1

Enigma

> Her Majesty's plenipotentiary has now to announce the conclusion of preliminary arrangements between the Imperial commissioner and himself involving the following conditions: The cession of the island and harbour of Hongkong to the British crown.[1]

Hong Kong remains wrapped in an enigma. Its intermediaries of capital, who include traders, financiers, and corporate managers, have made Hong Kong the pivot of decision-making about the exchange of capital within Asia and between that region and the rest of the world. Yet, for 150 years, this tiny island and adjacent peninsula could not even lay claim to status as a city-state. When Britain declared sovereignty over Hong Kong in 1841, after taking it from China under the terms of the Treaty of Nanking that settled the Opium War, the government and merchants had to build a town. The British viewed Hong Kong as their emporium of trade in the Far East, but they did not aspire to transform it into a commercial-military power similar to the earlier aggressive city-states of Genoa and Venice. From the start, Hong Kong and Asia remained peripheral to a British foreign policy focused on Europe, and up to 1860, the meager fleet on the China station seldom numbered more than six ships. Britain devoted greater attention to avoiding being drawn into the interior of China than to expanding trade.[2]

British governors of Hong Kong supported the traders and financiers and worked closely with them. Yet, for all the attention paid to British, and to a lesser extent, other "foreign" traders and financiers, city residents overwhelmingly consisted of Chinese, many of them also traders and financiers. Britain signed a treaty with China in 1898 that leased the New Territories, an area north of the Kowloon Peninsula, for ninety-nine years, and the governments set the return date for 1997, setting off a ticking clock that ended with

[1] Notification of Captain Elliot, January 20, 1841; quoted in Morse, *The international relations of the Chinese empire*, vol. I, p. 271.
[2] Endacott, *A history of Hong Kong*, pp. 25–50; Graham, *The China station*.

the monumental peaceful transfer of a global metropolis between nations. Nevertheless, seen from Britain's perspective, Hong Kong still resided outside the mainstream of foreign policy. Even during World War II, Britain conceded Hong Kong to Japan and concentrated its defensive resources in Singapore. At the end of the war, the foreign and Chinese traders and financiers quickly regrouped in Hong Kong, reconstituting it as the pivot of the Asian networks of capital. When Britain finally realized that it could not retain control of Hong Kong and signed the Joint Declaration with China in 1984 that set the return to China for July 1, 1997, Britain did not seriously consult Hong Kong's residents and refused to commit extensive political and economic resources to contest the transfer.[3] As the transfer date loomed and Hong Kong would gain a territorial hinterland coterminous with its sovereign power, skeptics depicted pro-democracy movements, China's assertions that it would not tolerate challenges to its authority, and emigration of professionals as signs that Hong Kong would decline; and shortly after the transfer proceeded smoothly, economic travails in Asia impacted Hong Kong and again called its viability into question.[4]

An interpretation of Hong Kong as the global metropolis for Asia must explain the enigma of its expansion without a sovereign territorial hinterland even as a British colonial policy kept it at the periphery of concern. It soared after 1945 even as advances in telecommunications raised the specter of seamless capital exchanges without the need for face-to-face communication, and improved air travel seemingly allowed firms to manage trade, finance, and corporate organizations from almost any city. And with increasing uncertainty surrounding its return to China in 1997, competitors such as Tokyo and Singapore failed to dethrone Hong Kong as the dominant Asian venue for decision-making about the exchange of capital. Suggestions that Hong Kong may become one of the greatest global metropolises must reckon both with the capacity of its intermediaries to remain dominant in Asia, even as economic turmoil threatens, and with its status as a "capitalist" bastion ruled by a "socialist" state.

