The Thirteenth Five-Year (2016-2020) Plan and Hong Kong

by

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Abstract: What are the implications of the Thirteenth Five-Year (2016-2020) Plan for Economic and Social Development of China for Hong Kong? While the Plan is mostly indicative even for the Mainland, and certainly not mandatory for Hong Kong, it does express support for Hong Kong to continue to develop as an international financial center (and the leading offshore Renminbi center), a center for innovation and an international legal, arbitration and mediation services center. Moreover, it also supports Hong Kong playing an active role in the "One Belt, One Road" initiative as well as the economic development of the Pearl River Delta region. It is, however, up to Hong Kong itself to devise a plan and a strategy to take advantage of these opportunities, which can be win-win for both the Mainland and Hong Kong.

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According to the just published Draft Outline of the Thirteenth Five-Year (201-2020) Plan for Economic and Social Development of China (the Plan), the average annual real rate of growth of the Mainland economy will slow down from 7.8% in the Twelfth Five-Year (2011-2015) Plan period to over 6.5%, and that of per capita disposable income from 7.7% to also over 6.5%. There is, however, for the first time, no numerical growth target for total international trade, except that it will be optimized by increasing domestic value-added content in exports and both quality and quantity in imports. This may imply little or no growth in the gross value of total exports and a decline in the trade surplus going forward. In fact, total Mainland international trade in goods alone declined 10.4% from US$4.15 trillion to US$3.72 trillion in 2015, even though total trade in goods and services remained essentially unchanged at US$4.67 trillion (see Chart 1). There is also a commitment in the Plan to making orderly progress towards full convertibility of the Renminbi, but without a specific date, which allows the Central Government a great deal of flexibility. In addition, there is also an extensive discussion of the continuing liberalization of both outbound and inbound investment by enterprises and individuals.

Chart 1: Total Mainland Cross-Border Trade in Goods and Services and in Goods Alone, US$ trillions

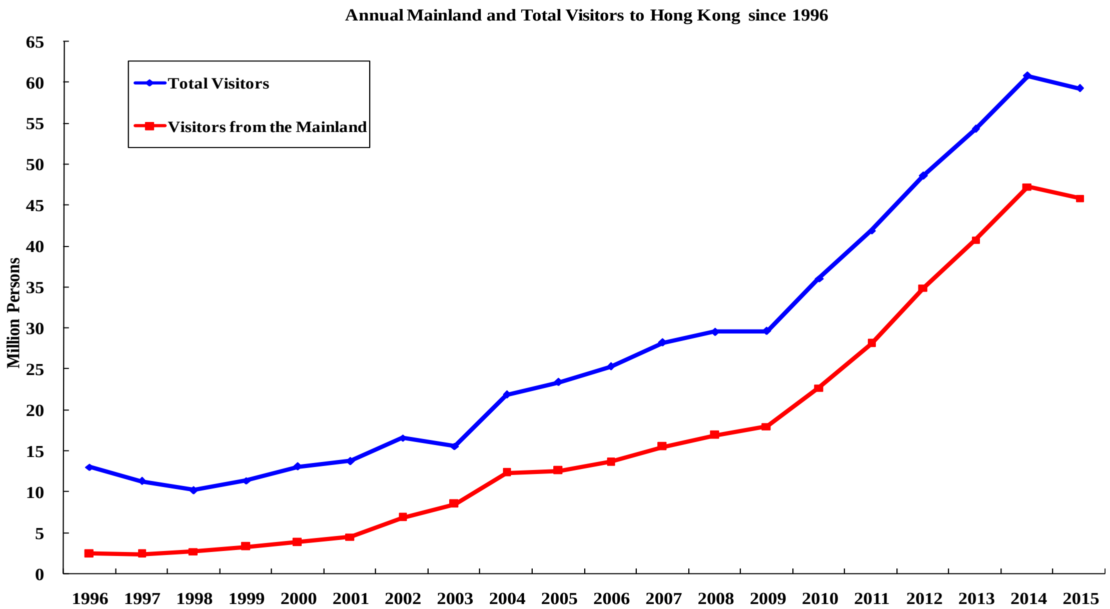
In the Hong Kong and Macau Chapter (Chapter 54) in the Plan, the Central Government reaffirms its general commitment to support Hong Kong and Macau in developing their economies, improving livelihood, advancing democracy and promoting social harmony. More specifically, the Plan indicates support for Hong Kong in: first, consolidating and elevating its position as an international center of finance, transportation and trade; second, developing and nurturing innovation and science and technology; and third, becoming an international legal, arbitration and mediation services center. The Plan also indicates continuing support for Hong Kong as the leading off-shore Renminbi center and an international asset management center, and in increasing the value-added in sectors such as finance, trade, logistics and professional services. Two other ideas that are mentioned are the "One Belt, One Road (OBOR)" initiative and the Pearl River Delta (PRD) regions (both the Greater PRD region which includes Guangzhou, Shenzhen, Hong Kong and Macau and all the area in between, and Pan PRD region which includes other provinces and autonomous districts in southern China). However, tourism from the Mainland to Hong Kong is no longer mentioned in the Chapter, even though total Chinese trade in services, which includes tourism as a major component, is expected to grow from US$713 billion in 2015 to over US$1 trillion in 2020.

