# The Economic Prosperity of Hong Kong

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# The Economy of Hong Kong before 1949

- Before 1949, Hong Kong was largely an entrepot port, engaged mostly in commerce and trade, serving southern China.  There was little industry. And the financial centre of the region at the time was clearly Shanghai. Shanghai was much more internationalized and economically much more developed than Hong Kong at the time.
- The establishment of the People's Republic of China on the mainland and its initial inward-oriented policies closed off the entrepot trade and forced Hong Kong to develop its light manufacturing industries in part on the basis of the influx of human and financial capital from the mainland.  (The Chinese University of Hong Kong was a beneficiary of this influx of human capital.  All three founding constituent colleges, Chungchi, New Asia and United were founded and staffed by intellectuals who fled the mainland.)

# Hong Kong without the Mainland, 1949-1978

- Towards the late 1950s, light industry such as textiles, plastic flowers, toys and wigs began to develop in Hong Kong, followed also by real estate development and re-development. One pioneer of the real estate industry was the late Mr. Henry Y. T. Fok, who introduced the condominium form of ownership of residential units into Hong Kong, thus greatly expanding the potential affordability of residential property ownership, especially the owner-occupied housing and hence the overall market. The result was a real estate boom that sustained the economic growth of Hong Kong for a couple of decades beginning in the mid to late 1950s.
- In the mean time, the Great Leap Forward (1958) and the Cultural Revolution (1966-1976) on the Mainland interrupted Chinese economic development and preoccupied the Chinese Government for almost two decades but provided Hong Kong an opportunity to develop and grow (with the exception of a couple of years around 1966-67 during which Hong Kong was also affected by the Cultural Revolution on the Mainland).

# The Opening of the Mainland Chinese Economy-Hong Kong as the Gateway

- With the re-opening of China to the rest of the world in 1978, Hong Kong became the sole gateway and bridge between Mainland China and the rest of the world for international trade, foreign direct investment and for exchange. It was also the primary source of the early foreign direct investment in the Mainland Chinese economy. Shanghai, which was starved of capital under Communist rule until 1992, was but a shadow of its former self during this initial period of Chinese economic reform.
- The Mainland has been Hong Kong's largest trading partner since 1985, with a total trade of almost US$300 billion in 2005, or almost one-quarter of total Chinese international trade with the world. Hong Kong was also the largest foreign direct investors in Mainland China, although the statistics may have been confounded by "round-tripped" investments (Chinese investments camouflaged as foreign direct investments, and investment by Hong Kong firms that are subsidiaries of firms in Taiwan and elsewhere.)

# The Opening of the Mainland Chinese Economy-Hong Kong as the Gateway

- Thus, Hong Kong and its people were indispensable in the initial success of the Chinese economic reform and opening to the rest of the world. Without Hong Kong, the Shenzhen Special Economic Zone would not have been a success. Nor would the development of the light industry in Dongguan have been possible. (The Hainan Special Economic Zone was largely a failure during its first ten years.)
- The manufacturing and service industries in Hong Kong faced competition from the Mainland with its much lower costs of labour (especially unskilled and low-skilled labour) and land.
- Many Hong Kong firms established manufacturing bases in Shenzhen and neighbouring regions in Guangdong Province (Pearl River Delta), taking advantage of the vastly lower labour (especially unskilled and low-skilled labour) and land costs. Back-office work also began to be moved from Hong Kong to the Mainland.
- Foreign direct investors at this time also relied on Hong Kong firms as partners in their direct investments in the Mainland because of their cultural affinity with and knowledge of China and its people.

# The Opening of the Mainland Chinese Economy-Hong Kong as the Gateway

- But with the success of Chinese economic reform and opening, Chinese capabilities and needs have gradually changed. The economic environment faced by Hong Kong has also changed.
- By now, all the low-skilled manufacturing jobs, as well as low-skilled back office jobs, have moved across the border to Mainland China. The wage differential between Mainland China and Hong Kong for low-skilled or no-skilled labour is simply too high for these manufacturing and service jobs to remain in Hong Kong. The demand for new construction in Hong Kong has also declined, in part due to the abundance of cheap land and labour just across the border.
- However, both New York and Silicon Valley have survived the out migration of its manufacturing jobs and continued to prosper. Hong Kong will be able to do the same.

# The Opening of the Mainland Chinese Economy-Hong Kong as the Gateway

- But increasingly Hong Kong is no longer the only gateway to the Chinese economy, especially after Shanghai began to take off in the early 1990s. (Taipei can also eventually become a competing gateway to China if the cross-strait political situation permits.)
- Hong Kong therefore needs to adapt to the changed circumstances. Hong Kong should focus on creating and renewing its core competences and comparative advantages, especially through investment in intangible capital (human capital, R&D capital, goodwill, intellectual property).
- It may not be the only gateway to China any more, but it can be the best, or at least the best to southern China.