Traders and financiers in Hong Kong always operated in multitiered national, world-regional, and global economies. Recognition of that business scope provides one key for unlocking the enigma of Hong Kong as the global metropolis for Asia. Since the Canton days of the early nineteenth century, foreign merchant traders operated as agents of powerful global firms headquartered in London, New York, and Boston, among other metropolises. Their arrival in Asia represented an extension of expansive colonial states in Europe, and Britain, the leading extractor of concessions from China after the

[3] Endacott, *A history of Hong Kong*, pp. 260–69; Welsh, *A borrowed place*, pp. 374–440, 502–36.
[4] For examples of skepticism, see: Kraar, "The death of Hong Kong"; Theroux, "Letter from Hong Kong." For the economic crisis in Asia and its impact on Hong Kong, see Guyot, "Fears rise in Hong Kong over credit"; Pesek, "Dis-oriented markets."

Opium War of the early 1840s, was the strongest imperial power based on its industrial might. The mad rush of great foreign trading firms to Hong Kong in the 1840s instantaneously established it as an arm of global firms in leading metropolises, and the simultaneous arrival of numerous Chinese trading firms boldly indicated that this metropolis operated more than as an outpost of foreign capital.

The trading firms and financial institutions that followed, nevertheless, always remained embedded in the political economy of Asia. Peasant impoverishment continually thwarted attempts of foreign trade and financial firms to find markets for their home-country products and capital, and this impoverishment impacted the firms' specialization, capitalization, and capacity to compete for control of the exchange of commodity and financial capital. As peasants started to rise out of poverty in the late twentieth century, traders and financiers transformed their businesses, but foreign firms confronted anew the reality of Asian economic exchange. Chinese traders and financiers dominated the exchange of commodity and financial capital at unspecialized, less-capitalized levels, and those intermediaries leveraged that dominance into higher levels of specialization and capitalization as economic growth and development of Asian countries accelerated.

Chinese and foreign traders and financiers always operated as two social networks of capital, a Chinese and a foreign network, and those networks intersected at key metropolises. The term "social networks" emphasizes that intermediary decision-making about the exchange of capital rests on bonds that extend beyond pure market calculations of profit and loss to include deeper, wider social relations. Those relations are essential to build trust and monitor malfeasant behavior, thus reducing the risks of exchange. Social networks provided the means for economic exchange within Asia and between Asia and the developed world of Europe and North America, and Hong Kong operated as the pivotal meeting-place of the Chinese and foreign social networks of capital in Asia. The first step in interpreting Hong Kong as the global metropolis for Asia requires a specification of behavioral principles that intermediaries use to control the exchange of commodity and financial capital. Then, these principles frame the interpretation of the changes in the social networks of capital in Asia that revolve around Hong Kong from antecedents in the Canton days around 1800 to the present. Rather than viewing the Chinese business networks as exceptional, these principles portray both the Chinese and foreign networks as pieces cut from the same cloth.

These behavioral principles also provide a lens with which to evaluate the skeptics' claim that Chinese government control weakens Hong Kong as the global metropolis for Asia. This claim dismisses too readily both Hong Kong's status as the pivot of the Chinese and foreign social networks of capital and China's commitment to preserving the Hong Kong jewel as its window to the world economy. The arrival of "red chips," mainland Chinese firms with government connections, infiltrates *guanxi* (connections) into the business environment and this undermines Hong Kong, the skeptics argue; yet, increasingly, mainland Chinese work in foreign firms and foreigners work in mainland firms. The influx of red chips and private mainland firms strengthens Hong Kong as the meeting-place of the Chinese and foreign social networks of capital. As economic crises swirl in Asia, the critics' predictions that China would undermine Hong Kong are contradicted by the unwavering support that China expresses for its international business center. That affirmation will reinforce Hong Kong's advance towards the level of London and New York during the twenty-first century as it becomes the global metropolis for one of the largest economies in the world.

