



**Riding on Mainland's Economic Development
in a New Era**

by

Liu Pak Wai, Kit-Chun Joanna Lam and Kenny Shui

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Executive Summary

Hong Kong as a Small Open Economy

1. Hong Kong, Ireland, Israel, Luxembourg, Singapore, Sweden and Switzerland are some examples of successful small economies. These seven economies are different in their economic characteristics but they share some common factors for their economic success – they are open economies.
2. Small economies need to be open in order to be successful economically. Economies of scale lower the average cost of production but large scale production is economical only if there is sufficient final demand for the output. The domestic demand of small economies is usually too small to support large scale domestic production. However, foreign demand can make up for the deficiency.
3. In fact, openness is essential to growth for economies of all sizes. Medium to large economies also have to be open to international trade and investment in order to maintain their economic growth, even though in comparative terms, they depend less on openness than the small economies.
4. The seven economies mentioned earlier illustrate several economic models that a small economy can follow, in order to maintain economic growth and a high living standard. Hong Kong as well as Singapore can continue to follow its current model with extremely high openness in trade, investments and financial services, or follow Luxembourg to focus and develop almost exclusively its financial service industry. It can follow the strategy of Israel, Ireland and Sweden to establish and enhance its technology and innovation industries. It can also choose to follow the path taken by Switzerland to have both financial services and technology as pillar industries.
5. No matter which direction is chosen, the economic relationship of Hong Kong and China is indivisible:
 - i. Mainland China is the largest trading partner of Hong Kong; the performance of Hong Kong's trading industry depends on the production and demand of Mainland China.
 - ii. To further develop its financial services, Hong Kong can take advantage of the

opportunities of intermediating the increasing savings and wealth of the Mainland and the internationalisation of its currency.

- iii. To develop the technology innovations, Mainland China can be the hinterland to resolve the problem of land shortage in Hong Kong and the market for the industrial, business and consumer demand for innovative products and services.
6. Hong Kong must continue to be very open to the world to remain successful and to stay ahead in competitiveness. What Hong Kong people should not do is to turn inward-looking, to ward off outsiders and to lure ourselves into believing that we can grow our economy in isolation because that will lead Hong Kong down the road of decline.

Economic Interdependence of Hong Kong and Mainland China Over Time

7. Mainland China has played an important role in various aspects of the economic development of Hong Kong:
- i. Mainland China has long been a major supplier of Hong Kong's imports in foodstuff, water and basic necessities. After the reform and opening up, Mainland's share of Hong Kong merchandise exports, which were mainly re-exports, rose rapidly to 54% in 2015. Mainland China also takes up the largest share in Hong Kong's export and import of services.
 - ii. Mainland China is both a major destination of Hong Kong's outward direct investment (ODI) and an important source of its inward foreign direct investment (FDI). In addition, Mainland China is a major contributor to Hong Kong's internationally recognised stock market. Mainland enterprises took the largest share of Hong Kong's IPO fund raising, constituting 92% of the IPOs in 2015. Trading in Hong Kong's stock market is increasingly dominated by trading in shares of listed Mainland enterprises. From 1997 to 2015, the share of Mainland enterprises' trading turnover in the total annual trading turnover of Hong Kong's stock market nearly doubled, from 38% to 73%. Moreover, Hong Kong capitalises on the opportunities arising from China's national policy of internationalising the Renminbi and establishes itself as the leading offshore Renminbi centre.

iii. Mainland China has always been the major source of immigrants for Hong Kong. Mainland talents come to Hong Kong as a supplement to its human capital stock and to diversify its labour supply.

8. Hong Kong has played a critical role in helping Mainland China go global at different stages of its development. Historically, Hong Kong has long been a bridge between the Chinese market and the international market. It has been a stepping stone for Mainland enterprises going overseas, as well as a conduit for foreign investment entering Mainland China.

