

The Economic Relationship between the Mainland and Hong Kong

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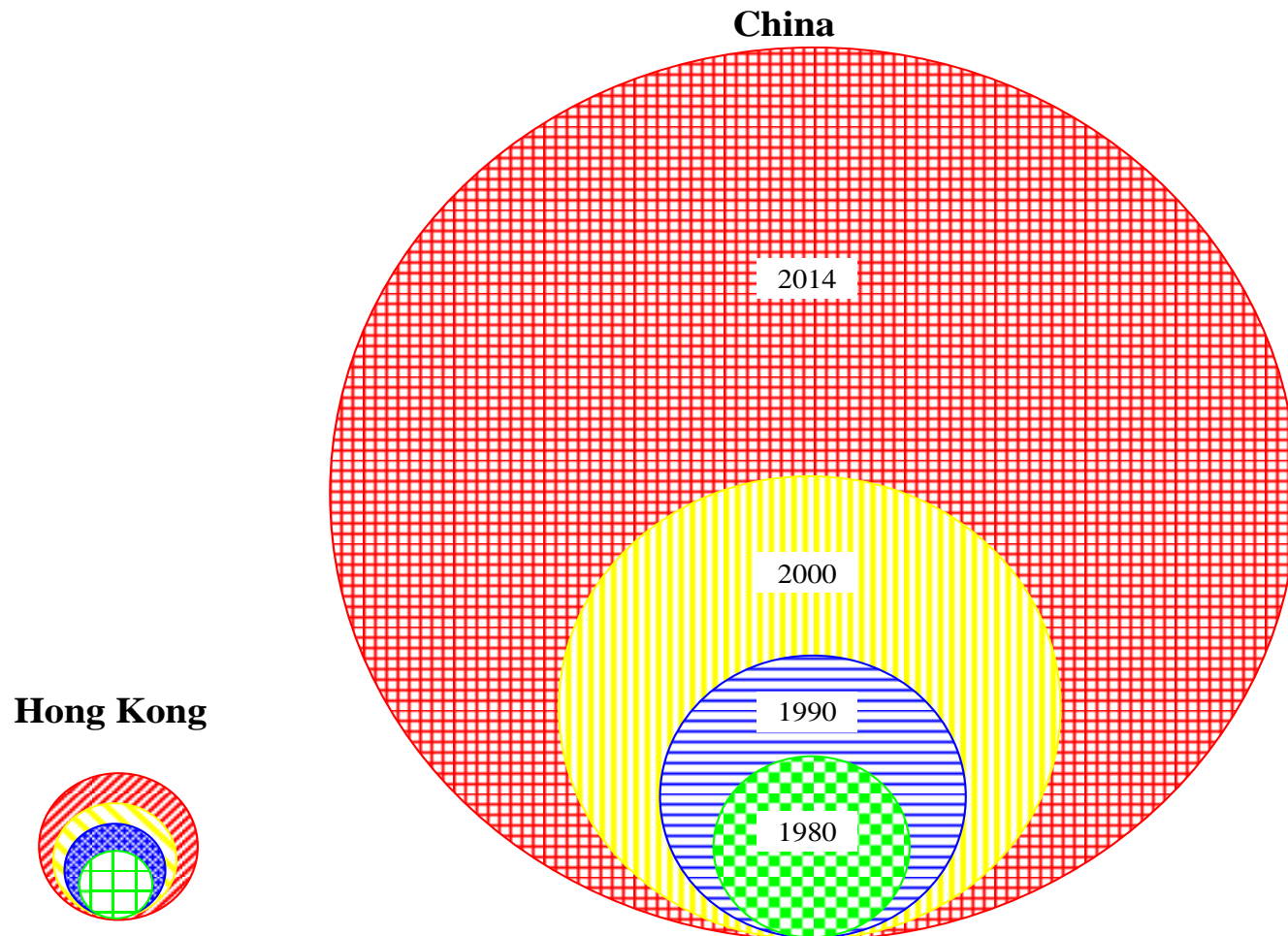
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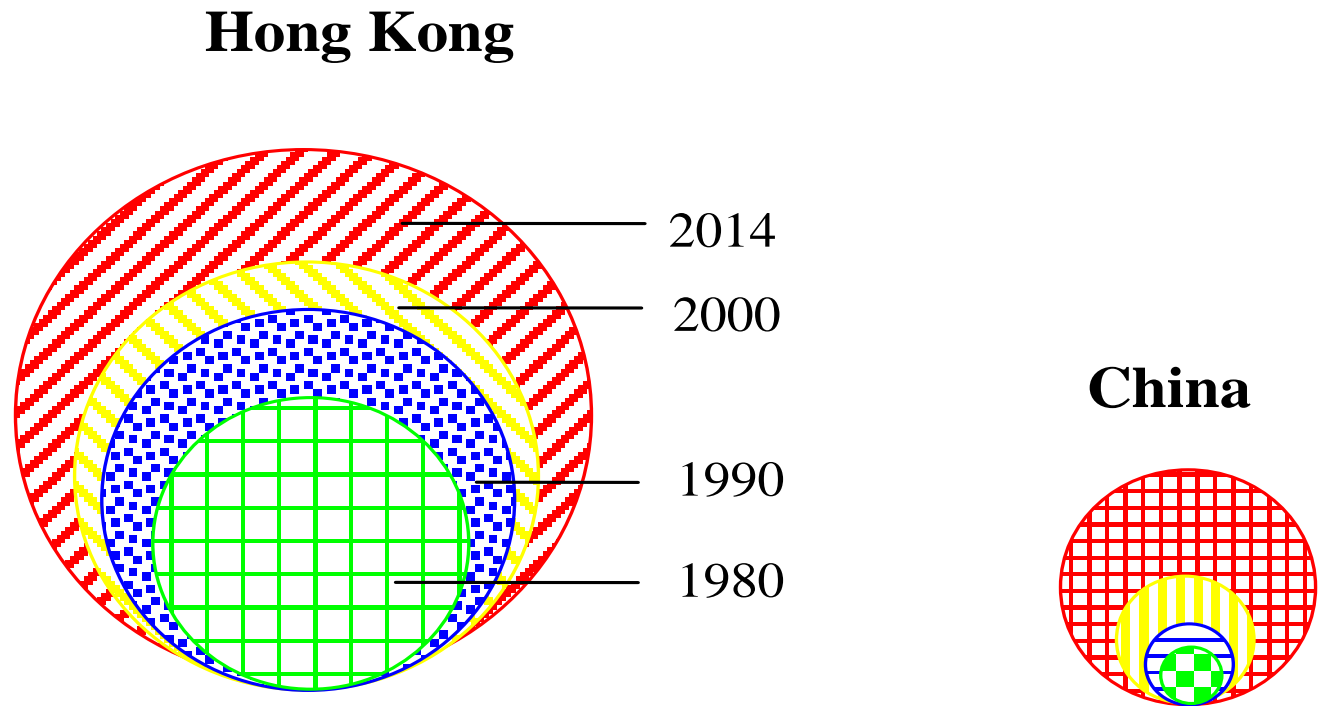
Comparison of the Economies of Hong Kong and the Mainland

- ◆ It is useful to compare the economies of Hong Kong and the Mainland over time.
- ◆ Huge changes have occurred since 1978 when the Mainland began its economic reform and opened its economy to the World.
- ◆ In 1980, the real GDP of the Mainland economy is only 7 times that of Hong Kong. By the end of 2014, it was 35.9 times (US\$10.4 trillion versus US\$290 billion).
- ◆ However, in terms of real GDP per capita, Hong Kong still led the Mainland at 5.3 times in 2014 (US\$39,986 versus US\$7,604), but the gap has shrunk significantly from 28 times in 1980.

Comparison of the Real GDPs of Mainland and Hong Kong (2014 USD Billions)



Comparison of the Real GDP per Capita's of Mainland and Hong Kong (2014 US\$)

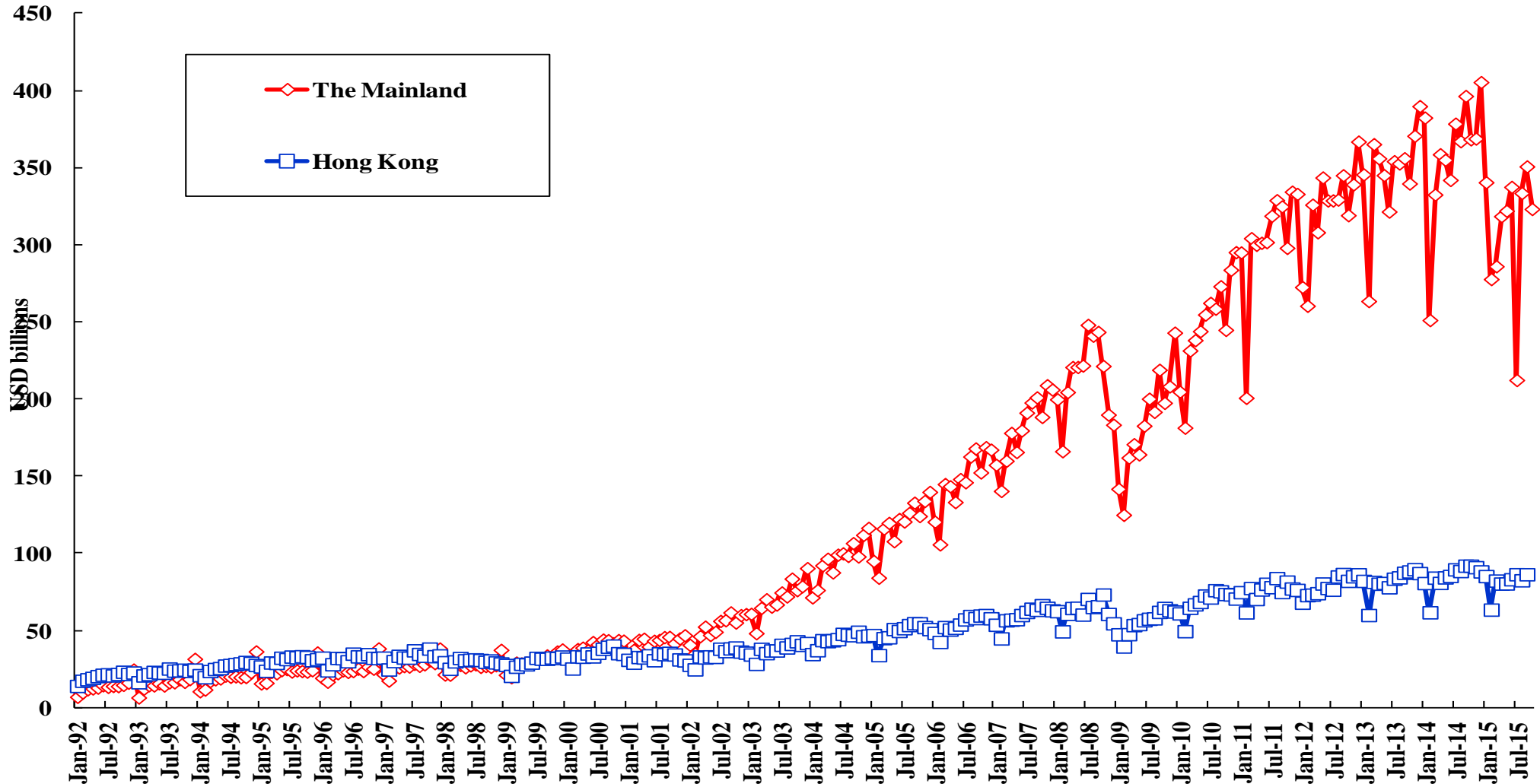


Comparison of the Economies of Hong Kong and the Mainland

- ◆ In terms of international trade, the Mainland, which started out at a very low level in 1978, reached approximately the same level as Hong Kong in the early 1990s. This is because the bulk of the Mainland international trade, whether exports or imports, was trans-shipped through Hong Kong. Hong Kong's domestic exports and imports, by comparison, were quite low.
- ◆ However, since the Mainland acceded to the World Trade Organisation (WTO) in 2001, direct Mainland international trade grew rapidly and total Mainland trade is now approximately 4 times as large as Hong Kong's.

