hinrich foundation

advancing sustainable global trade

NOVEMBER 2020

A new era in US-Hong Kong relations

BY HOLLY SMITH

The United States has declared that Hong Kong is no longer autonomous from mainland China for purposes of US law.

2020, a year of terrible superlatives, has not spared US-Hong Kong relations. This spring, shortly after China's National People's Congress announced plans to impose a National Security Law on Hong Kong, the United States declared that Hong Kong was no longer autonomous from mainland China for purposes of US law, setting off a cascade of changes in US treatment of Hong Kong. The outsized impact of Washington's responses, entangled with the Trump Administration's push against China more broadly, may accelerate seismic shifts in Hong Kong's role as a global financial center already underway as a result of the National Security Law. Given the pervasive negative sentiment toward China among Washington officials, whatever the outcome of this week's election, US-Hong Kong relations will likely remain challenged for the foreseeable future.

Why has Hong Kong received special treatment under US law?

Since 1992, US relations with Hong Kong have been governed by the United States-Hong Kong Policy Act ("Policy Act"). The Policy Act's goal was to provide US support for the stability of Hong Kong's economy and legal institutions through its transition from British to Chinese rule. To do so, the United States recognized Hong Kong as distinct from mainland China for the purposes of US law, but allowed the US President to end preferential treatment if Hong Kong were to lose its autonomy. Until this year, Hong Kong received separate export controls and customs treatment, and benefitted from different laws and policies governing currency exchange, law enforcement, and immigration compared to mainland China.

Why did the United States declare that Hong Kong has lost its autonomy?

The Policy Act requires the US State Department to monitor and annually report developments affecting Hong Kong's autonomy.

The Policy Act requires the US State Department to monitor and annually report developments affecting Hong Kong's autonomy. In 2019, the State Department declared that Beijing's intervention in Hong Kong affairs was increasing, "accelerating negative trends" with respect to Hong Kong's autonomy.[1] The 2019 report was published just as Hong Kong's leaders introduced an extradition bill, triggering months of widespread protests. For the United States, the introduction of the extradition bill, the Hong Kong authorities' response to the protests, and the adoption of the National Security Law crossed a red line on Hong Kong's autonomy. A law enacted in the US in late November 2019, the Hong Kong Human Rights and Democracy Act, converted this notional red line into a veritable trip wire, requiring the State Department to certify Hong Kong's continuing autonomy. On May 27, 2020, the Secretary of State certified that Hong Kong no longer warranted special treatment under US law,[2] triggering the need to decide exactly how US law and policy toward Hong Kong should change.

What are the most significant changes?

After declaring on May 29 that the United States would begin the process of eliminating policy preferences for Hong Kong, on July 14, 2020, President Trump signed the Hong Kong Autonomy Act and issued Executive Order 13936 on Hong Kong Normalization ("Executive Order"). The Executive Order directs a number of legal and policy shifts, including in four areas with direct bearing on economic relations: sanctions, export controls, trade in goods, and tax.

Sanctions

The most significant action to date may be the establishment and imposition of sanctions under the Executive Order and Hong Kong Autonomy Act.

On August 7, the US Treasury Department imposed sanctions authorized by the Executive Order on 11 Hong Kong and mainland Chinese officials, including Hong Kong's Chief Executive. These sanctions block access to property in, or linked to, the United States, and may be applied to anyone implementing the National Security Law or undermining Hong Kong's autonomy.[3] Individuals and entities, including financial institutions, may not provide goods or services to the blocked person, and may be subject to sanctions themselves.

The Hong Kong Autonomy Act establishes a more formal process for applying sanctions than the Executive Order.

The Hong Kong Autonomy Act establishes a more formal process for applying sanctions than the Executive Order, incorporating Congressional reporting requirements. On October 14, the Secretary of State submitted a report to Congress listing 10 of the 11 persons sanctioned on August 7. Between 30 to 60 days later, the Secretary of Treasury must list as sanctions targets any "foreign financial institutions" still conducting "significant transactions" with blocked individuals.[4] Financial institutions listed would be subject to no less than five of ten possible sanctions, including bans on: taking loans from US banks; serving as primary dealers, or repositories of government funds; foreign exchange, banking, or property transactions; and allowing US persons from investing in the financial institution.