9. However, times have changed: the overall importance of Hong Kong to Mainland China has been declining gradually since the 1990s. The relative size of the two economies changes as Mainland China grows rapidly to become the second largest economy in the world. The ratio of Hong Kong's GDP to Mainland China's GDP dropped sharply from 24% in 1994 to below 3% in 2015. Hong Kong's share of Mainland's external trade has also dwindled as China becomes the largest trading nation in the world. The share of Hong Kong in Mainland China's total merchandise trade peaked in 1992 at 49% and dropped to 12.8% in 2015. Nevertheless, Hong Kong remains important to the Mainland as China opens up its capital account, internationalises its currency and further integrates its economy with the global economy.

10. In view of these changes, Hong Kong should look for opportunities to get strategically connected with Mainland China again to try to play a significant role in its next phase of development. Hong Kong should position itself to become a relevant and significant partner of Mainland China as it enters a new era of economic growth to share the benefits of its growth.

Economic Growth and the Mainland China Factor

11. A set of supply, demand and industry-specific policies are proposed on the following premises buttressed by our historical and contemporary success experience:

- i. Hong Kong has a very open economy and its continual success depends on its remaining open; inward-looking and isolationist tendencies will emaciate the economy;

- ii. Hong Kong must remain friendly and welcoming to its trading partners, overseas investors and visitors;
- iii. Hong Kong has a small economy; its economic fortune inevitably rises and falls with its largest trading partner and investor, Mainland China;
- iv. Hong Kong must manage well its economic inter-dependent relationship with the Mainland; while leveraging on the Mainland economy for its own economic benefits, Hong Kong must remain relevant and a valuable asset to the Mainland for the win-win relationship to be sustainable.

Whither Hong Kong's External Trade

12. As China restructures its economy towards relying on internal demand as the driving force in economic growth and places more emphasis on the development of the tertiary sector, it is expected that the growth rate in China's merchandise exports will slow down. Inevitably Hong Kong's merchandise exports (which depend heavily on re-exports to and from the Mainland) and export-related industries like transport and logistics will also experience slow growth rate in the coming years.

13. As a small open economy, a balance in trade is important to Hong Kong. Hong Kong has been continuously running a deficit in merchandise trade which has been by and large offset by a surplus in trade in services. Since 2012 Hong Kong's surplus in services trade with respect to Mainland China has grown. Hong Kong must re-orient to the "New Normal" and focus more on trade in services with the Mainland for economic growth and employment.

14. The rising urban population and household income will continue to contribute to the rapid growth in the demand for high-value products and services in Mainland China. Hong Kong is a service-oriented economy with the services sector contributing to 92.7% of GDP. With the long-standing trading partnership with Mainland China, Hong Kong can seize the opportunity to provide high-value services for Mainland China:

- i. High-end tourism:

In order to bring more economic benefits and impose less stress on the infrastructure, Hong Kong's tourism industry should move up the high-value

added ladder. Apart from recreational travel, Hong Kong is well-equipped to develop high-end tourism, such as medical and beauty care tourism, cruise travel and meetings, incentives, conferencing and exhibitions tourism (MICE).

(a) Medical Tourism

- In view of the increasing spending power in Mainland China on the one hand, and population ageing and the one-child policy on the other, there will be a rising demand of the Mainland urban population for quality medical care and services.
- In developing medical tourism, the adverse impact on the medical services for local residents should be minimised and a balance must be struck between providing medical services for local people and catering for medical tourists. Therefore, medical services provided for foreign patients are recommended initially to be in areas where there is surplus capacity, for example, physical check-up services and follow-ups offered by private clinics and hospitals.

(b) Beauty Care Tourism

- The demand for beauty care services in Mainland China is rising. The average annual growth rate of Mainland China's beauty care services was 20% in the past five years by 2013. Besides traditional facial or body treatments by hand, technologies-assisted beauty care will probably be the future trend in Hong Kong. Consumers tend to associate hi-tech beauty instruments, such as ultrasound and nano ion, with high quality and good results, and they are willing to pay a higher price for better performance.

(c) Cruise Tourism

- Mainland China's annual passenger growth rate from 2012 to 2014 was 79%, the highest among Asian markets. The facilities in the Kai Tak Cruise Terminal greatly increase Hong Kong's capacity to receive cruise passengers.
- As the transportation hub of Asia and Asia's top travel destination,

Hong Kong can serve as a home port or port of call in cruise tours. Besides short cruises, following the Belt and Road strategy, cruise tourism can also be encouraged by extending cruise journeys to countries along the Maritime Silk Road.