Comparison of the Total International Trade of the Mainland and Hong Kong

Total International Trade of the Mainland and Hong Kong



Mainland-Hong Kong Economic Interactions: Government Revenue

- ◆ The Central Government and the Government of the Hong Kong Special Administrative Region (HKSAR) are financially completely independent. The Central Government does not collect any taxes in the HKSAR. Nor does it receive any revenue from the Government of the HKSAR. The HKSAR does not receive any direct subsidy from the Central Government. Whether the HKSAR budget is in surplus or deficit is entirely a matter for the HKSAR Government alone.
- ◆ When Hong Kong was a British Crown Colony, the Hong Kong Colonial Government paid for the British Garrison with the taxes it collected in Hong Kong. Today, the Chinese Garrison was funded directly and entirely by the Central Government.

Mainland-Hong Kong Economic Interactions: Foreign Exchange Reserves

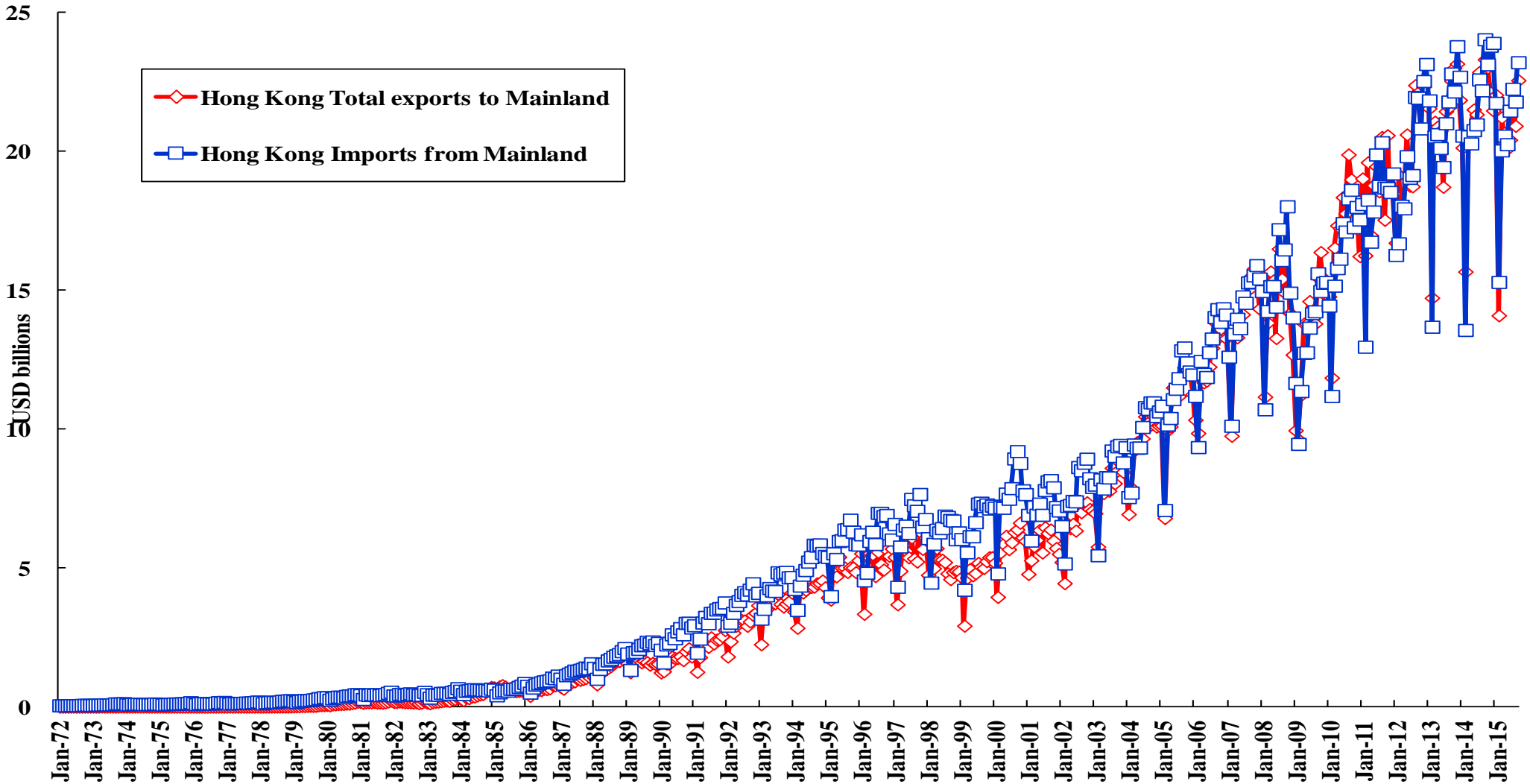
- ◆ The Hong Kong Monetary Authority (HKMA) also manages the Exchange Fund, which includes Hong Kong's foreign exchange reserves as well as the cumulative budget surpluses of the HKSAR Government, entirely on its own and is not required to deposit any of its reserves with the People's Bank of China, the central bank of China. During Colonial times, the HKMA was sometimes required to deposit part of its foreign exchange reserves with the Bank of England, the central bank of the United Kingdom.

Mainland-Hong Kong Economic Interactions: International Trade

- ◆ Hong Kong was effectively the only gateway to the Mainland for international trade and direct investment when China began its economic reform and opened to the World in 1978.
- ◆ Most of the early international trade between the Mainland and the rest of the World was routed through Hong Kong. Hong Kong provided the financing, logistics and port facilities for the trade. Later on, the Mainland developed its own facilities at Shanghai, Shenzhen and elsewhere.
- ◆ Trade between Hong Kong and the Mainland has grown rapidly since 1978, with most of it being re-exports from and to the Mainland. Re-exports still constitute the major proportion of total Hong Kong exports today.

Total Hong Kong Exports to and Imports from the Mainland since 1972

Total Hong Kong Exports to and Imports from the Mainland since 1972

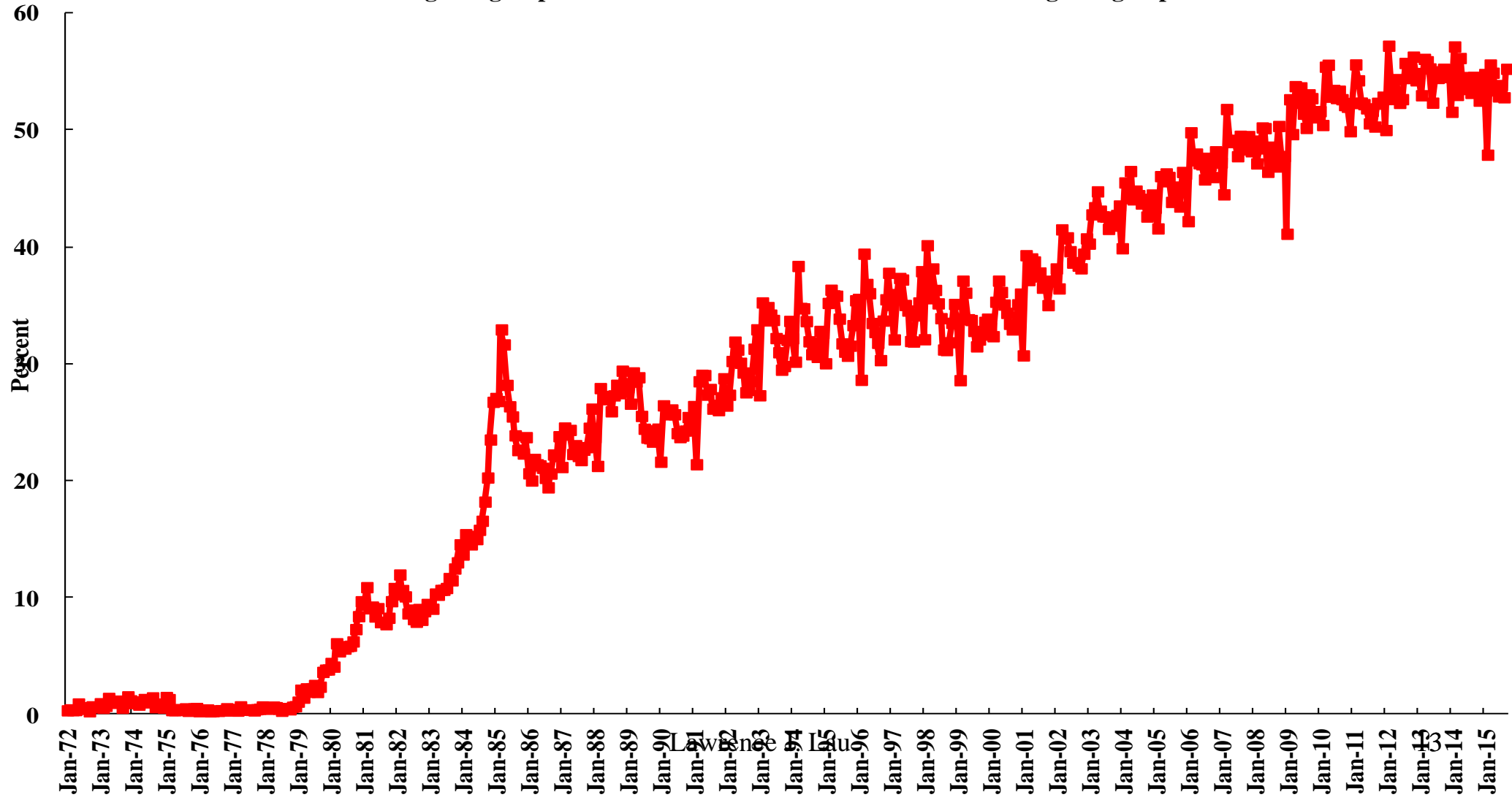


Mainland-Hong Kong Economic Interactions: International Trade

- ◆ The Mainland has become the most important trading partner of Hong Kong. It is the most important destination for Hong Kong exports as well as the most important source of Hong Kong imports, accounting for respectively 52.9% and 48.2% in 2014.
- ◆ Since 2008, the Mainland has become even more important to the Hong Kong economy because of the economic problems in the United States and Europe.
- ◆ The advances in information and communication technology and globalisation have also meant that any job, including back offices such as accounting, and data and call centers, that can be moved away to a lower-cost location will be moved away. This has happened to the U.S., Japan, Taiwan, Hong Kong and even the Mainland.

