

## Sights and Insights From Hong Kong

*Former AIER Summer Fellow James Zhang, now a third-year student in the law and economics program at the University of Chicago, recently completed a legal internship in Hong Kong. As his remarks below may suggest, even in this Asian capitalist Mecca the legal protections to capital, which apparently often are arbitrary and rely mainly on graft and "guanxi," remain astonishingly inadequate by U.S. business standards.*

*He also reminds us of the crucial importance of the checks and balances inherent in democracies. As inefficient as the democratic process may sometimes be, it has a long leg up on totalitarian dirigisme.*

During the summer of 1997, I obtained an internship in a prominent British law firm in Hong Kong. As the whole world watched, Hong Kong, the former British Crown Colony ceded by China one and a half centuries ago, formally reverted to Chinese sovereignty, marking the first time since World War II that a capitalist territory was peacefully transferred to a communist government. The internship gave me an opportunity to observe Hong Kong's unique culture from a special perspective — I was raised in China, educated in the United States, and was setting foot in Hong Kong for the first time at this historic moment. In particular, my visit offered insight into the strengths and weaknesses of Hong Kong's economy, which (until recently, at least) has benefited from the vast economic development in Asia in general and the rapid economic growth in China in particular.

### *Asian Miracle*

During the summer, Hong Kong's financial market was still in its heyday, with the bellwether Hang Seng Index topping 16,000 points in mid-August (it has since plummeted and is currently at 11,000). Major international corporations were seeking to raise capital amid these favorable market conditions, and one of my responsibilities as an intern was to prepare announcements for them. I also drafted a few memoranda to the Hong Kong Securities

and Futures Commission, functionally equivalent to the U.S. Securities and Exchange Commission. The bullish atmosphere may be indicated by these memoranda, which in essence disclaimed any knowledge by the companies as to why their respective stock shares had shot so high (or in Federal Reserve Chairman Alan Greenspan's words, why investors exhibited "irrational exuberance" for their respective companies' shares).

It thus seemed to many that Hong Kong, given its capital market structure at that time, would be immune to the Asian economic contagion that started when the Thai baht was devalued in July. Indeed, the International Monetary Fund was so confident about Hong Kong's financial stability that during its annual meeting in Hong Kong in late September, it focused its attention on Asian economies *excluding* Hong Kong.

Hong Kong's stock market crashed in October, demonstrating that its economic and political structures are not immune to the economic virus from other Asian Tigers. Based on my experiences working on a few commercial transactions and my insight into the way people conduct business in Hong Kong, I conclude that Hong Kong and the rest of Asia will have to make substantial reforms to build a sound and healthy economic structure. However, if this economic structure is devoid of democracy — which all Asian countries view as a Western import and alien to their cultural identities — it would be a castle in the air.

The most striking aspect of practicing law in China is that China is a land governed not by law but by a gargantuan bureaucracy under a totalitarian regime. Chinese law is vague and very incomplete, so the government officials' words command almost exclusive authority.

As an example, I was involved in a commercial lending project of a Japanese bank that intended to make loans to a Chinese State-Owned Enterprise (SOE). The bank wanted to know whether it could sue the SOE in a Chinese court in the event of the SOE's default. Since Chinese law regarding SOE does not provide

any regulation relating to its liability, I had to telephone the official in the ministry that owns and supervises the SOE and inquire whether the concerned SOE could be brought into court for trial. The official said yes. My employer in the law firm then told me that this Chinese government official's response was sufficient, and I should write a memorandum detailing the telephone conversation and deliver it to the Japanese lender.

I was appalled by my employer's loose legal practice, since the legal evidence and conclusion were based solely on information provided by one Chinese government official, and the information was not even written but oral, not much different from hearsay. I was later informed that an oral response from a Chinese government official usually is the only solution to a legal question and is always better than any legal analysis based on published statutes. Judging from my experience working in an American law firm, if I were to present a legal finding and conclusion to a client based solely on a telephone conversation with someone, be it William Rehnquist or Bill Clinton, I could start to count the number of days I would remain in the firm.

Investors from outside of the Republic of China, including Westerners, Japanese, and Chinese living elsewhere — in particular, Hong Kong investors — do not view the lack of the rule of law in Mainland China as the termite that undermines China's economic development and may someday eat away their own investment. Instead, these investors accommodate the Chinese government officials' desire to maintain the status quo, in which decisions are made by government officials without the check of law; personal connections, or *guanxi*, determine virtually all final outcomes of commercial activities; and corruption and graft are ubiquitous in almost any business dealing.