For Hong Kong, the key question will be whether any financial institutions will be sanctioned.

For Hong Kong, the key question will be whether any financial institutions will be sanctioned, and if so, how their operations will be affected. Though the Hong Kong Monetary Authority has stated that the sanctions have no legal status within Hong Kong, foreign financial institutions with a US presence, or that use the US financial system for settlement of banking transactions, may be affected. Arguably, financial institutions that comply with the US sanctions may also risk violating Article 29 of the National Security Law, which prohibits "accepting foreign support" to impose sanctions against Hong Kong or mainland China.[5] US entities in Hong Kong or mainland China could also face various forms of retaliation.[6] Moreover, US sanctions have rarely if ever been imposed on actors in such a large and globally integrated economy as Hong Kong's, and their consequences may be greater than anticipated.[7] For example, sanctioned Chinese banks could lose access to the US dollar clearing system, which could have ripple effects throughout the world if they lose the ability to perform transactions and service debt.[8]

Export controls

Another significant action is US revocation of Hong Kong's special status with respect to exports of "dual-use" technologies and defense equipment.[9] For dual-use technology exports, Hong Kong will only have access to the license exceptions already eligible for exports to mainland China[10] – eliminating 13 license exceptions previously available to Hong Kong importers. Hong Kong's country group designation under US regulations, as well as underlying controls, license review policies and supporting documentation requirements, remain unchanged.[11] Separately, the United States now can deny Hong Kong licenses and approvals for trade in defense equipment and services.[12] Authorizations previously awarded are still valid, however, and Hong Kong persons outside of Hong Kong or mainland China can still receive licenses.

Hong Kong importers must now obtain individual licenses for controlled dual-use exports.

It should come as no surprise that Hong Kong's export controls privileges are among the first to go. Since 2018, the US-China Economic and Security Review Commission has recommended enhanced Congressional scrutiny of Hong Kong's export control treatment over concerns about diversion of items to mainland China.[13] In terms of economic impact, Hong Kong imports a relatively low amount of goods under license exceptions – only approximately 1.4% of total US exports to Hong Kong in 2019,[14] while controlled defense articles comprised only 0.01% of the 2019 total.[15] However, Hong Kong is losing access to license free imports of certain items not as easily imported by other economies, a "distinct advantage" compared to mainland China.[16] Hong Kong importers must now obtain individual licenses for controlled dual-use exports.[17]

Labelling

The Executive Order suspends Hong Kong's separate treatment for labelling of imported goods, requiring goods from Hong Kong to be labelled as "Made in China" rather than "Made in Hong Kong".[18] Failure to change the labelling by November 9 will result in levy of a 10% duty.[19] The new labelling requirement has no bearing on tariff treatment for Hong Kong's exports.[20]

The economic impact of the labelling change is likely to be limited, as in 2019 Hong Kong exported only approximately US$474 million[21] worth of locally-made goods to the United States, about 1% of total exports, and it is unclear whether the change would have any impact on demand for these goods. Under both World Trade Organization ("WTO") rules, where Hong Kong is a separate member, and for Hong Kong's manufacturers, however, the distinction between marking goods as from Hong Kong versus mainland China is important.[22] Accordingly, Hong Kong's government has taken steps to contest the US requirement as a violation of WTO rules, sending a formal letter in protest to the US Trade Representative and registering a "formal intervention" at the WTO. Though Hong Kong may have arguments in its favor under WTO rules, given that the WTO dispute settlement process is hardly functioning it may be quite some time before the WTO could possibly help Hong Kong find relief.[23]

Tax

US and foreign companies shipping between Hong Kong and the United States may now be subject to a 4% US tax on gross transportation income.

On August 19, the State Department announced that it was terminating the Agreement concerning Tax Exemptions from the Income Derived from the International Operation of Ships, which allowed reciprocal tax exemptions for shipping companies in the United States and Hong Kong. US and foreign companies shipping between Hong Kong and the United States may now be subject to a 4% US tax on gross transportation income as well as Hong Kong tax, while Hong Kong shipping companies will owe only the US tax.[24] Termination is likely to have a limited quantitative impact, given the relatively small trading relationship,[25] though some mainland Chinese shipping companies that use Hong Kong as an intermediary port may be subject to higher taxes and may stop shipping goods through Hong Kong.

