

The Economic Relationship between the Mainland and Hong Kong

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Outline

- ◆ An Overview of the Mainland Chinese Economy
- ◆ Comparison of the Economies of Hong Kong and the Mainland
- ◆ Mainland-Hong Kong Economic Interactions
- ◆ Concluding Remarks

An Overview of the Mainland Chinese Economy

- ◆ The Mainland of China has made tremendous progress in its economic development since it began its economic reform and opened to the World in 1978.
- ◆ The Mainland of China is one of the very few socialist economies that have made a smooth and successful transition from a centrally planned economic system to a market economic system.
- ◆ It is a model for other transition economies such as Vietnam and potential transition economies such as Cuba, Laos, and North Korea.

An Overview of the Mainland Chinese Economy

- ◆ A commonly used measure of the size of an economy is GDP, or Gross Domestic Product. It is defined as the total value of all goods and services produced within the geographical boundaries of an economy in a given period of time, for example, a year or a quarter. The value of a good or a service is defined as its price less the costs of all the intermediate goods and services used in its production, but not the costs of direct capital and labour services.
- ◆ The pure appreciation in value of an asset, such as a piece of unimproved land, a security, or an antique, is not considered GDP as no new goods are produced and no new services are performed (and as a result no new direct employment is generated).

An Overview of the Mainland Chinese Economy

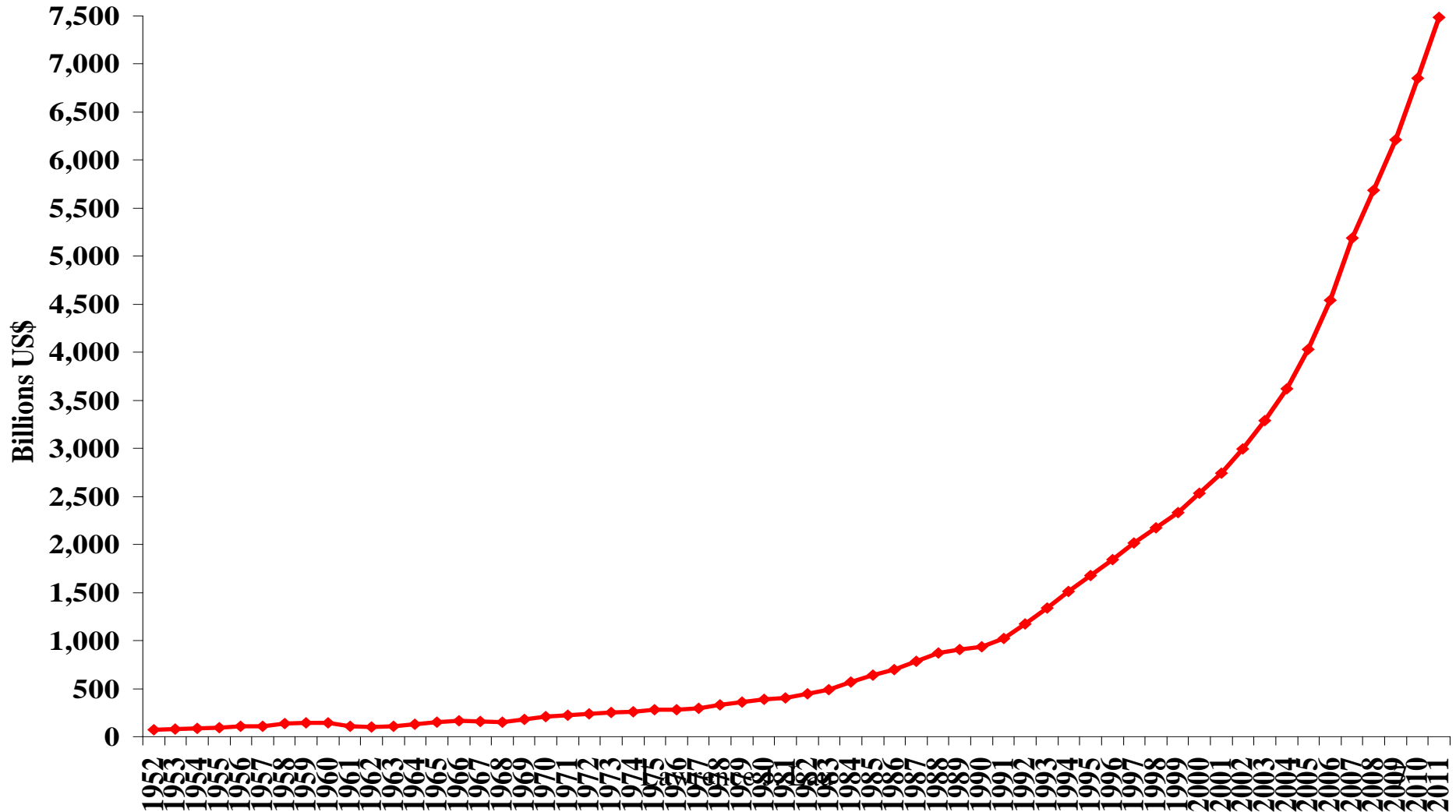
- ◆ Real GDP is a concept used to compare the values of GDP at different points of time that are net of the effects of the changes in the prices of goods and services. A change in the nominal value of GDP due solely to changes in prices is not “real” because in real terms no more goods and services have been produced.
- ◆ Typically, real GDP is measured in terms of the fixed constant prices of a given period. We focus on real GDP because a change in the price of a good or a service, whether up or down, does not affect its utility to consumers.

An Overview of the Mainland Chinese Economy

- ◆ The Mainland is currently the fastest growing economy in the World—averaging 9.8% per annum over the past 33 years. It is historically unprecedented for an economy to grow at such a high rate over such a long period of time.
- ◆ Between 1978 and 2011, Mainland Chinese annual real GDP grew almost 22 times, from US\$333 billion to more than US\$7.5 trillion (2011 prices) to become the second largest economy in the World, after the United States.
- ◆ By comparison, the U.S. GDP (approximately US\$15.1 trillion in 2011 prices) was more than 2 times the Mainland Chinese GDP in 2011.
- ◆ Hong Kong GDP in 2011 was only US\$225 billion, or 3.7% of the Mainland GDP.

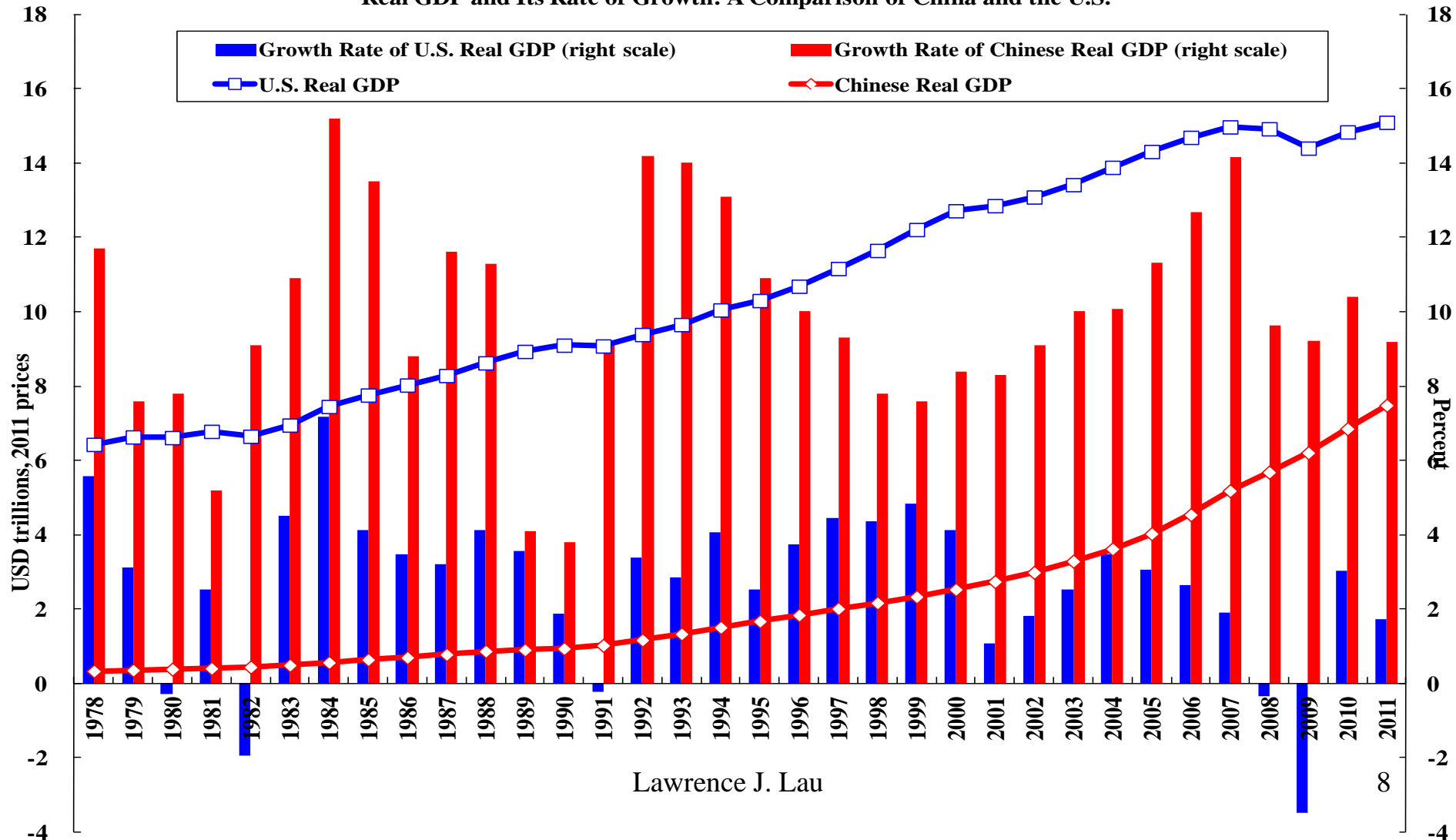
Mainland Chinese Real GDP in US\$ since 1952 (2011 Prices)

Chinese Real GDP since 1952, in 2011 prices



Real GDP and Its Rate of Growth: Mainland China and the U.S. (2011\$)

Real GDP and Its Rate of Growth: A Comparison of China and the U.S.



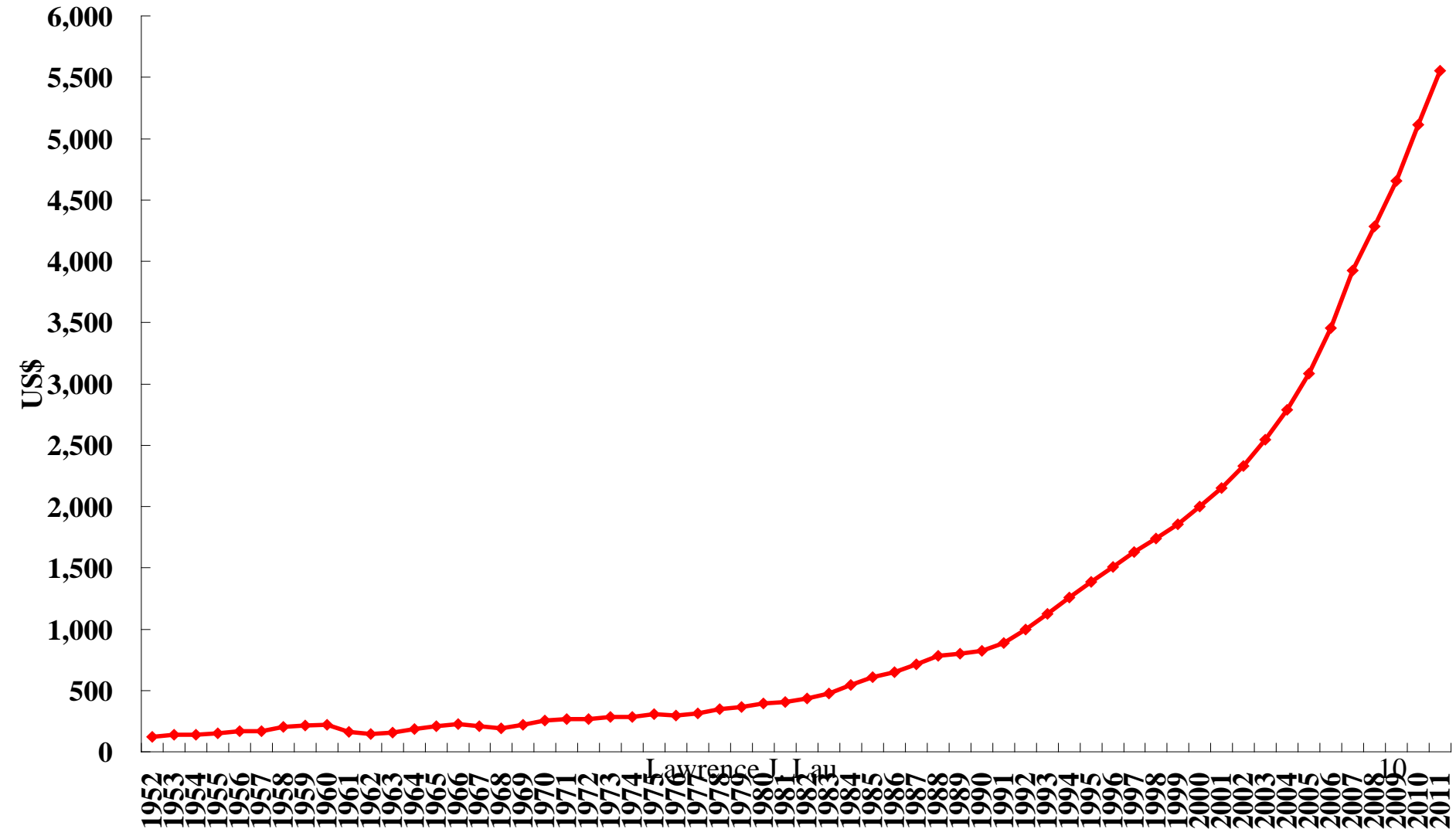
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An Overview of the Mainland Chinese Economy

- ◆ Despite its rapid growth, in terms of its real GDP per capita, Mainland China is still a developing economy.
- ◆ Between 1978 and 2011, Mainland Chinese real GDP per capita grew 15 times, from US\$346 to US\$5,555 (in 2011 prices). By comparison, the U.S. GDP per capita (approx. US\$48,236) was 8.7 times Mainland Chinese GDP per capita in 2011.
- ◆ Hong Kong GDP per capita in 2011 was US\$31,813, or a little less than 6 times the Mainland GDP per capita.
- ◆ Mainland GDP per capita ranks below 90th among all countries in the World.

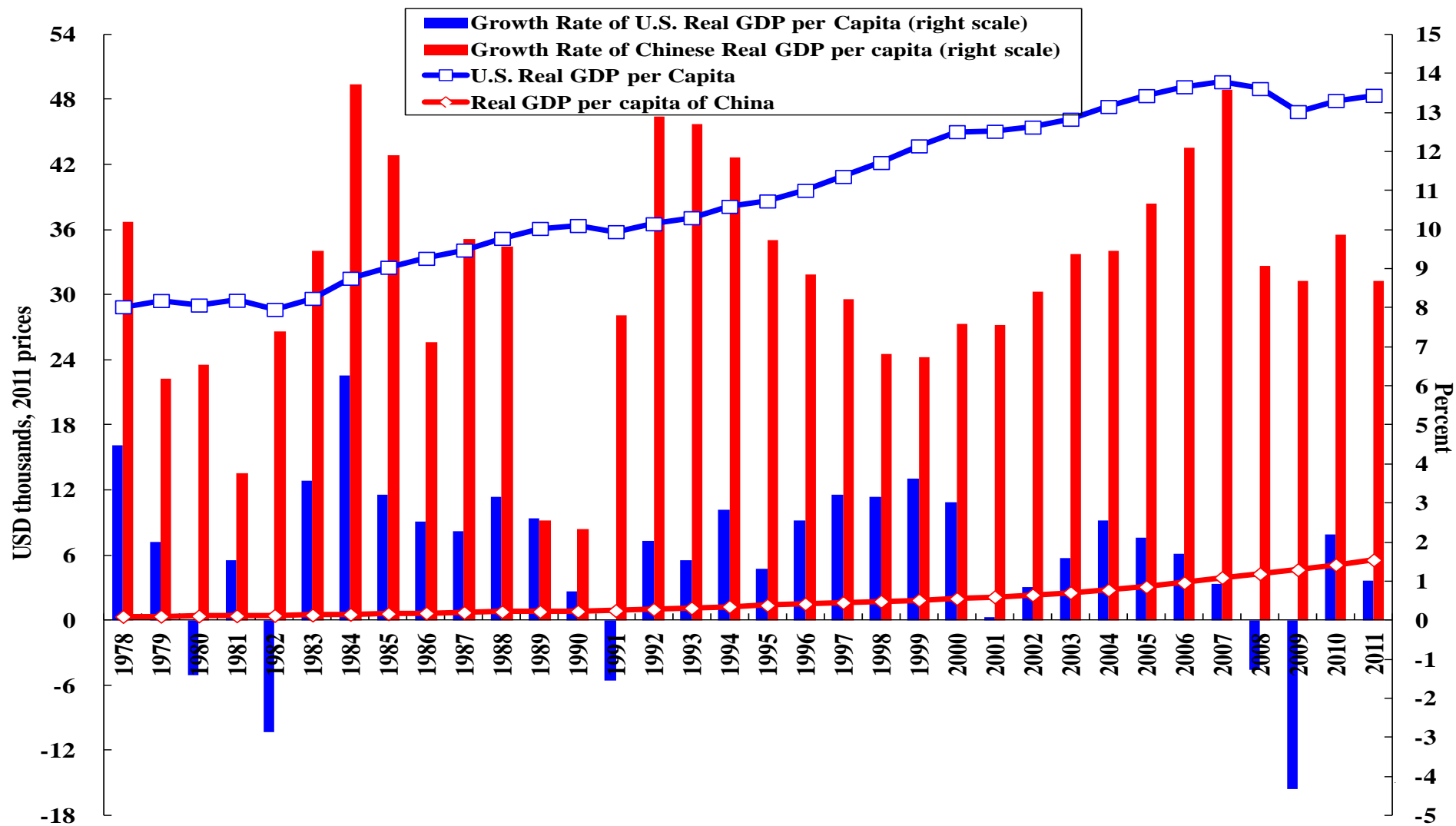
Real Mainland Chinese GDP per Capita in US\$ Since 1952 (2011 Prices)

Real Chinese GDP per Capita since 1952, in 2011 prices



Real Mainland Chinese and U.S. GDP per Capita in US\$ Since 1952 (2011 Prices)

Real GDP per Capita and Its Rate of Growth: A Comparison of China and the U.S.



An Overview of the Mainland Chinese Economy

- ◆ While many problems have arisen in the Mainland Chinese economy within the past decade—for example, increasing income disparity--both inter-regional and intra-regional--uneven access to basic education and health care, environmental degradation, inadequate infrastructure and corruption—it is fair to say that every Mainland Chinese citizen has benefited from the economic reform and opening since 1978, albeit to varying degrees, and few want to return to the central planning days.