Many foreign investors think that they can curry the Chinese officials' favor, but by the time those investors discover that they have been outfoxed by their Chinese counterparts, they have already lost a good fortune. For example, in early 1997, the British telecommunications company Cable & Wireless (C&W) sold a portion of HongKong Telecom to the Chinese

government at a substantial discount; in return it received a promise of special access to the Mainland phone market when a portion of China Telecom would later go to C&W. However, in the end C&W did not get any shares of China Telecom's initial public offering; instead it was the usual China's cronies in the Hong Kong tycoon class who received discounted allocations of the new shares.

If Britain's Cable & Wireless seems a remote example to Americans, the company of Morgan Stanley, Dean Witter, Discover & Co. should be more familiar. It encountered a similar fate. It has been one of the most active American investment banks in China, and it put up \$35 million to capitalize Beijing's first joint-venture investment bank. In due course, it found itself squeezed out of a lead role in the China Telecom flotation by the new investment bank it helped create. Moreover, this new bank has now located in Hong Kong, where it competes head-to-head with Morgan Stanley, rather than helping to open the door for it to be a player on the Mainland, as originally hoped.

It is unfair to say that personal connections and cronyism are exclusively Asian characteristics. But in America these things are balanced by democracy, which is its greatest strength, as Alexis de Tocqueville observed long ago in his classic treatise *Democracy in America*. In Asia, leaders are not as accountable to the public. They refuse to accept responsibility for the current deepening economic crisis, but instead rail against the Western world's "conspiracy" to contain Asian countries' economic development.

As long as Asian leaders do not reform their political structure to accommodate the needs of rapidly growing economies, the Asian contagion that has dragged many nations into deep recession will continue to haunt the region. In this respect, the "Asian Miracle" is *not* that Asian countries had achieved, until last year, rapid growth rates while at the same making no extensive efforts to expand democracy and protect individual human rights. The real miracle is that Asian economies had grown rapidly in spite of, not because of, their totalitarian regime. □

## Julian Simon, 1932-1998

Julian Simon, who died on February 8, was an antidote to economic and environmental doomsayers. In *The Ultimate Resource* and other books he persuasively challenged the conventional, pessimistic view — namely, that the earth is running out of resources and that we should try to postpone the day of reckoning by limiting population growth and consumption. He pointed out that things have gotten better, not worse: every trend in material welfare has improved remarkably in this century, the environment has become cleaner, and resources have become less rather than more scarce. If humans are given sufficient economic and political freedom to respond to problems, he said, things will continue to improve. His contrarian optimism annoyed his critics, but he had the weight of evidence on his side. The characteristic passage below is taken from *The State of Humanity*, (Blackwell Publishers, 1995):

"Every forecast of the doomsayers has turned out to be wholly wrong. Metals, foods, and other natural resources have become more available rather than more scarce throughout the centuries. The famous *Famine 1975* forecast by the Paddock brothers — that we would see millions of famine deaths in the U.S. on television — was followed instead by gluts in agricultural markets. Paul Ehrlich's primal scream about "What will we do when the [gasoline] pumps run dry?" was followed by gasoline cheaper than since the 1930s. The Great Lakes are not dead; instead, they offer better sport fishing than ever. The main pollutants, especially the particulates that have killed people for years, have lessened in our cities.

"The false forecasts have not been harmless, however. They have caused economic disasters for (just a few examples) mining companies and the poor countries which depend on natural resources, by misleading them with unsound expectations of increased prices for metals; wasted expenditures for aircraft manufacturers and airlines who planned on high prices for gasolines; and chaos in the auto market for auto makers and for consumers, as a result of laws about fuel economy premised upon a growing scarcity. But neither their personal embarrassment nor their public damage has reduced the doomsayers' credibility with the press, or their command over the funding resources of the federal government.

"Not much more than one century ago — after more than 50 centuries of recorded history and hundreds of centuries of unrecorded history — for the first time people had something better than a firelight or oil lamp to break the darkness after dusk. And the absence of electricity continued almost into the second half of the twentieth century for substantial portions of the population of the richest country in the world. Now all of us Americans take Edison's gift for granted.

"Less than two centuries ago there appeared the first land transportation that did not depend entirely on animal muscles. Now we complain about the ubiquity of cars. In the last two centuries the first anesthetics other than alcohol became available to provide surcease from the hellish pains of hospital and dental operations, and of diseases such as cancer, as well as to give those women in childbirth who want it another option besides deep breathing. How can one *not* recognize that this is truly a new age of the liberation of humanity from the bonds in which nature has kept us shackled throughout all of our history? And what liberation in the future could possibly match this one?"