2

Intermediaries of capital

> As it is the power of exchanging that gives occasion to the division of labour, so the extent of this division must always be limited by the extent of that power, or, in other words, by the extent of the market.[1]

Insights of the social theorists

Social theorists who observed the world economy during the early history of Hong Kong provided clues to understanding the behavior of traders, financiers, corporate managers, and other intermediaries of capital. From the late eighteenth century to the early twentieth century, theorists such as Emile Durkheim, Karl Marx, Adam Smith, Herbert Spencer, Ferdinand Tonnies, and Max Weber witnessed a transformation of the world economy as revolutionary as that of the late twentieth century.[2] Railroads dramatically lowered the cost and raised the volume and speed of commodity and passenger movement over land, and steamboats and steamships did the same for waterborne transport. The telegraph bound cities within nations from the 1840s, and by the 1880s, a global network had emerged. This provided almost instantaneous communication of information and separated information transmission from physical movements of passengers and commodities. Industrial growth, first in Western Europe, then in the United States, and finally in Japan, generated swelling volumes of commodities for shipment, and burgeoning factories drew on widening source areas for raw material inputs and forged increasingly elaborate linkages of intermediate goods. This astounding rise in social complexity fascinated the theorists; their clues to explaining it rested in the causes and consequences of the division of labor.[3]

1 Smith, *An inquiry into the nature and causes of the wealth of nations*, p. 8.
2 Durkheim, *The division of labor in society*; Marx, *Capital*; Smith, *An inquiry into the nature and causes of the wealth of nations*; Spencer, *The principles of sociology*; Tonnies, *Community and society (Gemeinschaft und Gesellschaft)*; Weber, *Economy and society*.
3 Rueschemeyer, *Power and the division of labor*.

They had divergent social, economic, and political views, but the social theorists shared three fundamental points: local economies made a transition from self-sufficiency to integration with other local economies as the division of labor advanced; the increase in exchange among local economies supported this metamorphosis; and differentiation (specialization) and integration were mutually reinforcing processes. To grapple with this complexity, they posed an ideal state, the local self-sufficient economy, that existed only in remote, exotic places. A web of intertwined economic relations bound the residents: isolation from external information kept technological innovation low; production technologies stayed primitive; most goods were exchanged face to face because inadequate transportation media made transactions over greater distances impossible; locally produced goods limited population size; the small population kept demand low and the labor force tiny; and this constricted labor specialization and economies of scale. In sum, the theorists had articulated the state of impoverishment.[4]

To break out of this state, residents of a local economy had to exchange with other local economies. Adam Smith articulated the brilliant insight that the growth of exchange unleashed and molded the possibilities of the division of labor, but citations of his statement trivialized it to an aphorism: "the division of labor is limited by the extent of the market."[5] This aphorism focuses on a body-count of consumers that form the market and shifts attention to the supply side and the production economies of firms. The growth of the market enhances possibilities for the division of labor and economies of scale of firms; these translate into lower production costs, such as in the pin factory that Smith immortalized. The aphorism, however, circumvents attention to broader effects of increased exchange that the social theorists recognized; exchange enhances flows of information and that raises awareness of new sources of demand and supply and promotes technological innovation. Greater exchange also stimulates demand for improvements in transportation and communication, and this permits greater specialization. Residents of local economies do not have the time, information, and capital directly to forge exchange linkages to other local economies. Many theorists took another critical step; they identified agents, or intermediaries, of exchange and termed their headquarters the "metropolis."[6] These actors, who included wholesalers and financiers, destroyed the stagnation of self-sufficient local

4 Meyer, "The division of labor and the market areas of manufacturing firms," pp. 433–38.

5 For the full statement of Adam Smith, see the quotation at the head of this chapter; Smith, *An inquiry into the nature and causes of the wealth of nations*, p. 8. The shortened aphorism appears in numerous places; for one of the most famous, see Stigler, "The division of labor is limited by the extent of the market."

6 Smith, *An inquiry into the nature and causes of the wealth of nations*, book 2; Weber, *Economy and society*, vol. I, pp. 156–59, vol. II, pp. 1216–17; Tonnies, *Community and society (Gemeinschaft und Gesellschaft)*, pp. 82, 227; Marx, *Capital*.

economies through non-local exchange of commodity and financial capital. Intermediaries specialize in controlling and coordinating exchange among local economies; as the division of labor advances, greater complexity of exchange requires more sophisticated intermediaries. The theorists did not elaborate their ideas about intermediaries and metropolises, but subsequent studies provide a basis for an explanation of the growth and change in Hong Kong as the global metropolis for Asia.[7]