The United States has not taken any steps to restrict Hong Kong dollar convertibility or limit access to the US dollar clearing system for banking transactions.

Could the United States take additional actions?

Yes. To date, the United States has not taken any steps to restrict Hong Kong dollar convertibility or limit access to the US dollar clearing system for banking transactions. US authorities could apply more stringent export controls by moving Hong Kong to the same country group classification as mainland China, reducing the types of license exceptions that Hong Kong can use, blacklisting Hong Kong companies, or applying a less favorable licensing policy. Despite the likelihood of WTO litigation, the United States could also impose tariffs on imports from Hong Kong as it does imports from mainland China. Additionally, the United States could enhance scrutiny of Hong Kong investments under the CFIUS review process. Legislation currently pending before Congress could also give the United States additional authority to impose sanctions or provide preferential treatment for Hong Kong citizens who wish to emigrate to the United States.[26]

What does this mean for Hong Kong's business environment?

Between the 2019 protests, the global pandemic, US-China trade tensions, and the imposition of the National Security Law, Hong Kong's economy, and confidence in Hong Kong's economic future have certainly been shaken. Hong Kong has now been in recession since the third quarter of 2019, and it is unclear when it will begin to recover.

US legal and policy responses are only likely to worsen Hong Kong's business environment.

US legal and policy responses are only likely to worsen Hong Kong's business environment. Already, about 44% of American companies recently surveyed said that moves made under the Executive Order and the Hong Kong Autonomy Act were having a negative impact on their business.[27] American companies are uniquely positioned to bear the brunt of US-China tensions over Hong Kong, as they must follow two sets of potentially contradictory laws, and may be targeted for retaliation if relations worsen. Conditions could deteriorate precipitously if the United States decides to impose sanctions on mainland China financial institutions. Over the long run, the US policy shift toward Hong Kong may lead the territory and its institutions to pivot away from reliance on the United States and the US dollar in favor of the stability offered by mainland China's market and institutions to drive its economy.[28]

A tenser US-Hong Kong relationship and a more challenging economic environment are here to stay.

The Policy Act and other laws governing the US relationship with Hong Kong were drafted to provide carrots and sticks for encouraging Beijing to maintain Hong Kong's autonomy. Yet, despite all of the actions Washington has taken so far, and threats to do more, Beijing appears unmoved and unlikely to reverse its current course on Hong Kong. Perhaps this is because Beijing views its own interests toward Hong Kong as too important to compromise, even if Washington's actions hurt Chinese interests; perhaps it is because Beijing knows that too drastic an action on the part of Washington will serve as a self-inflicted wound on Hong Kong's economy, on American companies, and on the global economy.[29] Unless Beijing moves to restore Hong Kong's autonomy, Washington is unlikely to reverse its policy course or lift sanctions any time soon, even with a leadership change in 2021. A tenser US-Hong Kong relationship and a more challenging economic environment are here to stay.

Ending Hong Kong's privileges under the Policy Act has been described as "a trigger Washington doesn't want to pull," as doing so hurts the people and economy the United States purportedly wants to help. Now that the gun has been fired, it seems apparent that not only will Hong Kong suffer wounds, but America's own interests will, as well.

***

Holly Smith is a consultant based in Hong Kong. From 2009 to 2015, she served in the Office of the United States Trade Representative as a Director for Intellectual Property and Innovation, a Director for China Affairs, and a senior policy advisor to the Deputy US Trade Representative.

Footnotes

[1] US Department of State, 2019 Hong Kong Policy Act Report (Washington, D.C., March 21, 2019) Key Findings, https://www.state.gov/2019-hong-kong-policy-act-report.

[2] Secretary of State, Press Statement, "PRC National People's Congress Proposal on Hong Kong National Security Legislation," (Washington, D.C., May 27, 2020) https://www.state.gov/prc-national-peoples-congress-proposal-on-hong-kong-national-security-legislation.

