

# 2020 Vision: Does Hong Kong Have a Home in China's Xiaokang Society?

*By Fred Armentrout*

While Hong Kong people have for a decade rued the absence of a “vision thing” from their leaders and grown increasingly frustrated with growing gridlock in government, China has moved along smartly toward its dream of having a moderately wealthy society in the year 2020, as set forth in 2000 by the 16<sup>th</sup> Party Congress's 10<sup>th</sup> Five Year Plan.

Its subsequent 11<sup>th</sup> Five Year “Program” (a name change intended to suggest setting priorities rather than rely on inflexible planning) has moved that nation-building momentum into high gear by emphasizing three main themes starting from 2006: economic efficiency, sustainability, and innovation and high technology.

In line with those goals, Guangdong province has been given the task of building an economic platform cloned from the Korean model of industrial policy, with Hong Kong included for the first time—but only as an appendage of the provincial master plan. Guangdong province's future is now officially tied to nine sectors, but in particular favoring automotive and other heavy industry, petrochemicals, and advanced electronics based on large investments in research and development, with state incentives to cement its lead in information technology manufacturing. None of these include Hong Kong capital or manufacturers as a significant source of support.

Since 2007, both central and Guangdong governments have also been diligently working to turn Hong Kong's export processing manufacturers into figures from its economic past. The ‘front shop, rear factory’ (*qiandian houchang*) relationship of Hong Kong to cities in the eastern Pearl River Delta (PRD), like Dongguan and Shenzhen, is over. However friendly and anodyne the language, Guangdong's industrial blueprint assumes its cities can replace Hong Kong altogether, and invites Hong Kong to send its service sector experts to assist in that process as the main means for it to remain engaged and relevant. Basically, the province is saying: grow with us or decline on your own.

## **New Mainland Competition**

Pearl River Delta Cities, specifically Guangzhou and Shenzhen, now compete in areas of Hong Kong strengths – logistics and trade services are already rapidly shifting there. Next in the line of fire are headquarters and financial services and air logistics. Hong Kong's service economy is not driven by the growth of consumer services, but producer services – business and trade services like banking, accounting, legal and logistics and supply chain management, all intimately tied to the manufacturing base of the delta.

To date, Hong Kong has had a virtual monopoly on providing such services to China. Shifts of manufacturing to the Yangtze River Delta and Bohai Rim will require that service professionals find new cities from which to commute to their industrial parks. Most PRD factories are owned by Hong Kong companies whose managers commute.

Over 7% of the SAR's workforce commuted to China, with over 87% of those workers employed in Guangdong province in 2005 – usually with higher qualifications and positions than the rest of Hong Kong's domestic working population. That year, over a third of Hong Kong departures to the mainland (22.7 million) were by commuters who reside in the SAR but work across the border. Factories in the Yangtze delta are not similarly owned by Shanghai companies. They rely on managers from elsewhere and, unlike Hong Kong, Shanghai imposes few restraints on cross-border immigration.

Major Hong Kong land developers are already building new 'Grade A' business districts in these cities, just as Hong Kong's container port developers provided the shipping infrastructure in Shenzhen and Nansha and soon Zhuhai that signal the decline of the SAR's former maritime dominance. Hong Kong now provides overflow capacity for Shenzhen ports rather than the reverse, according to one study, and its share of South China cargo has fallen from 80% in 2000 to 48% in 2006.

The impact of lost market share is largely ignored because the pie has grown so much that Hong Kong's absolute volume still increased, despite a decline of its market share, but capacity constraints here and the enormous expansion of mainland ports now underway in the Pearl and Yangtze river deltas suggests that

price pressure will continue to divert traffic flows northward. This will be exacerbated by the dramatic decline of export processing re-exports and Guangdong's shift to heavy industry, for which Hong Kong's port is unsuited.

Other historical negatives in the PRD, like customs clearance delays, are being improved with help from local governments and Hong Kong's experienced port developers. For instance, Federation of Hong Kong Industries surveys saw a drop in enterprises experiencing delays in mainland PRD ports from over 73% in 2003 to only 3% in 2006.