Intermediaries confront dilemmas

Control of exchange

To control the exchange of commodity and financial capital, intermediaries must acquire public and specialized business information about their international demand and supply.[8] Because intermediary profitability often depends on being the first to make exchanges, delays in receipt and transmission of information are costly. Printed and electronic mass media, unrestricted spoken information, and official government sources provide public information, but all intermediaries have similar access to this information. Instead, specialized business information communicated face to face, in written forms (mail and journals), and through telecommunications (telegraph, satellite, and fiber optics) constitutes the critical information for intermediary decision-making. This complex information requires synthesis, analysis, and interpretation, and these processes have large fixed-cost components because intermediaries need highly skilled people, trained in quantitative and financial analysis, and information processing capabilities, such as computers, models, and software. Intermediaries often rely on face-to-face contact for close coordination, negotiation, communication of complex information, and transmission of confidential information. Short-distance travel requires little time and money, but these costs escalate rapidly for longer-distance travel; therefore, intermediaries agglomerate at origins and destinations for efficient face-to-face contact. Those who engage in larger-scale, more complex exchange over wider territories typically require greater amounts of capital to fund information acquisition and processing.

The amount of capital required to underwrite exchange must rise along with swelling volumes of exchange. Even intermediaries that exchange capital without acquiring ownership of it need larger capital bases as exchange

7 The framework draws partly on Meyer, "A dynamic model of the integration of frontier urban places into the United States system of cities"; Meyer, "The world system of cities"; Meyer, "The formation of a global financial center," pp. 98–99; Meyer, "Change in the world system of metropolises," pp. 398–406.
8 This discussion of information draws on Pred, *City-systems in advanced economies*, pp. 19–22.

expands because they must fund costs associated with transactions before they receive payment for services. For example, a commodity broker of wheat who operates on commission must fund storage, transportation, and insurance costs of moving wheat between seller and buyer. As business with a buyer expands, the broker may buy on the basis of an order or even advance money to the buyer for the purchase. Intermediaries who take ownership of capital as a customary business practice without a binding or firm commitment from a buyer must augment their capital bases to fund larger ownership positions. For example, an investment bank that speculates in currency movements must raise its capital as larger positions are taken even though these positions are often financed with borrowed money, because the capital base of the firm directly impacts the capacity to borrow.

Crossing boundaries

The exchange of commodity and financial capital across international boundaries confronts intermediaries with two distinctive problems: they must physically move themselves and commodities and they must transfer the control of capital.[9] Total cost rises with distance, but typically less than proportionally to the increase in distance, because fixed terminal costs at origin and destination are spread over longer distances; therefore, the fixed portion of the cost per kilometer declines. Transportation media are organized hierarchically; smaller carriers bring passengers and commodities to nodes for aggregation onto the services of larger carriers before long-distance transportation. Because intermediaries use passenger travel for contact with other intermediaries and for gathering information for exchange, centers of intermediary activity require high-quality passenger services. Physical movements of passengers and commodities need not directly trace linkages that intermediaries forge to transfer control of capital. After the introduction of the telegraph (1840s), information could move independently of the transportation of passengers and commodities. Oil traders, for example, buy and sell oil on different international commodity exchanges, whereas physical movements of oil connect producing nations with consuming ones. This focus on transfers of control of capital, rather than simply their physical exchanges, directs attention to the fundamental activities of intermediaries. To implement exchanges of capital, they must either take ownership before transferring capital between buyer and seller or provide services that enable exchanges to occur. An exporter, for example, buys textiles from a factory in one nation and sells them

[9] This discussion of physical movement and the transfer of the control of capital is adapted from Meyer, "A dynamic model of the integration of frontier urban places into the United States system of cities." The discussion focuses on international exchange, but the concepts also fit intranational exchange.

to an importer or to a retail chain in another nation. Similarly, a bank collects money from depositors in one nation, pays them interest, and lends this money to a factory in another nation. In this case, the bank controls the financial exchange without actually taking ownership of capital, but the bank remains liable for the security of the capital.