(d) Meetings, Incentives, Conferencing and Exhibitions Tourism (MICE)

- With the growing demand for exhibitions in Mainland China, Hong Kong should attract Mainland China's exhibitors and organisers to come and participate in international exhibitions in Hong Kong. Taking advantage of its close geographical location, and the bi-literate and tri-lingual environment, Hong Kong can act as a window for Mainland China's enterprises to go global and meet worldwide potential customers.
- However, in developing as a city for MICE, Hong Kong will be facing competitions from other Asian countries, such as Singapore and South Korea. Therefore, a long-term development plan for MICE should be set up by the Government, for example, to further enhance the business facilities around exhibition venues, especially the Asia World-Expo (AWE).

ii. Professional services:

Besides providing direct professional services for Mainland clients, Hong Kong can assume the role of middleman in bridging Mainland China producers and consumers to the rest of the world (for example, through providing consulting, market research, talents hunting and legal support services). Hong Kong can offer support for parties involved in the Belt and Road projects in arbitration, financing and insurance services. It can help Mainland China's enterprises improve their service quality through professional training and quality accreditation. Moreover, Hong Kong can be the support centre for those professional services that are being provided in Mainland China through CEPA arrangements. Hong Kong SAR Government should encourage Hong Kong service providers to relocate or outsource part of their business in Mainland China to Hong Kong. Being the back-end support centre, employment

opportunities can be generated in Hong Kong so that the economic benefits brought by CEPA can be further extended to a wider range of beneficiaries in Hong Kong.

iii. Film and Audiovisual services:

The box office revenue of the Mainland China film market is growing rapidly. Through co-production films, Hong Kong filmmakers have contributed a lot to the flourishing of Mainland China's film market. We should further strengthen the policy for nurturing Hong Kong filmmakers and other relevant professionals, to enable them to continue to actively take part in the Mainland China's market.

iv. Financial services:

In 2014, Mainland China only contributed to 7% of Hong Kong's total exports of financial services (excl. FISIM), while U.S. and U.K. contributed to 31% and 21% respectively. There remains considerable room for Hong Kong to further expand the financial services exports to Mainland China.

Hong Kong as a Gateway for Two-Way Capital Flow

15. From its humble beginning of a Pearl River Delta port that finances the entrepot trade of South China and intermediates the remittances from overseas Chinese to their relatives in their home villages in China, Hong Kong has grown into a premier international financial centre. The increasing global reach of its financial centre is expected as Hong Kong positions itself as a small open economy.

16. Hong Kong has many unique strengths as an international financial centre. Unlike any Mainland Chinese city, its capital market is completely open with unrestricted flow of funds. The Linked Exchange Rate System enables market participants to minimise exchange risk in holding the currency. Its profit tax rate is low and there is no capital gain tax and estate tax, making it an attractive jurisdiction for asset management. Hong Kong is 7 hours and 12 hours respectively ahead of London and New York, allowing trading before these markets open. It has a bilingual culture with a common law tradition which is the dominant legal framework for international financial markets. Hong Kong is a suitable gateway to Mainland China for the West and to the West for Mainland China in capital flow.

17. Hong Kong has been a major source of inward foreign direct investment for the Mainland and a major destination of its outward direct investment. As a gateway for a two-way flow of capital, Hong Kong can be an international financial centre for the intermediation of Mainland China's enormous savings and wealth. Given a high saving rate and persistent balance of trade surplus for decades, China has accumulated a huge foreign exchange reserve. It has become a net exporter of capital in 2015. Chinese enterprises and investors are starting to look for investment opportunities overseas to deploy their surpluses profitably. On the other hand, foreign investors are increasingly interested in hitching a ride on China's fast moving economic growth train and investing in China. Hong Kong should seize the growing opportunities and benefit as the intermediary and gateway in both directions.