The Shenzhen bourse is working with London's to learn the ropes of financial management, working to build its capacity and sophistication as a financial center. Meanwhile, high costs in Hong Kong have already driven major banks here to outsource their data and call centers to Guangzhou and Shenzhen – transferring their service technologies with them to train mainlanders.

New 2007 rules on land, labor, environment and taxes have ended three decades of favorable treatment for Hong Kong's migrant manufacturers since the *kai fang*, or liberalization policy, began in 1979. Increasing costs and competition are expected to ultimately cause the relocation or demise of 70% to 80% of the export processing plants in Guangdong, reported Cheng Jiansan, with the Guangdong Academy of Social Sciences, in 2006, and a Hong Kong Trade Development Council survey in June 2007 indicated that almost 40% of Hong Kong manufacturing enterprises planned to relocate some or all of their activities from the PRD by 2010 (Implications of Mainland Processing Trade Policy on Hong Kong).

Trade services will follow relocated manufacturers wherever they go, which could be in China or elsewhere; Vietnam and Bangladesh are favored current alternatives. Surveys by the Federation of Hong Kong Industries in 2003 and 2006 found a sharp drop in Hong Kong-funded enterprises that maintained offices in and conducted financial management from the SAR, to about half and a third, respectively. There was a similar decrease in IT management. (*Made in PRD, Challenges & Opportunities for HK Industry, 2007 conducted by The Hong Kong Centre for Economic Research*).

The ratio of Hong Kong to mainland employees in the PRD is also declining. Over half the management and engineering staffs expected to be replaced in five years (from 2006). Even more pronounced shifts were expected in finance, accounting and legal staffs (67%+), sales and marketing staffs (66%) and R&D staff (62%). In short, Hong Kong's producer service provider role is rapidly shrinking. Within a decade Hong Kong will be competing head-to-head with Guangzhou and Shenzhen for producer services business. What does this say about continuance of Hong Kong's fabled 'gateway' role for foreign direct investors?

According to a study by the Hong Kong Institute of Asia Pacific Studies, "These manufacturing firms also directly or indirectly created 1.5 million job openings for Hong Kong residents. That is to say that every 23 job openings in the PRD generated one job opening in supporting operations for Hong Kong residents." That's about half of Hong Kong's work force. (*China's 11<sup>th</sup> Five-year Plan: Opportunities and Challenges for Hong Kong, Final Report, Oct 2006, by Yeung Yue-man, Shen Jianfa and Zhang Li*).

### **What is Hong Kong's Role to be?**

Today's question: Does Hong Kong truly have a home in the brave new world of the *xiaokang* society or does its appendage status mark it as the concubine's child of Chinese lore, with only a small unspecified claim to any share of the coming national wealth?

It took until March 2006 for the Hong Kong government to take note of the immense changes under way across the border, when then-Chief Secretary, Rafael Hui Si-yan, wondered aloud at a public gathering if Hong Kong was facing any serious threat of being marginalized by the mainland's 11<sup>th</sup> Five Year Plan (2006-2010). A clutch of studies have followed from think tanks and universities, with many and various problems and solutions identified. These range from turning Shenzhen and Hong Kong into "twin cities", to creating an expanded free trade zone with Macau and Zhuhai included.

All of the reports seem to agree on the inadequacy of Hong Kong's response to the sea change underway in Guangdong, and with the Pearl River Delta's response to China's other two growth centers, the Yangtze River Delta with

Shanghai as its “dragon head” and the Bohai Rim near Beijing, led by the city of Tianjin and its Binhai New District in Hebei province.

Unlike these, the Pearl River Delta has no single “dragon head”. Instead there’s a tripartite division of influence and economic power among Guangzhou, Shenzhen and Hong Kong. They must converge around the PRD’s competitive interests and yet compete on increasingly equal terms among themselves. But this also means that Hong Kong’s leading PRD role is far less secure than that of Shanghai for the Yangtze region.