# The Chinese Economy Today

- East Asia is the fastest-growing region in the world over the past quarter of a century, notwithstanding the East Asian currency crisis of 1997-98.
- China is the fastest growing country in East Asia—almost 10% p.a. since beginning of economic reform in 1978.
- Between 1978 and 2005, Chinese real GDP grew from US$170 billion to US$2.25 trillion (2005 prices) (4$^{th}$ largest GDP in the world) and real GDP per capita grew from US$180 to US$1,730. By contrast, the U.S. GDP (approximately US$12.5 trillion) and GDP per capita (approximately US$42,000) are respectively more than 5.5 and 24 times the comparable Chinese figures in 2005. The Hong Kong GDP per capita may be estimated at US$26,000 in 2005, also significantly higher than the Chinese GDP per capita.
- Despite its rapid growth, China is still a developing economy in terms of its real GDP per capita, which will remain low relative to the developed economies for decades to come.

# The Chinese Economy To-Morrow

- The Chinese economy is likely to continue to grow, more or less independently of what happens in the rest of the world, over the next several decades at an average annual rate of approximately 8%.
- The source of this growth will come primarily from tangible capital accumulation, supported by a national savings rate of over 30% (in 2005, the savings rate approached 50%), human capital accumulation, and economies of scale, and to a lesser extent on the growth of intangible capital (for example, R&D capital) and improvements in efficiency.

# The Chinese Economy To-Morrow

- Between 2005 and 2025, Chinese real GDP is projected to grow from US$2.25 trillion to US$10 trillion (2005 prices) (second largest GDP in the world) and real GDP per capita to grow from US$1,730 to US$6,500.
- By contrast, the then U.S. GDP (approximately US$18 trillion) and GDP per capita (approximately US$57,500) are respectively 1.8 and 9 times the comparable Chinese figures.
- By 2025, aggregate Chinese GDP is projected to exceed the then aggregate GDP of Japan.
- Some time between 2030 and 2040, aggregate Chinese GDP may reach the same level as aggregate U.S. GDP, assuming that steady economic growth continues.
- Even then, there will still be surplus labour in the Chinese economy—consequently the real wage rate of unskilled labour will remain low.

# The Chinese Economy To-Morrow

- Aggregate household consumption will have risen, with the aggregate savings rate settling down at a level of approximately 30%. Investment demand will continue to be strong—even the service sector may require large capital investments, e.g., communication and transportation facilities and equipment.
- The average level of human capital will also continue to rise, thanks to the commitment of the Central Government to improve the provision of basic education nationwide. With the increase in the average level of education and income, environmental consciousness and the demand for a higher quality of life will also strengthen.

# The Chinese Economy To-Morrow

- The international sector
  - By 2025, exports as a percentage of GDP will have declined to below 15% from the current one third. The rate of growth of international trade will approximate the rate of growth of GDP.
  - Net FDI will turn negative.
  - Net “Foreign Portfolio Investment” will also become negative.
  - The World Tourism Organization predicts that China will become the world’s fourth largest source of overseas tourists, reaching 100 million annually, by 2020. This projection may turn out to be too conservative.
- The balance of payments
  - If the Renminbi becomes a major reserve currency, China will definitely run a large capital account deficit (outflows greater than inflows), and probably a current account deficit vis-à-vis the rest of the world, but the current account can also be in equilibrium.

# The Chinese Economy To-Morrow
# The Renminbi

- The exchange rate of the Renminbi was "unpegged" from the U.S. Dollar in July, 2005. Since then, the Renminbi has been appreciating gradually. It currently stands at 7.86 Yuan per US$ and will probably cross the psychologically important barrier of 7.8 Yuan per US$ some time within the next year. When that happens, one may see a shift in the currency preferences of Hong Kong households and firms, even though the Renminbi will remain officially non-convertible for capital purposes for the next few years.
- The Renminbi may be expected to be fully convertible within at most ten years. And the Hong Kong Dollar, if it continues to exist at the time, will most likely be pegged to the Renminbi once the Renminbi becomes fully convertible.
- The Renminbi will also become over time one of the strongest currencies in East Asia and a quasi-reserve currency like the Euro. However, this also implies that China will eventually have a much higher rate of consumption and run balance of payments deficits with the rest of the world.