18. Hong Kong can be a premier offshore Renminbi centre as the currency internationalises. The international use of Renminbi as a trading currency, investment currency and reserve currency will expand. In 2014, 24% of China's merchandise trade was settled in Renminbi. As the payment currency for 1.9% of world payment, Renminbi is the 5th most used world payment currency. Renminbi has been incorporated into the basket of currencies of the Special Drawing Rights (SDR). At present Renminbi constitutes about 1.9% of all international foreign exchange reserve. In the next 3-5 years, it will increase to 4-5%. With the rise of the Renminbi as a major international currency, the offshore Renminbi centre will propel Hong Kong's international financial centre to new heights. Hong Kong's offshore Renminbi market is a platform for the Mainland to experiment with different measures in opening the capital account and pilot testing the offering of Renminbi-denominated investment products. Hong Kong must position itself as an offshore supermarket of a wide range of Renminbi-denominated securities.

19. When China's capital account is fully open and the Renminbi becomes convertible, Hong Kong's offshore Renminbi centre will face a new challenge but it will continue to have an advantage over Shanghai's onshore centre in its soft infrastructure which includes a low profit tax rate, zero capital gain tax, a low salary tax rate for the professional employees, a predictable and transparent regulatory regime, a robust judicial system and an independent court using common law. With full convertibility, Renminbi deposits and denominated assets will expand tremendously overseas and Hong Kong will benefit from the larger pie. London is the

top one or two leading international financial centre mainly because it has the largest offshore Eurodollar market which competes with the onshore US market in New York. Hong Kong can do the same by leveraging on the rise of Renminbi as a major international currency and its unique strengths over the onshore market.

20. Hong Kong can be a financial hub for the “One Belt One Road” (OBOR) countries. The demand for funds for infrastructure investments in the Asian countries will amount to US\$750 billion a year starting from 2020. Hong Kong can provide both a US dollar and a Renminbi financing platform to fill in the funding gap. AIIB and the Silk Road Fund can be requested to set up a branch or its treasury fund management centre in Hong Kong. They can tap into the US dollar and Renminbi liquidity in Hong Kong by issuing bonds. OBOR projects can be financed by debt or equity, which can be listed in the Hong Kong market as a primary listing or secondary listing. Hong Kong should offer a wide range of financial instruments to cater for the demand for yields and risk diversification, such as to develop a market for sukuk.

Immigrants and Human Capital from Mainland China

21. A controlled flow of immigrants is important to Hong Kong, in terms of enhancing the human capital stock, rejuvenating the ageing population, and averting the decline of the labour force.

22. Japan is number one as a super-aged society in Asia and the world. Hong Kong is number two in Asia as an aged society. Today Japan has 1 million fewer people than in 2008. Its labour force shrinks even faster. Japan’s per capita nominal GDP has fallen behind that of Hong Kong since 2013. In fact, were it not for the generation of the post-war baby boomers, the pre-1980 waves of massive immigration and the post-1980 steady flow of immigrants from the Mainland, Hong Kong’s ageing problem could be as advanced as Japan’s because Hong Kong has lower total fertility rate and higher life expectancy than Japan.

23. It is important to understand statistically whether immigrants and their second generation in general assimilate well into society economically, educationally and culturally. Economically, after 2001 the Mainland immigrants’ earnings gap with respect to the natives is narrowing. With the improvement in the educational background of the recent Mainland immigrant cohorts, the gap will narrow faster in

the future.

24. Similar to the experience of other countries, the second-generation immigrants in Hong Kong fare better than the native born in educational attainment and intergenerational educational mobility. Whilst the first-generation Mainland immigrant young adults have lower educational attainment than the Hong Kong born, they have taken advantage of the educational opportunity in Hong Kong to surpass their parents in educational achievement. The second-generation, born in Hong Kong, is especially successful in educational attainment and mobility.

25. Culturally, we found that individuals with Mainland parents are in general very similar to individuals with Hong Kong born parents in social, cultural, political and ethical values, based on the result of 2013 World Value Survey. Out of the 270 questions asked, the responses of individuals with Hong Kong-born parents and individuals with Mainland immigrant parents are statistically different in only 37 questions. Mainland immigrants and their children have integrated reasonably well into Hong Kong society in values, beliefs and attitudes towards work, family, life, children, ethics, trust, culture, religion and politics.