An Overview of the Mainland Chinese Economy

- ◆ The Central Government leaders have also demonstrated their ability to confront important challenges and solve difficult problems, as for example, in maintaining Mainland Chinese economic growth during the 1997-1998 East Asian currency crisis, the 2007-2009 global financial crisis and the more recent European sovereign debt crisis.
- ◆ The Mainland of China is one of the very few socialist economies that have made a smooth transition from a centrally planned to a market system. It is a model for other transition economies such as Vietnam and potential transition economies such as Cuba, Laos, and North Korea.

An Overview of the Mainland Chinese Economy

- ◆ In the following table, the key performance indicators of the Mainland Chinese economy before and after the initiation of the economic reform and opening policy in 1978 are compared. It is readily apparent that there has been a huge improvement in every aspect of the economy—rates of growth of GDP, consumption, and international trade, on both an aggregate and per capita basis—except the average rate of inflation, which has become considerably higher in the period since 1978.

Key Performance Indicators Before and After Mainland Chinese Economic Reform

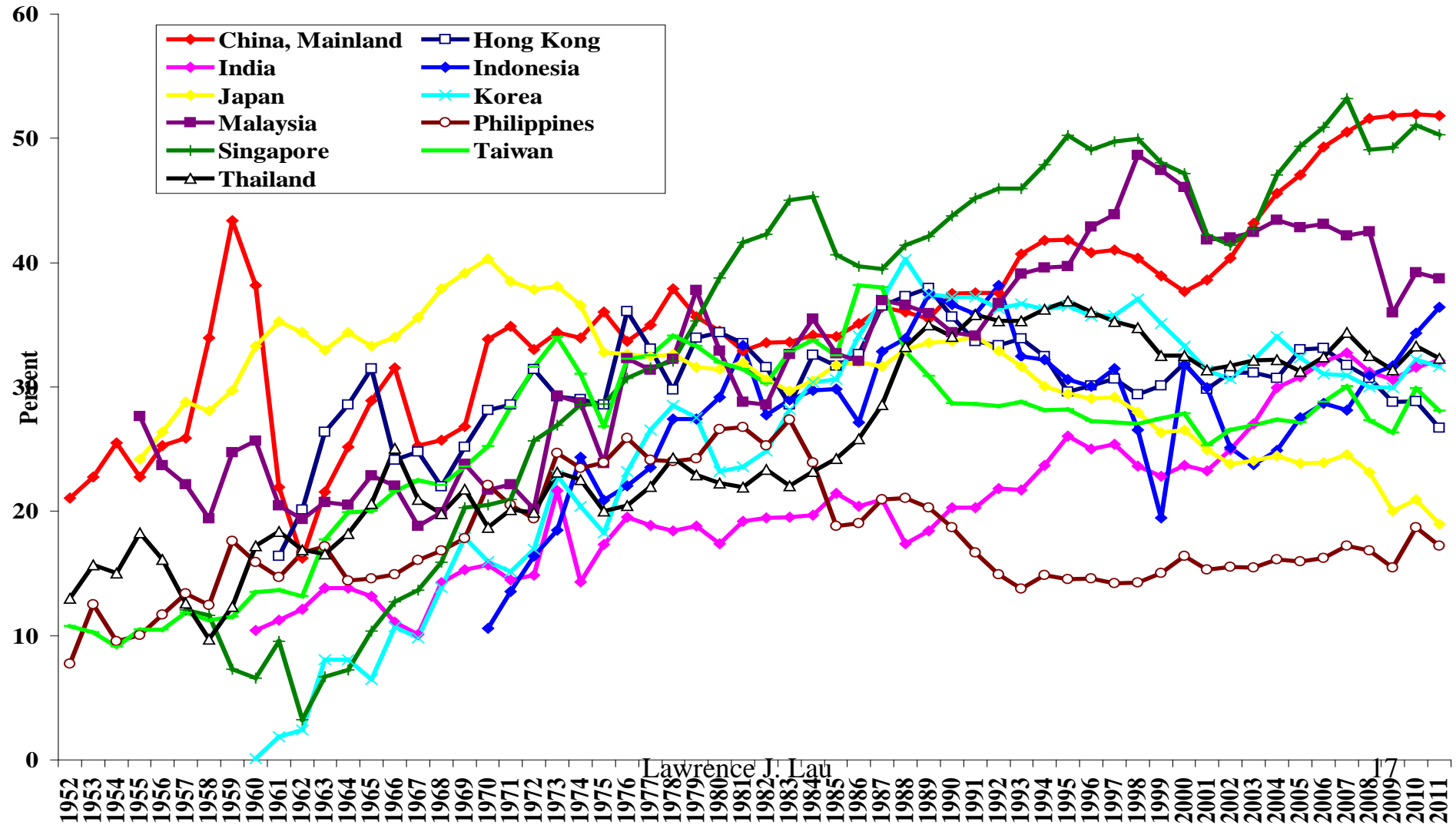
	Growth Rates	
	percent per annum	
	Period I	Period II
	1952-1978	1978-2011
Real GDP	6.15	9.89
Real GDP per Capita	4.06	8.78
Real Consumption	5.05	9.04
Real Consumption per Capita	2.99	7.94
Exports	9.99	17.32
Imports	9.14	16.63
	0.50	4.24

An Overview of the Mainland Chinese Economy

- ◆ The Mainland has consistently had a high national savings rate in excess of 30% which in the last decade has exceeded 40% and even approached 50%. This savings rate is more than adequate to finance all of its domestic investment needs. It does not need to depend on foreign direct investment, foreign portfolio investment, or foreign loans.
- ◆ The Mainland has an almost unlimited supply of surplus labour, ensuring that there will be little or no pressure on the real wage rate of unskilled, entry-level labour for decades to come.

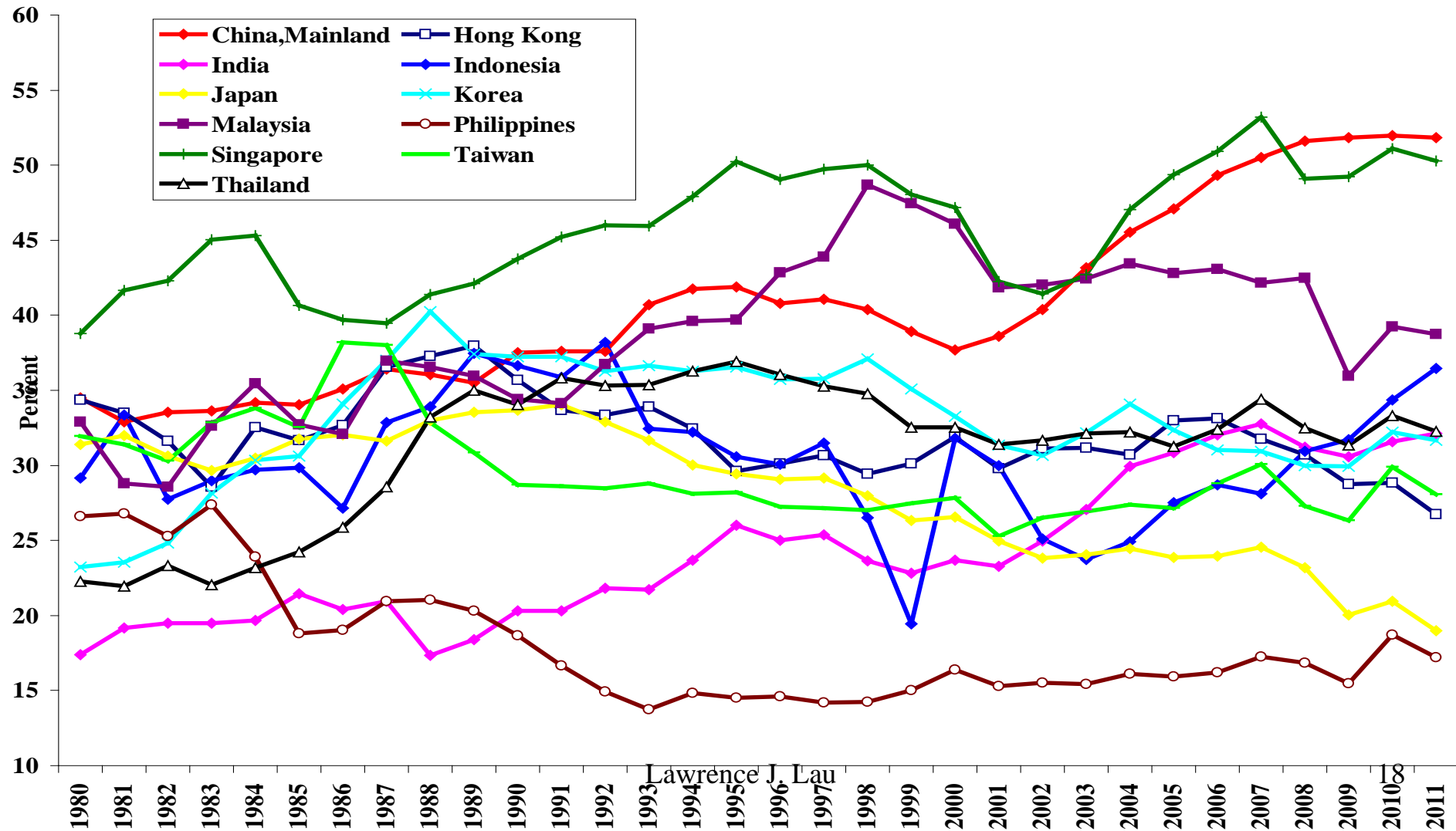
Savings Rates of Selected Asian Economies (1952-present)

Savings Rates of Selected East Asian Economies



Savings Rates of Selected Asian Economies (1980-present)

Savings Rates of Selected Asian Economies



An Overview of the Mainland Chinese Economy

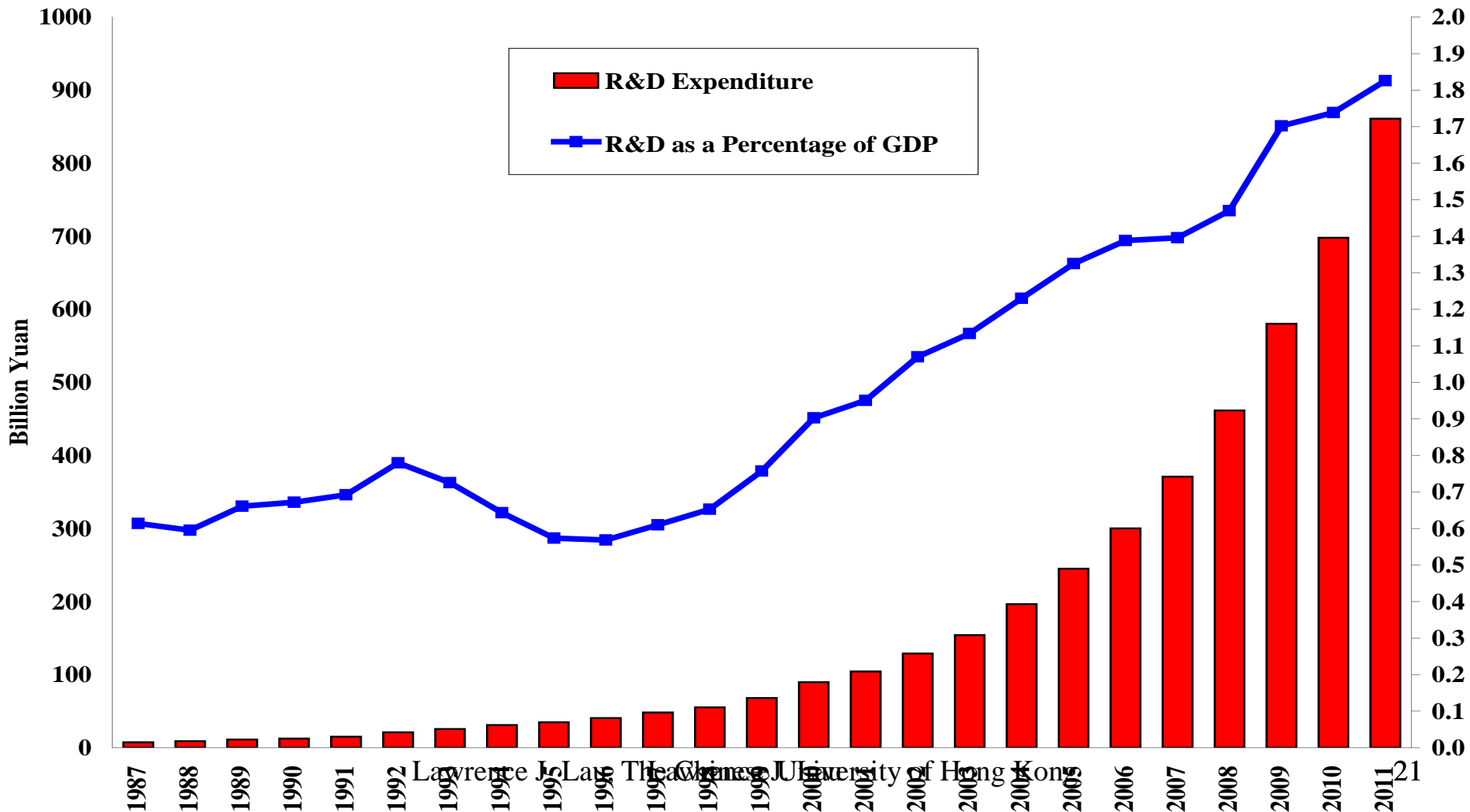
- ◆ The huge potential domestic market of 1.34 billion consumers allows the economies of scale in production and in innovation to be easily realised on the Mainland.
- ◆ The Mainland also has a long tradition of emphasis on education and learning (human capital) and will be increasing its investment in human capital. The enrollment rate of tertiary education has been rising rapidly and stands at 26 percent today. It is expected to rise further over the next decades as private tertiary educational institutions become more numerous in response to demand and facilitated by government policy.

An Overview of the Mainland Chinese Economy

- ◆ Sustained investment in R&D is essential for technical progress in an economy. The Mainland has also begun to invest heavily in R&D in recent years--R&D expenditure has been rising rapidly, both in absolute value, and as a percentage of GDP, but still lags behind the developed economies as well as the newly industrialised economies of East Asia. (The Mainland Chinese R&D Expenditure/GDP ratio is targeted to reach 2.2% in 2015, still below the historical average of 2.5% for the U.S.)
- ◆ By comparison, both Japan and South Korea invest more than 3% of their GDPs in R&D annually. The United States has on average invested approximately 3% of its GDP in R&D since the late 1950s.

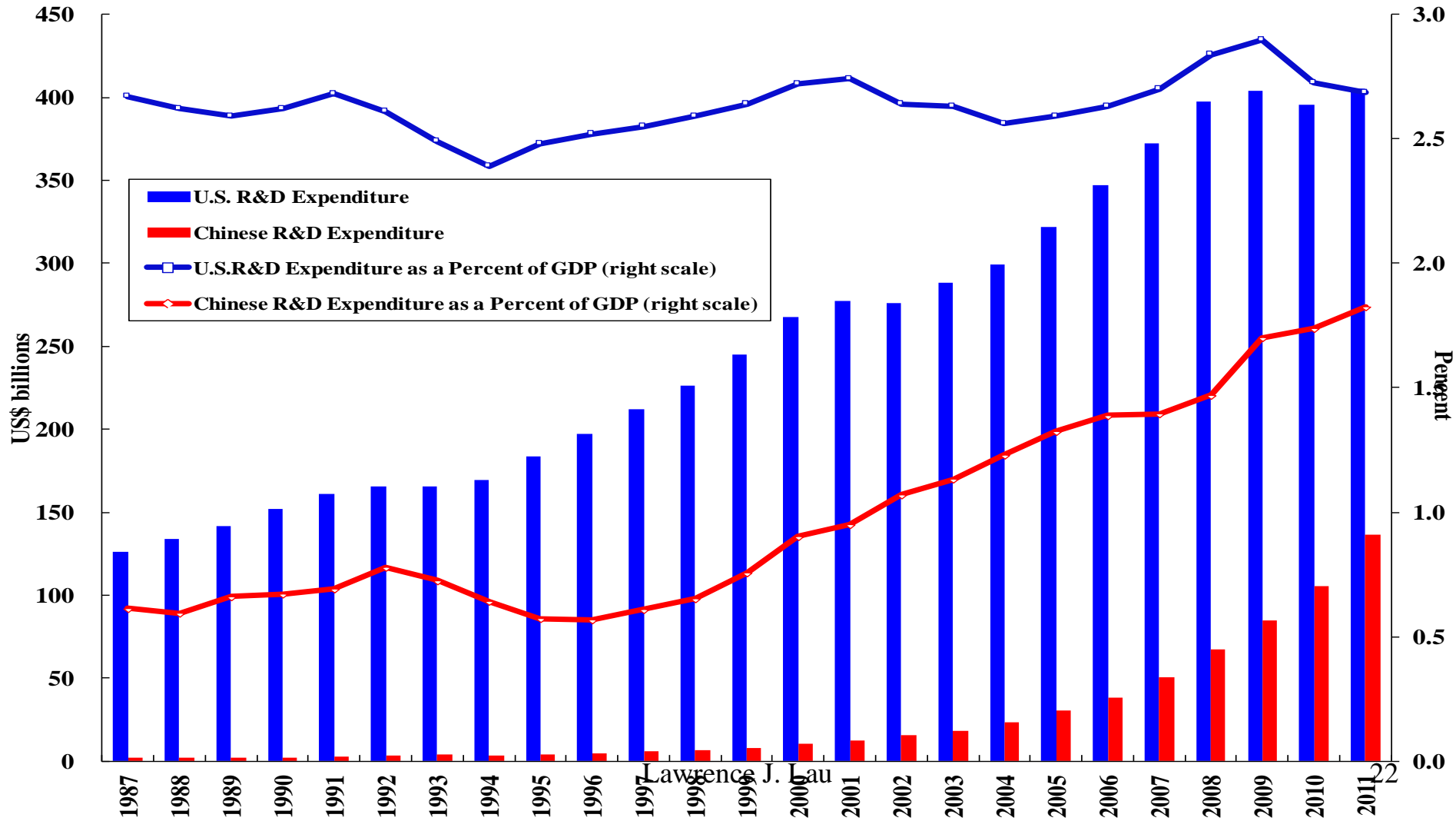
China's R&D Expenditure and Its Share of Chinese GDP

China's R&D Expenditure and Its Share of GDP



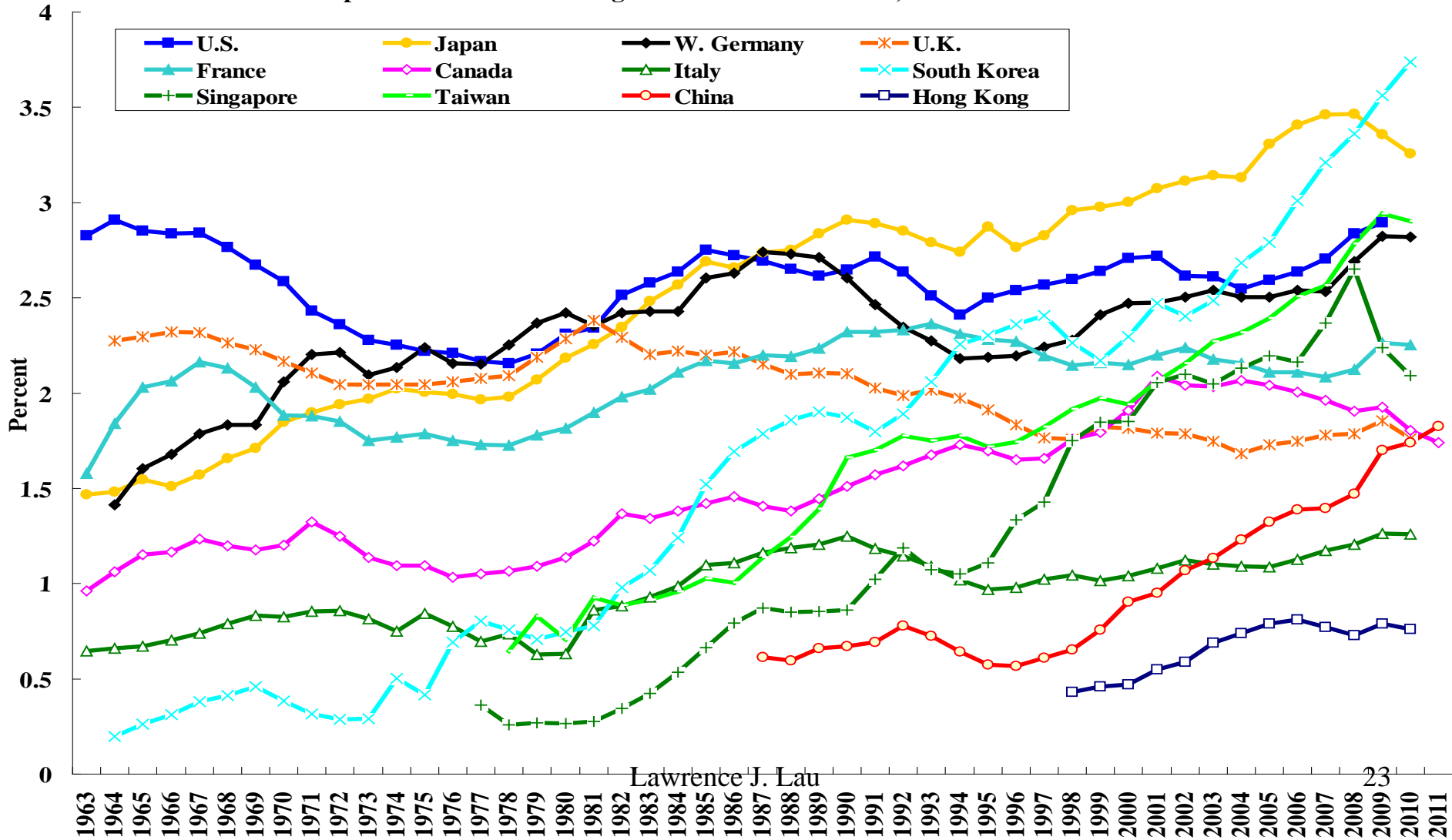
R&D Expenditure and Its Share of GDP: Mainland China and the U.S.