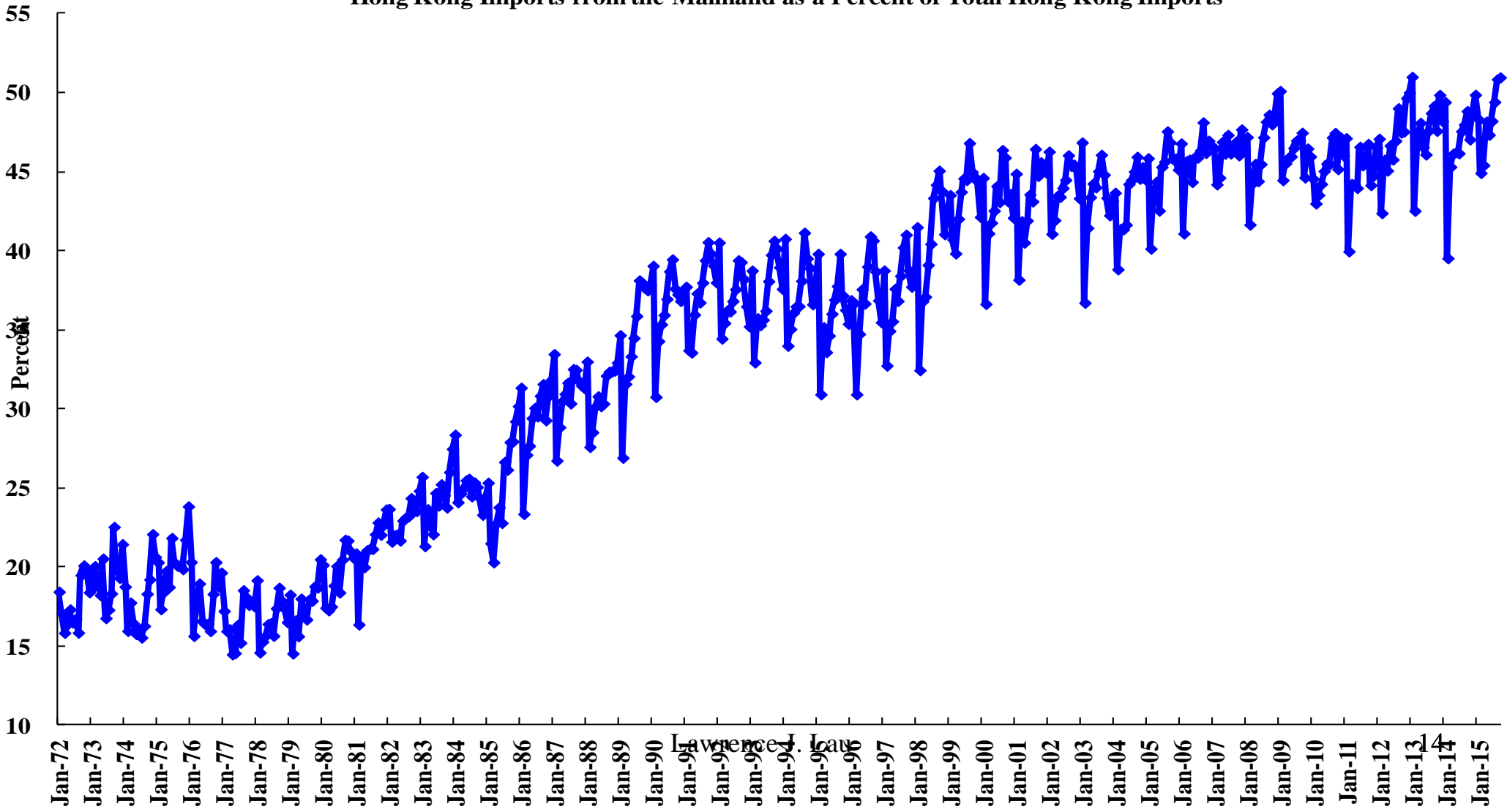
Hong Kong Exports to the Mainland as a Percent of Total Hong Kong Exports

Hong Kong Exports to the Mainland as a Percent of Total Hong Kong Exports



Hong Kong Imports from the Mainland as a Percent of Total Hong Kong Imports

Hong Kong Imports from the Mainland as a Percent of Total Hong Kong Imports

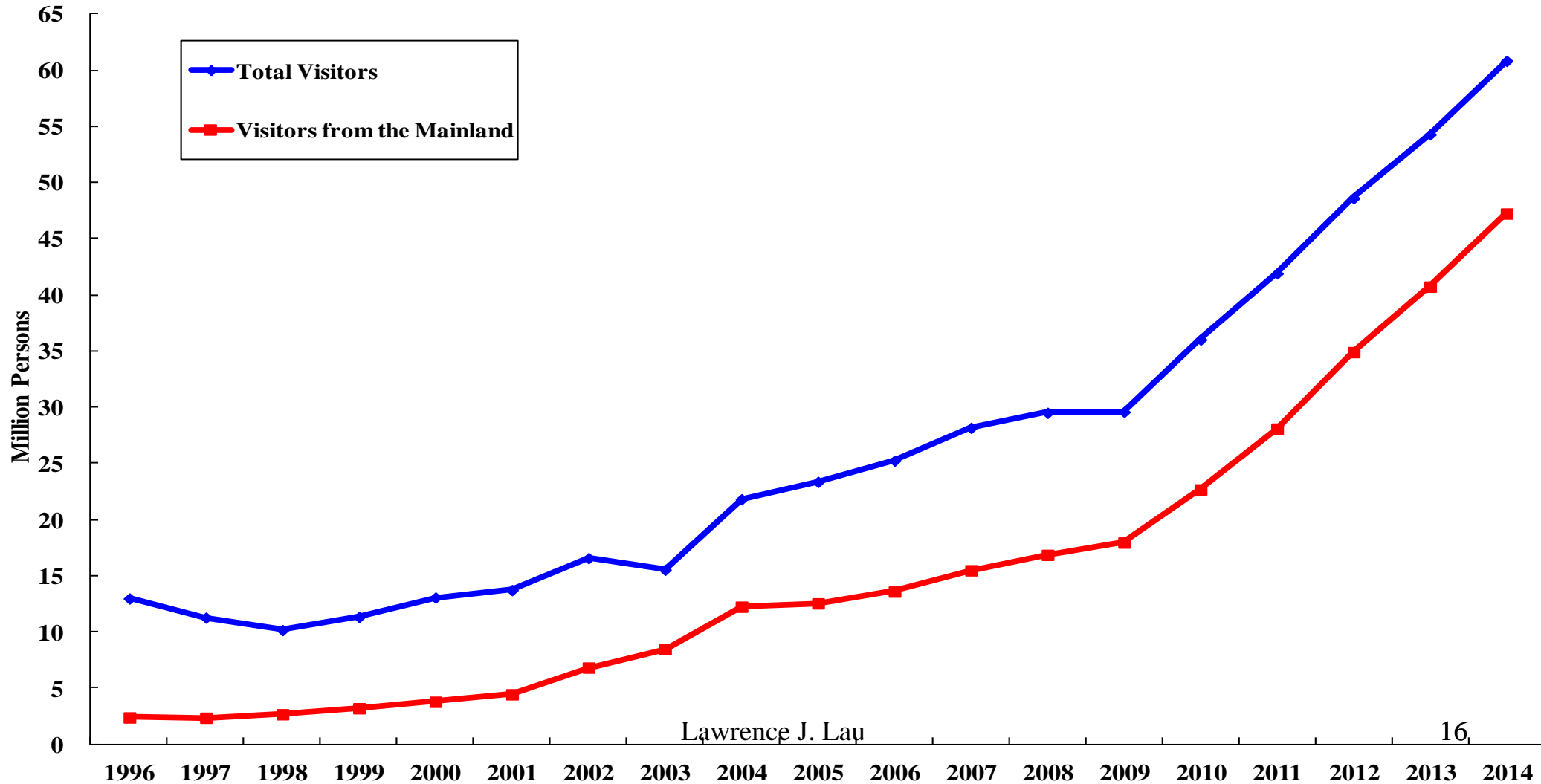


Mainland-Hong Kong Economic Interactions: International Trade

- ◆ The Mainland has also become the most important source of visitors to Hong Kong, especially since the introduction of the “Individual Visit Scheme” in 2003. Mainland visitors constituted 77.7% of all visitors to Hong Kong in 2014. The proportion of Mainland visitors on the “Individual Visit Scheme (IVS)” amount to approximately 70% of all Mainland visitors. These Mainland visitors spend on average 3 days in Hong Kong and approximately US\$750 per day.
- ◆ The total number of visitors from the Mainland to Hong Kong is currently running at the rate of approximately 50 million a year, not including day visitors.
- ◆ The total expenditure of the “IVS” visitors alone amount to over HK\$600 billion, compared to a Hong Kong GDP of HK\$2,145 billion. They generate demands for hotels, restaurants, retail, and transportation and through these demands create many job opportunities that cannot be moved away. It is fair to say that without the Mainland visitors, the unemployment rate in Hong Kong would have been at least two percentage points higher.
- ◆ However, for a variety of reasons, the total number of visitors from the Mainland has probably peaked and is likely to begin to decline over time.¹⁵