What implications does the Plan have for Hong Kong? The slowdown in the rates of growth of both GDP and international trade means a potential reduction of demands from the Mainland for Hong Kong goods, services such as shipping, transportation, logistics, retail and tourism, and assets (including stocks and real estate). The potential reductions in the Mainland tariff and non-tariff barriers to imports and the progress towards full convertibility of the Renminbi also chip away at the two principal competitive advantages of Hong Kong over the Mainland: namely, essentially zero import tariff rates and completely free capital flows.

Tourism is an important pillar industry for the economy of Hong Kong. It generates a large number of low-skilled jobs in entertainment, lodging, restaurants, retail and transportation and is the principal reason why the unemployment rate has remained low in Hong Kong. The Mainland is the most important source of tourists for Hong Kong. The annual number of Mainland tourists was only 6.83 million in 2002. In 2003, in response to requests from the Government of the Hong Kong SAR, which was then suffering from an economic recession caused by the SARS crisis, the "Individual Visit Scheme" was introduced and expanded. The annual number of

Mainland tourists began to rise rapidly to 17.96 million in 2009. Then in 2009, again in response to the requests from the Government of the Hong Kong SAR, which was once again suffering from an economic recession caused by the global financial crisis, the rate of growth of the number of Mainland tourists was allowed to accelerate. The total annual number reached a peak of around 47.25 million in 2014 However, after the anti-corruption campaign was introduced on the Mainland in November, 2013, gift-giving to and gift-acceptance by government officials are no longer allowed. This no-gift rule has had a large negative impact on the retail purchases of high-end luxury goods by Mainland tourists to Hong Kong. Moreover, for various reasons, Mainland tourists nowadays feel unsafe and unwelcome in Hong Kong. As a result, the annual number has already begun to decline (see Chart 2).

Chart 2: Number of Total and Mainland Visitors to Hong Kong since 1996



All of this means that Hong Kong cannot expect to continue to prosper by doing “business as usual”. Hong Kong needs to re-invent itself. However, as the Plan for Hong Kong is only a list of intentions, it is up to the people of Hong Kong to work together to develop a consensual vision and implementable strategies.

Hong Kong as an International Financial Center

Against this backdrop, what is the future of Hong Kong as an international financial center? It is still entirely possible for Hong Kong to eventually surpass New York to become the leading international financial center of the whole World. Hong Kong can establish itself as the securities (both bonds and stocks) market for the entire East Asian region, so that all East Asian, not just Chinese, enterprises and governments can come to Hong Kong to raise capital and issue equity and debt, and investors worldwide, including asset managers, investment and pension funds and institutions, only need to come to Hong Kong to invest in all of the East Asian economies, in bonds, stocks and private equity (including venture capital). Historically, Hong Kong has always been regarded as a "safe haven" for parking their capital by residents in Southeast Asian countries in times of turmoil. They are likely to find the idea of an East Asia-wide securities market in Hong Kong hospitable.