R&D Expenditure and Its Share of GDP: A Comparison of China and the U.S.



R&D Expenditures as a Ratio of GDP: G-7 Countries, 4 East Asian NIES & Mainland

R&D Expenditures as a Percentage of GDP: G-7 Countries, 4 East Asian NIES and China

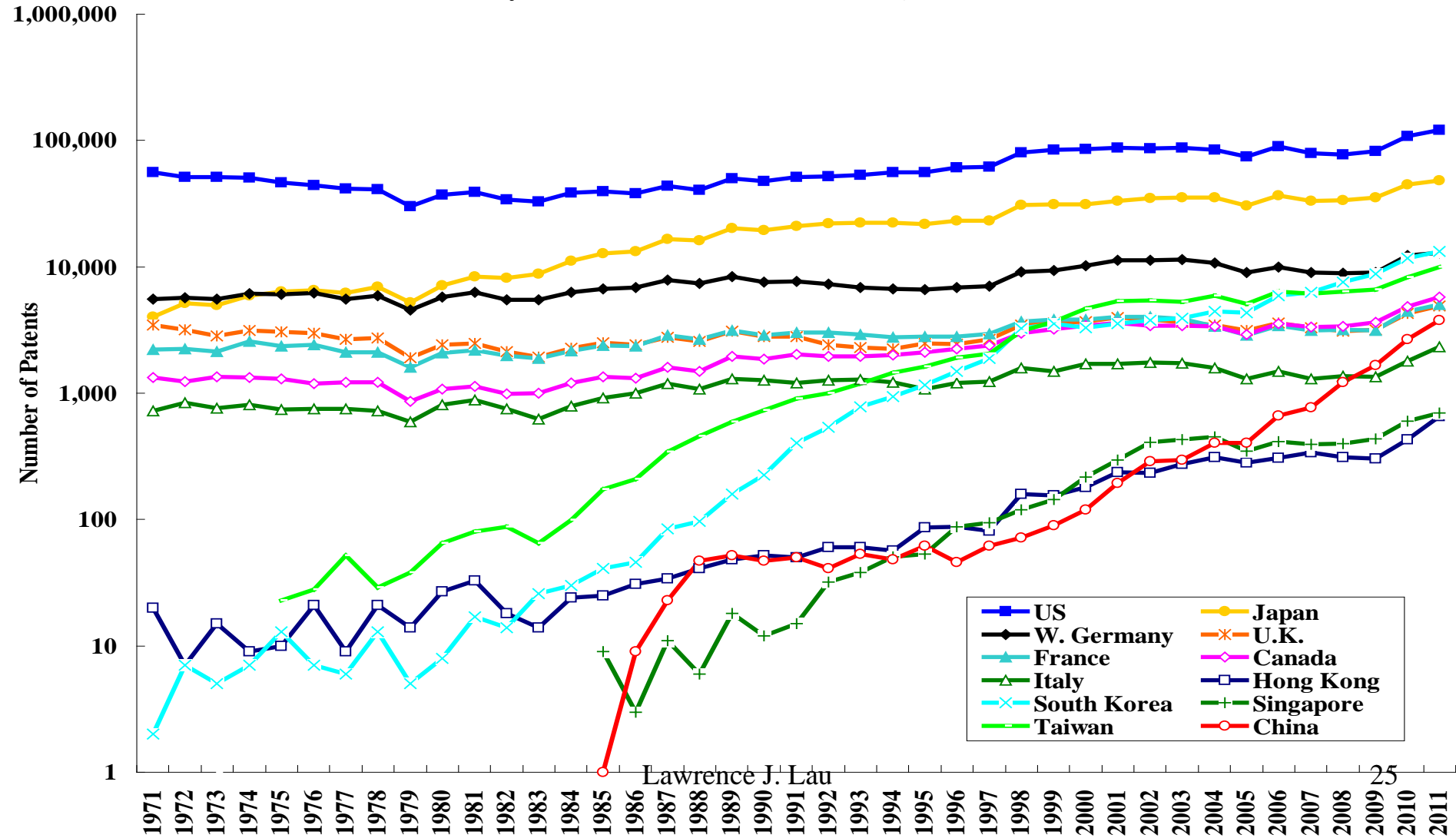


An Overview of the Mainland Chinese Economy

- ◆ One indicator of the potential for technical progress (national innovative capacity) is the number of patents created each year. In the following chart, the number of patents granted in the United States each year to the nationals of different countries, including the U.S. itself, over time is presented. The U.S. is the undisputed champion over the past forty years, with more than 120,000 patents granted in 2011, followed by Japan, with approximately 48,000.
- ◆ Since these are patents granted in the U.S., the U.S. may have a home advantage; however, for all the other countries, the comparison across them should be fair.

Patents Granted in the United States: G-7 Countries, 4 East Asian NIEs & China

Patents Granted Annually in the United States: G7 Countries, 4 East Asian NIEs and China



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An Overview of the Mainland Chinese Economy

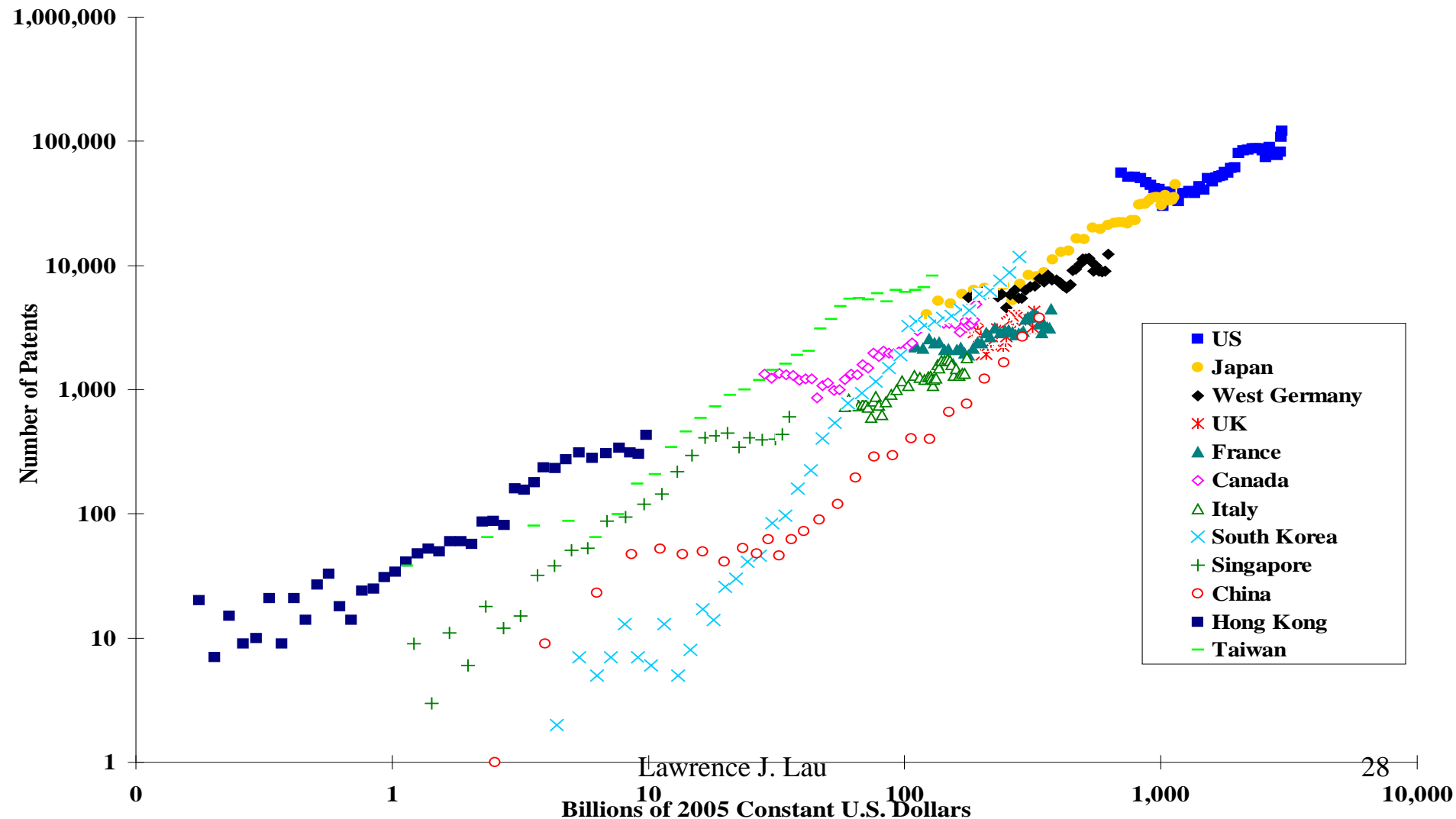
- ◆ The number of patents granted to Mainland Chinese applicants each year has increased from 1 in 1985 to 3,786 patents in 2011.
- ◆ The economies of South Korea and Taiwan, granted 13,239 and 9,907 U.S. patents respectively in 2011, are still far ahead of Mainland China—they have been averaging approximately 10,000 patents a year each.

An Overview of the Mainland Chinese Economy

- ◆ The stock of R&D capital, defined as the cumulative past real expenditure in R&D less depreciation of 10% per year, can be shown to have a direct causal relationship to the number of patents granted (see the following chart, in which the number of patents granted is plotted against the R&D capital stock for each country and each year).

Patents Granted in the United States and R&D Capital Stocks, Selected Economies

The Number of U.S. Patents Granted Annually vs. R&D Capital Stocks



An Overview of the Mainland Chinese Economy

- ◆ The huge domestic market of the Mainland greatly enhances the productivity of intangible capital (e.g., R&D capital, goodwill). The fixed research and development costs of a new product or process can be easily amortised over a large market. The benefits of investment in goodwill, e.g., brand-building, are also much greater in a large market.
- ◆ The huge domestic market also enables active Mainland Chinese participation in the setting of product and technology standards, for example, fourth-generation (4-G) standards for telecommunication, and sharing the benefits of such standard-setting.

An Overview of the Mainland Chinese Economy

- ◆ The Mainland has also made tremendous progress in science and technology in recent years.
- ◆ The Mainland now publishes the second largest number of articles in professional journals (Science Citation Index (SCI) journals) in science and engineering in the World, just after the United States.
- ◆ The Mainland has had a highly successful space programme, sending satellites, vehicles and astronauts into space.

An Overview of the Mainland Chinese Economy

- ◆ Brand-building is a pre-requisite for Mainland Chinese enterprises to re-orient themselves to take advantage of the huge domestic market. It is true that brand-building requires resources, but it also enables the owners of brand names to have much more pricing power and higher profit margins than enterprises that do only OEM (original equipment manufacturing) business. Examples of successful brand-building in the Mainland market include Haier, Kang Shifu, Want Want, and Chow Tai Fook.

An Overview of the Mainland Chinese Economy

- ◆ In addition to a high national savings rate, a large pool of surplus labour, a huge domestic market, and rising investment in intangible capital (human capital and R&D capital), The Mainland also has the advantage of relative backwardness. It has:
 - ◆ The ability to learn from the experiences of successes and failures of other economies;
 - ◆ The ability to leap-frog and by-pass stages of development (e.g., the telex machine, the VHS video players, the fixed landline phones); and
 - ◆ The possibility of creation without destruction (e.g., online virtual bookstores like Amazon.com do not have to destroy brick and mortar bookstores which do not exist in the first place).
- ◆ The Mainland also possesses an abundance of scientific and technical manpower the cost of which is a fraction of the cost in developed economies.

The Metaphor of the “Wild Geese Flying Pattern”

- ◆ The metaphor of the "wild-geese-flying pattern" of East Asian economic development over time (Kaname Akamatsu (1962)) suggests that industrialisation will spread from economy to economy as the initially fast-growing economies, beginning with Japan, run out of surplus labour and face labour shortages, rising real wage rates, and quota restrictions on their exports.
- ◆ Thus East Asian industrialisation spread from Japan to first Hong Kong, and then Taiwan, and then South Korea, and then Southeast Asia (Thailand, Malaysia, Indonesia), and then to Guangdong, Shanghai, Jiangsu and Zhejiang in Mainland China. During this industrial migration, the large trading firms such as Mitsubishi, Mitsui, Marubeni and Sumitomo of Japan and Li and Fung of Hong Kong played an important role as financiers, intermediaries and managers of logistics and supply chains.

The Metaphor of the “Wild Geese Flying Pattern”

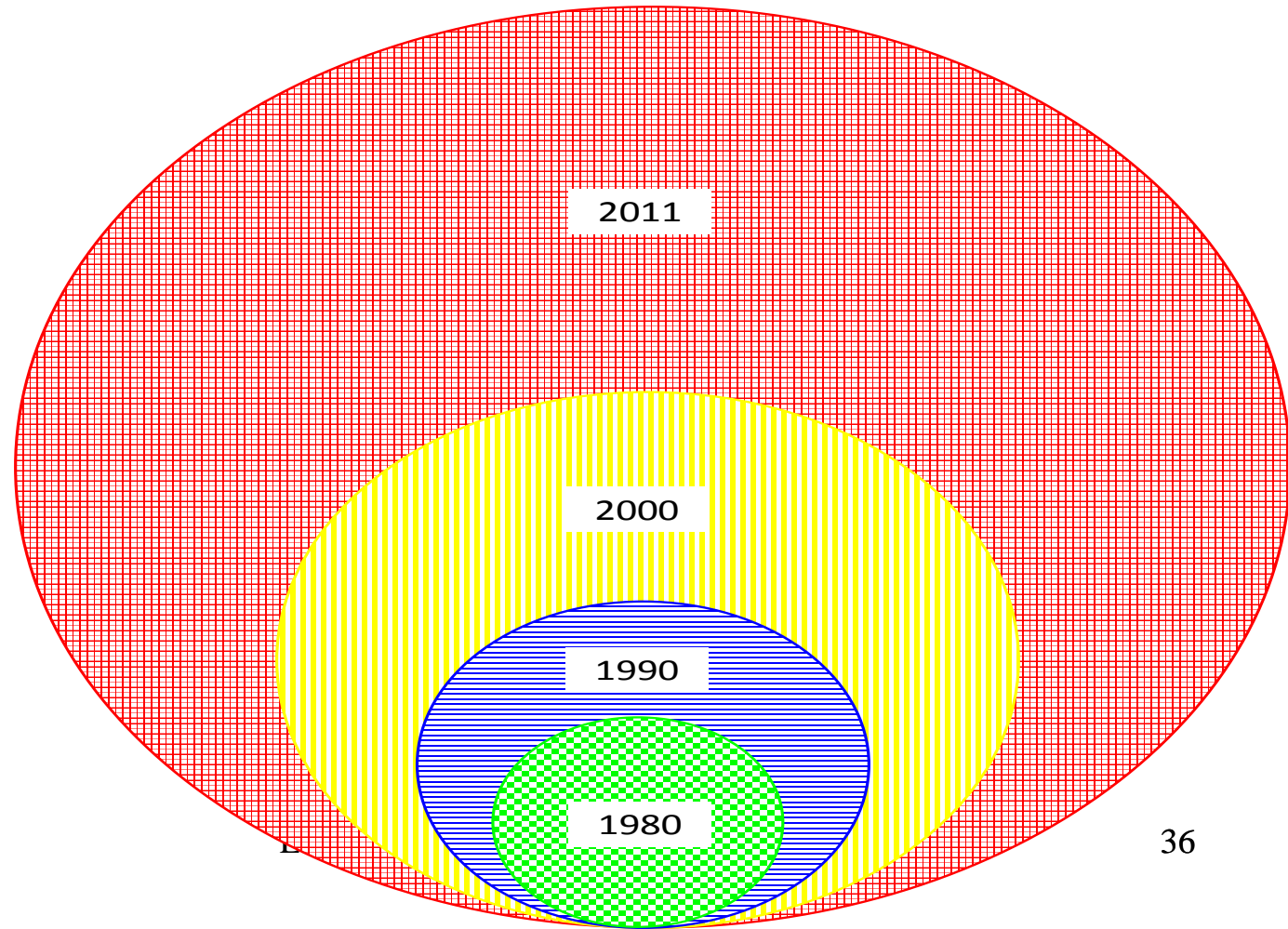
- ◆ This metaphor applies not only to East Asia but also to the Mainland itself. Within the Mainland, industrialisation first started in the coastal provinces, regions and municipalities. It has begun to migrate and spread to other provinces, regions and municipalities in the interior—to Chongqing, Henan, Hunan, Jiangxi and Shaanxi. As the coastal provinces, regions and municipalities slow down in their economic growth, the central and western provinces, regions and municipalities will take their turn as the fastest growing areas on the Mainland. The Mainland as a whole will be able to maintain its high rate of growth for many years to come.