# The Chinese Economy To-Morrow
# The Pearl River Delta

- By 2025, the GDP per capita of the Pearl River Delta will have reached almost US$20,000 per capita, approximately 60% of Hong Kong. The GDP per capita of Shenzhen will have reached a level comparable to Hong Kong.
- Guangzhou-Dongguan-Shenzhen-Hong Kong will become one giant metropolis.
- There will be virtually free movement of people and goods between Hong Kong and Shenzhen. Economically, Hong Kong and Shenzhen will have become an integrated city, e.g., cooperation in airport facilities; joint stock exchanges; universities serving the residents of both cities.

# The Risk Factors for the Mainland Economy

- Armed conflict between the two sides of the Taiwan Straits.
- Disruption of the supply of oil to the world from the Middle East.
- "The China Threat" threat.

# The Hong Kong Economy Today

- Hong Kong, by virtue of its rule of law, active financial markets and absence of capital control, has served as the principal financial hub for Mainland China and the region.
- By virtue of its location, and of the advanced development of its maritime industry and services, Hong Kong has also become the logistics hub of the region.
- The Hong Kong economy has gradually recovered from its long slump due to the bursting of the property price bubble in 1997, caused in part by the East Asian currency crisis.
- The Hong Kong economy has been doing well lately
  - The rate of growth of real GDP for 2005 is 7.3%, the best since 1997.
  - The rate of unemployment has fallen to an eight-year low.
  - Deflation has stopped and instead there is slight inflation; the price of real estate is once again rising.

# The Hong Kong Economy Today

- The robust growth of the Mainland Chinese economy and its international trade is a major positive factor in the economic recovery of Hong Kong, by generating significant growth in the demand for financial services, international trade-related services, (communication, transportation and logistics), and tourism services (individual visit scheme).
- The continuing provision of gainful employment for the unskilled and low-skilled labour in Hong Kong is a major challenge (creation of unskilled and low-skilled jobs that cannot move away--mostly through tourism services).

# Symbiosis and Co-Prosperity

- The individual visit scheme under which residents in selected provinces and cities can come to Hong Kong as tourists has also helped the economy of Hong Kong enormously, especially through the provision of low-skilled jobs in the service sector (hotels, restaurants, transportation, retail). Mainland visitors now account for more than half of the 23.4 million visitors in 2005.
- Hong Kong's economic fortunes are now inextricably linked to those of the Mainland. If the Mainland Chinese economy prospers, so will Hong Kong. If the Mainland Chinese economy goes into a recession, so will Hong Kong. The economic well-being of Hong Kong depends critically on the economic performance of the Mainland Chinese economy.

# Symbiosis and Co-Prosperity

- In another decade, the rate of growth of Chinese international trade will have slowed considerably, and with it, the growth in demand for international trade-related services. When that time comes, such services will no longer be a major source of growth for Hong Kong.
- However, with the continued rise in the Chinese real GDP per capita, more and more Mainland provinces/municipalities/regions will introduce the individual travel scheme, and Mainland tourists will continue to be the mainstay of the tourism industry in Hong Kong.
- There will also be greatly enhanced mobility of capital and human capital between Hong Kong and the mainland (for examples: reciprocal recognition of professional qualifications; tax agreements).
- The Closer Economic Partnership Arrangements provide Hong Kong with unique opportunities to take advantage of the continued rapid economic growth on the Mainland. Hong Kong should pursue cooperative long-term win-win strategies with the Mainland and its entities (provinces, municipalities, enterprises, institutions). Only win-win strategies, that is, strategies that benefit both sides, are durable in the long run.

# Symbiosis and Co-Prosperity

- Hong Kong can become the key service hub serving southern China and in particular the Pan Pearl River Delta region—providing financial services, logistical and transportation services, industrial design and marketing services, tourism services, educational and health care services.
- To maintain its position as the only such service hub, it must pursue long-term mutually beneficial collaboration with the relevant neighbouring provincial/municipal/local governments (for examples: development of a high-speed rail service between Guangzhou and Shenzhen; cooperation with Shenzhen on airports and stock exchanges).

# The Comparative Advantages of Hong Kong

- Hong Kong will within the next ten years lose its advantage over the Renminbi as a convertible currency. currency—the Renminbi is certain to become fully convertible during this period and when it does, it will substantially displace and replace the Hong Kong Dollar.
- It will also lose much of its advantage of a free port/low tariff on account of Chinese accession to the WTO. Hong Kong will therefore have to rely on its other comparative advantages.
- The Mainland will catch up quickly on Hong Kong's comparative advantage in human capital as its economy continues to be globalised, its institutions of higher learning continue to improve, and the use of English becomes more and more common.