The securities can be denominated in U.S. Dollars or Renminbi (or even in the local currencies of the individual East Asian economies) and traded in either U.S. Dollars or the Renminbi. The non-Hong Kong stocks will be listed and traded in Hong Kong in the form of Hong Kong Depositary Receipts (HDRs) as a secondary listing. The basic idea is to have all of the major East Asian blue-chip stocks such as China Mobile, Toyota, Samsung, TSMC, San Miguel, Siam Cement, Indo Foods list and trade in Hong Kong. Both the Shanghai-Hong Kong Connect, under which investors in Shanghai can invest directly in the Hong Kong market and vice versa, and the forthcoming similar Shenzhen-Hong Kong Connect, should help in increasing the liquidity of and the number of potential investors in the Hong Kong market.

Hong Kong must also work hard to develop an active, deep and liquid bond market for both short and long maturities, which it has never had. One way to get the process started is to have the Hong Kong Mortgage Corporation Limited issue long-term fixed-rate bonds (for example, 35-year bonds), the proceeds of which are used to purchase qualified owner-occupied residential mortgage loans originated by commercial banks in Hong Kong. Insurance companies and pension funds are dying to buy such long-term bonds issued by the Hong Kong Mortgage Corporation which should have a quasi-sovereign rating that is as good as Hong Kong's. Such long-term fixed-rate bonds can help to make residential housing much more affordable in Hong Kong both because of its longer maturity and lower rates due to the Hong Kong Mortgage Corporation Limited's quasi-sovereign rating.

The successful creation of a deep and wide East Asian securities market will attract global and regional financial institutions to establish their headquarters in Hong Kong, further cementing Hong Kong's position as a premiere international financial center. The Asian Infrastructural Investment Bank (AIIB), the China Development Bank, and the New Development Bank BRICS (also known as the BRICS Development Bank) can also establish branch operations in Hong Kong to facilitate their financing activities for Chinese and foreign borrowers. In addition, they can also raise additional capital by issuing long-term bonds in Hong Kong. A deep and wide East Asian securities market will also encourage major multinational financial and non-financial corporations to set up their treasury operations here. However, the Hong Kong regulatory and tax frameworks for financial institutions and asset management companies must be updated to reflect the multinational nature of these businesses so as to avoid disadvantaging a company that establishes its global or regional headquarters and/or conduct its treasury operations in Hong Kong.

Hong Kong, by serving as the international financial center for East Asian economies, will achieve a suitable division of labor with Shanghai, which can serve as the international financial center for the Mainland. The two cities can specialize in accordance with their relative comparative advantages and cooperate rather than compete with each other. For this strategy to succeed, it requires a pro-active HKSAR government to plan long-term and to rally everyone in Hong Kong, including its major corporations, to work together to make it happen. It will also require the support of the Chinese Central Government, not only because the Mainland investors will be supplying much of the investment funds but because the Chinese Central Government can also help to persuade the governments of other East Asian economies to come along. Hong Kong is currently by far the largest and most active offshore center for Renminbi clearing, settlement, transactions and financing, with average daily volume of transactions approaching 1 trillion Yuan. It is likely to continue to be so. And this is a huge advantage of Hong Kong as the Renminbi becomes increasingly internationalized. Once Hong Kong is established as the home of the East Asia-wide securities market, it will be almost impossible for Hong Kong to be displaced or replaced.

Hong Kong can also become the re-insurance center for the East Asian region. As the demands for property, casualty and life insurance increase by leaps and bounds in East Asia, so do the derivative demands for re-insurance. East Asia has now grown sufficiently to realize the economies of scale of re-insurance on its own. There is therefore no reason to continue to let most of the re-insurance business go to London and Zurich. Hong Kong, because of its complete freedom of capital flows, its stable currency, its tradition of rule of law, its efficient and fair judicial system, and its large supply of accounting, actuarial, legal and other professionals, is an ideal place to become the East Asian re-insurance center. In addition, the Mainland and other East Asian economies are potentially major sources of risk capital for the re-insurance business. Moreover, once Hong Kong can establish itself as an international re-insurance center, insurance companies worldwide will also come to Hong Kong for part of their re-insurance to diversify their risks.