Comparison of the Economies of Hong Kong and the Mainland

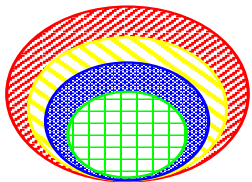
- ◆ It is useful to compare the economies of Hong Kong and the Mainland over time.
- ◆ Huge changes have occurred over the past 30 odd years.
- ◆ In 1980, the GDP of the Mainland economy is only 7 times that of Hong Kong. Today, it is 32 times.
- ◆ However, in terms of GDP per capita, Hong Kong still leads the Mainland at 6 times in 2011, but the gap has shrunk significantly from 28 times in 1980.

Comparison of the Real GDPs of Mainland and Hong Kong (2011 US\$)

China

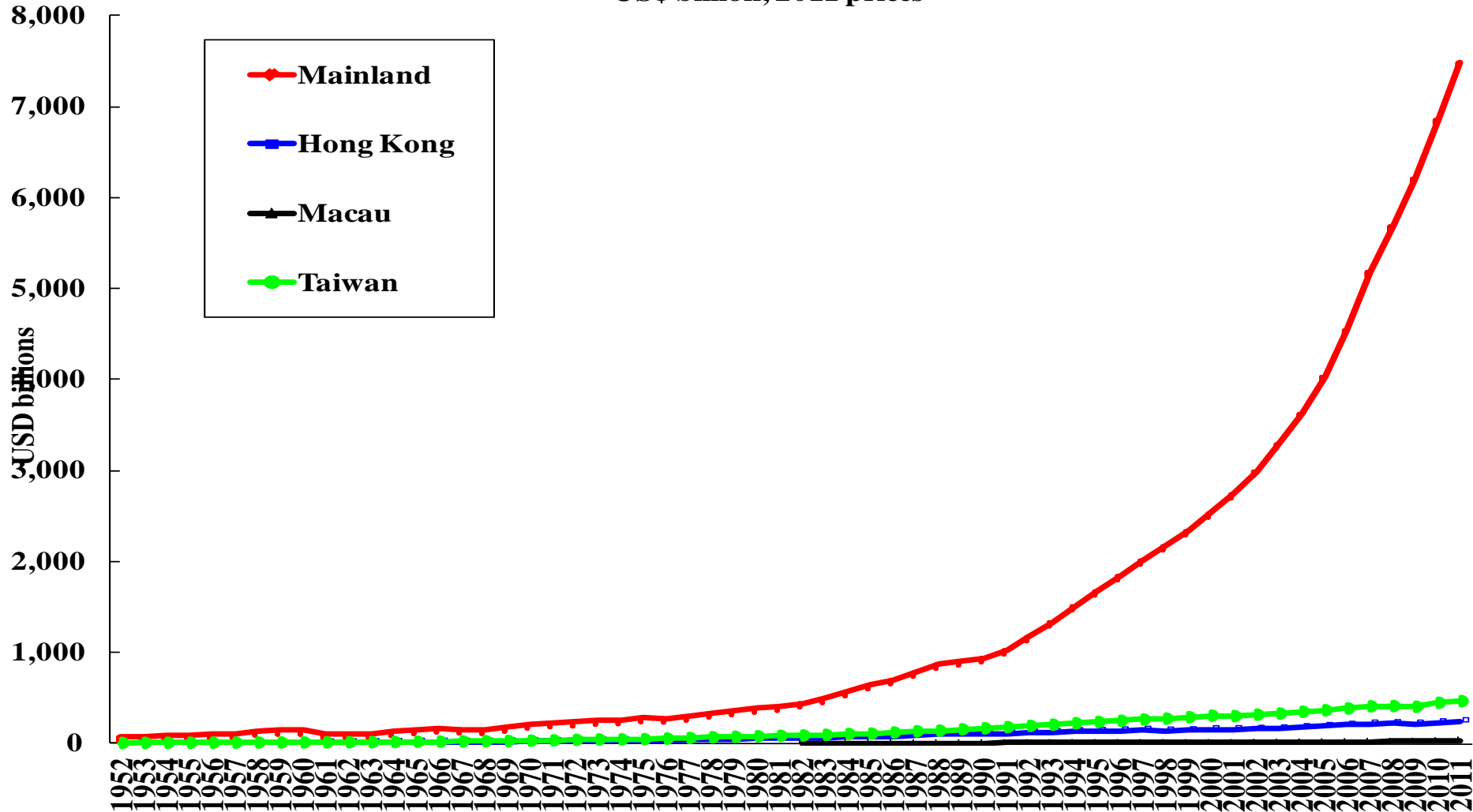


Hong Kong



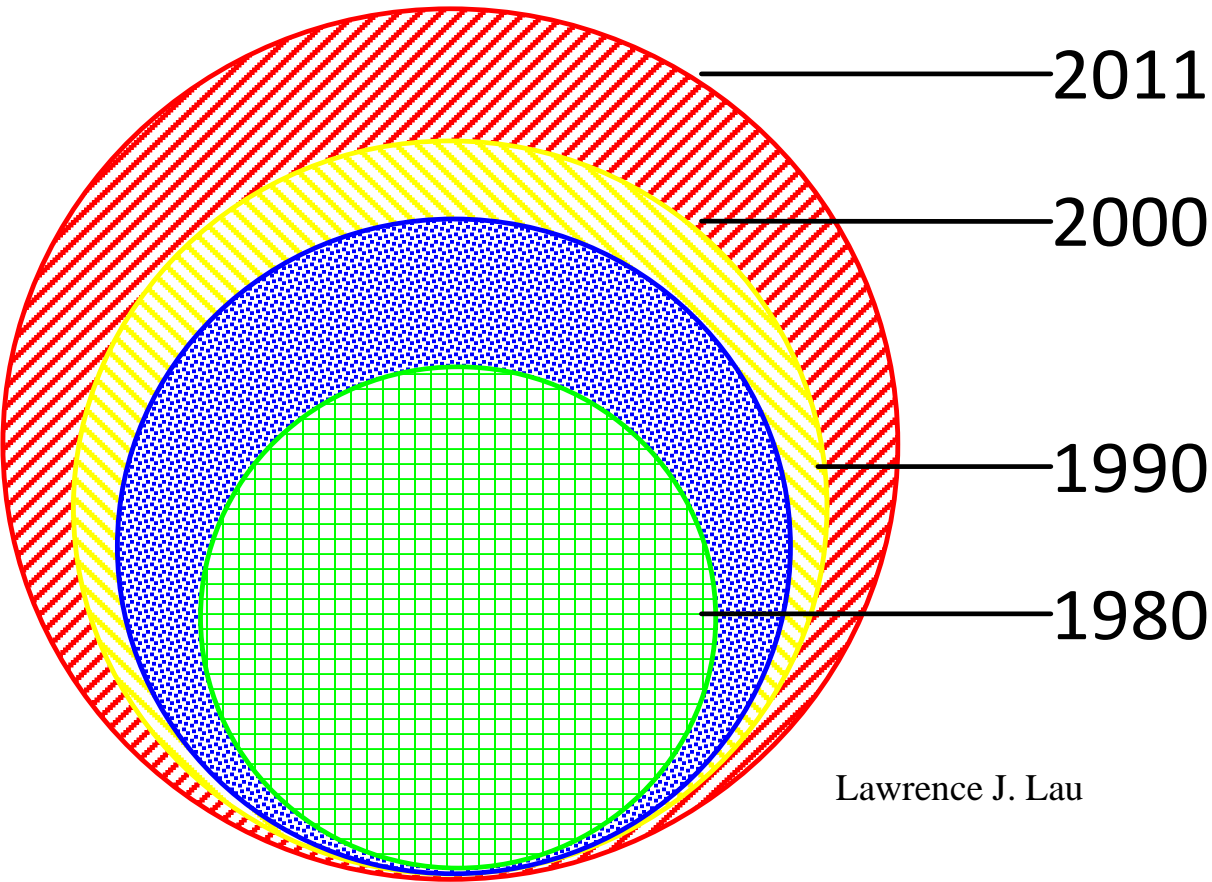
Comparison of the Real GDPs of Four Regions (2011 US\$)

Comparison of the Real GDPs of the Four Regions in the Greater Chinese Economy
US\$ billion, 2011 prices

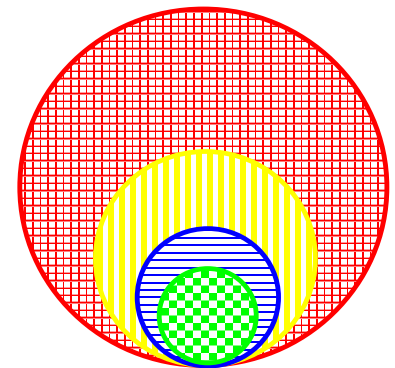


Comparison of the Real GDP-per-Capita's of Mainland and Hong Kong (2011 US\$)

Hong Kong



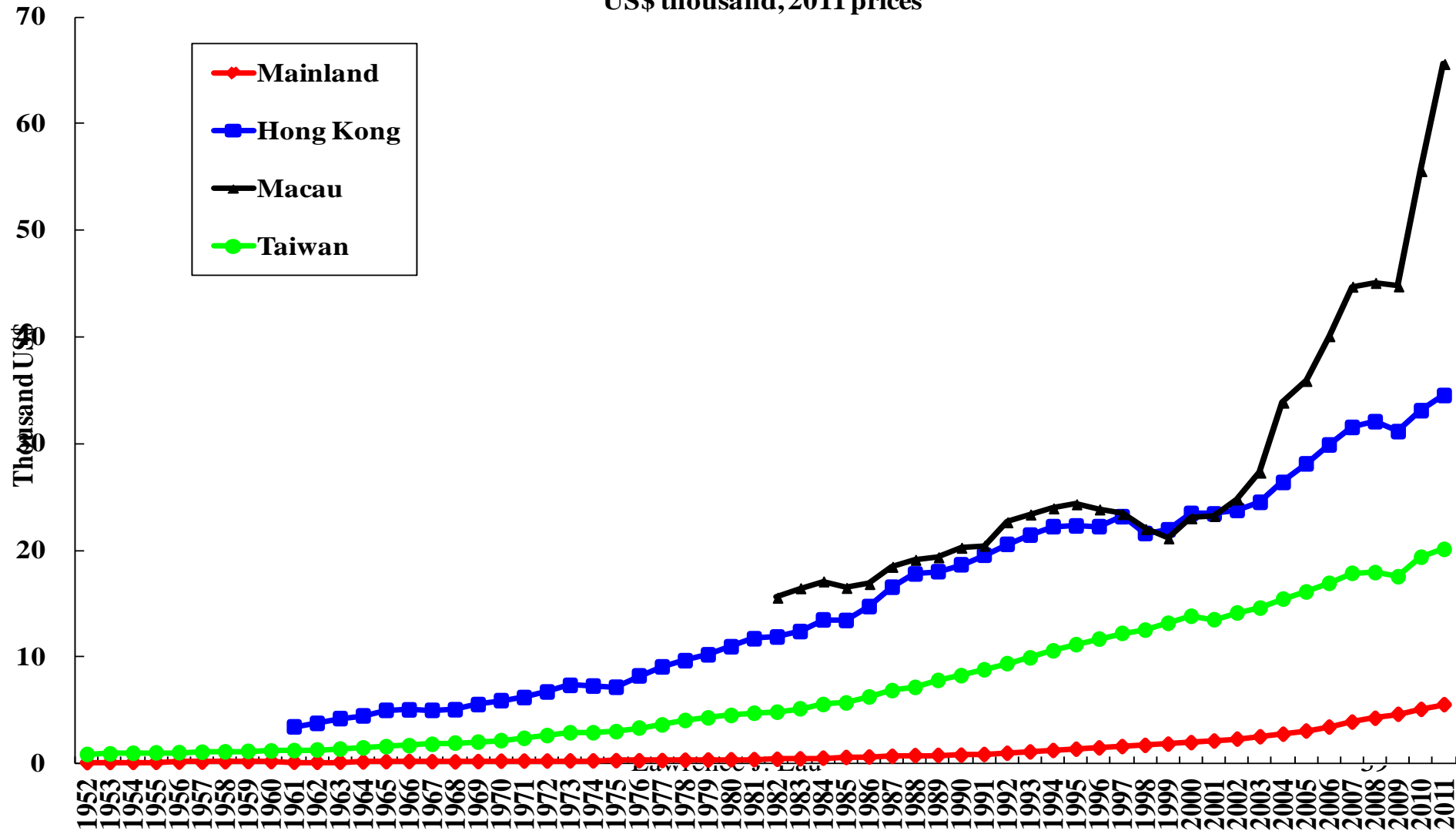
China



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Comparison of the Real GDP-per-Capita's of Four Regions (2011 US\$)

Comparison of the Real GDP per Capita's of the Four Regions in the Greater Chinese Economy
US\$ thousand, 2011 prices

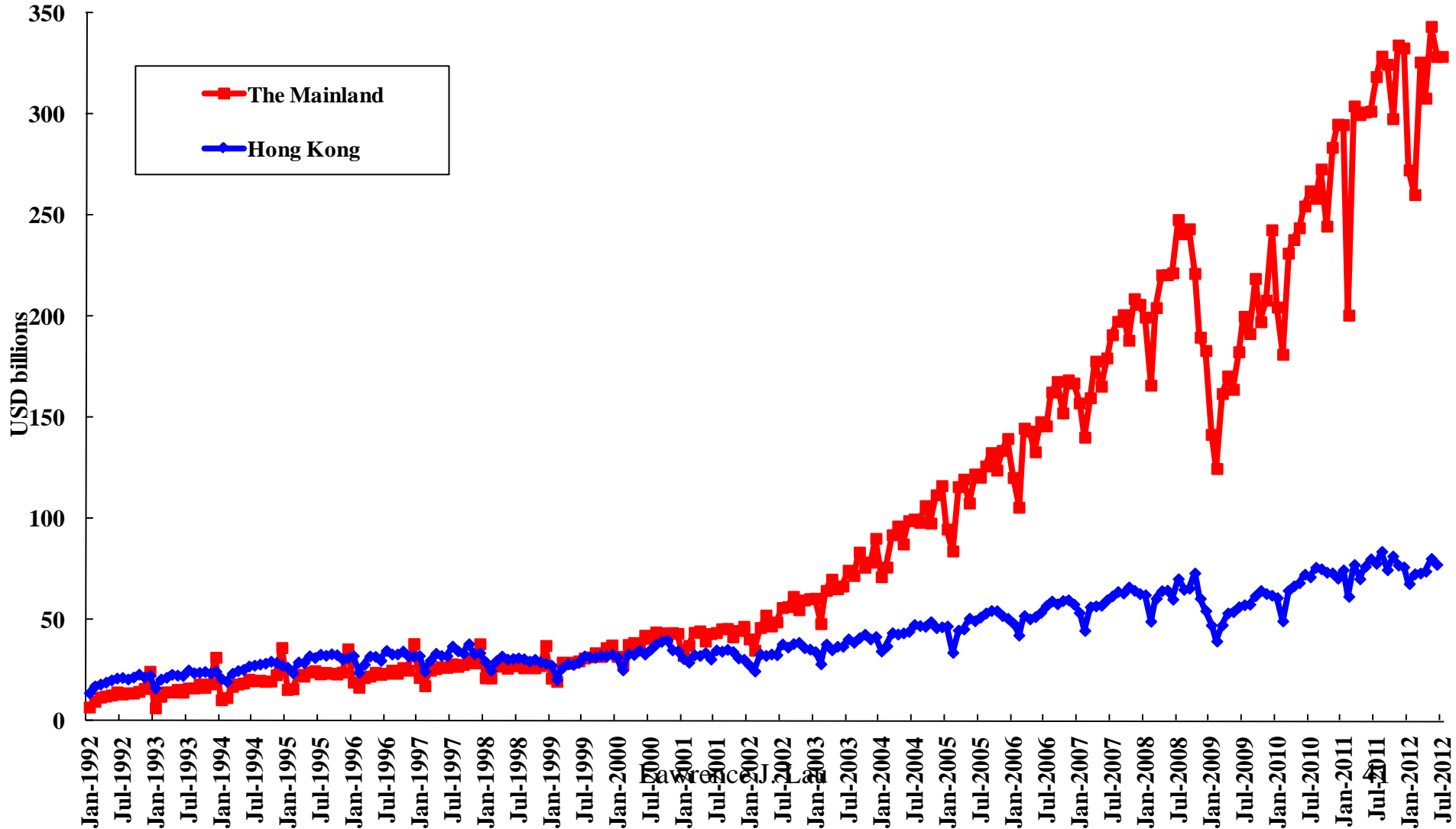


Comparison of the Economies of Hong Kong and the Mainland

- ◆ In terms of international trade, the Mainland, which started out at a very low level in 1978, overtook Hong Kong in the early 1990s and is now approximately 4 times as large as Hong Kong.
- ◆ The Mainland is the most important trading partner of Hong Kong.
- ◆ In terms of foreign direct investment (FDI), the Mainland has consistently attracted more direct investment than Hong Kong since it adopted the economic reform and opening policies in 1978.