## BOOMING AGAIN

*Construction spending historically has played a major role in business expansions. It also is a feature of the economy that is largely immune to exogenous shocks such as the Asian meltdown. Seen in this light, the current building boom may be especially timely.*

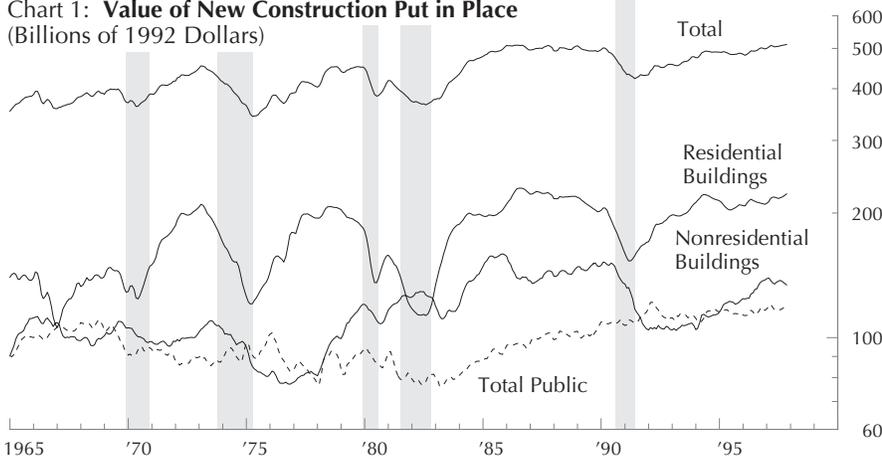
Probably due largely to continued low interest rates, the value of new construction topped \$600 billion last year — ad-

justed for price inflation the highest level since the booming mid-1980s. The "ripple effects" of this activity on the

general economy were even larger. When construction increases, so do sales and jobs in furniture, carpeting, fixtures, appliances, real estate brokerages, and other related industries.

Housing accounts for 4 of every 10 dollars spent on construction, and this was the strongest sector in 1997. As can be seen in Chart 1, the value of new construction work on residential buildings rebounded last year following a tepid

Chart 1: **Value of New Construction Put in Place**  
(Billions of 1992 Dollars)



Note: All series are 3-month moving averages of seasonally adjusted monthly data at annual rates. Source of data for Charts 1 and 2: Commerce Department, *Current Construction Reports*.

1996. Adjusted for price inflation, outlays last year roughly matched their level at the peak of the 1982-1990 business expansion. Outlays for renovations, additions, and other home improvements led the increase last year, followed by construction of multi-family housing (apartments, condos, and townhouses). Outlays for single-family housing, which accounts for the bulk of residential construction, increased moderately in 1997.

In contrast, the value of new work on private nonresidential buildings, in constant dollars, actually decreased last year. Construction spending on office buildings, hospitals, and hotels increased, but this was offset by reduced outlays for industrial sites and other commercial buildings. Overall, activity in this sector remains well below the exceptional pace of the mid-80s.

The frenzied levels of commercial construction during the 1980s, of course, had been fueled by a speculative real estate boom and reckless lending. The subsequent bust resulted in huge numbers of empty offices and bank failures. Such excesses do not appear to be a problem in the current upturn. In part, this is because the savings and loan industry, which played a major role in the earlier boom-and-bust cycle, is much smaller now, thanks to a wave of failures and mergers in the early 1990s, and the remaining institutions are financially sounder than they were in the 1980s. The same may be said of the banking sector. Speculative lending may yet become a problem, but today the lending industry appears to be in much better shape than it was a decade ago.

Construction spending in the public sector in real terms increased slightly in the fourth quarter of 1997 over its level a year earlier. Outlays for public buildings (schools, hospitals, public housing,

etc.) decreased during the year, but this was more than offset by higher spending on other public works. In particular, spending on highways and streets, which accounts for nearly a third of all public construction, increased to a seasonally adjusted annual rate of \$42 billion in the fourth quarter — five percent higher, in real terms, than a year earlier. Given that 1998 is an election year and the coffers at every level of government are overflowing with revenue from the strong economy, we expect such outlays will continue to increase this year.

**Record Housing Sales**

The continued boom in residential housing is evident in Chart 2, which plots a number of key indicators arranged by the sequence of the construction process. Over 1.4 million permits were issued last year for new housing (both single and multi-family units), the most since 1988. The number of units started also rose to a 9-year high. However, the number of houses completed in 1997 decreased from a year earlier, reflecting a drop in late 1996 in permits issued and units started. Completions are likely to pick up later this year.