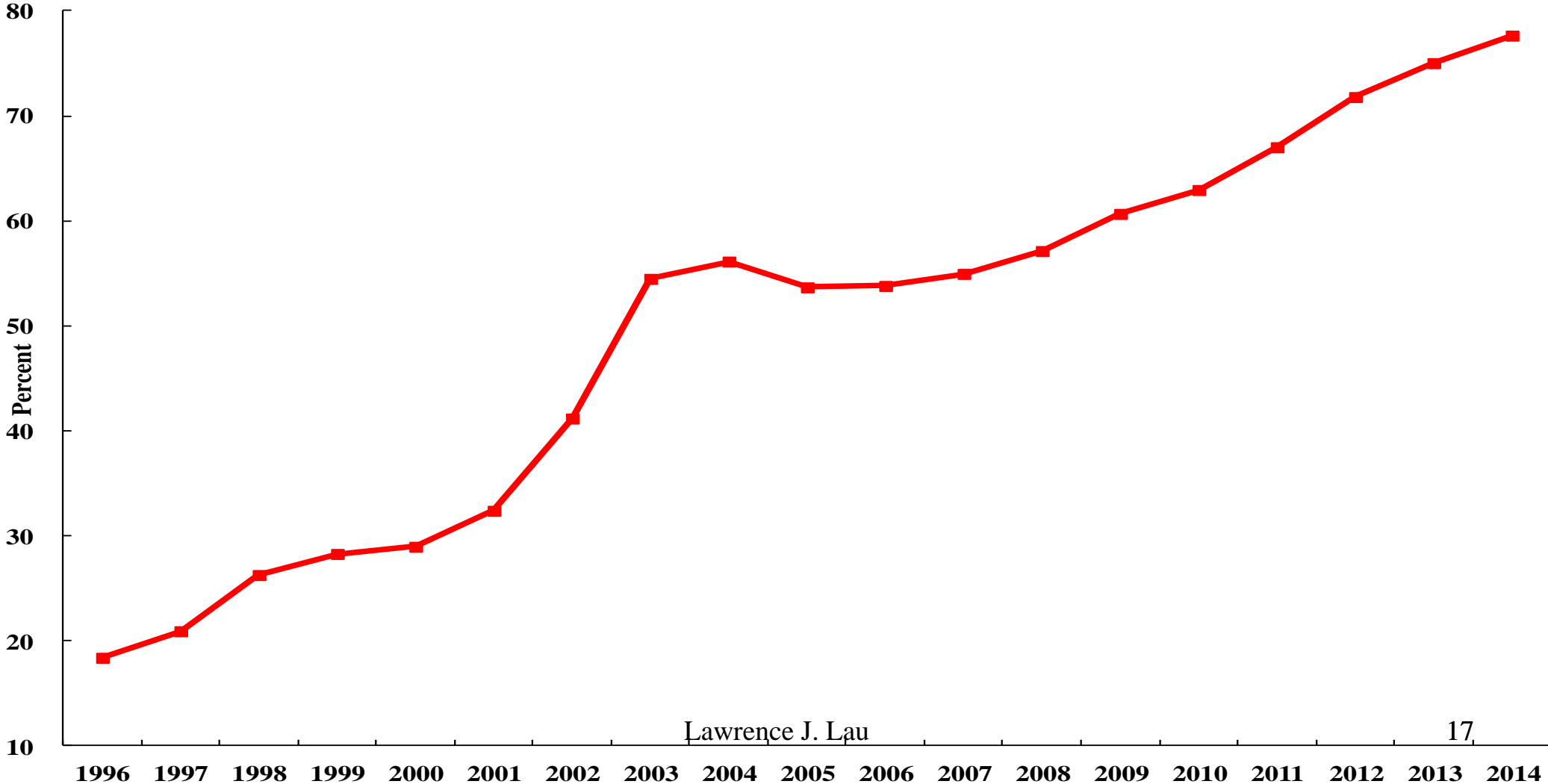
Annual Mainland and Total Visitors to Hong Kong since 1996

Annual Mainland and Total Visitors to Hong Kong since 1996



Visitors from the Mainland as a Percent of Total Visitors to Hong Kong

Visitors from the Mainland as a Percent of Total Visitors to Hong Kong



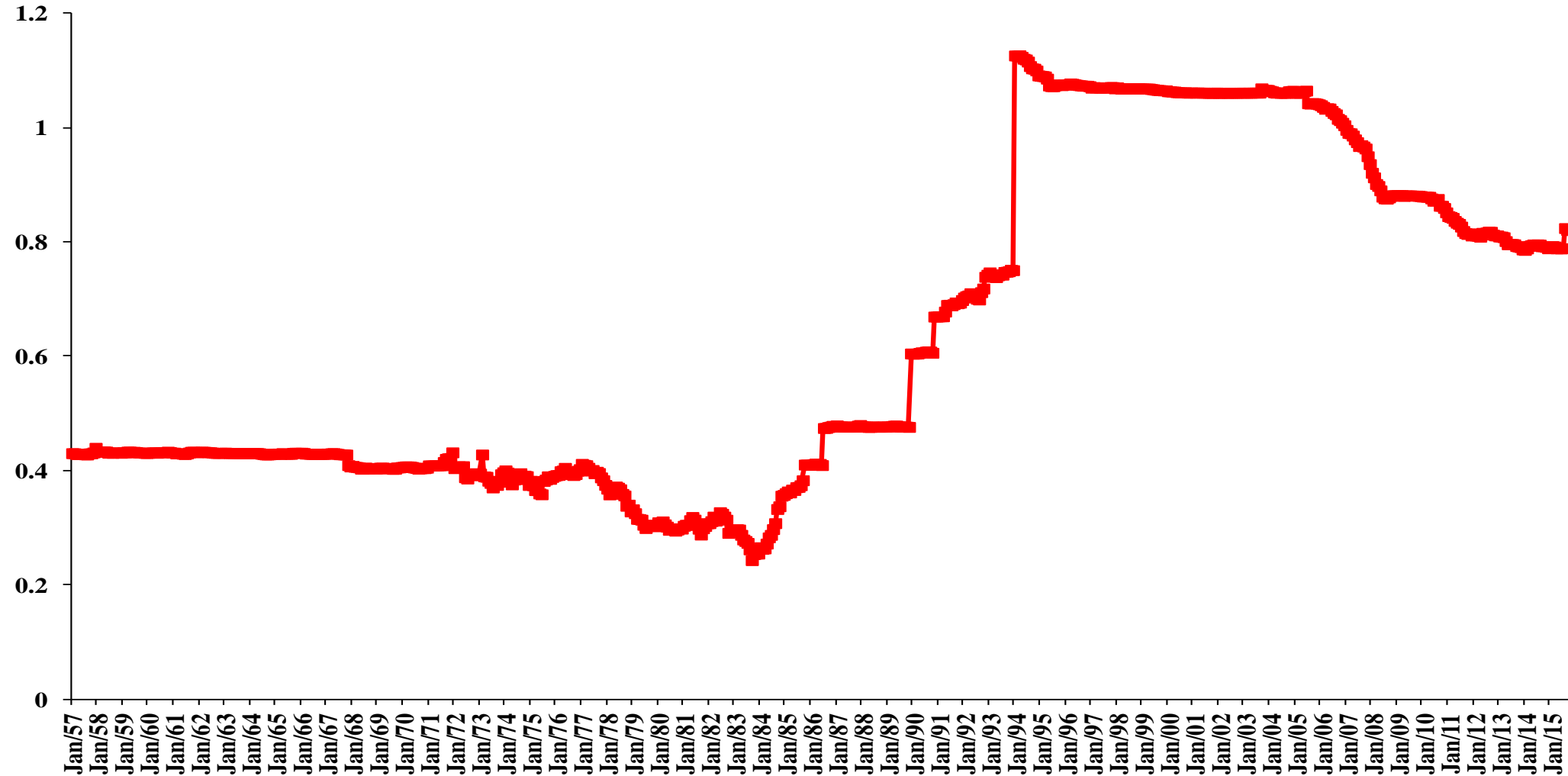
The Yuan-Hong Kong Dollar Exchange Rate

- ◆ The Yuan-Hong Kong Dollar exchange rate also reflected the relative fortunes of the Mainland and Hong Kong economies. The Hong Kong Dollar was worth slightly more than 0.4 Yuan/HK\$ in 1957, fell to a low of less than 0.3 Yuan/HK\$ in 1984, and rose to a peak of 1.12 Yuan/HK\$ in 1994, when the Yuan became current accounts convertible. The value of the Hong Kong Dollar then remained higher than the Yuan until the Yuan began to appreciate in mid-2005. The Hong Kong Dollar is now worth approximately 0.822 Yuan/HK\$ (at 11/13/2015).
- ◆ In the foreseeable future, the Yuan is not expected to devalue significantly vis-a-vis the U.S. Dollar and hence the Hong Kong Dollar as long as the linked exchange rate system of Hong Kong remains unchanged. The devaluation of last August was an one-off event and is not likely to be repeated.

The Yuan-HK\$ Exchange Rate

End of Month, Yuan/HK\$

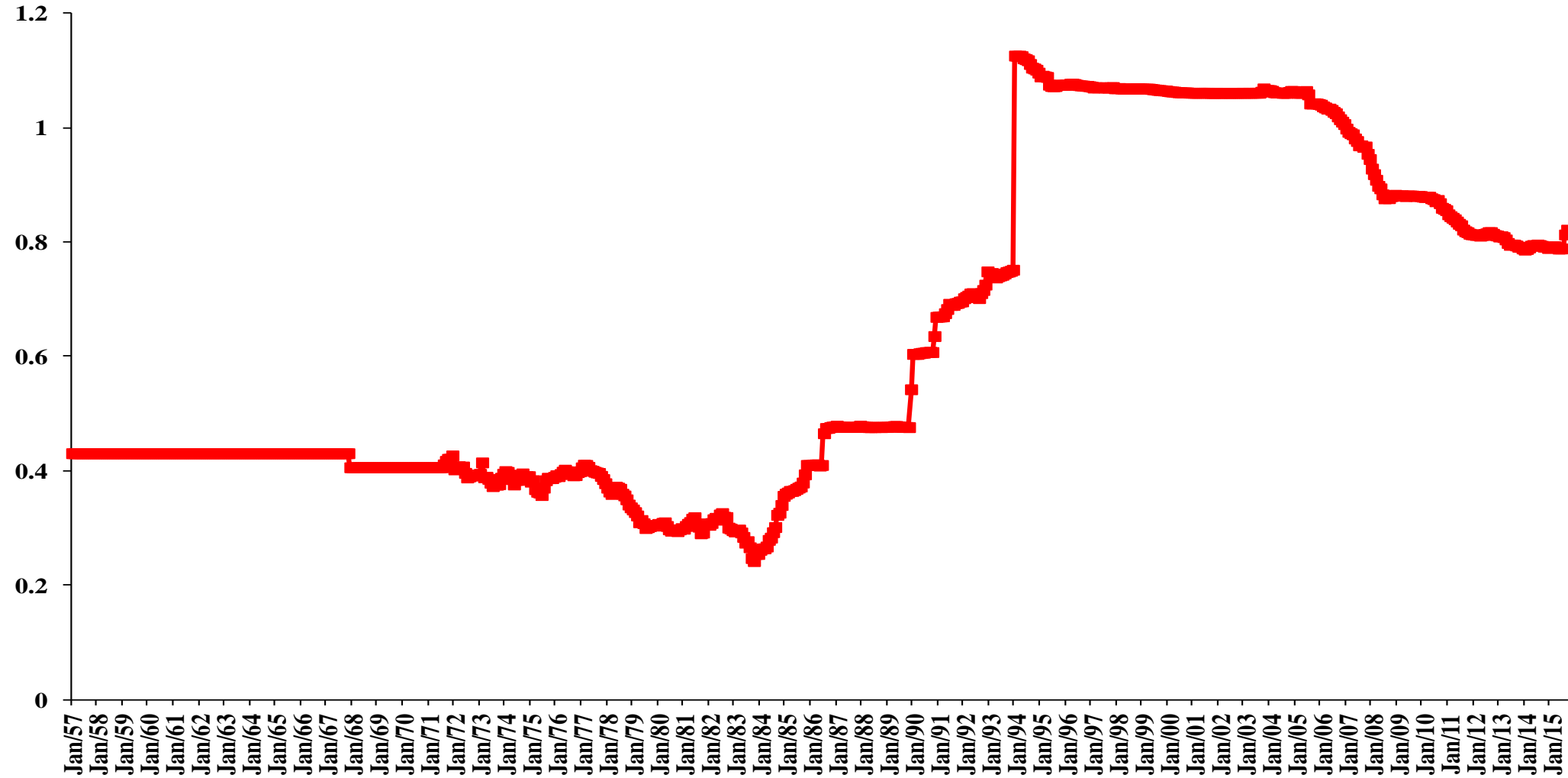
The Yuan-HK\$ Exchange Rate, End of Month, Yuan/HK\$