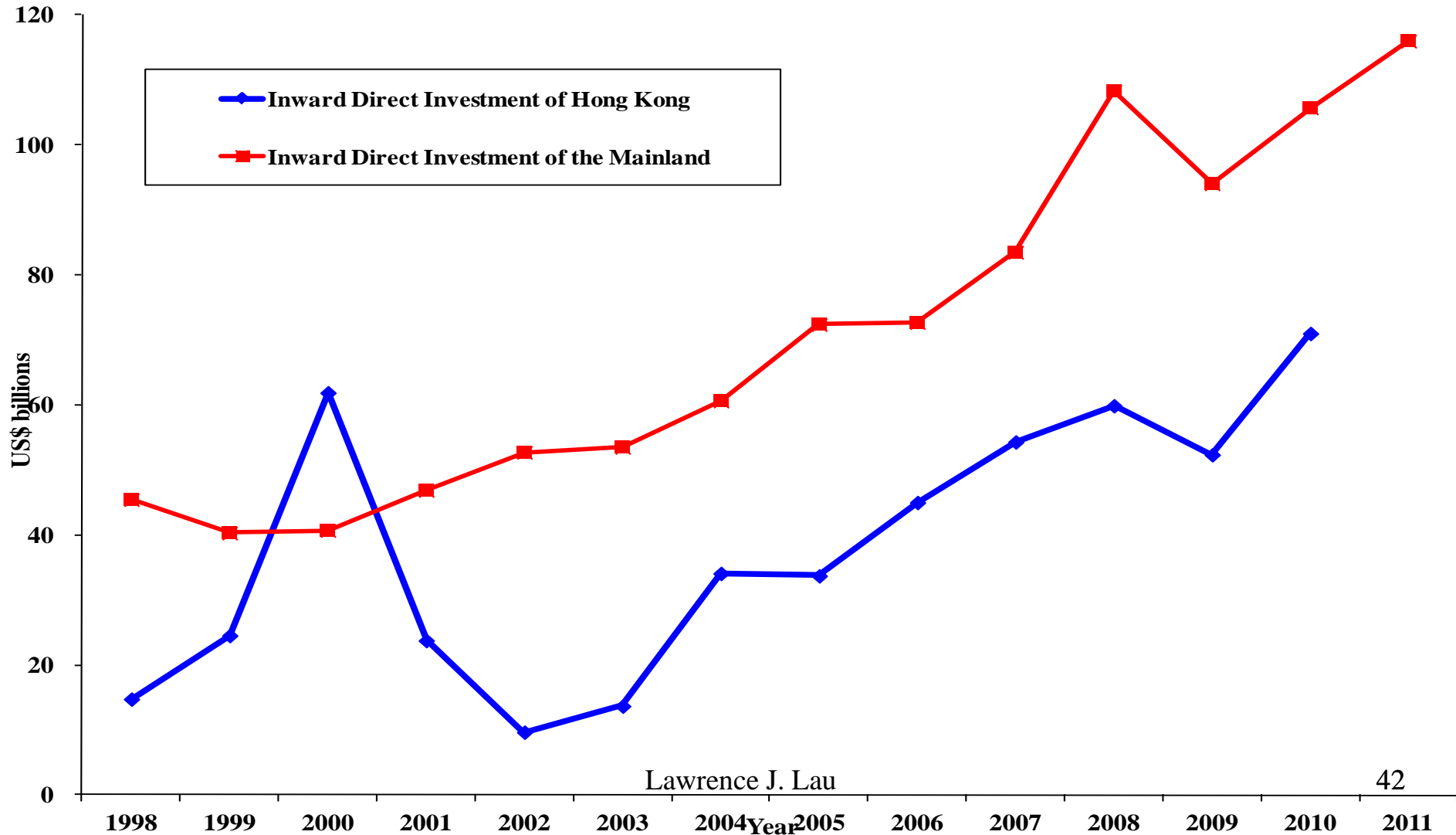
Comparison of the Total International Trade of the Mainland and Hong Kong

Total International Trade of the Mainland and Hong Kong



Comparison of the Inbound Foreign Direct Investment: Mainland and Hong Kong

Annual Inward Direct Investment of the Mainland and Hong Kong



Mainland-Hong Kong Economic Interactions: International Trade

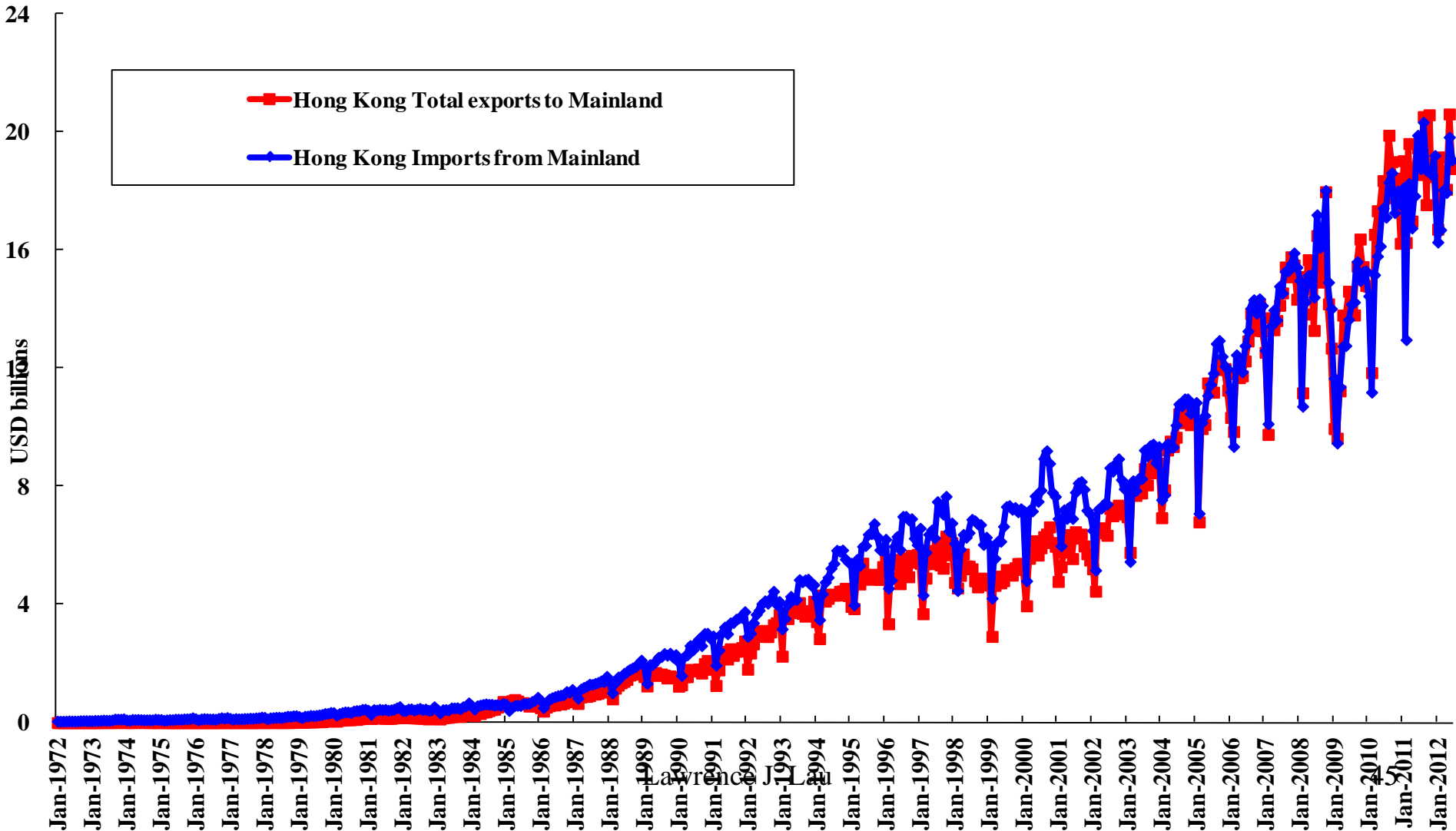
- ◆ Hong Kong was effectively the only gateway to the Mainland for international trade and direct investment when China began its economic reform and opened to the World in 1978.
- ◆ Most of the early international trade between the Mainland and the rest of the World was routed through Hong Kong. Hong Kong provided the financing, logistics and port facilities for the trade. Later on, the Mainland developed its own facilities at Shanghai, Shenzhen and other ports.
- ◆ 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.

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 (over 50% in 2011) as well as the most important source of Hong Kong imports (over 50% in 2011).
- ◆ The Mainland has recently become even more important to the Hong Kong economy because of the economic problems in the United States and Europe since 2008.
- ◆ The advances in information and communication technology and globalisation have also meant that all jobs 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.

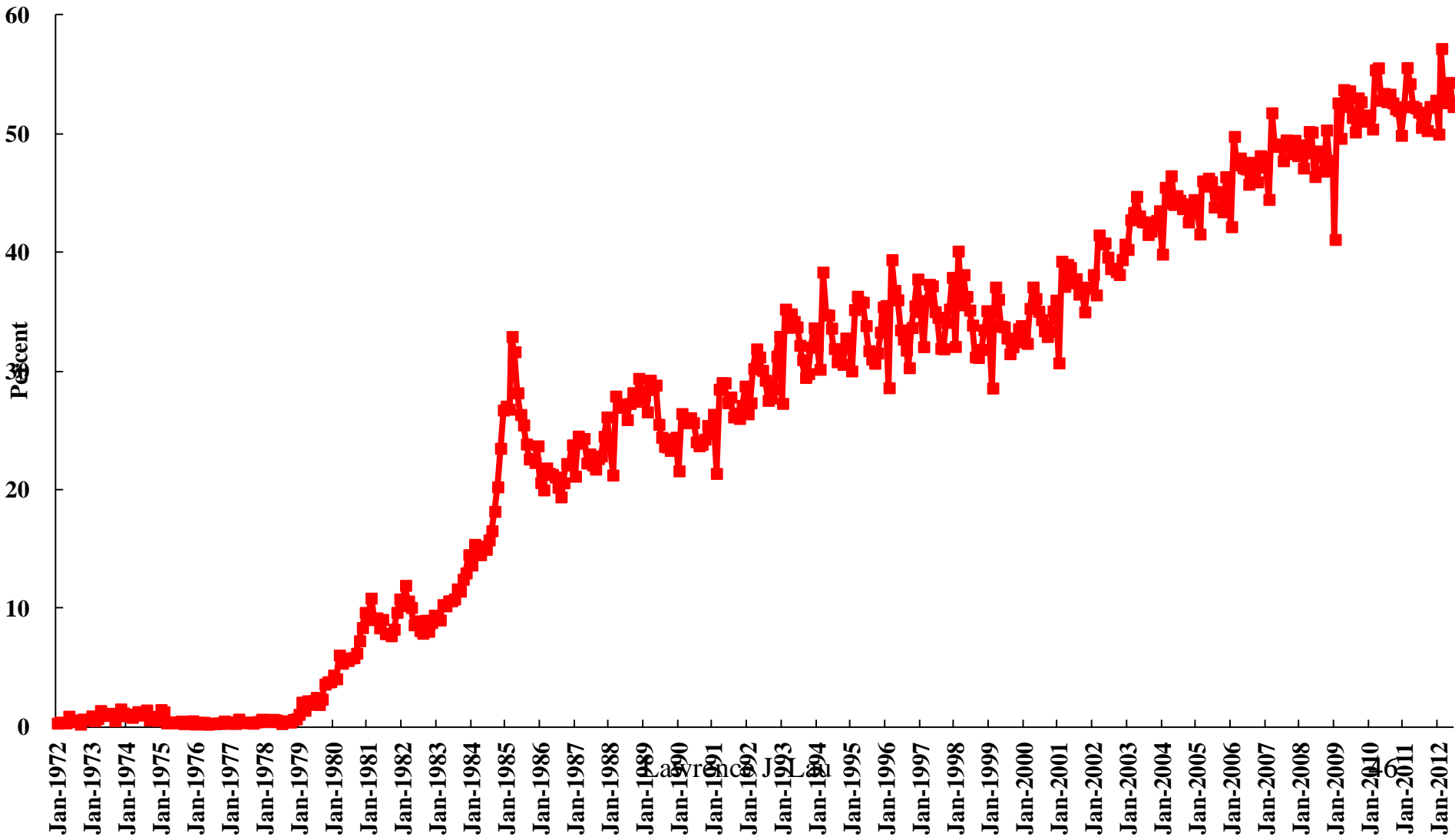
Total Hong Kong Exports to and Imports from the Mainland since 1972

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



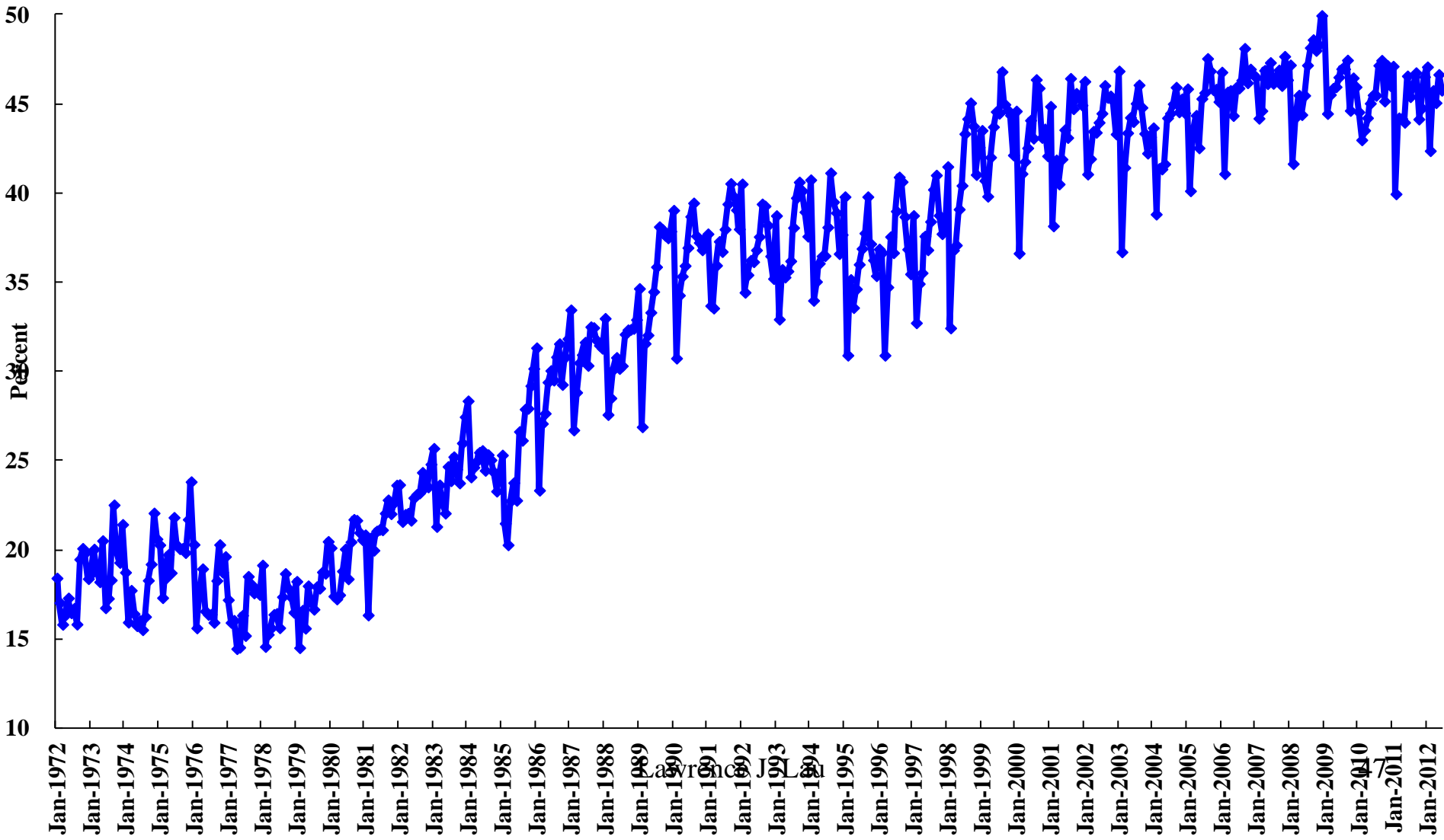
Hong Kong Exports to the Mainland as a Percent of Total Hong Kong Exports

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

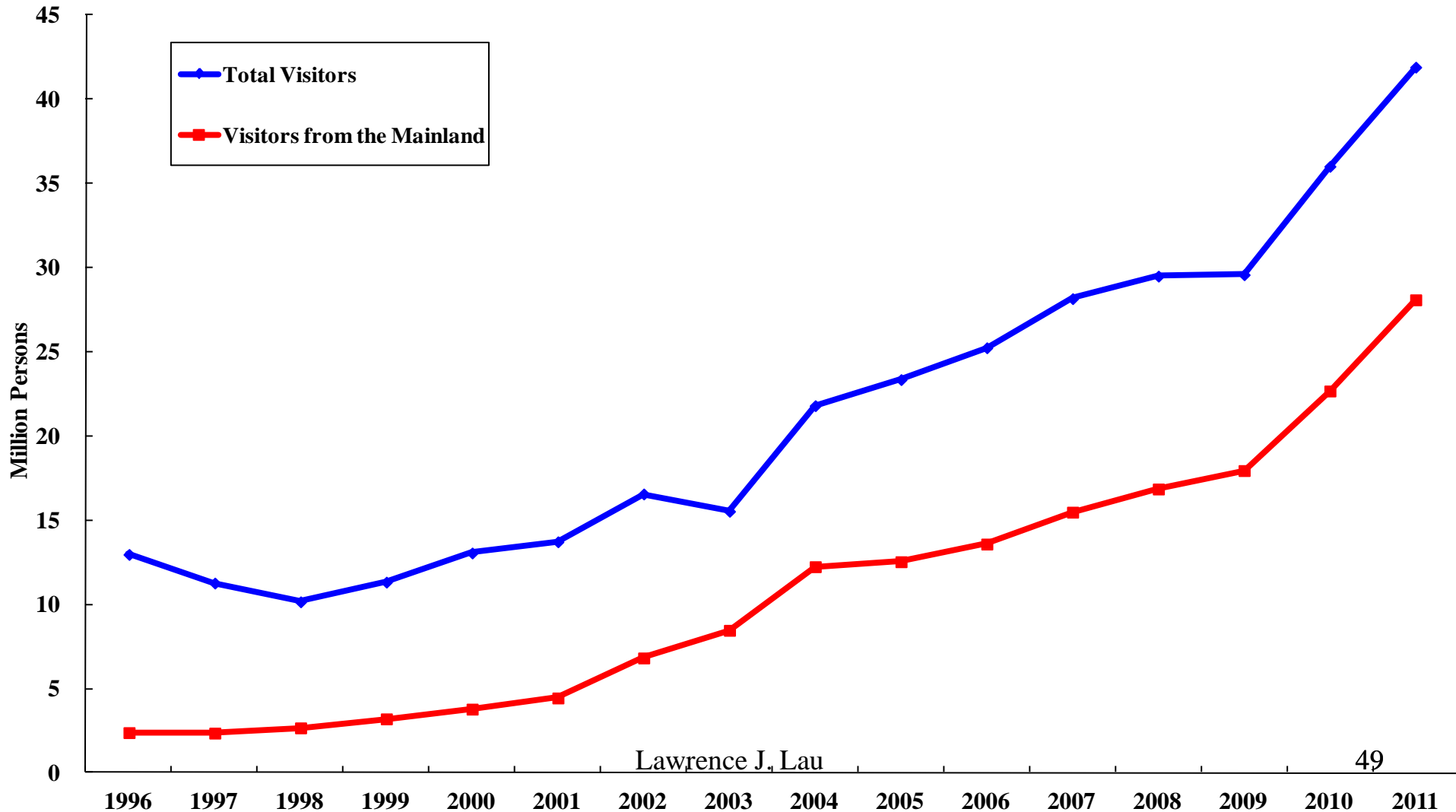


Mainland-Hong Kong Economic Interactions: International Trade

- ◆ 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 more than 70% of all visitors to Hong Kong in 2011. Mainland visitors spend on average 3 days in Hong Kong and US\$750 per day.
- ◆ These visitors 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.