The control of the process of exchange across boundaries constitutes the core business of intermediaries; they exert that control whether capital exists as physical or symbolic assets. Intermediaries may directly exchange physical assets, such as precious metals (gold, silver) and commodities (grain, manufactures), or create symbolic measures of the assets such as option contracts to buy or sell. Similarly, they can exchange currencies (dollars, yen), stocks, and bonds that represent stores of value, or transform them into even more abstract symbols such as derivatives. Intermediaries can transform assets such as loans and real estate portfolios into marketable securities that trade. The shift of emphasis from physical to symbolic assets forces intermediaries to invest more resources in telecommunications and information processing capabilities. Assets ultimately exist as claims on ownership; exchange reduces to a transfer of information.

Regardless of the form of assets, exchange of capital across international boundaries always enmeshes intermediaries in political negotiation and conflict.[10] Because intermediaries need approval to operate as importers and exporters of capital, government officials have leverage to extract political and financial support from them. Intermediaries may lobby their government to enforce sanctions against foreign competitors, or, when sanctions from other nations impact them, they may request support from their government. Governmental actions pose risks for intermediaries, but these episodes pale compared with the risks they confront on every exchange of capital across political boundaries. Partners to an agreement to buy or sell may fail to complete transactions, payments may not be made, and credits or loans may remain unpaid. All businesses face these risks, but most have only a small share of their capital at risk away from their business at any time. Because intermediaries allocate most of their capital to underwriting exchange, the bulk of it remains outside their immediate control either in transit or at a distant site as a store of value such as in commodities, investments, or loans. They cannot continuously monitor partners to exchange transactions, and the costs to guarantee or enforce contracts are prohibitive; those efforts slow the exchange process, reducing the rate of return on capital. Enforcement of contracts across political boundaries remains difficult because exchange partners reside outside the authority of the home nation. Sanctions against exchange

[10] Block, “The roles of the state in the economy”; Corbridge, Thrift, and Martin, *Money, power and space*.

partners for malfeasance depend on the willingness of the other nation to take enforcement actions; yet, malefactors can lobby national leaders for support, thus deflecting or stopping sanctions.

Intermediaries must reduce this ongoing risk of exchange across boundaries; exchange with friends offers a plausible solution. Social theorists from the eighteenth-century Scottish Enlightenment, including Adam Smith and David Hume, nevertheless, identified a paradox.[11] In precommercial societies, the social group encompassed the full range of social and economic transactions of individuals; calculations of self-interest pervasively shaped friendship, but these bonds drew individuals into transactions that did not have commercial feasibility. Strangers, in contrast, loomed as potential enemies outside the group. The social theorists argued that the advent of commercial society, namely economic exchange in the market across local economies, shifted the calculation of self-interest to the market. This freed friendship from economic self-interest and allowed it to flourish, founded on sympathy and affection. The theorists identified serious problems with embedding economic transactions in bonds of friendship. Their belief that market transactions could stand without friendship implicitly rested on a practical fact. Exchange of capital across local economies cannot rest solely on friendship bonds because intermediaries do not have the time and monetary resources to forge those bonds. Friendship, therefore, fails to fully govern intermediary exchange, but an alternative exists, the building of trust; individuals trust their friends, but people they trust do not have to be friends.

Trust as a bedrock

Everyone participates in forms of community, including family, ethnic group, religion, or common interest group, such as a social club, business association, or professional organization. Persons in a community share beliefs and values, and relations among members are direct, many-sided, and reciprocal.[12] Members trust each other, but they need not be friends. Given that a trustee (actor being trusted) gains by being trusted in the future, then a close community among potential trustors (actors trusting the trustee) leads to greater trustworthiness; this follows for two reasons. First, the trustee expects greater benefits in the future when the relationship with the trustor continues than if it terminates after one exchange. This encourages the trustee to engage in more trustworthiness because the trustee incurs high cost by failure to act that way. Second, extensive communication among the trustor and other actors from whom the trustee might expect to receive trust in the future encourages the

[11] Silver, "Friendship in commercial society."
[12] Taylor, *Community, anarchy and liberty*, pp. 26–33.