Hong Kong can also be a springboard for outbound Chinese direct investment because of its international links and highly developed professional services sector. The Hong Kong capital market can also provide Chinese enterprises the ability to use “natural” hedges for their outbound foreign direct investments (by, for example, borrowing the foreign currency in Hong Kong to fund the outbound investment and thus matching the foreign-currency assets with foreign-currency liabilities).

Hong Kong as a Center for Innovation

Hong Kong can also develop into a center of innovation for the East Asian region. This will involve a three-pronged complementary approach: increasing investment in human capital, specifically in tertiary education; increasing investment in research and development (R&D); and creating a nurturing eco-system for venture capital. Hong Kong must increase its tertiary education (bachelor degree) enrolment rate substantially from its current 20 plus percent. By comparison, the enrolment rate for the Mainland is 30 percent, for South Korea is over 90 percent, and for Taiwan it is over 100 percent[2]. Hong Kong must also increase its investment in R&D, which is indispensable for innovation, very significantly. Currently Hong Kong invests less than 0.8% of its GDP in R&D annually, compared to 2.1% for the Mainland, around 3% for the U.S. and Japan, and over 4% for Shenzhen, Israel, South Korea and Taiwan. It is not necessary for the Government of the HKSAR to bear the

[2] It can be over 100 percent because there are students who are enrolled successively in two bachelor degree programs.

entire cost itself, but it should encourage and facilitate the private and non-profit sectors to invest in R&D through its land and tax policies. Similarly, Hong Kong should also provide the appropriate incentives to private equity and venture capital firms and facilitate the listing of successful start-up firms on the Hong Kong stock exchanges.

However, innovation, whether it is the invention of a new product, a new service, or a new process, has significant fixed costs, which can be better and more readily amortized in a large potential market. That is why access to and freedom to serve the huge Mainland market are critical to the success of Hong Kong as an East Asian innovation hub. Hong Kong inventions must be patented on the Mainland as well as in the U.S. in order to realize their full value. In addition to being a market, the Mainland can also serve as a manufacturing base for Hong Kong inventions. Da-Jiang Innovations Science and Technology Co., Ltd. (DJI), a start-up aerial photography firm founded in 2006, typifies this approach: developing the products in Hong Kong, manufacturing them in Shenzhen, and selling them in the Mainland and the entire World. DJI is now the World's leading designer and manufacturer of drones.

As a center of innovation, Hong Kong must also strengthen its intellectual property (including copyright) protection, so as to protect not only scientific and technological innovations but also to encourage the development and commercialization of creative arts such as books, designs, dramas, fashions, films, music, paintings, sculptures, etc.

The Mainland has made enormous progress in the generation of new inventions in recent years. In 2014, the Mainland granted 162,680 patents for invention to applicants within the Mainland, the second highest number of domestic patents granted in the World, compared to the 177,750 domestic patents granted by Japan, which came in second (the U.S. was third, with 144,621 domestic patents). In 2015, the number of Mainland domestic patents increased by almost 60 percent to 256,000, the highest number in the World. The Mainland has now established special national intellectual property courts in Beijing, Shanghai and Guangzhou to deal exclusively with such cases. It behooves Hong Kong to enter into an agreement with the Mainland patent authorities for reciprocal recognition of patents (and failing that for reciprocal expedited application of inventions with each other's patents). Without access to the Mainland market, Hong Kong innovations are unlikely to become commercial successes. But access to the Mainland market is useless unless there is Mainland patent protection. If Hong Kong can obtain reciprocal recognition for its patents with the Mainland, it will greatly benefit inventors and innovators in Hong Kong by facilitating their entry into the huge Mainland domestic market. It may even be able to attract foreign inventors to apply for patents in Hong Kong so as to secure protection on the Mainland. It will also be a boon for the platform developed by the Hong Kong Trade Development Council for the trading of patent rights in Hong Kong, which has thus far attracted 15,000 users.