# The Comparative Advantages of Hong Kong

- Hong Kong’s other comparative advantages include the rule of law, effective regulation and supervision, transparency, efficiency, flexibility and adaptability (an international financial center for institutional investors? A center for registration of patents and intellectual property?)
- At this time, Hong Kong has the advantage of its reputational capital (also known as goodwill) and should capitalize on it to build a lead especially in retail services, not just in Hong Kong, but also on the Mainland, taking advantage of CEPA.
- Hong Kong can leverage on Mainland China’s huge internal market and enhance the return on its investment in intangible capital.

# The Comparative Advantages of Hong Kong

- The service sector in Hong Kong will become even more important, with emphasis on high-value-added services—financial services, education and health care, creative industries such as advertising, marketing and design. It will be human-capital and skill-intensive (Think Boston).
- The service sector should be developed in such a way as to enable Hong Kong to become a "destination" rather than simply a transit/trans-shipment point. Jobs will be much easier to retain if Hong Kong is the "destination" (consider tourism).
- With the Mainland as a potential market, investment in intangible capital (innovation, design, brand building) becomes much more attractive in Hong Kong.

# Possible Strategies Forward

- Hong Kong should strive to be simultaneously a Chinese city and a World city (Shanghai before 1949 was in fact both a Chinese city and a World city) and not an island on its own.
- The Closer Economic Partnership Arrangements provide Hong Kong with unique opportunities.  CEPA I took effect on 1 January 2004; CEPA II took effect on 1 January 2005; and CEPA III took effect on 1 January 2006.  There are opportunities not only for manufactured goods of Hong Kong origin but also for services including those in the financial, audiovisual and medical industries.  Moreover the threshold requirements for Hong Kong firms are often lower than those for foreign firms under Chinese WTO commitments.

# Possible Strategies Forward

- Hong Kong should strive for closer economic cooperation and pursue long-term win-win arrangements with the Mainland and its entities (provinces, municipalities, enterprises, institutions) with clear role differentiation and avoidance of potentially ruinous competition.
- For example, there can be greatly enhanced mobility of capital and human capital between Hong Kong and the Mainland (reciprocal recognition of qualification insofar as possible); the twin-cities of Hong Kong-Shenzhen can be more fully economically integrated.
- The Pan Pearl River Delta region, i.e., the 9 (Guangdong, Guangxi, Hainan, Fujian, Jiangxi, Hunan, Sichuan, Guizhou, Yunnan) +2 (Hong Kong and Macau) can become Hong Kong's economic hinterland.

# The Implications for Hong Kong

- Hong Kong must become more competitive—upgrading the labour force through better education and attracting more outside talents, investing in education and R&D, lowering the cost of doing business in Hong Kong, reducing red tape, and generally making Hong Kong much more user-friendly. It is a service business!
- For example, tax treaties/agreements with mainland China and the United States; bringing more traffic through Hong Kong--more airlines and cruise ships--through more open skies and seas; reductions of tariffs and other barriers to trade in goods and services.

# The Implications for Hong Kong

- With the appropriate support from the Government of the Hong Kong SAR, Hong Kong can easily developed into an education and health service hub and R& D centre for the region.
- Internationalization and bilingualism (trilingualism) are the unique comparative advantages of Hong Kong that not only must be maintained but also encouraged and enhanced.
- The government can become more pro-active—it should try to intervene whenever and wherever there are significant positive or negative externalities.  Taiwan would not have had a thriving high-technology sector had the government there not promoted it actively in the 1980s.

# The Implications for Hong Kong

- Hong Kong should try to broaden its revenue base, and reduce, over time, its dependence on land sales as a source of revenue. This will help decrease the volatility of its income stream and enable long-term planning. It will then be able to reform its social safety net (including pension and health care) and welfare system so as to provide both economic security and an incentive to work and to save. The ultimate objective is for the Hong Kong SAR Government to be able to achieve long-term fiscal sustainability.

# Concluding Remarks

- Hong Kong is potentially vulnerable to external forces that affect Mainland China and the world.
- Hong Kong should diversify its geographical dependence (which would also avoid over-competition with Shanghai, for example) and become a service (financial, logistics, education, health care and R&D) hub not only for the Mainland but also for the entire East and Southeast Asia.
- Hong Kong must establish a credible, affordable and durable social safety net, so that people can live and pursue their goals with security.
- To sustain Hong Kong's position in the Greater Chinese economy, Hong Kong just pursue strategies that add long-term value to both Hong Kong and Mainland China (and provinces and regions in Mainland China). The Central Government can only help so much. In the long run, only mutually beneficial win-win strategies are durable and viable.