A report by Edith Terry for Civic Exchange, a leading Hong Kong research institution, describes the worst-case alternative to Hong Kong’s dream of becoming a ‘World City’ able to compete with London and New York:

“Hong Kong has faced the change in processing trade policy and the erosion of its lead in mainland listing with (a) disturbing lack of urgency and calls for delay. It will be for reasons like this if Hong Kong is to fade in the way some other major port cities have for reasons of history – the decline of Trieste with the fall of the Austro-Hungarian Empire and its annexation to Italy; or Shanghai’s hibernation during the era of Mao Zedong.” (*Beyond the Pearl River Delta: The contest begins, Feb 2008*).

Besides political problems resulting from having a testy Legislative Council and the lack of a democratic mandate for its Chief Executive, Hong Kong’s civil service approach to development projects is typified by the way its ports have been built and expanded with a so-called ‘trigger mechanism principle’. Basically, it ensures that capacity expansion is led by demand so the government can offer operators assured profits and itself collect very high premiums up front for the right build or expand. China competitors add capacity rapidly, without political constraints, and do so ahead of demand.

This means provinces like Guangdong can virtually reinvent themselves within a five-year plan while Hong Kong moves at a glacial pace. There is a long list of major projects that have languished for a decade or more while the Hong Kong government has dithered or endlessly and inconclusively ‘consulted’ stakeholders and the public in its oblique way.

Hong Kong's partial democracy gives no incentives to either legislators or civil servants to innovate or openly plan ahead of the curve of its urban competitors in China or Southeast Asia. Instead, legislators win notice and votes with vetoes and attacks on policies, while civil servants abhor the legislative and public attention they receive when called upon to advocate or defend planning decisions. And the Basic Law's corporate empowerment of Functional Constituencies has given half the legislative votes to vested special business and labor interests by law. They defend their industry sectors with votes already in hand, votes government may need to get something else done.

Finally, the absence of meaningful competition policies or laws to prohibit collusion and other practices illegal elsewhere have tied government's hands in dealing with powerful local cartels or even securing critical planning information. Oligopolies controlling the ports are under no legal obligation to provide information on "commercial matters" and, in an absurd irony, competing ports of Singapore and Dubai have more information on the economics of the port of Hong Kong than does the Hong Kong government – via investments of their state-owned companies in those operating local container ports.

The principle of demand-led development informs all planning decisions of the Hong Kong government, whether it's for railway expansion or creating a new West Kowloon Cultural District. It worked well when Hong Kong had no competition on the business side and no accountability on the political side. All the players made money and there was little downside risk.

Then there are the humbling realities of limits on its financial services role: Hong Kong is not truly a global or even regional financial center. Instead, it is a China financial center. Only 1% of the companies listed on Hong Kong's main exchange are non-Hong Kong or non-Chinese, reports Enright, Scott & Associates in a study sponsored by the Bauhinia Foundation Research Centre (*Hong Kong's Competitiveness: A Multidimensional Approach, Phase II: Industry Level Competitiveness, Feb. 2007*).

At street level that means Hong Kong's future prospects as a financial center are tied to the whims of China's central government and the continued state management of the renminbi capital account. A good example is the recent thaw

in cross-straits relations with Taiwan. A Hang Seng Bank study notes that Taiwan companies are the source of 8.9% to 13.1% of all foreign direct investment into Hong Kong; as of July 2007 there were 56 Taiwan companies listed on Hong Kong's exchange; and about 7.3% of Hong Kong's total exports are in fact destined for China from Taiwan. Hong Kong won't sink if most or all of that is lost in the so-called 'three-links' scenario for agreements between China and Taiwan, but such significant interest shifts don't help its economic ship of state either, and they take place entirely out of Hong Kong's control.

In addition, its reliance on expatriate talent means these outsiders will move where the most money flows, irrespective of what other appeals the SAR may offer. Meanwhile, there was no increase in financial services industry employment between 2001 and 2006, despite a booming industry and world-ranked initial public offerings of shares (IPOs), because high Hong Kong costs have driven major banks to export much of their back-of-the house work to the Pearl River Delta.