[3] US President, Executive Order, "The President's Executive Order on Hong Kong Normalization, E.O. 13936 of Jul 14, 2020." Federal Register 85, no. 43413 (July 17, 2020): 43413-43417, https://www.federalregister.gov/d/2020-15646. The Executive Order arguably implements sanctions provided for under the Hong Kong Autonomy Act and the Hong Kong Human Rights and Democracy Act, but more likely taps powers granted to the President under the International Emergency Economic Powers Act.

[4] Hong Kong Autonomy Act, Public Law 116-149 (2020), Section 5(a) – 6.

[5] US Library of Congress, Congressional Research Service, China's National Security Law for Hong Kong: Issues for Congress, by Susan V. Lawrence and Michael F. Martin, R46473 (2020), 32. Amy Gunia, "How US Sanctions on Hong Kong Could Leave Banks Caught in the Middle," TIME, August 13, 2020, https://time.com/5878037/us-sanctions-hong-kong-banks/.

[6] Beijing has already announced sanctions on US persons in response to the August 7 sanctions, for example. "Beijing sanctions 11 including US Senators Ted Cruz, Marco Rubio," The Standard, August 10, 2020, https://www.thestandard.com.hk/breaking-news/section/4/152794/Beijing-sanctions-11-including-US-Senators-Ted-Cruz,-Marco-Rubio.

[7] See Angela Zhang, Benjamin Kostrzewa, Elizabeth Rosenberg and Victor Shih, "US Sanctions on Hong Kong and The Legal and Financial Implications," University of Hong Kong panel discussion, September 3, 2020, https://video.law.hku.hk/us-sanctions-on-hong-kong-and-its-legal-and-financial-implications/.

[8] Angela Zhang, "US Sanctions on Hong Kong and The Legal and Financial Implications ".

[9] Secretary of Commerce, Statement from US Secretary of Commerce Wilbur Ross on Revocation of Hong Kong Special Status, June 29, 2020, https://www.commerce.gov/news/press-releases/2020/06/statement-us-secretary-commerce-wilbur-ross-revocation-hong-kong; Secretary of State, Press Statement, US Government Ending Controlled Defense Exports to Hong Kong, June 29, 2020, https://www.state.gov/u-s-government-

ending-controlled-defense-exports-to-hong-kong. The Executive Order later confirmed these policy changes.

[10] Bureau of Industry and Security, Commerce, Final rule, "Revision to the Export Administration Regulations: Suspension of License Exceptions for Hong Kong," Federal Register 85, no. 45998 (July 31, 2020): 45998-46000 https://www.federalregister.gov/d/2020-16278.

[11] Alison J. Stafford Powell, et al, "US Suspends EAR License Exceptions and Halts Defense Exports for Hong Kong, Imposes Visa Restrictions in Response to China's New National Security Law for Hong Kong," Baker McKenzie, July 4, 2020, https://sanctionsnews.bakermckenzie.com/us-suspends-ear-license-exceptions-and-halts-defense-exports-for-hong-kong-imposes-visa-restrictions-in-response-to-chinas-new-national-security-law-for-hong-kong.

[12] US Department of State Directorate of Defense Trade Controls, "Hong Kong Executive Order: Licensing Policy Change for Hong Kong," https://www.pmddtc.state.gov/ddtc_public?id=ddtc_search&q=hong%20kong.

[13] US-China Economic and Security Review Commission, 2019 Report to Congress, 116th Congress, First Session, November 2019, https://www.uscc.gov/sites/default/files/2019-11/2019%20Annual%20Report%20to%20Congress.pdf.

[14] US Department of Commerce, Bureau of Industry and Security, US Trade with Hong Kong (2019), https://www.bis.doc.gov/index.php/country-papers/2577-2019-statistical-analysis-of-u-s-trade-with-hong-kong/file.

[15] US Department of Commerce, US Trade with Hong Kong.

[16] Thomas Hale, "How will Washington's intervention affect Hong Kong business?," Financial Times, May 28, 2020, https://www.ft.com/content/b8728741-2ca1-45fb-ac12-cbc9043ff7ba.

[17] Alison J. Stafford Powell, et al, "US Suspends EAR License Exceptions."

[18] US Customs and Border Protection, General Notice, "Country of Origin Marking of Products of Hong Kong," Federal Register 85, no. 48551, (August 11, 2020): 48551-48552, https://www.federalregister.gov/d/2020-17599.

[19] Federal Register 85, no. 48551.