The Yuan-HK\$ Exchange Rate

Monthly Average, Yuan/HK\$

The Yuan-HK\$ Exchange Rate, Monthly Average, Yuan/HK\$



Mainland-Hong Kong Economic Interactions: The Stock Market

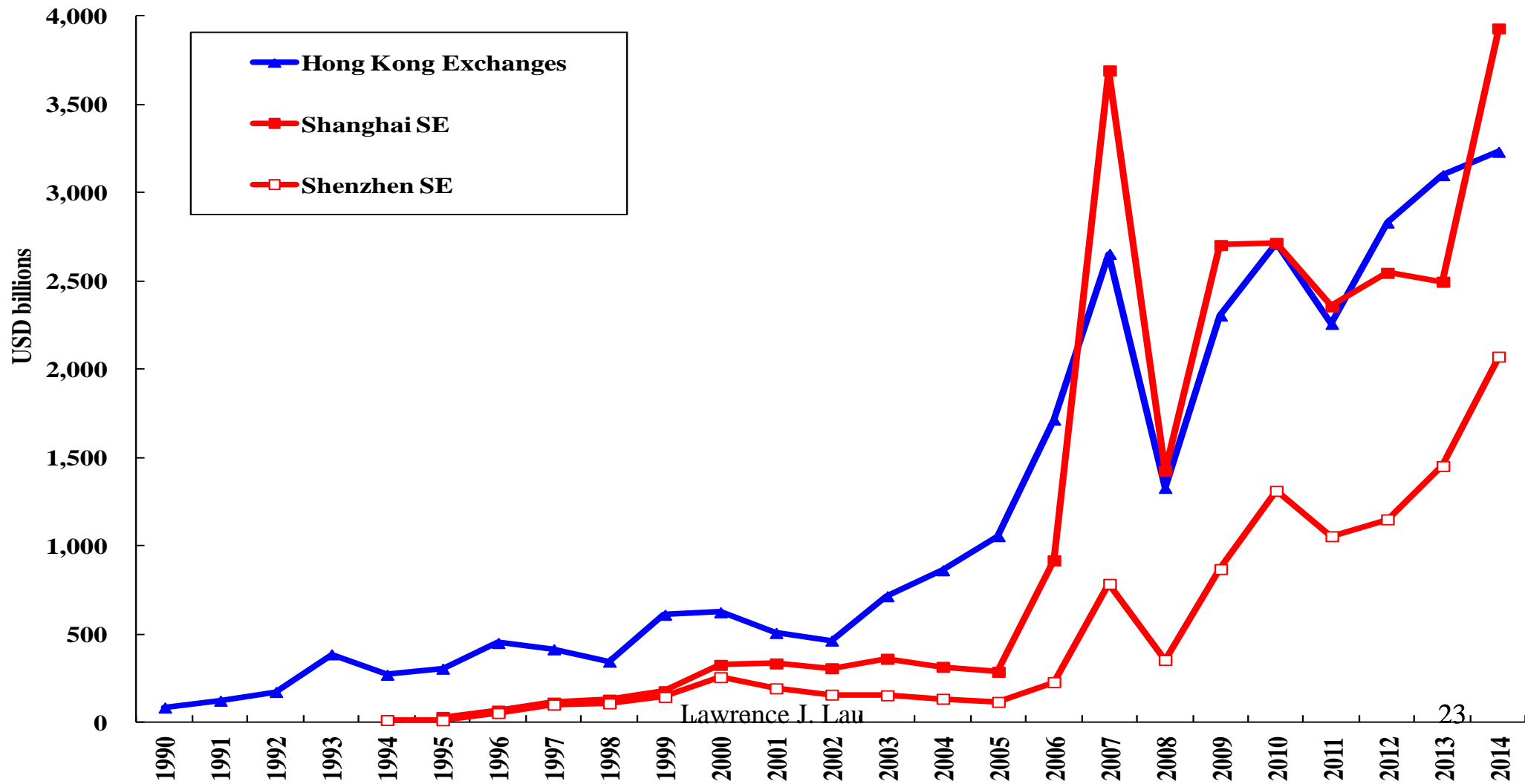
- ◆ Stock exchanges on the Mainland were first established in the early 1990s, much later than the Hong Kong Stock Exchange. However, in terms of total market capitalisation—the total value of all the companies listed on the stock exchange at the prevailing share prices of the market—the Shanghai Stock Exchange alone is now comparable to the Hong Kong Stock Exchange. The Shanghai and Shenzhen Stock Exchanges combined have a total market capitalisation that exceeds Hong Kong's.
- ◆ Mainland firms now constitute more than 50% of the Hong Kong Stock Exchange by market capitalisation but less than 20% by the number of listed firms—indicating that the Mainland firms listed on the Hong Kong Stock Exchange are on average much bigger than the other firms listed there.

Mainland-Hong Kong Economic Interactions: The Stock Market

- ◆ However, the Hong Kong Stock Exchange was also instrumental in attracting foreign portfolio investors to invest in the shares of Mainland Chinese enterprises at the start of the Mainland stock exchanges in the early 1990s through the listing of their shares as H-shares. The Hong Kong Stock Exchange provided the easy access, the liquidity and the strict regulation expected by the foreign portfolio investors. Listing of Mainland enterprises on the Hong Kong Stock Exchange also helped to bring in foreign exchange, which was needed by Mainland enterprises at the time.

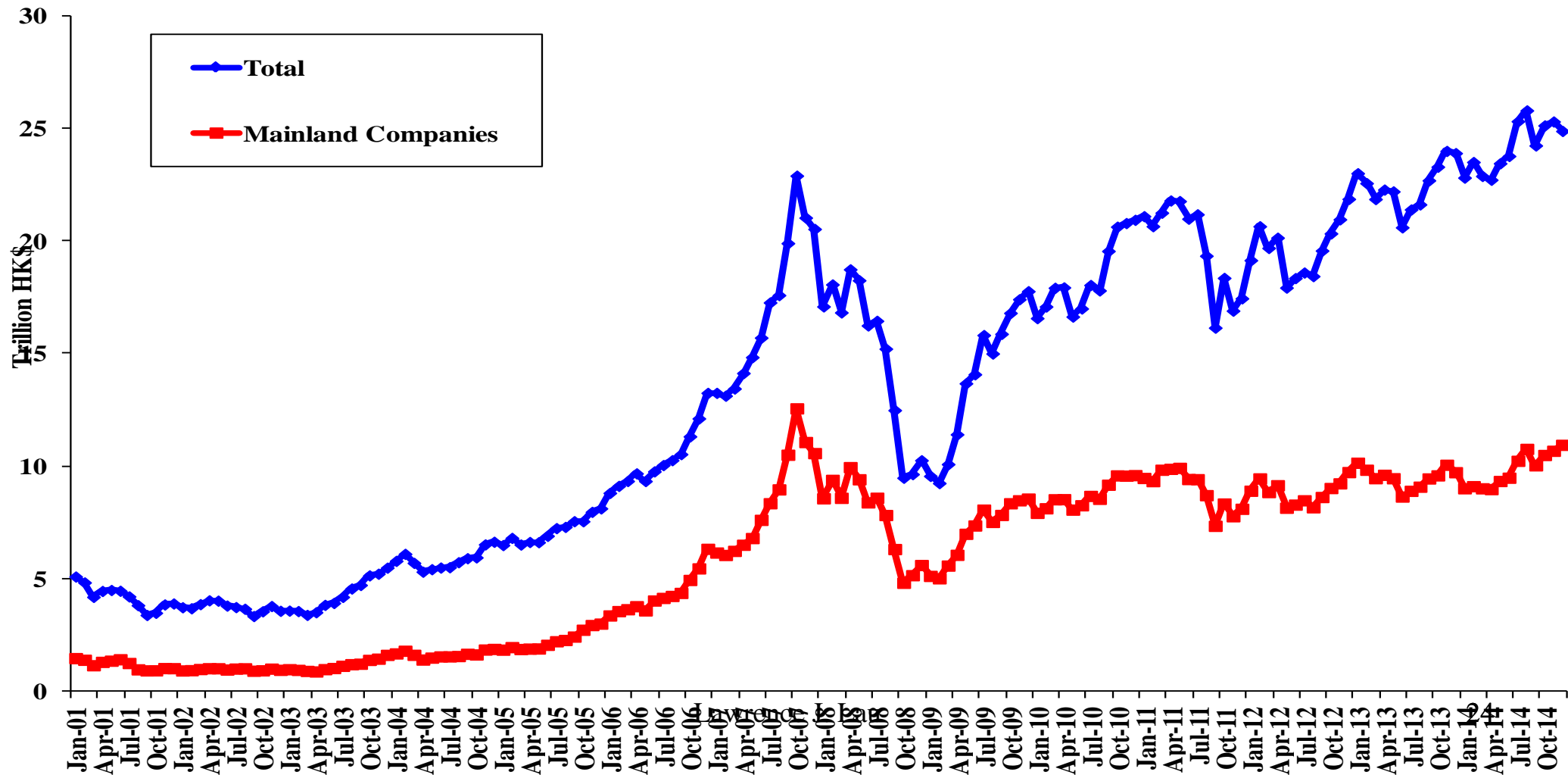
Comparison of Market Capitalisations of Mainland and Hong Kong Stock Exchanges

End-of-Year Market Capitalisation of Mainland and Hong Kong Stock Exchange in US\$ billions



