A new era in US-Hong Kong relations

BY HOLLY SMITH
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. 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. 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, 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. Individual entities may also be subject to sanctions. Financial institutions list 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.

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. For dual-use technology exports, Hong Kong will only have access to the license exceptions already eligible for exports to mainland China – 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. Separately, the United States now can deny Hong Kong licenses and approvals for...
trade in defense equipment and services.\textsuperscript{12} Authorizations previously awarded are still valid, however, and Hong Kong persons outside of Hong Kong or mainland China can still receive licenses.

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.\textsuperscript{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,\textsuperscript{14} while controlled defense articles comprised only 0.01% of the 2019 total.\textsuperscript{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.\textsuperscript{16} Hong Kong importers must now obtain individual licenses for controlled dual-use exports.\textsuperscript{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”.\textsuperscript{18} Failure to change the labelling by November 9 will result in levy of a 10% duty.\textsuperscript{19} The new labelling requirement has no bearing on tariff treatment for Hong Kong’s exports.\textsuperscript{20}

The economic impact of the labelling change is likely to be limited, as in 2019 Hong Kong exported only approximately US$474 million\textsuperscript{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.\textsuperscript{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.\textsuperscript{23}

**Tax**

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.\textsuperscript{24} Termination is likely to have a limited quantitative impact, given the relatively small trading relationship,\textsuperscript{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.
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.  

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. 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. 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.

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. 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.

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Footnotes


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


8 Angela Zhang, “US Sanctions on Hong Kong and The Legal and Financial Implications”.

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


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


19 Federal Register 85, no. 48551.


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.


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