26. Since 1997, there have been significant changes to the demographic and socioeconomic characteristics of Mainland immigrants. The immigrants have more schooling and are more active economically. They should be able to integrate more easily into the Hong Kong labour market than their pre-1997 counterparts.

27. Under the One-Way Permit Scheme, the largest scheme for Mainland immigrants, the percentage of children admitted has been falling since 1997 whilst the percentage of spouses for family reunion has been rising. The trend in cross-border marriage is changing. In 2014 80% of these marriages were registered in Hong Kong whereas in 1997 it was 13%. The percentage of Hong Kong brides marrying Mainland bridegrooms is also increasing from 14% in 1997 to 27% in 2015. Compared with previous cross-border married couples, it is likely more of them are young well-educated professionals who met their future spouses at work or in school either in Hong Kong or in the Mainland. This new trend will add to Hong Kong's human capital stock and help to rejuvenate the ageing population. There is a reason to keep to the annual quota of One-Way Permit Holders (OWPH) as there may be an increasing uptake of this quota even though currently it is not fully filled.

28. A policy that allows OWP who migrate to Hong Kong to either retain or re-establish their household registration in their home towns/villages will be very appreciated in Hong Kong, as it will alleviate its burden of supporting immigration misfits.

29. An increase in non-local students should be a key link in a population policy that promotes growth and slows down ageing. There are cogent arguments in favour of enrolling more non-local students to fill the permitted undergraduate quota (20% of enrolment), noting that this will not affect the chance of university education of local students as it is outside the UGC-funded undergraduate student quota. Compared with the non-local postgraduates, they are younger and probably learn the Cantonese dialect faster. They are more likely to live in the university dormitories. They have four years to be acculturated before they graduate. Presumably their transition into the Hong Kong society after graduation should be easier and smoother. However, a balance between non-local students from the Mainland and from other countries and also the shortage of student hostel places would be the concerns.

30. Whilst increasing the intake of non-local undergraduate students, the government should also consider increasing the enrolment of local undergraduates. Through appropriate curriculum and training, local young people should be educated and prepared to be more competitive in the new era, thereby enhancing the local human capital stock.

31. Singapore government is careful in managing the size of its permanent residents. We can take reference of Singapore's immigration policy and carry out scenario analysis to figure out what should be the size of the annual immigrant inflow. If we have zero immigration, the population and the labour force will start to decline almost immediately, sliding downward and reaching a negative growth rate of 1.2% and 1.3% p.a. respectively in 2064. Even if we lift up the fertility rate to 2.1, the ageing problem and the shrinkage in labour force will still be worse than the baseline scenario, which assumes a migration flow under the existing policies.

32. To stabilize the size of the population and the labour force as well as to slow down the growth in the elderly dependency ratio, we propose to augment the inflow of immigrants to be phased in over a number of years subject to the capacity constraints in housing and infrastructure.

33. We propose that the additional immigrants should not be from the One-Way Permit Scheme but from the other schemes importing young and educated people. If the expansion of all the existing immigrant programmes does not yield the target increase of additional immigrants, Hong Kong may consider a limited version of the Diversity Immigrant Visa Program of the U.S.. Hong Kong can set its own target number and the qualifications for application under the scheme, including age brackets, educational attainment, work experience and no criminal record. The selection will be by lottery if the number of applicants exceeds the quota.

34. Most recently, an U.S. report points out that skilled immigrants have a positive wage and employment effect on both university and non-university educated natives because skilled immigrants are often complementary to native workers. For Hong Kong, there is no evidence that the increment in university enrolment would significantly increase the unemployment rate or reduce the university earnings premium of university graduates. Also, since almost all of the additional immigrants are university-educated and some will have work experience and presumably savings, their admission is not expected to impose pressure on the social welfare system or the public housing system but there will be implications on private housing and the infrastructure. Government should plan ahead of time and phase in the increase in immigrants over a number of years in sync with capacity expansion in housing, medical facilities and transport infrastructure.