The bank study adds: "It should be noted that Hong Kong succeeds in financial services because it is in a growing market and it is considered better than regional competitors, not because it has all the skills, capabilities, and systems present in more advanced financial centers, like New York or London." It also opines that finance-related programs at universities are often oversubscribed and understaffed and the "amount of money the Hong Kong Government spends on research in the natural sciences through the University Grants Committee dwarfs that spent on research in finance." Yet financial services are now seen as the central pillar of the SAR economy, and their expansion and increased sophistication as its best hope for 'World City' status and continued relevance to mainland China.

High pollution and high costs are even eroding its position relative to other Chinese cities. In a 2006 survey of 200 Chinese cities, Hong Kong ranked poorly in living environment (29<sup>th</sup>), size of living space (51<sup>st</sup>), leisure and entertainment (28<sup>th</sup>), and sports facilities (53<sup>rd</sup>).

Tourism, yet another economic pillar, was bolstered by the mainland's decision to let its people visit under the Individual Travel Scheme of July 2003.

Hong Kong's tourism numbers tripled during the following three years, tourism employment increased by almost 24,000 in amusement and recreation – very likely due to Disneyland and Ocean Park expansion – and the retail sector was saved from terminal decline. A new real estate bubble also began in earnest that has driven the market back to pre-1997 prices.

But, as in all sectors, Hong Kong is more expensive than competitors and will soon be seen to offer fewer integrated resort options than its competitors, Macau and Singapore. This gives Hong Kong an important disadvantage in the regional MICE competition (Meetings, Incentives, Conferences, Exhibitions) for high-paying business travelers. And Macau is engaged in wholesale employee piracy of skilled Hong Kong workers, to meet its burgeoning human resources demand. Meanwhile, Beijing and Shanghai are seen as having more to offer to non-Chinese as a 'China experience.'

Hong Kong also suffers from the perception of suffocating air pollution, although this is true of most China cities.

The Enright, Scott & Associates industry level competitiveness study cited above also notes that an insufficient supply of museums, galleries, and dedicated tourism facilities has become a major disadvantage for Hong Kong tourism. This is supported by Census and Statistics Department employment surveys that show staff declines from 2001 to 2006 in motion picture and entertainment services and libraries, museums and cultural services, which likely reflect declines in funding as well. While the government talks about creating culture centers in West Kowloon or at the site of the former central police station, its main concerns remain wedded to commercial real estate.

For one thing, property costs continue to be driven up by the government's continued dependence upon land premiums as a chief revenue source. There also are constant land-use conflicts that almost invariably end up favoring developers because government pays for most capital construction projects by collecting these land premiums and related stamp duties. Notably, almost 11% of Hong Kong's 2006 GDP was from the ownership of premises, while employment in the real estate sector grew by 15,288 between 2001 and 2006 (to about 98,000).

Major property developers are generally the owners, operators or managers of hotel properties, but hotels typically comprise only small parts of large conglomerates. So even within businesses there are land use conflicts based on the desire to maximize rents, with hotels often losing to commercial complexes and a related reluctance to build anything but grand luxe hotel properties. This has led to a shortage of moderately-priced hotels and pushes budget travelers elsewhere.

For the moment Hong Kong remains a city of economic superlatives. But there is the sense of reckoning in the air for what is viewed locally as a lack of firm executive leadership from its Chief Executives and the continuance of outdated policies. The present Chief Executive, Donald Tsang, clearly understands this and has made a number of efforts to address shortcomings described in various reports, but so far with limited success.

What is really lacking is serious public discussion of the way Hong Kong has lived and thrived for the past 30 years, and about what remains possible in its economic relationship with China. This includes the need for more discussion about what are its intrinsic strengths and how to build upon them. Hong Kong helped make an economic miracle of itself and the Pearl River Delta, as China achieved the fastest improvement in living conditions for the largest number of people in human history. The message of the 11<sup>th</sup> Five Year Plan is that the miracle has run its course: now what can you show us?

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