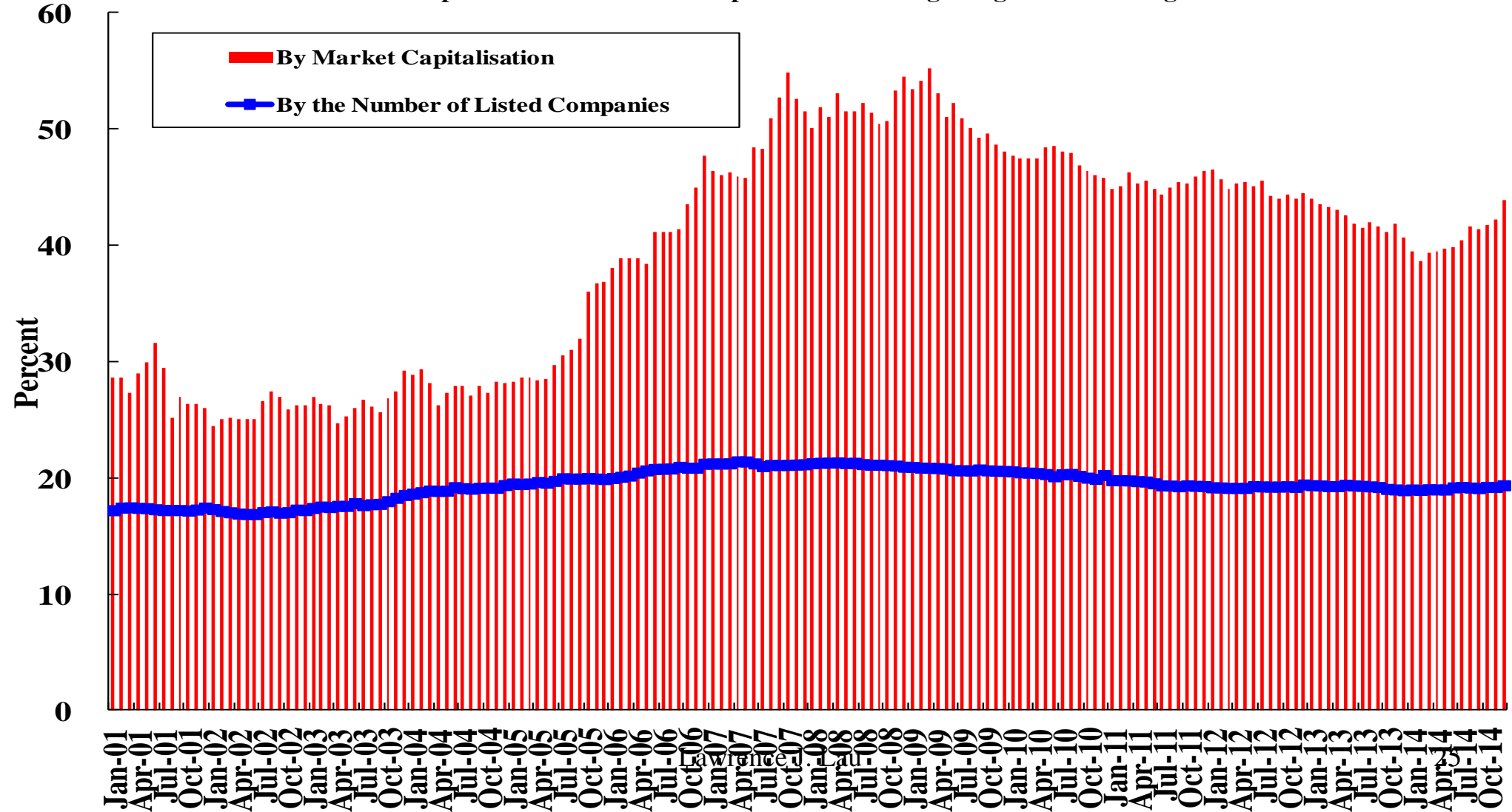
Year-End Market Capitalisation of Mainland and All Firms Listed on HKSE

Year-End Market Capitalisation of Mainland and All Firms Listed on Hong Kong Stock Exchange, HK\$ trillions



Year-End Market Capitalisation of Mainland and All Firms Listed on HKSE

The Proportions of Mainland Companies on the Hong Kong Stock Exchange

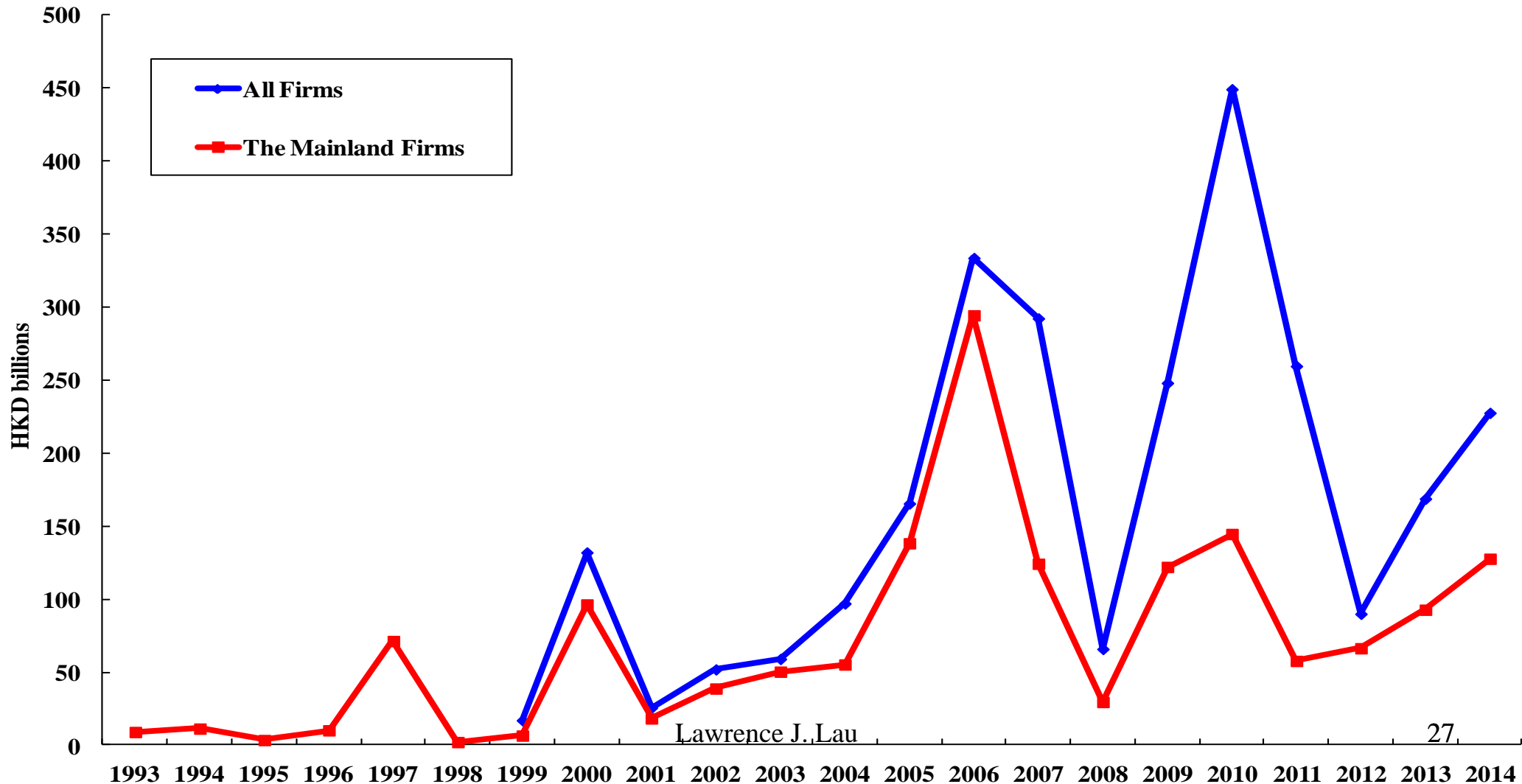


Mainland-Hong Kong Economic Interactions: The Stock Market

- ◆ In terms of initial public offerings (IPOs), that is, the first-time sales of shares by firms to public investors on the stock exchange, Mainland firms have been the mainstay of the Hong Kong Stock Exchange, accounting for most of the value of its IPOs, except in the global financial crisis years of 2009-2011 when firms from other countries came to Hong Kong to raise money because of the lack of activities in New York and London.
- ◆ Increasingly, however, Mainland enterprises may find listing on the Shanghai Stock Exchange much more attractive because there is substantial domestic investor demand and the enterprises need to raise Renminbi rather than foreign exchange. The Mainland, with foreign exchange reserves exceeding US\$4 trillion, does not need any more inflow of foreign exchange. Moreover, funds raised offshore cannot be automatically remitted to the Mainland for use on the Mainland. Specific approval from the People's Bank of China is required. However, there is a long queue of firms at the Shanghai Stock Exchange waiting for their turns for IPO.
- ◆ That is also why Hong Kong has to seek firms from other countries and regions to list their shares on the Hong Kong Stock Exchange.

Annual IPO Value of Mainland and All Firms on Hong Kong Stock Exchange

Annual IPO Value of Mainland and All Firms on Hong Kong Stock Exchange



Mainland-Hong Kong Economic Interactions: The Stock Market

- ◆ More recently, Alibaba wanted to list on the Hong Kong Stock Exchange but was turned away by the Hong Kong Stock Exchange because Alibaba would like to maintain a two-class share ownership structure which implies that some shares will carry more voting power than others.
- ◆ While this may seem inequitable, it is not uncommon. Hong Kong Stock Exchange actually permitted such structures before the 1990s. Swire and quite a few other public listed firms in Hong Kong had such structures. Similarly, Ford Motor Company, listed on the Hong Kong Stock Exchange, also has such a structure.
- ◆ The motivation of such a structure is to enable the some shareholders (usually the founding shareholders and the senior management) to maintain control with less than a majority of the shares.
- ◆ It is possible that not only these controller shareholders, but also the other minority shareholders, may prefer such an arrangement because they are comfortable with the continuation of the existing senior management.

Mainland-Hong Kong Economic Interactions: The Stock Market

- ◆ As long as there is full disclosure, and certain safeguards as discussed below to be put in place, there is actually no compelling reason not to allow two classes of shares.
- ◆ The possible safeguards include (1) Once the original shares with super-voting power are sold or transferred by the original owners, they will cease to have super-voting power; and (2) These shares can only be sold with advance notice, for example, 3 months, so that the other shareholders can have a chance to decide whether they should exit first.
- ◆ Many more IPOs such as Alibaba are likely, as many privately owned enterprises on the Mainland will want to raise capital for their expansion. However, they are almost always headed by relatively young founders themselves who want to maintain their control of their businesses. Hong Kong should welcome these entrepreneurs and their enterprises by allowing two-class ownership structures.