35. Under different assumptions of additional inflow, we simulate the trend of population, labour force and total dependency ratio up to 2064. Ageing of the population can only be alleviated but cannot be reversed unless there is a continuous massive influx of young immigrants. Nevertheless, maintaining the size of the population and the labour force are important as they have a positive impact on sustaining economic growth.

36. In 2010, some 235,000 Hong Kong people were in the Mainland for various purposes. When the difference in the standard of living between Hong Kong and the Mainland gets smaller, it is expected that there will be an increasing two-way flow of people for the purpose of study, work and business.

Concluding Remarks

37. China is now entering a “New Normal” phase of growth with economic re-balancing and re-structuring, emphasising internal demand and further opening up of its capital account and internationalising its currency. In this new phase Hong Kong must re-position itself as a major service provider for the Mainland and a gateway for the two-way flow of capital, with Mainland on one side and the rest of the world on the other. While Hong Kong is still an attractive place for Mainland’s skilled professionals to work and to live, Hong Kong must be effective in bringing in more skilled Mainland immigrants to add to its human capital stock to stimulate growth, and to alleviate its ageing problem.

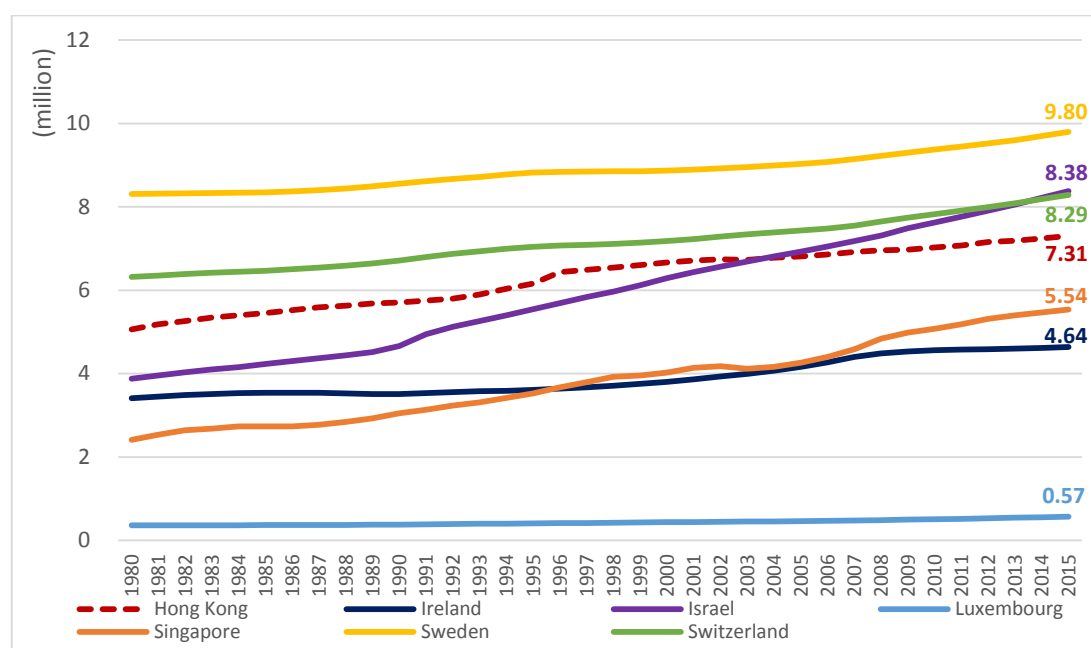
38. As old windows of opportunities in manufacturing and re-export trade close, new windows of opportunities open. Hong Kong must look out for these new opportunities and ride with the tide of China’s rise to become, in the not too distant future, the largest economy in the world. In the process Hong Kong must play a critical role and be an indispensable partner of Mainland in some, if not all, aspects of its economic development. Only then will the Hong Kong-Mainland productive economic relationship be sustainable.

