clearly identifiable. The event study uses daily stock returns of the Hang Seng for the 11/1/86 to 2/28/87 period as a dependent variable.

The following independent variables reflect the determinants of the Hang Seng index. The study includes all major foreign influences and excludes domestic influences on the Hang Seng on purpose to show only the influences of foreign investments and stock markets. The constant demonstrates the expectation that daily returns are constant on average. The first group of independent variables shows potential influences of other stock markets on Hong Kong. Although a daily dependence of the Hang Seng on the Dow Jones or the Nikkey is not expected it is nevertheless tested with two respective regressors. The Dow Jones variable is lagged

Figure 3: Hang Seng Stock Market Index, 11/1/86 - 2/28/87
(daily data)



- 4-5 Australian investment (11/9.86 - 11/10/86)
- 8 Mitsubishi take over bid for Hong Kong land (11/13/86)
- 15 Spillover from scandal in US and Singapore stock market (11/24/86)
- 52 Resignation of Chinese Party Secretary Hu Jao Bang (11/1/87)
- 54 Chinese promise of stability in Hong Kong (1/21/87)
- 58-60 Cathay Pacific investment (1/27/87 - 2/2/87)
- 66-70 Japanese interest in Cathay Pacific (2/10/87 - 2/16/87)

by one day because the Hong Kong stock market closes before the New York stock exchange opens. A scandal in the US and Singapore stock markets on November 24, 1986 pushed investors into the Hong Kong market. A one time gain for the Hang Seng on that date is anticipated. The corresponding dummy variable is expected to have a positive sign.

The Cathay Pacific event followed the political turbulence around the resignation of Hu Yaobang. This leads to three variables. Two dummy variables, taking the value of one on the 19th and 21st of January 1987 respectively, stand for the resignation of the general secretary and Peking's promise of stability. While the coefficient of the first variable is expected to have a negative sign, the anticipated one of the second variable is positive. We have chosen two windows to trace the effect of the Cathay Pacific purchase. The immediate effect is tested with a dummy variable taking the value of one for the three trading days between January 27th and February 2nd, i.e. for the rest of the trading week. The second window comprises the period up to February 9th and indicates the less immediate effects. The two dummy variables take the value of one for the respective windows with an expected positive sign.

It is important to see whether the effect of this purchase is different from other foreign investments in Hong Kong. An alternative hypothesis could be that all foreign investments have a positive effect on the Hang Seng and not only the Chinese ones. Between November 1st and March 1st,

there were two major Japanese projects and one Australian engagement. (This defines the total of four months for this event study.) The coefficients of the dummy variables which stand for these foreign investments should be insignificant according to our hypothesis. A dummy, taking the value of 1 for the two trading days November 7th and 9th, stands for the heavy Australian investment in the stock market on those days. On November 13th, Mitsubishi launched a takeover bid for an important company, Hong Kong Land. Another dummy stands for the Mitsubishi engagement (19th November=1). In the week from February 12 to 16, Japanese investors showed strong interest in Cathay Pacific and other blue chips which is also represented by a dummy variable.⁵

Results: The results as indicated in table 2 support our "hostage" hypothesis. The variables from the resignation of Hu Yaobang to the Citic-investment in Cathay Pacific are all significant. This illustrates the strong effect of political events as well as Chinese investments on the confidence in the Hong Kong economy. The coefficient of the Cathay Pacific variable with the 3-day window is only significant at the 90% level of confidence while the coefficient of the variable for the extended period is significant at the 95% level.

⁵ In the following 5 months (March-July), there were two more Japanese projects. Their effect on the Hang Seng is also tested with the help of dummy variables. From April 30th to May 4th, Japanese investors showed interest in the new office complex (Bond Centre). On July 5th to 6th, rumours indicated Japanese interests in a controlling stake in Hong Kong Land.

Table 2: The Effect of the Chinese Cathay Pacific Engagement on the Daily Stock Returns in Hong Kong.

OLS: Dependent Variable is the daily return of the Hang Seng stock market index.
Sample: (1.11.86 - 28.2.87)

Variables	Expected sign	Results - Estimation Coefficients (t - statistics)			
		(1)	(2)	(3)	(4)
Constant	(+)	0.24 (1.91)	20.11 (1.53)	25.72 (1.90)	15.96 (1.19)
Dow Jones, lagged by one period	(+)	-	-	6.88 (0.52)	-
Nikkei	(+)	-	-	-13.19 (-0.78)	-
Scandal in US and Singapore stock market	(+)	-	286 (2.66)**	268.23 (2.52)**	290.15 (2.72)**
Resignation of Chinese party secretary	(-)	-3.47 (3.14)**	-343.04 (-3.19)**	-347.94 (-3.33)**	-338.90 (-3.18)**
Chinese Promise of stability in HK	(+)	3.19 (2.88)**	322.85 (3.00)**	331.22 (3.14)**	326.99 (3.06)**
Cathay Pacific investment 1/27 - 2/2	(+)	1.09 (1.69)*	113.46 (1.80)*	112.68 (1.80)*	
Cathay Pacific 1/27 - 2/9	(+)				89.50 (2.12)**
Australian investment	(0) ^a	-	-74.70 (-0.98)	-66.48 (-0.88)	-70.56 (-0.93)
Mitsubishi bids for Hong Kong Land	(0)	-	76.96 (0.72)	71.45 (0.68)	81.10 (0.76)
Japanese interest in Cathay Pacific	(0)	-	18.60 (0.38)	11.24 (0.23)	22.75 (0.46)
R ² adjusted		0.19	0.24	0.24	0.25
DW statistic		1.94	2.05	2.11	2.12
F - statistic		7.08	4.47	3.74	4.71
No. of observations		80	80	79	80

^a The alternative hypothesis is that all foreign investment variables also have an anticipated positive sign

The other foreign investment variables, however, are all insignificant.⁶ The significance of the scandal variable illustrates that strong spillovers from other stock markets are possible. As expected, however, our estimations do not show a daily correlation between the Hang Seng and the Dow Jones or the Nikkey Index.

The overall explanatory value of the specification looks relatively low with an adjusted R^2 between 0.19 and 0.25. These figures are not so bad, considering the high volatility of the Hang Seng, due to strong speculative and random elements in daily returns and the domestic events which we did not include.

4. Conclusion

The paper argues that the Chinese government invested in the Hong Kong economy to raise its credibility with respect to its post-1997 promise to keep Hong Kong capitalist. Chinese investments therefore resemble "hostages" as defined in the New Institutional Economics literature. Two empirical studies show a significant effect of the Chinese investment activities on the Hong Kong Stock Market Index.

The results have implications for the analysis of economic policy when there is a potential for time inconsistency through government opportunism. As demonstrated, the threat of government opportunism undermines economic confidence; hostages can reduce such fears.

⁶ This is also true for the two Japanese projects in April/May and July 1987 which are not indicated.

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Appendix: Values of the "Distrust" Variable in Model Specifications (1-3)

Specification:	(1)	(2)	(3)
1972-1981:	0	0	0
1982: Chinese demands, British recognition in September	0.5	0.5	0.5
1983: no progress, British administration not acceptable to China	1	1.25	1
1984: continuity in economic policy regime negotiated, agreement in September	0.75	1	0.75
1985-1988: accord raised trust but problem of opportunism remained	0.5	0.5	0.25
1989: suppression of democratization	0.75	0.75	0.75