Mainland-Hong Kong Economic Interactions

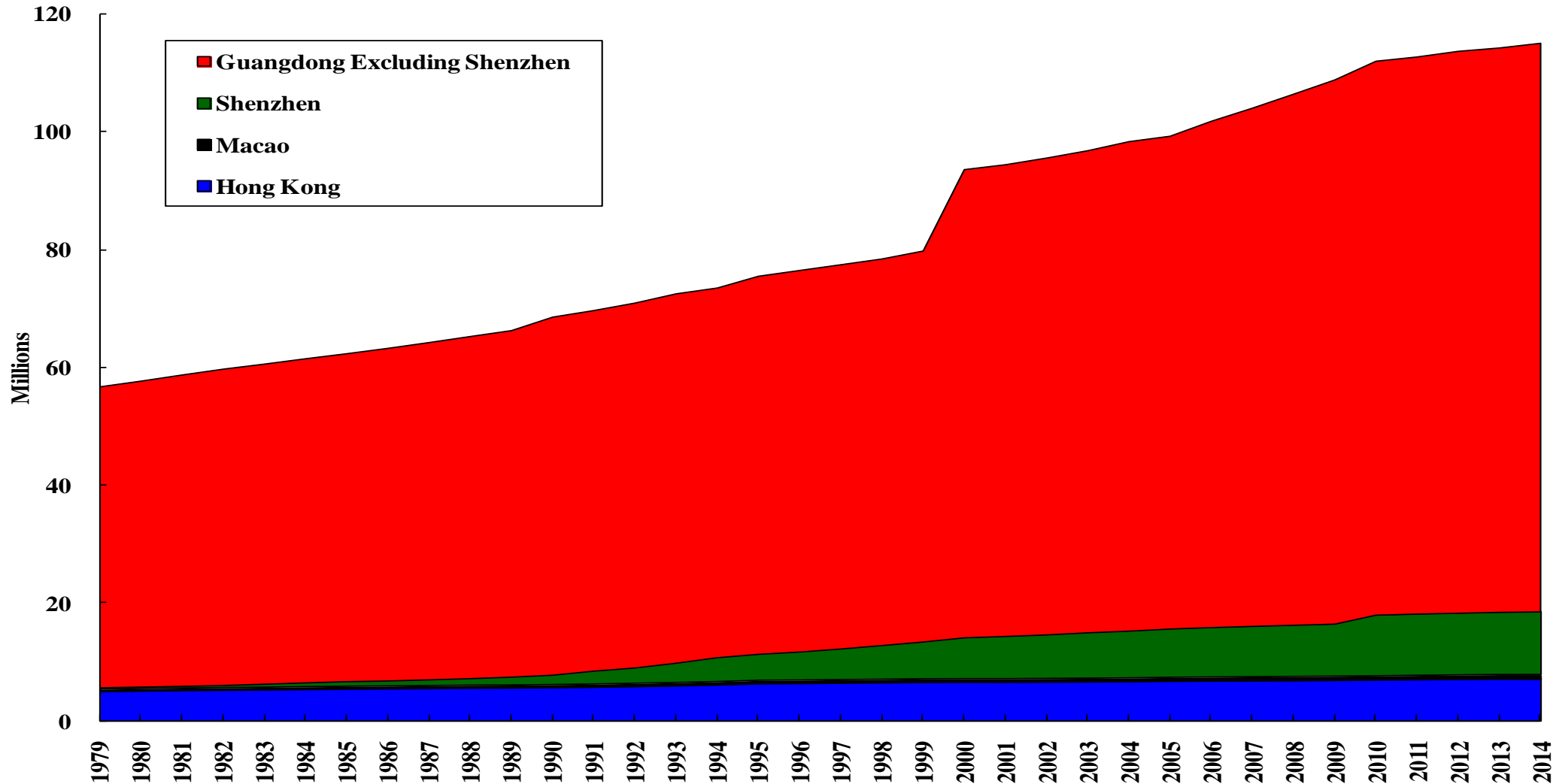
- ◆ Hong Kong and its entrepreneurs were indispensable for the success of the economic reform and open-door policy on the Mainland, and in Guangdong and Shenzhen in particular.
- ◆ Hong Kong may not be the only gateway to the Mainland for international trade and investment any more, but it can be the best gateway, or at least the best gateway to southern China.
- ◆ It can also be the best gateway for outbound Mainland investment to the rest of the World, capitalising on Hong Kong's higher degree of internationalisation, its complete freedom of capital movements, its pool of accounting, legal and other professional talents, its highly developed financial markets, its tradition of rule of law and protection of property rights, and its facilities for international arbitration and mediation.

Economic Cooperation between Hong Kong and Guangdong

- ◆ Hong Kong should also capitalise on its geographical position to cooperate closely with Shenzhen, Pearl River Delta, Guangdong and southern China.
- ◆ Hong Kong can compete effectively with Shanghai as an international financial center only if Hong Kong becomes more closely integrated economically with Guangdong (including Shenzhen).
- ◆ Guangdong, Hong Kong and Macau together can potentially become an economy as large as that of Japan today.
- ◆ The Province of Guangdong, including Shenzhen, has a population of 107.24 million in 2014, and is the most populous province on the Mainland.
- ◆ If the populations of Hong Kong (7.23 million) and Macau (0.63 million) are added to that of Guangdong, the total population becomes 115.11 million, more than that of Germany (82.7 million) and almost equal to that of Japan (127 million).

Populations of Hong Kong and Its Neighboring Economies, millions

Populations of Hong Kong and Its Neighbouring Economies, millions

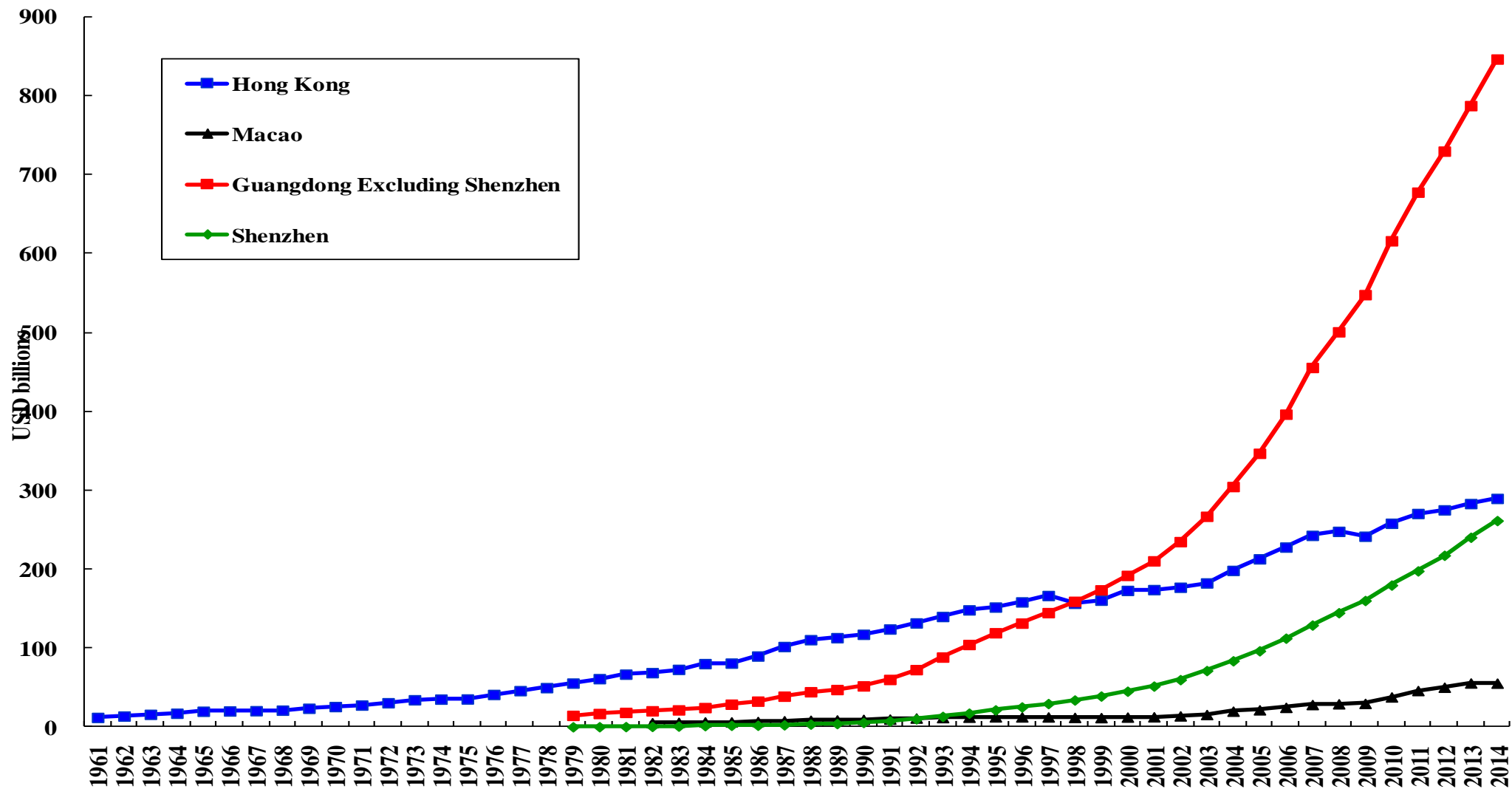


Economic Cooperation between Hong Kong and Guangdong

- ◆ The GDP of the Province of Guangdong, including Shenzhen, was US\$1,108 billion in 2014, 3.8 times the Hong Kong GDP of US\$290 billion. It is also the province with the largest GDP on the Mainland, constituting 11% of the Mainland GDP. The GDP of Guangdong and Hong Kong combined was US\$1.40 trillion in 2014, about 1/7th of the Chinese GDP.
- ◆ The GDP per capita of the Province of Guangdong in 2014 was US\$9,656, compared to Hong Kong's US\$39,986. The GDP per capita of the combined region was US\$12,622, comfortably exceeding the so-called middle-income threshold of US\$10,000.
- ◆ Thus, together, there is a huge consumer market with ample labor force, and the region has the potential of eventually surpassing Japan to become the third largest economy in the World.