Hong Kong as an International Law, Arbitration and Mediation Center

Hong Kong has always been and continues to be a common-law jurisdiction. Because of its long tradition of rule of law, its efficient and fair judicial system, and its abundance of professional legal manpower, Hong Kong can be used as a center for international legal, arbitration, dispute mediation and settlement services. It can also provide the necessary accounting, legal and other services, and the infrastructural support for Chinese enterprises investing abroad (through their Hong Kong subsidiaries) and foreign enterprises investing in the Mainland as well as the clients and customers, both Chinese and foreign, of the proposed East Asia-wide securities market.

The "One Belt, One Road (OBOR)" Initiative

The "OBOR" initiative, and its affiliated projects (including the Asian Infrastructural Investment Bank (AIIB), the New Development Bank BRICS (also known as the BRICS Development Bank) and the Silk Road Fund), involves 66 countries with a combined population of 4.4 billion people and a combined GDP of US$21 trillion, and is expected to take several decades to complete. Hong Kong can provide the platform for the financing of equity and debt, both public and private, of "OBOR" projects as well as a secondary market for these securities. It can also supply accounting and legal, including arbitration and mediation services. Moreover, since many countries on the Belt and Road, from Azerbaijan and Bangladesh to Turkey and Uzbekistan are Islamic, Hong Kong can further develop into an international center for "Sukuk" or "Sharia (Islamic Law)-compliant" bonds, which are the only debt-like instruments that can be used by Islamic countries. The establishment of an East Asia-wide securities market in Hong Kong also fits in with the "OBOR" initiative. The Government of the HKSAR has already been actively pursuing double-tax agreements with "OBOR" countries. Furthermore, one ultimate objective of the "OBOR" initiative is to try to integrate Asia and Europe into one large integrated market. The Belt and Road will play the same role for Eurasia as the trans-continental railroad for the U.S. in the Nineteenth Century, linking the Pacific and the Atlantic, spurring economic development along the way. One terminus of the Belt and Road is Europe. Hong Kong, with its long tradition of close economic relations with Europe, can also play an important role in involving European businesses in the "OBOR" initiative.

Pearl River Delta Economic Cooperation

The core of both the Greater PRD region and the Pan PRD region is the Province of Guangdong (including Shenzhen) and also Hong Kong and Macau. Economically, Guangdong, Shenzhen, Hong Kong and Macau are complementary to one another. Together they have a combined population of 116.5 million, more than Germany (81.5 million) and only 10 percent less than Japan (126.88 million), and a combined GDP of US$1.44 trillion in 2015. Given the rapid rates of economic growth of Guangdong and Shenzhen, and the economic stagnation of Japan, they constitute a region with the potential of eventually surpassing Japan to become the third largest economy in the World in a couple of decades.

In order for this four-way economic cooperation to be successful, it is necessary to promote the free flow of goods and services, people and capital among them. The plan for a Guangdong-Shenzhen-Hong Kong-Macau Pilot Free Trade Zone should be actively pursued and developed. Goods and services should flow freely within the Pilot Free Trade Zone. Once a good is imported, it can be shipped to anywhere within the Zone without any further tariff or inspection. The freer flow of people can be achieved through the simplification of entry/exit and customs formalities and the mutual selective recognition of academic degrees and professional qualifications. The free flow of capital within the Pilot Free Trade Zone will require some restrictions on both the inbound and outbound capital flows between the Pilot Free Trade Zone and the rest of the Mainland.

Concluding Remarks

The success of the strategies described above depends critically on the support of the Central Government. However, Hong Kong must also do its own part in devising implementable plans and strategies and requesting assistance and support from the Central Government on the basis that these initiatives are win-win. It is up to Hong Kong to make itself indispensable once again, as it was during the early days of the Chinese economic reform and opening to the World.