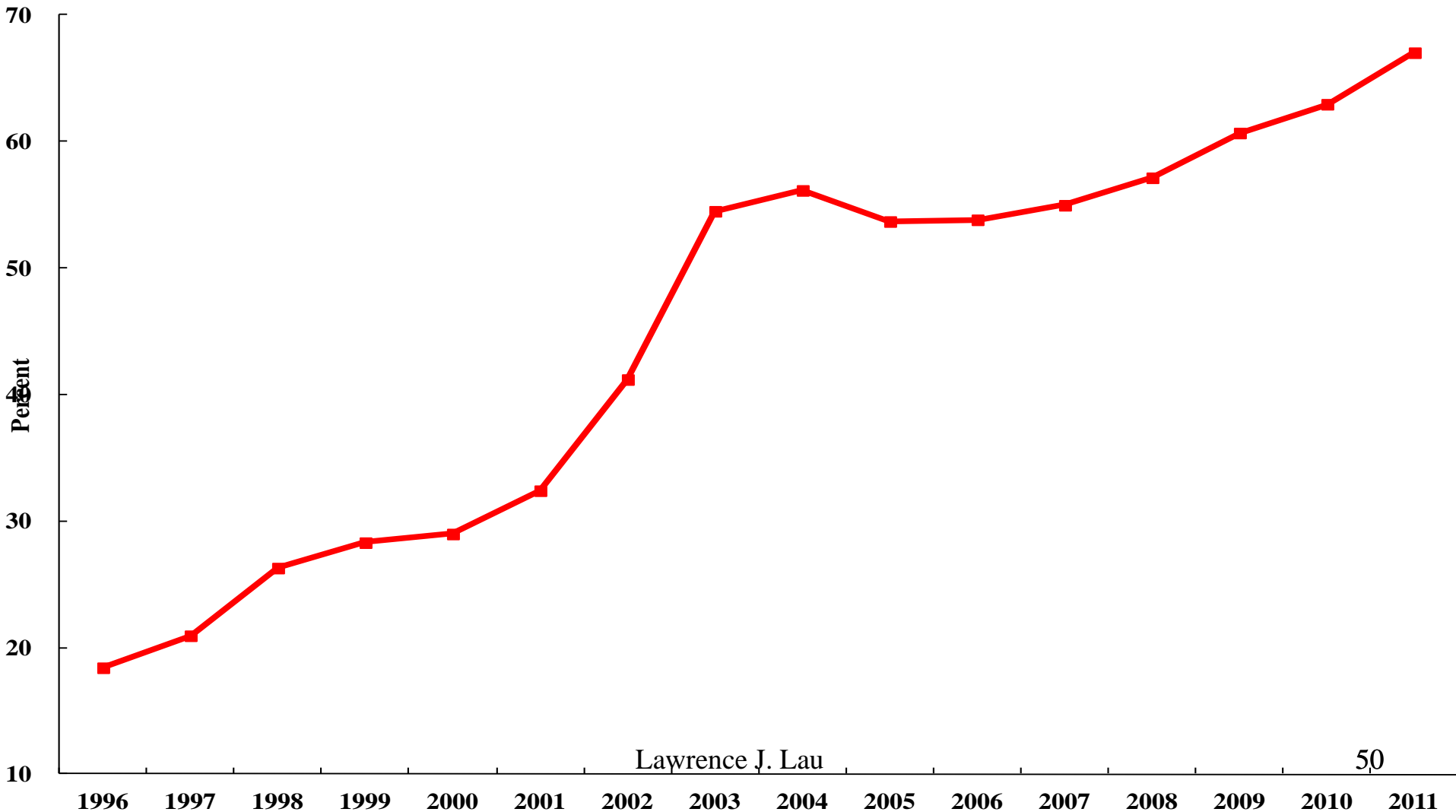
Annual Mainland and Total Visitors to Hong Kong since 1990

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



Mainland-Hong Kong Economic Interactions: Direct Investment

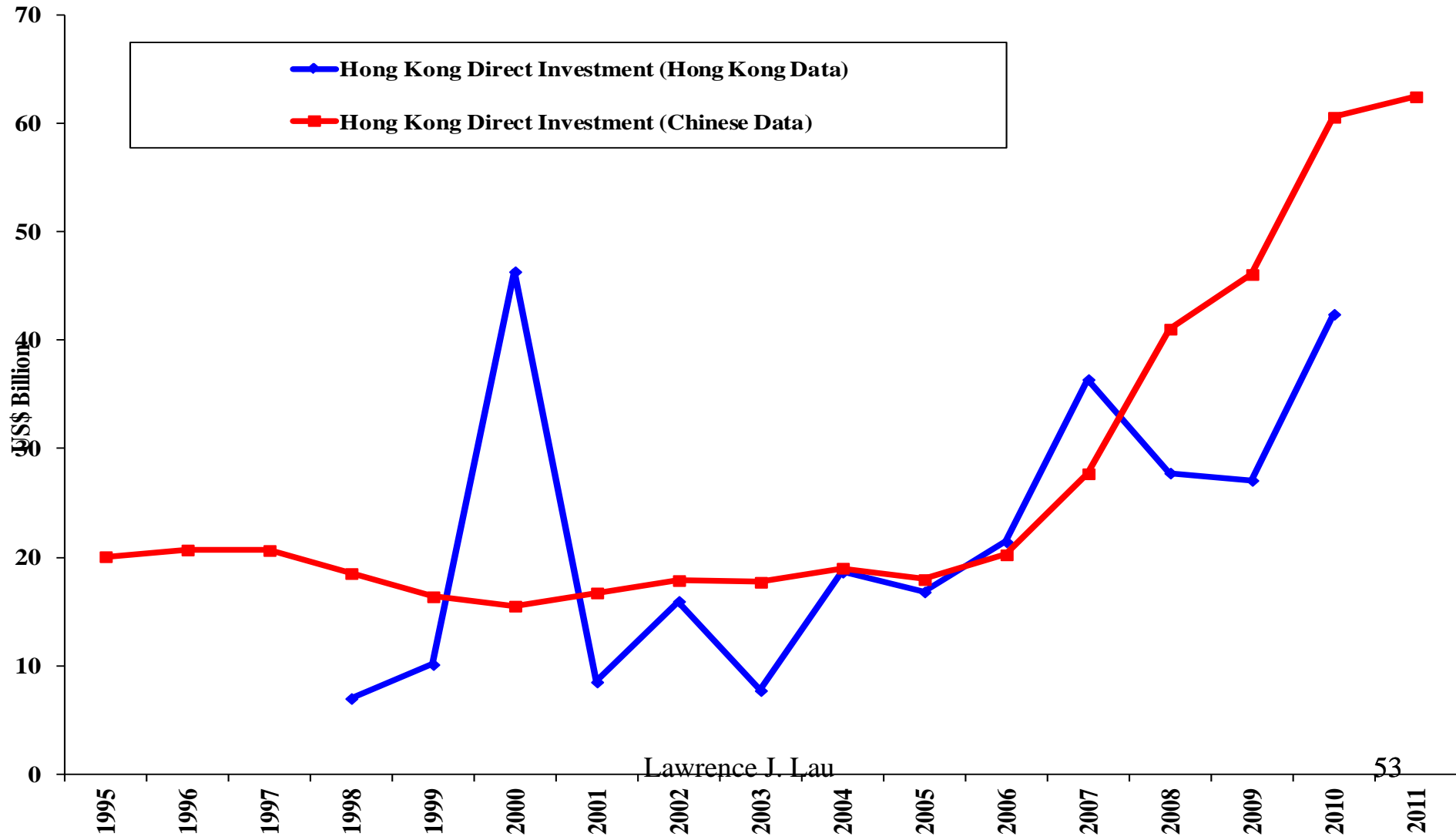
- ◆ Hong Kong investors were the first to invest in the Mainland when it first opened to the World in 1978 and were instrumental for the successful development of the Special Economic Zones such as Shenzhen.
- ◆ It is fair to say that without Hong Kong, Shenzhen would probably not have been a success. The other Special Economic Zones have not been notably successful.
- ◆ But today, even total foreign direct investment, from all sources, constitutes only a very small and quantitatively unimportant percentage of total gross domestic investment on the Mainland (less than 5% in 2011).
- ◆ Mainland investment now constitutes almost 50% of all FDI into Hong Kong.

Mainland-Hong Kong Economic Interactions: Direct Investment

- ◆ Hong Kong data on direct investment by country or region of origin are not completely reliable. On the one hand, Hong Kong direct investment can include not only investment from Hong Kong firms and residents, but also investment from Taiwan and elsewhere routed through Hong Kong subsidiaries, taking advantage of the Closer Economic Partnership Agreement (CEPA) between the Mainland and Hong Kong, as well as round-tripped investment, that is, investment from Mainland firms and residents camouflaged as Hong Kong firms in order to enjoy certain special tariff and tax privileges.
- ◆ On the other hand, there is also Hong Kong direct investment that is routed through tax havens such as the British Virgin Islands, Cayman Islands and Netherland Antilles.
- ◆ Hong Kong data and Mainland data on FDI do not agree. Taking into consideration all of these data problems, Hong Kong is still the most important source of foreign direct investment into the Mainland, accounting for between 20% and 40% of total FDI.

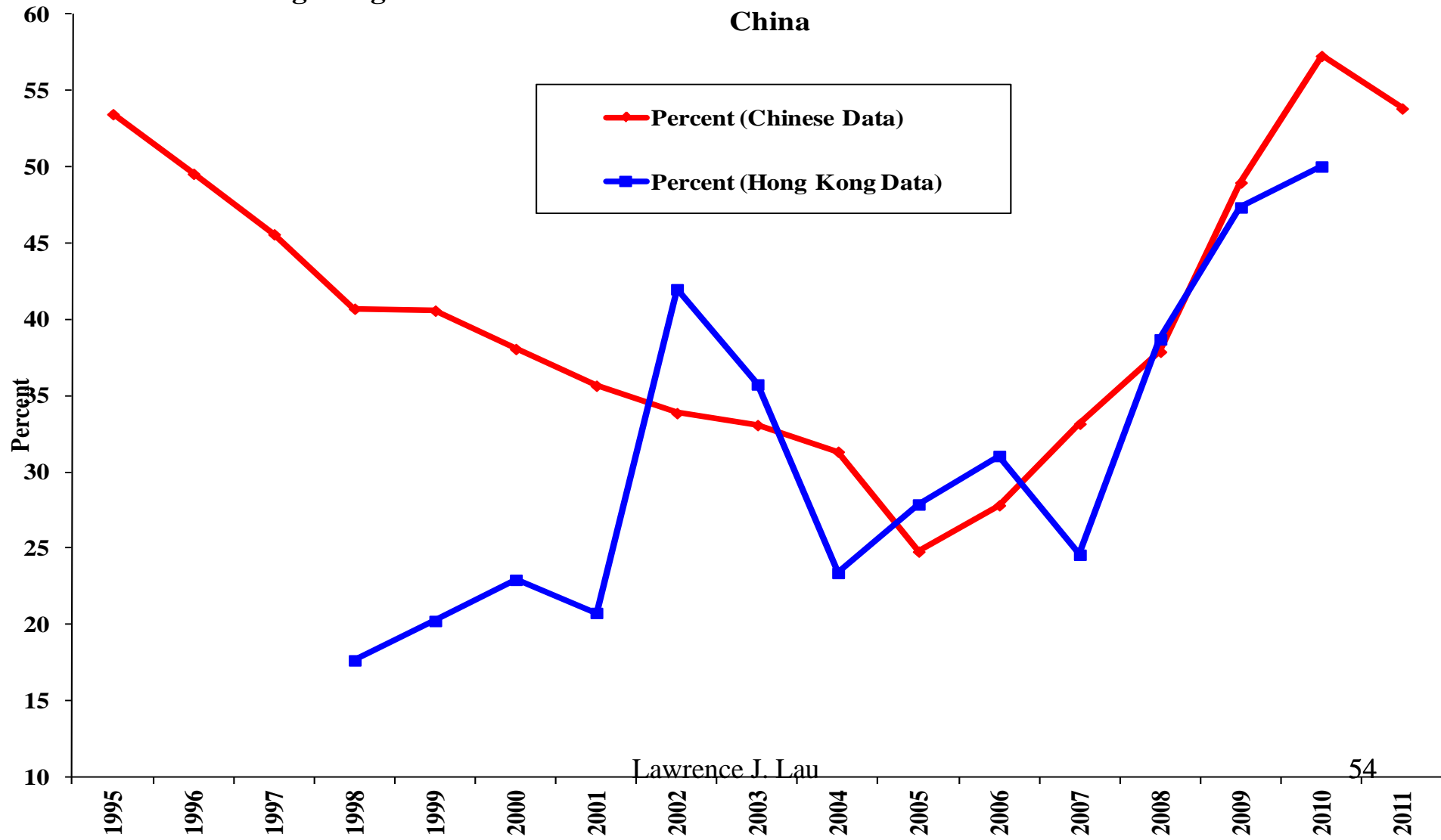
Annual Hong Kong Direct Investment to the Mainland (US\$)

Annual Hong Kong Direct Investment to the Mainland



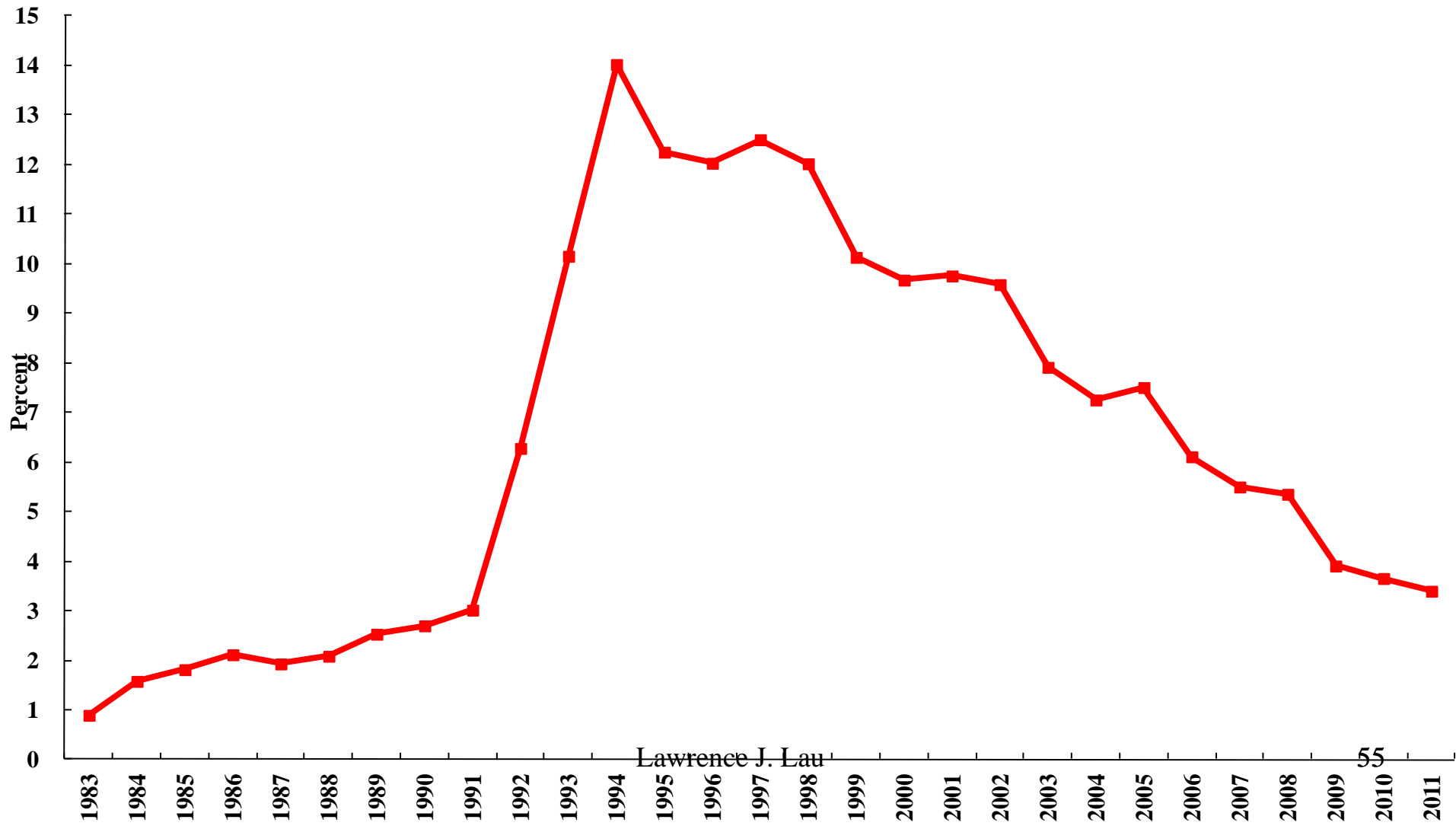
Hong Kong Direct Investment as a Percent of Total Inbound Direct Investment

Hong Kong Direct Investment as a Percent of Total Inbound Direct Investment of China



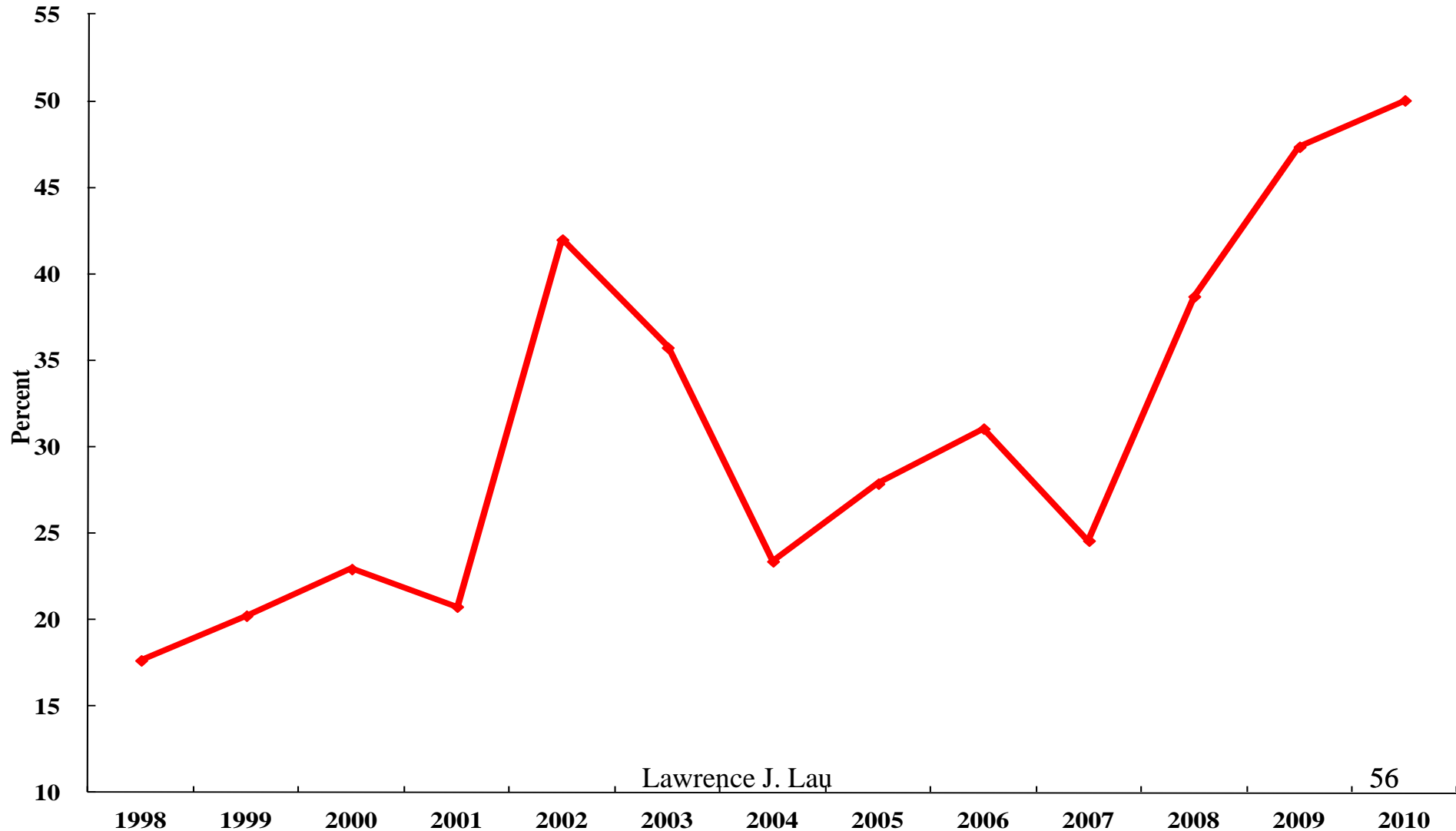
Foreign Direct Investment as a Percent of Total Mainland Domestic Investment