1. Hong Kong as a Small Open Economy

1.1 Small Open Economies and Their Success

Hong Kong is well known as a small open economy. A small economy is defined in terms of population size instead of land area. Kuznets (1960), the Nobel Memorial Prize Laureate in Economics, defined small economy as one with a population fewer than or equal to 10 million.¹ Hong Kong, Ireland, Israel, Luxembourg, Singapore, Sweden and Switzerland are some examples of successful small economies. In 2015, the population of Hong Kong was 7.31 million, slightly smaller than that of Israel, Sweden and Switzerland but larger than that of Ireland, Luxembourg and Singapore (see **Figure 1**). These seven economies are different in their economic characteristics but they share some common factors for their economic success. A review of these economies will highlight the success factors for small economies and the implications for Hong Kong.

Figure 1: Total Population of Hong Kong, Ireland, Israel, Luxembourg, Singapore, Sweden and Switzerland, 1980-2015



Note: According to the World Bank, total population covers all residents regardless of legal status or citizenship--except for refugees not permanently settled in the country of asylum.

Source: The World Bank

¹ Commonwealth Advisory Group (1997) and Commonwealth Secretariat and the World Bank (2000) used a threshold of 15 million population to define small states in their reports.

The International Chamber of Commerce's (ICC) Open Markets Index scores the openness of economies on four factors: trade openness, trade policy regime, trade-enabling infrastructure, and openness to Foreign Direct Investment (FDI). According to the latest ICC Open Markets Index released in September 2015, Singapore and Hong Kong are ranked as the most open economies with an open market index of 5.5. Luxembourg, Ireland, Switzerland and Sweden are in category 2 as economies with above average openness, while Israel ranks first in category 3 of economies with average openness (see **Table 1**). There is a positive correlation² between the standard of living (measured by GDP per capita) and the open market index. A country with a higher open market index usually has a higher standard of living. **Figure 2** plots the distribution of the countries in **Table 1** according to their open market index and GDP per capita, with one colour spot representing one country. The distribution follows an upward sloping curve. Two points are evident. First, small economies (blue spots) tend to have higher GDP per capita. Second, the slope of the curve defined by the blue spots is especially steep, indicating that small economies generally pursue greater market openness to achieve a higher living standard than other economies. In contrast, economies with very weak openness in the ICC report like Bangladesh, Ethiopia and Sudan and other essentially closed economies such as North Korea and until very recently Myanmar have very low standard of living³.

² The correlation coefficient of open market index and standard of living (measured by GDP per capita) is 0.70.

³ GDP per capita in 2015: Bangladesh (US\$1,287), Ethiopia (US\$687), Sudan (US\$2,175), Myanmar (US\$1,204), North Korea (no published data)

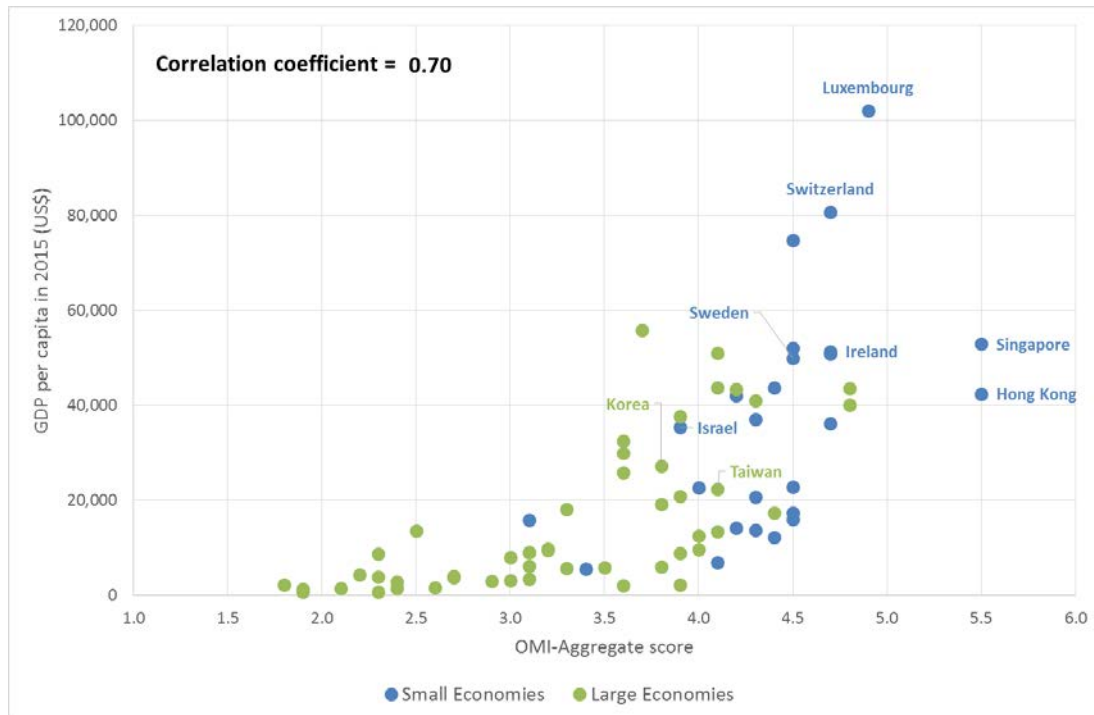
Table 1: Scores and Rankings of Economies According to the International Chamber of Commerce Open Markets Index, 3rd Edition 2015