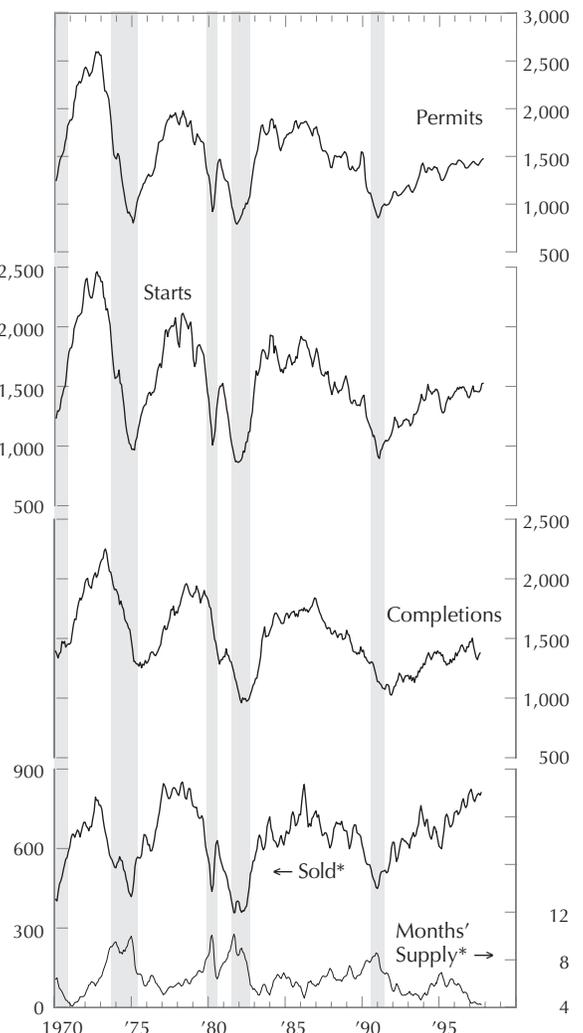
Sales of single-family houses set a record pace last year. According to the latest data, newly-built homes sold at an annualized rate of

830,000 in November, an exceptionally high rate, and total sales for 1997 exceeded 800,000 units, the highest rate in 20 years. Sales of existing homes, which account for a much larger share of total sales, reached 4.2 million share of total sales, the highest sales total on record.

Because sales have been so strong and fewer completed units have been coming onto the market, the inventory of unsold new single-family houses has dropped by 25 percent in the past two years, and is now at a four-year low. At the current sales rate, it would take just over four months to sell off this stock. By this measure, the supply of unsold new houses is the leanest in over 25 years (see the last panel of Chart 2). This lean inventory bodes well for new construction.

As always, the national data mask wide variation across regions. Demand for new homes is strongest in the South, thanks to the region's booming

Chart 2: **New Housing Units**



Note: In thousands of units, except months' supply in months. \* Single-family houses.

economy and growing population. Demand is also brisk in the West, where the number of residential building permits issued in the fourth quarter of 1997 was 20 percent higher than a year earlier. In contrast, the number of permits issued in the Midwest and Northeast was relatively flat last year.

Record home sales have been accompanied by rising prices. The average purchase price of a new single-family house, purchased with a conventional mortgage, increased to \$188,400 last fall — nearly matching the all-time high reached in 1996 (see top panel of Chart 3). As a result, the average down payment on a newly built house increased to \$42,500 and the average mortgage loan rose to a record \$145,900.

Homebuyers are willing and able to take on record mortgages in part because of relatively low interest rates. The average rate on a conventional mortgage was 7.54 percent in October, half a percentage point lower than it was in May. It has declined further since then. According to the National Association of Realtors, 30-year fixed-rate mortgages fell to 7.1 percent in December, and adjustable rates leveled off at 5.5 percent. Consequently, mortgage payments have not increased much despite the rise in house prices.

The average monthly mortgage payment on a new home was \$1,045 in late 1997. This is roughly the same as it was in 1989 — even though homebuyers now pay about \$30,000 more, on average, for a new house than they did in 1989. The difference is interest rates, which are 300 basis points (*i.e.*, three percentage points) lower now.

The prices of existing houses also continued to increase. Last summer the average price paid for a previously-occupied house rose to \$163,700, a record high. Again, low interest rates have been the key to keeping these homes affordable. The average monthly mortgage payment rose to about \$925, which is about the same as it was in 1989, even though previously-occupied houses sell for about \$25,000 more now.