Foreign Direct Investment as a Percent of Total Mainland Domestic Investment



Mainland Investment as a Percent of Total Inbound Direct Investment of Hong Kong

Mainland Investment as a Percent of Total inbound Direct Investment of Hong Kong



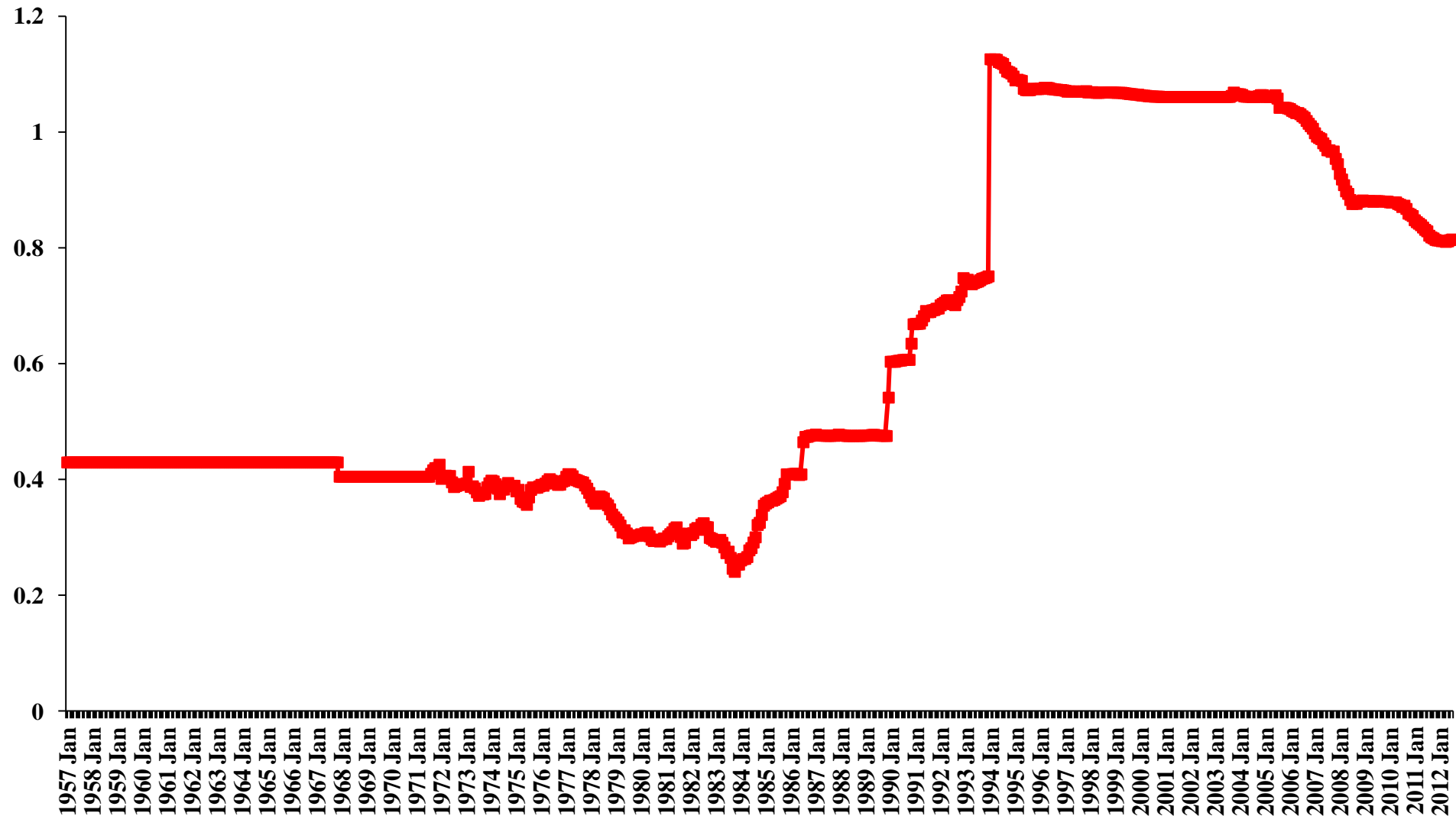
The Yuan-Hong Kong Dollar Exchange Rate

- ◆ 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 less than the Yuan until 1994, when the Yuan became current accounts convertible. The Hong Kong Dollar then became worth more than the Yuan, until the Yuan began to appreciate in mid-2005. The Hong Kong Dollar is now worth approximately 0.80 Yuan.
- ◆ In the long run, the Yuan is expected to continue to rise in value 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 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

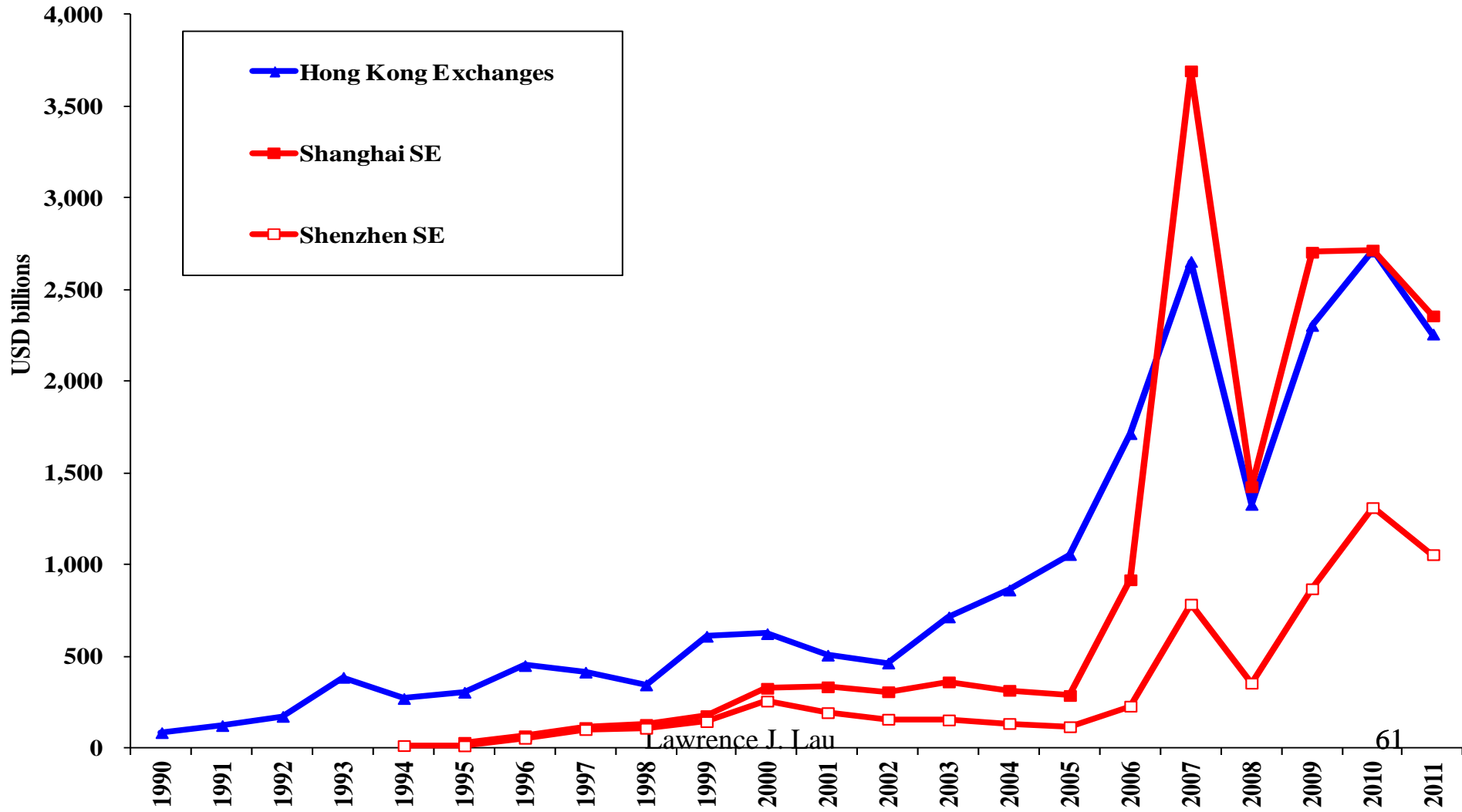
- ◆ Stock exchanges on the Mainland were first established in the early 1990s. In terms of market capitalisation—the total value of all the companies listed on the stock exchange at the prevailing share prices of the market—the Shanghai Stock Exchange alone now exceeds the Hong Kong Stock Exchange.
- ◆ 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 beginning 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. This also helped to bring in foreign exchange, which was needed by the Mainland at the time.

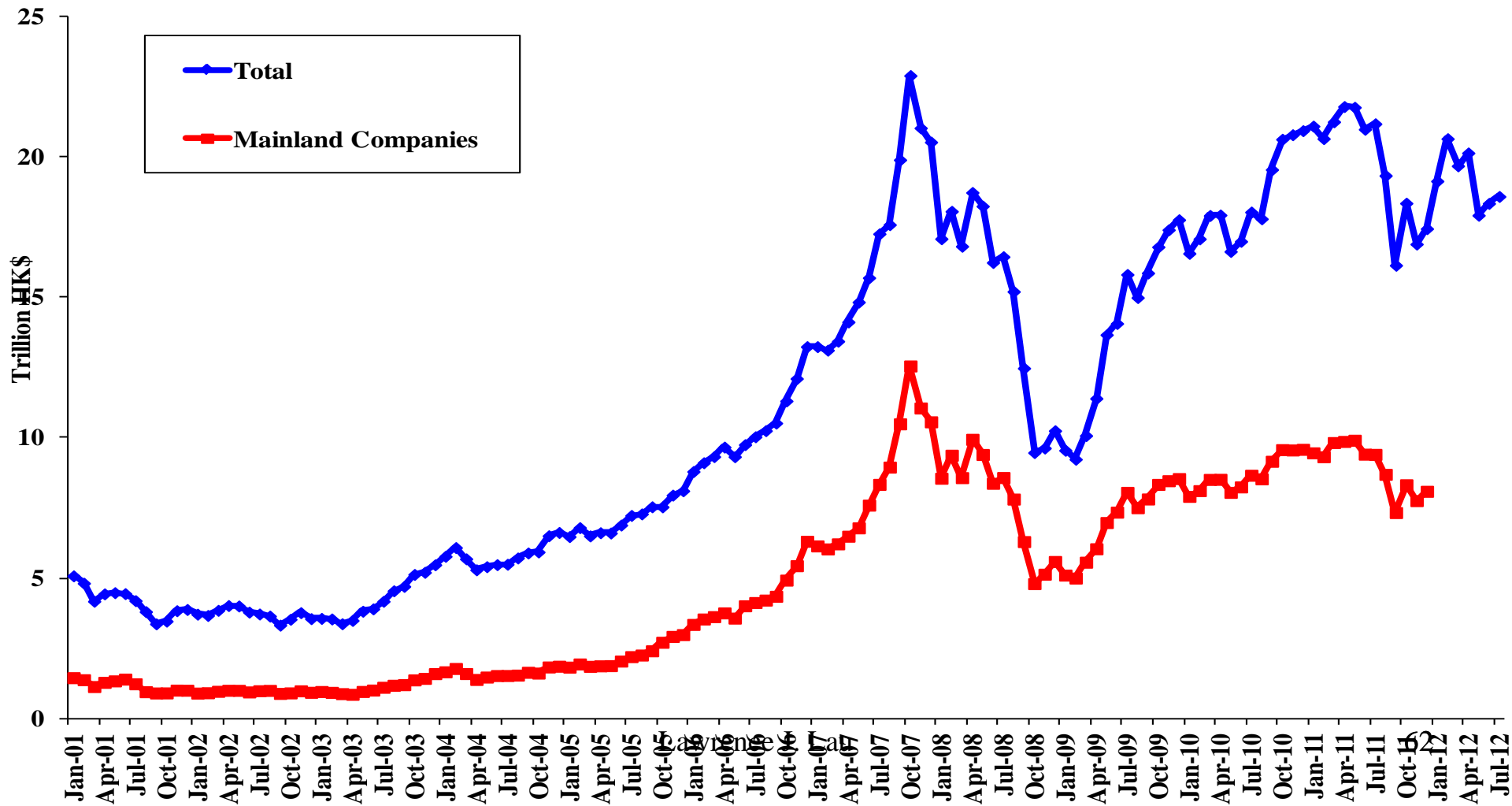
Comparison of Market Capitalisations of Mainland and Hong Kong Stock Exchanges

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



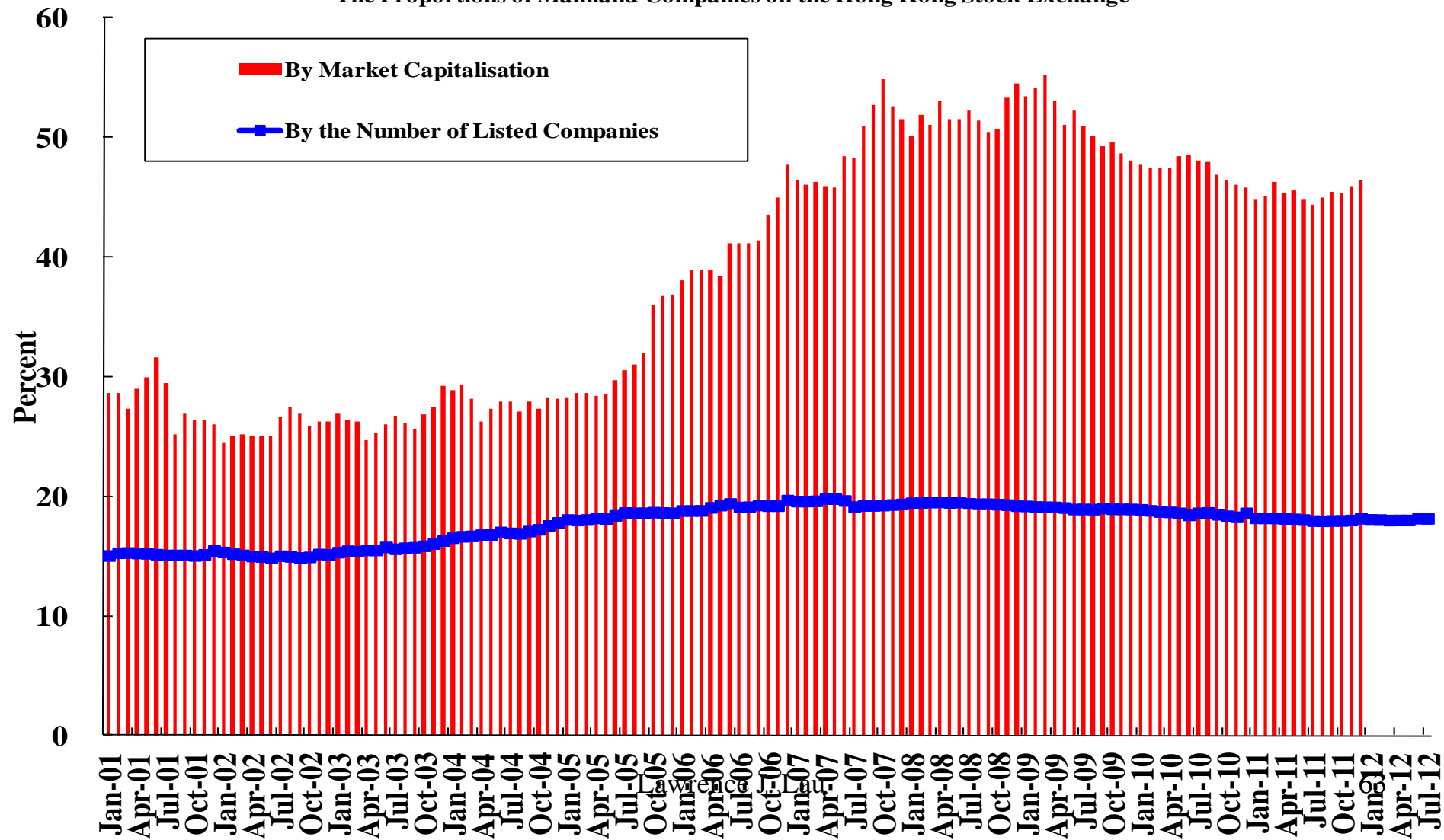
Market Capitalisation of Mainland and All Firms Listed on HKSE

Market Capitalisation of Mainland and All Companies on the Hong Kong Stock Exchange, HK\$ trillions



Market Capitalisation of Mainland and All Firms Listed on HKSE

The Proportions of Mainland Companies on the Hong Kong Stock Exchange

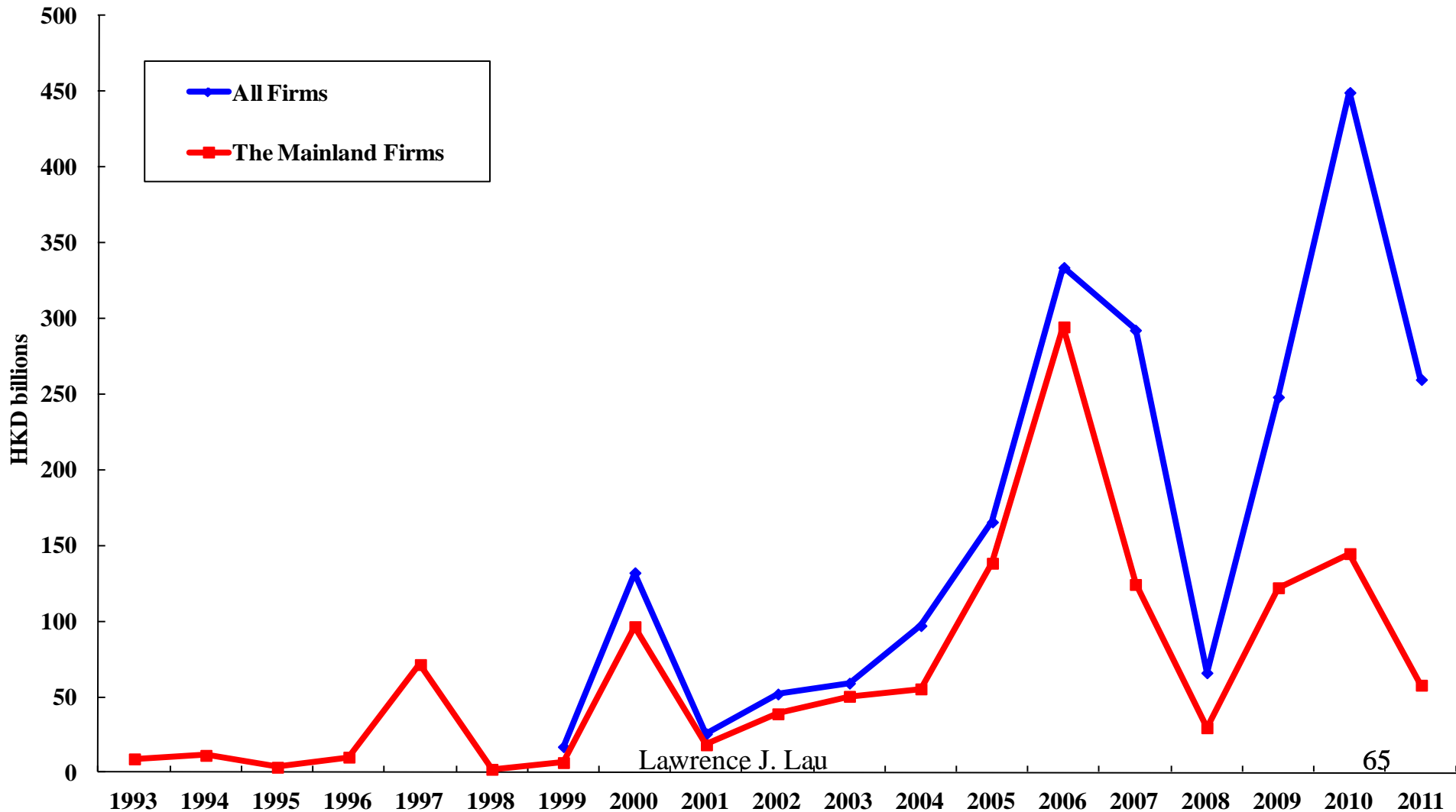


Mainland-Hong Kong Economic Interactions: The Stock Market

- ◆ 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 firms find listing on the Shanghai Stock Exchange much more attractive because there is substantial domestic investor demand and the firms need to raise Renminbi rather than foreign exchange. The Mainland, with foreign exchange reserves exceeding US\$3.2 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.
- ◆ That is 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