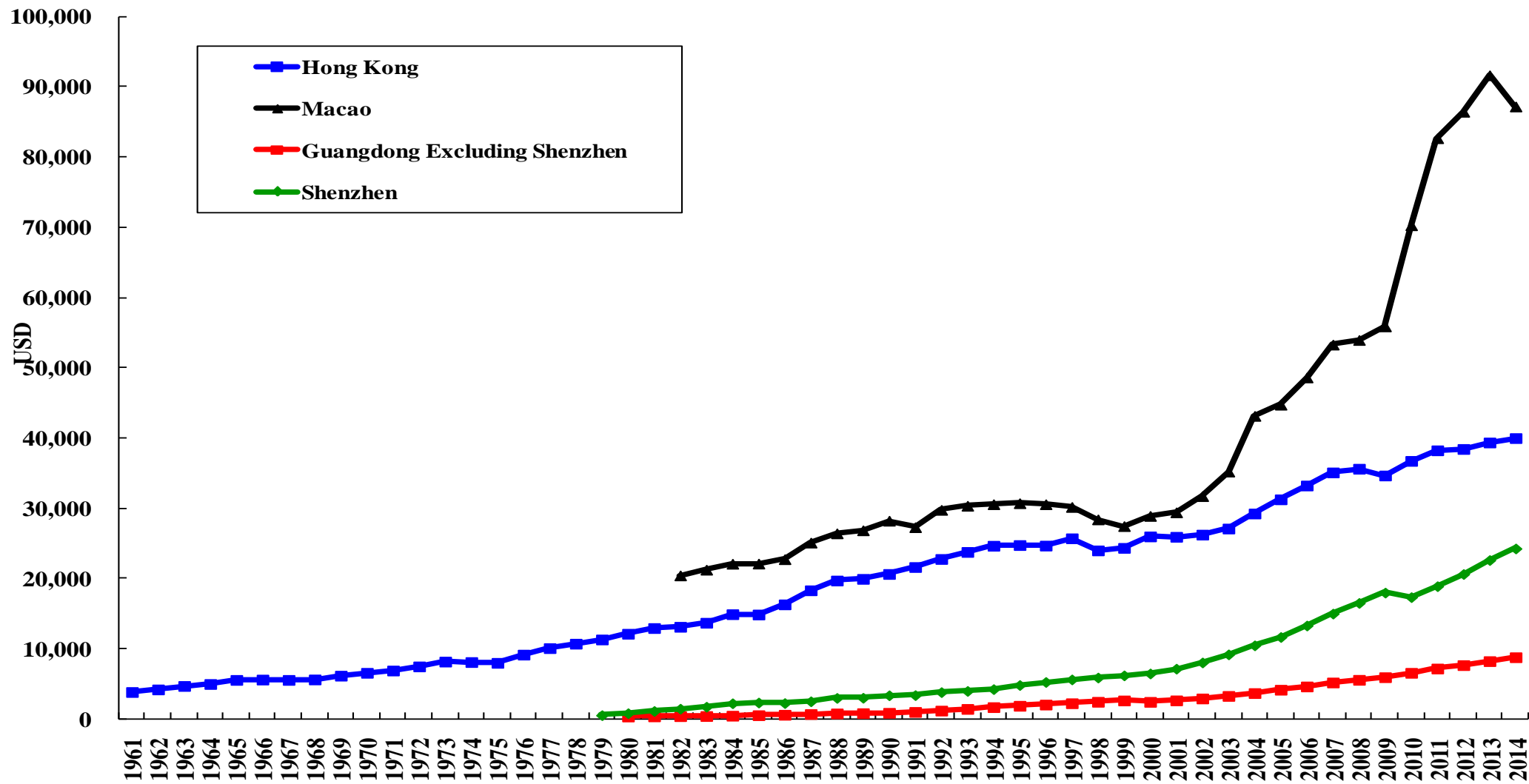
Real GDPs of Hong Kong and Its Neighboring Economies, billion 2014US\$

Real GDPs of Hong Kong and Its Neighbouring Economies, billion 2014 US\$



Real GDP-per-Capita's of Hong Kong and Its Neighboring Economies, 2014 US\$

Real GDP-per-capita's of Hong Kong and Its Neighbouring Economics, 2014 US\$



The Role of Hong Kong in the “One Belt, One Road (OBOR)” Project

- ◆ The “One Belt, One Road (OBOR)” Project, launched by the Central Government, is a multi-country, multi-decade project that has the potential of transforming the economies of not only China, but the entire Asia-Europe-Africa.
- ◆ It will promote the development of infrastructure linking all three continents by land and by sea (the Eurasia land bridge, the maritime silk road, the northern passage), promoting economic development and international trade among all the countries involved.
- ◆ Hong Kong can be a center for the financing of the component projects of OBOR in terms of raising equity and public as well as private debt and providing accounting and legal, including arbitration and mediation services.

The Comparative Advantages of Hong Kong

- ◆ A tradition of capitalist free market economy—the flows of people, goods and capital into and out of Hong Kong have always been free and open.
- ◆ A cosmopolitan international metropolis that is bilingual (Chinese and English) and bicultural, and closely connected to both China and the rest of the World
- ◆ Stable exchange rate, freely convertible currency, full capital mobility and free trade
- ◆ A well-developed financial market with close links to the other international financial centers
- ◆ Low corporate and individual income tax rates with exemption for income generated outside the HKSAR
- ◆ Rule of law, effective regulation and supervision of financial markets, transparent governance, and civil liberties comparable to the most developed countries in the World
- ◆ An established international arbitration center

The Comparative Advantages of Hong Kong

- ◆ An environment hospitable to entrepreneurs and potential entrepreneurs
- ◆ The favorable commercial reputations of Hong Kong and its firms
- ◆ Academic freedom, freedom of speech and real-time full access to information everywhere—the internet is entirely open and the press is among the freest in the World
- ◆ A well-educated and experienced professional labor force
- ◆ World-class, research-oriented universities
- ◆ Geographically well located--proximity to the Mainland, a huge market and a huge source of savings, and right at the junction between the Mainland China and the emerging ASEAN region

The Comparative Vulnerabilities of Hong Kong

- ◆ High cost structure for both local and international businesses, especially the cost of land (and hence the costs of office space and housing) which is artificially high because of government policy
- ◆ The lack of a large domestic market
- ◆ A narrow tax base, and over-dependence of government revenue on land sales, resulting in its excessive volatility and also high and rising land prices
- ◆ The lack of double-tax agreements (DTAs) with many countries and regions (a problem that is in the process of being corrected)
- ◆ Insufficient support for higher education and for R&D, hindering Hong Kong's transformation into an innovation-based economy (Tertiary education enrolment rate is around 20% compared to over 30% for the Mainland and 100% for Taiwan; R&D expenditure is only 0.8% of Hong Kong's GDP, compared to 3% or above for Japan and the U.S., 4.15% for South Korea and 7% for Shenzhen).

The Comparative Vulnerabilities of Hong Kong

- ◆ Local protectionism of many service professions such as the legal and the medical
- ◆ Declining English proficiency and an increasingly inward-looking mentality
- ◆ Lack of a long-term plan and strategy
- ◆ Lack of unity of purpose and a sense of urgency

The Opportunities and Challenges for Hong Kong

- ◆ Hong Kong will within the next five years lose its advantage of the Hong Kong Dollar over the Renminbi as a convertible currency—the Renminbi is certain to become capital accounts convertible during this period (perhaps with some residual controls over short-term capital inflows); and when it does, it will substantially displace and replace the Hong Kong Dollar both as an international medium of exchange and as a store of value even as the Hong Kong Dollar remains the legal tender for Hong Kong as provided in the Basic Law.
- ◆ Paradoxically, the rising acceptance and use of the Renminbi, including its eventual full convertibility, can be a great opportunity for Hong Kong as a center for Renminbi-denominated financing. That is why the ability to conduct domestic and international transactions and hence to clear and settle in Renminbi is so important for Hong Kong.

The Opportunities and Challenges for Hong Kong

- ◆ Hong Kong will also lose much of its advantage of a free trade port/low tariff on account of Chinese accession to the WTO. In any case, growth of Chinese exports and imports will slow as the Mainland economy further reorients itself to its own huge domestic market. 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 globalized, its institutions of higher learning continue to improve, and the use of English becomes more and more common, at least in its major cities.

The Opportunities and Challenges for Hong Kong

- ◆ Hong Kong can also be a springboard for outbound Chinese direct investment because of its international links and highly developed service sector. It can provide the necessary accounting, legal and other services and the infrastructural support for Chinese enterprises investing abroad (through Hong Kong subsidiaries).
- ◆ The Hong Kong capital market can also provide Chinese enterprises the ability to use “natural” hedges for their outbound foreign direct investments (by, say borrowing the foreign currency in Hong Kong to fund the outbound investment thus balancing the foreign-currency assets with foreign-currency liabilities).
- ◆ Hong Kong must also try to increase its investment in intangible capital—human capital and R&D capital—which are indispensable for innovation. Moreover, it must aim to take advantage of the huge Mainland market if its innovation activities were to succeed commercially.
- ◆ In the transition, policy support from the Hong Kong SAR Government is crucial (e.g., concluding double-tax agreements with foreign tax jurisdictions).

Concluding Remarks

- ◆ Hong Kong was indispensable to the initial success of the Mainland's economic reform and opening to the World.
- ◆ However, with the success of the Mainland economy, the fate of the Hong Kong economy is now inextricably intertwined with that of the Mainland. The Mainland is now critically important to the Hong Kong economy. If the Mainland economy prospers, the Hong Kong economy will prosper. If the Mainland economy slows, the Hong Kong economy will slow.

Concluding Remarks

- ◆ It is because of the strength of the Mainland economy that Hong Kong has been able to survive the current European sovereign debt crisis as well as the earlier 2007-2009 global financial crisis, the “Severe Acute Respiratory Syndrome (SARS)” crisis and the 1997-1998 East Asian currency crisis relatively unscathed.
- ◆ The “Individual Visit Scheme” has been instrumental in lowering the unemployment rate of Hong Kong down to its current 3.2%.
- ◆ Hong Kong must try to take full advantage of its Mainland opportunities, such as those offered by CEPA, so that its economy can continue to grow, especially given the weak recoveries of the United States and European economies. The Hong Kong domestic market alone is too small for innovation activities to be commercially successful.

Concluding Remarks

- ◆ Guangdong has a diversified industrial base—with light industry, heavy industry and high-technology industries. but is relatively weak in the higher education and research and development sectors. Hong Kong has little or no industry, especially high-technology industry, but has world-class research universities to provide scientific and technological manpower and R&D. There is therefore room for specialisation and division of labor between Hong Kong and Guangdong, which can be win-win for all.

Concluding Remarks

- ◆ If Hong Kong were to become an international financial center for China, it must begin by trying to provide the firms and households in its potential hinterland (Guangdong and the Greater Pearl River Delta) with the best financial service possible, so that they do not need to go to Shanghai or develop their own international financial center(s). If Hong Kong cannot hold on to these potential customers, it can never compete with Shanghai.

Concluding Remarks

- ◆ The economies of Hong Kong and Guangdong are complementary to each other. What Hong Kong lacks, Guangdong can provide; and vice versa. Their economic cooperation can be win-win; it can benefit both places.
- ◆ Hong Kong should therefore intensify its economic cooperation with Guangdong (and Shenzhen). Guangdong is Hong Kong's natural economic hinterland. Hong Kong cannot compete with Shanghai if it is unable to hold on to Guangdong.

Concluding Remarks

- ◆ Hong Kong should also capitalize on the opportunities provided by the OBOR Project.
- ◆ Hong Kong can also further develop into an international center for sukuk bonds (Islamic bonds) structured in such a way as to generate returns to investors without infringing Islamic law which prohibits pure interest payments as many Belt and Road countries are Islamic.
- ◆ The Government of the HKSAR is already actively promoting double-tax treaties with countries on the Belt and Road so as to facilitate investment by Hong Kong entities as well as subsidiaries of Chinese and multinational corporations established in Hong Kong to do OBOR related business in the countries concerned.

Concluding Remarks

- ◆ It is necessary to promote the freer flow of goods and services between Guangdong and Hong Kong and between the OBOR countries and Hong Kong. There should be a pilot programme for a Guangdong-Hong Kong Pilot Free Trade Zone.
- ◆ It is also necessary to promote the freer flow of people—the simplification of entry/exit and customs formalities, the mutual selective recognition of academic degrees and professional qualifications.
- ◆ Finally, it is necessary to promote the financial cooperation between Guangdong and OBOR countries and Hong Kong and to facilitate the cross-border flow of capital.