Many factors of supply and demand affect house prices, but one reason that they continue to increase is that buyers continue to demand larger homes and more amenities. In 1970 (when the average price of a new single-family house was about \$35,000), the average size of a new single-family house was 1,500 square feet. In 1996 it was 2,120 square feet, or 40 percent bigger. In 1970, half of all new houses had 1.5 bathrooms or fewer. Now, half of new homes have 2.5 bathrooms or more. Only one out of three

houses built in 1970 had central air-conditioning, while today 80 percent do. Today two-thirds of new homes have fireplaces, up from one-third in 1970.

### Outlook

Given an expanding economy, rising incomes, and high employment, demand for housing is likely to remain strong. Despite rising prices, the combination of income growth and relatively low mortgage rates has kept housing affordable — and housing as well as other construction can be expected to benefit as long as interest rates remain relatively low.

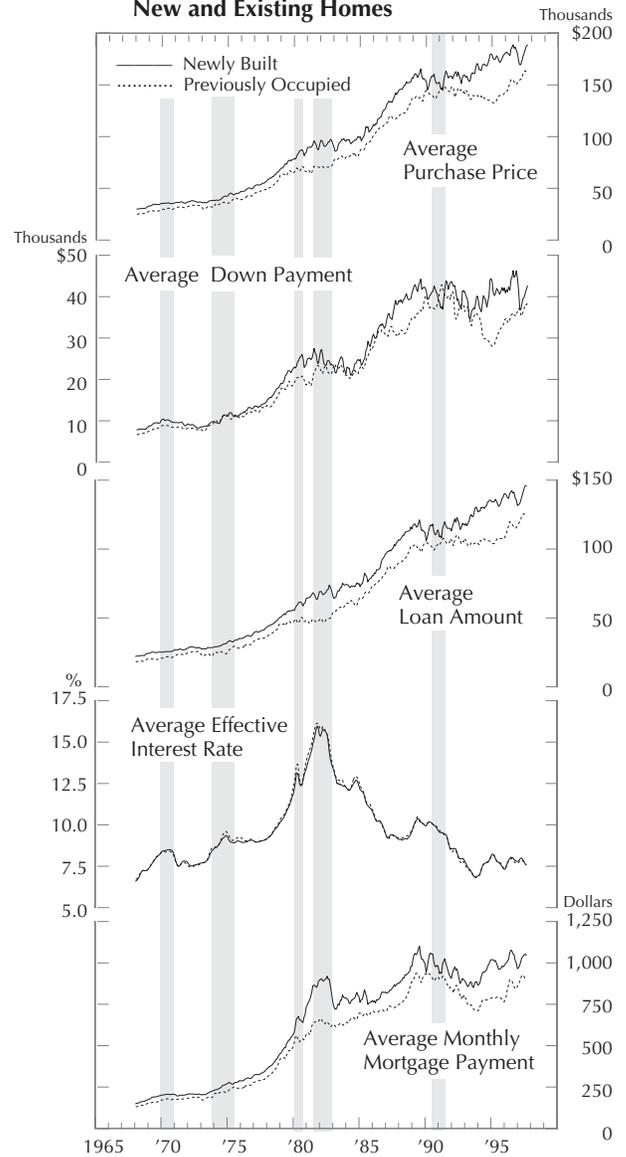
Will rates stay down? One factor in the recent drop in rates apparently was the Asian economic crisis. Worried investors shifted to the safety of U.S. Treasuries, and consequently both short- and long-term bond yields — and mortgage rates — dropped. The Federal Reserve, of course, directly influences only short-term interest rates, and what its discount rate policy over the next year might be no one can say at this time. Continued uncertainty about Asia would seem to militate against rate increases, but the housing sales figures discussed above have been cited recently by some analysts as reason to believe the Fed's next rate change might be upward.

In any event, the Fed has no direct control over long-term rates. Although these have rebounded somewhat from their recent lows, the more significant point for construction is that they remain far below their 1980s construction boom

levels. Barring unforeseen developments, the current mortgage environment would seem highly favorable to continued building.

Perhaps the best news is that construction is a *domestic* activity. Whatever happens in Asia is largely inconsequential to this sector of the U.S. economy, and in this sense the current building boom could scarcely be more timely. □

Chart 3: Prices and Mortgage Terms for New and Existing Homes



Source: Federal Housing Finance Board, News.

### PRICE OF GOLD

	1996	1997	— 1998 —	
	Mar. 7	Mar. 6	Feb. 26	Mar. 5
Final fixing in London	\$393.90	\$353.10	\$293.00	\$293.70

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