- ◆ 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.
- ◆ Hong Kong should capitalise on its geographical position to co-operate closely with Shenzhen, Pearl River Delta, Guangdong and southern China. Hong Kong can compete effectively with Shanghai as an international financial centre 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 Opportunities and Challenges for Hong Kong: Comparative Advantages

- ◆ Hong Kong has the following long-term comparative advantages:
 - ◆ Close international links
 - ◆ Stable exchange rate, full capital mobility and free trade
 - ◆ Low corporate and individual income tax rates
 - ◆ Bilingualism and biculturalism
 - ◆ Rule of law and civil liberties
 - ◆ Proximity to China, a huge market and a huge source of savings
 - ◆ A well-educated labour force
 - ◆ An entrepreneurial environment
 - ◆ Academic freedom and freedom of information
 - ◆ World-class, research-oriented universities
 - ◆ Geographically well located at the junction between Mainland China and the ASEAN region

The Opportunities and Challenges for Hong Kong: Vulnerabilities

- ◆ However, Hong Kong also has the following vulnerabilities:
 - ◆ Volatility of government revenue which depends heavily on land revenue and a narrow tax base
 - ◆ High cost structure for both local and international business, including the cost of land (and hence the costs of office space and housing) and the lack of double-tax agreements (DTAs) which is currently in the process of being corrected
 - ◆ Insufficient support for higher education and for R&D
 - ◆ Local protectionism of many service professions such as the legal and the medical
 - ◆ Lack of a long-term plan and strategy
 - ◆ Lack of unity of purpose (and a sense of urgency)
 - ◆ Declining English proficiency and an increasingly inward-looking mentality

The Opportunities and Challenges for Hong Kong

- ◆ Hong Kong is an ideal place to capitalise on the World's interest in the Chinese economy and other East Asian economies in general. It is an excellent place to learn about China and the Chinese economy.
- ◆ In addition, it has the following advantages as a regional hub:
 - ◆ A non-Chinese speaker can live, study and work in Hong Kong using only English without any problem.
 - ◆ There is complete personal freedom, including academic freedom, in Hong Kong.
 - ◆ There is also complete freedom of access to information—the internet is entirely open and the press is among the freest in the world.
 - ◆ There is also easy access to China and to other parts of East Asia.

The Opportunities and Challenges for Hong Kong

- ◆ Hong Kong will within the next ten 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 a medium of exchange and as a store of value even as the Hong Kong Dollar remains the legal tender 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 centre 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 globalised, 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

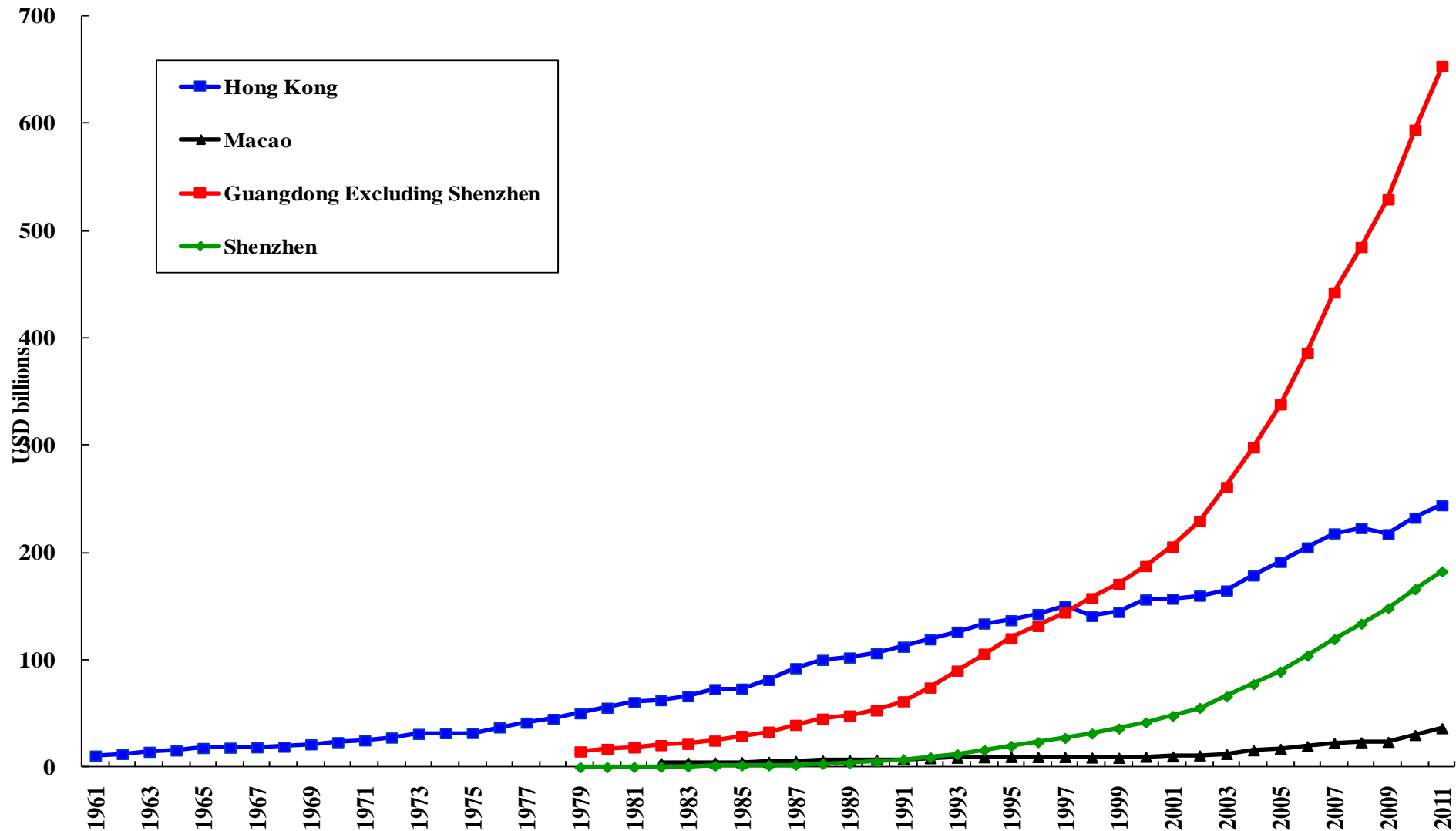
- ◆ Hong Kong's other comparative advantages include the rule of law, effective regulation and supervision, transparency, efficiency, flexibility and adaptability (An insurance and re-insurance centre for the region? An East-Asian wide stock exchange? An international financial center for institutional investors? A center for registration of patents and intellectual property?)
- ◆ At this time, Hong Kong also has the advantage of its reputational capital (also known as goodwill) and should capitalise on it to build a lead especially in retail services, not just in Hong Kong, but also on the Mainland, taking advantage of the Closer Economic Partnership Agreement (CEPA). Taiwan firms such as Kang Shifu, Wang Wang, Tianfu and Giant have been extraordinarily successful in building their brands in Mainland China. Chow Tai Fook of Hong Kong has also been very successful. Other Hong Kong firms should be able to do the same, beginning in Shenzhen and Guangdong.

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).
- ◆ In the transition, policy support from the Hong Kong SAR Government is crucial (e.g., concluding double-tax agreements with foreign tax jurisdictions).

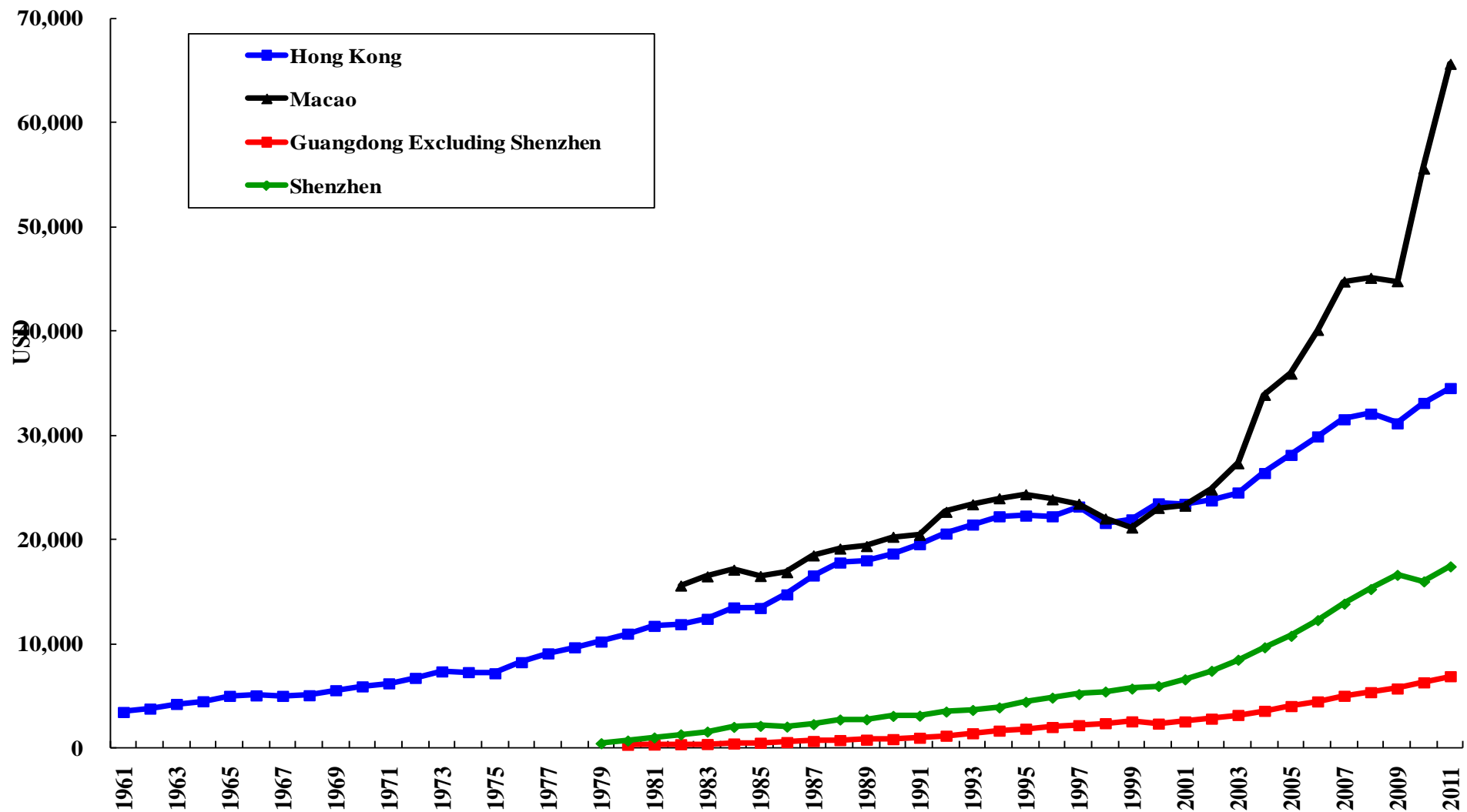
Real GDPs of Hong Kong and Its Neighbouring Economies, billion 2011US\$

Real GDPs of Hong Kong and Its Neighbouring Economies, billion 2011 US\$



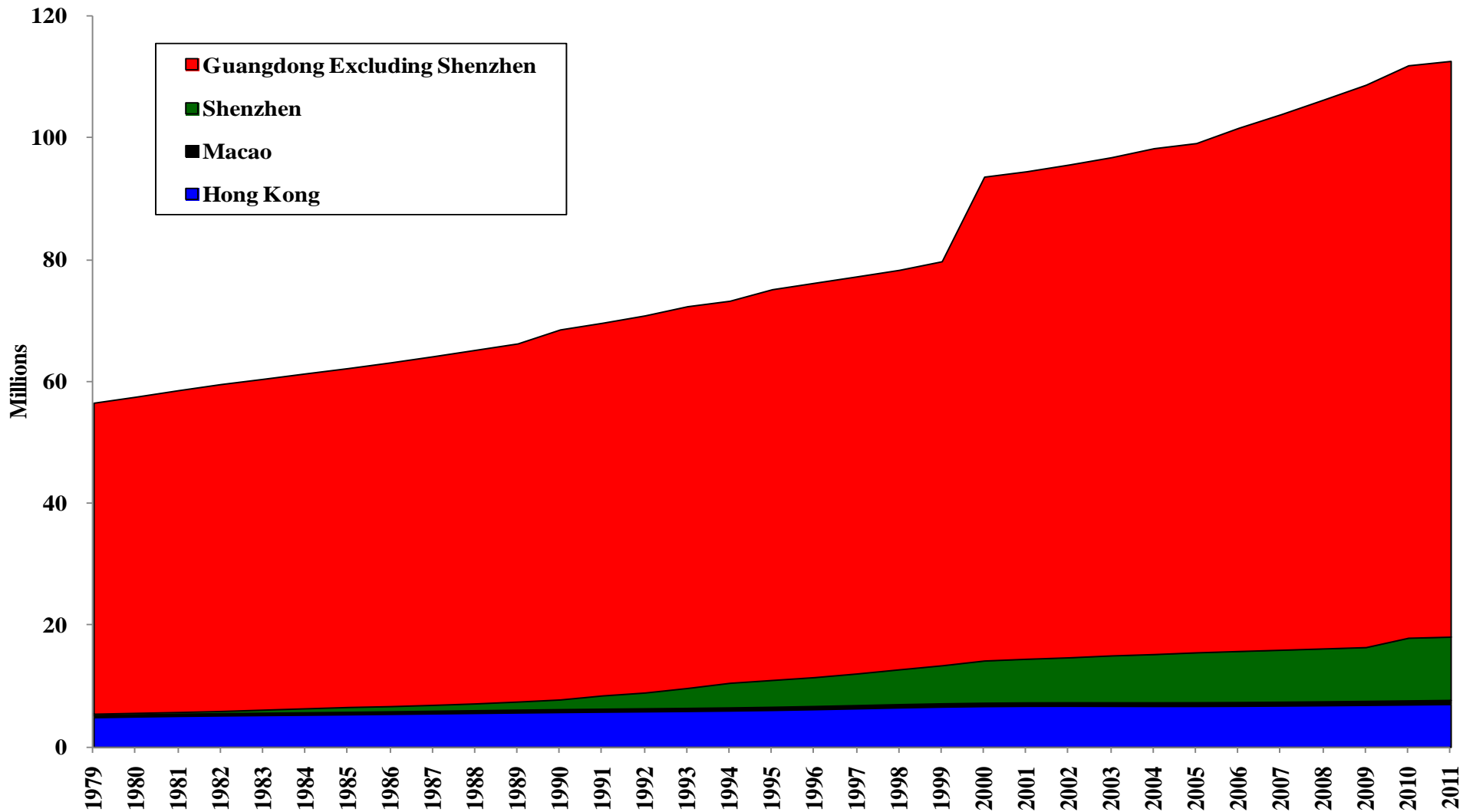
Real GDP-per-Capita's of Hong Kong and Its Neighbouring Economies, 2011 US\$

Real GDP per capita's of Hong Kong and Its Neighbouring Economics, 2011 US\$



Populations of Hong Kong and Its Neighbouring Economies, millions

Populations of Hong Kong and Its Neighbouring Economies, millions



Mainland-Hong Kong Economic Interactions

- ◆ The Pearl River Delta is the natural potential economic hinterland for Hong Kong.
- ◆ The Greater Pearl River Delta Economic Zone, comprising the following 9 municipalities of Guangdong: Dongguan, Foshan, Guangzhou, Huizhou, Jiangmen, Shenzhen, Zhaoqing, Zhongshan and Zhuhai + Hong Kong and Macau, has a GDP of almost US\$400 billion and population over 60 million, constituting a giant metropolitan region linked by high-speed railroads and highways.
- ◆ Hong Kong and Shenzhen will in time become twin cities economically even though not politically.

Mainland-Hong Kong Economic Interactions

- ◆ Guangdong has a permanent population of approximately 95 million, which together with Hong Kong and Macao is as large as Japan and almost half as large as the United States.
- ◆ Guangdong has a GDP in excess of US\$844.6 billion, approximately the same size as Taiwan, and a per capita GDP in excess of US\$7,866.

Mainland-Hong Kong Economic Interactions

- ◆ 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 specialization and division of labor among Hong Kong, Guangdong and Shenzhen, which can be win-win for all.

The Opportunities and Challenges for Hong Kong

- ◆ Pan-Pearl River Delta (9+2), comprising of 9 provinces of Fujian, Jiangxi, Hunan, Guangdong, Guangxi, Hainan, Sichuan, Guizhou and Yunnan + Hong Kong and Macao (with a population over 400 million)
- ◆ East and Southeast Asia (ASEAN and ASEAN + 3). By East Asia, we mean the ASEAN group of countries (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) + 3 (China, Japan and South Korea). China also includes, implicitly, Hong Kong and Macau and Taiwan.

The Opportunities and Challenges for Hong Kong

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

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 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 that the United States and European economies remain mired in recession and unlikely to resume normal growth any time soon.

Concluding Remarks

- ◆ Can Hong Kong continue to be internationally competitive?
 - ◆ Hong Kong needs to re-examine its cost structure, whether with its high land prices, it can remain internationally competitive. It also needs to consider how to avoid the volatility of its government revenue stream going forward—how it can smooth its government revenue and expenditure. This may require a rethink and restructuring of the revenue base.
- ◆ Beyond Renminbi convertibility
 - ◆ With the U.S.\$ likely to devalue over the intermediate to long term, despite its short-term strength, Hong Kong must prepare for the arrival of the full or almost full convertibility of the Renminbi.

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.
- ◆ The Mainland economy will be able to grow at a minimum at 7.5% in 2012 and will grow even faster in 2013. The rate of Mainland Chinese inflation should be below 3% for the whole year of 2012. Hong Kong should be able to grow at least 3% in 2013 on the strength of the Mainland economy.