[20] US Customs and Border Protection, Frequently Asked Questions, "Guidance on Marking of Goods of Hong Kong – Executive Order 13936", accessed October 14, 2020, https://www.cbp.gov/trade/rulings/frequently-asked-questions-guidance-marking-goods-hong-kong-executive-order-139362.

[21] "Hong Kong's Principal Trading Partners in 2019," Trade and Industry Department, Government of HKSAR, accessed October 6, 2020, https://www.tid.gov.hk/english/trade_relations/mainland/trade.html. The vast majority of Hong Kong's exports to the United States are re-exports originating in mainland China or elsewhere.

[22] See, Denise Tsang, "Trump's attack on the 'Made-in-Hong Kong' label expected to hurt some firms but not local pride in brand," South China Morning Post, September 16, 2020, https://www.scmp.com/news/hong-kong/politics/article/3101691/trumps-attack-hong-kong-label-expected-hurt-some-firms-not.

[23] Finbarr Bermingham, "Hong Kong's WTO threat against US 'Made in China' ruling puts city in uncharted waters," South China Morning Post, August 21, 2020, https://www.scmp.com/economy/china-economy/article/3098203/hong-kongs-wto-threat-against-us-made-china-ruling-puts-city.

[24] The Government of the Hong Kong Special Administrative Region, Press Release, "HKSAR Government strongly reprimands unilateral decision by the US on suspension or termination of bilateral agreements," August 20, 2020, https://www.info.gov.hk/gia/general/202008/20/P2020082000265.htm.

[25] Barbara C. Matthews, "New US Hong Kong tax treaty suspension sends important signal, despite the costs," The Atlantic Council, New Atlanticist, September 14, 2020, https://www.atlanticcouncil.org/blogs/new-atlanticist/new-us-hong-kong-tax-treaty-suspension-sends-important-signal-despite-the-costs/.

[26] Pending legislation includes the Hong Kong Be Water Act, the Hong Kong Freedom Act, the Hong Kong People's Freedom and Choice Act, the Hong Kong Safe Harbor Act, and the Hong Kong Victims of Communism Support Act.

[27] American Chamber of Commerce Hong Kong, "AmCham Temperature Survey Findings: OFAC's Sanction on Hong Kong and National Security Law," August 2020, https://amcham.org.hk/sites/default/files/content-files/WOI%20Judge%20Bios/WOI%20Judge%20Bios%202019/Survey%20Findings/OFAC's%20Sanction%20on%20Hong%20Kong%20%26%20National%20Security%20Law.pdf.

[28] Fareed Zakaria, "Op-ed: America's excessive reliance on sanctions will come back to haunt it," Washington Post, August 28, 2020, https://www.washingtonpost.com/opinions/global-opinions/americas-excessive-reliance-on-sanctions-will-come-back-to-haunt-it/2020/08/27/e73a9004-e89c-11ea-970a-64c73a1c2392_story.html.

[29] See Edward Wong, "Hong Kong Has Lost Autonomy, Pompeo Says, Opening Door to US Action," New York Times, May 27, 2020, https://www.nytimes.com/2020/05/27/us/politics/china-hong-kong-pompeo-trade.html; Demetri Sevastopulo, "Donald Trump to revoke Hong Kong trade privileges in China escalation," Financial Times, May 29, 2020, https://www.ft.com/content/4c620b9e-90b7-47bd-afe0-bec216bfa631.

hinrich foundation

advancing sustainable global trade

The Hinrich Foundation is a unique Asia-based philanthropic organization that works to advance mutually beneficial and sustainable global trade.

We believe sustainable global trade strengthens relationships between nations and improves people's lives.

We support original research and education programs that build understanding and leadership in global trade. Our approach is independent, fact-based and objective.

MEDIA INQUIRIES

Ms. Berenice Voets,
Director of Public Affairs
T: +852 9081 8210
berenice.voets@hinrichfoundation.com

There are many ways you can help advance sustainable global trade. Join our training programs, participate in our events, or partner with us in our programs.
inquiry@hinrichfoundation.com

Receive our latest articles and updates about our programs by subscribing to our newsletter

hinrichfoundation.com

hinrichfdn
hinrichfoundation
hinrich foundation
hinrichfoundation