Category		Rank	Score		Rank	Score	
1 Most open	Singapore	1	5.5	3 Average openness	Romania	38	3.9
	Hong Kong	2	5.5		Portugal	39	3.8
2 Above average openness	Luxembourg	3	4.9		Peru	40	3.8
	Belgium	4	4.8		Republic of Korea	41	3.8
	Netherlands	5	4.8		United States	42	3.7
	Ireland	6	4.7		Italy	43	3.6
	Switzerland	7	4.7		Japan	44	3.6
	United Arab Emirates	8	4.7		Viet Nam	45	3.6
	Iceland	9	4.7		Spain	46	3.6
	Sweden	10	4.5		Thailand	47	3.5
	Estonia	11	4.5		Jordan	48	3.4
	Denmark	12	4.5		Greece	49	3.3
	Malta	13	4.5		South Africa	50	3.3
	Norway	14	4.5		Turkey	51	3.2
	Slovakia	15	4.5		Kazakhstan	52	3.2
	Austria	16	4.4		Uruguay	53	3.1
	Czech Republic	17	4.4		Mexico	54	3.1
	Hungary	18	4.4		Colombia	55	3.1
	Germany	19	4.3		Indonesia	56	3.1
	Latvia	20	4.3		Russian Federation	57	3.1
	New Zealand	21	4.3		Morocco	58	3.0
	Slovenia	22	4.3		China	59	3.0
Lithuania	23	4.2	4 Below average openness		Philippines	60	2.9
Canada	24	4.2			Egypt	61	2.7
Finland	25	4.2			Tunisia	62	2.7
Bulgaria	26	4.1			India	63	2.6
Australia	27	4.1			Venezuela	64	2.6
Chinese Taipei	28	4.1			Argentina	65	2.5
Chile	29	4.1			Nigeria	66	2.4
United Kingdom	30	4.1			Kenya	67	2.4
Poland	31	4.0			Sri Lanka	68	2.3
Cyprus	32	4.0			Uganda	69	2.3
Malaysia	33	4.0			Brazil	70	2.3
3 Average openness	Israel	34		3.9	Algeria	71	2.2
	Ukraine	35	3.9	Pakistan	72	2.1	
	Saudi Arabia	36	3.9	5 Very weak	Bangladesh	73	1.9
	France	37	3.9		Ethiopia	74	1.9
			Sudan		75	1.8	

Note: Score of 5-6: Most open economies; Score of 4-4.99: Economies with above average openness; Score of 3-3.99: Economies with average openness; Score of 2-2.99: Economies with below average openness; Score of 1-1.99: Very weak economies

Source: International Chamber of Commerce Open Markets Index

Figure 2: GDP Per Capita vs Open Markets Index (OMI) Aggregate Score



Sources: *International Monetary Fund, International Chamber of Commerce*

1.2 Necessity of Openness

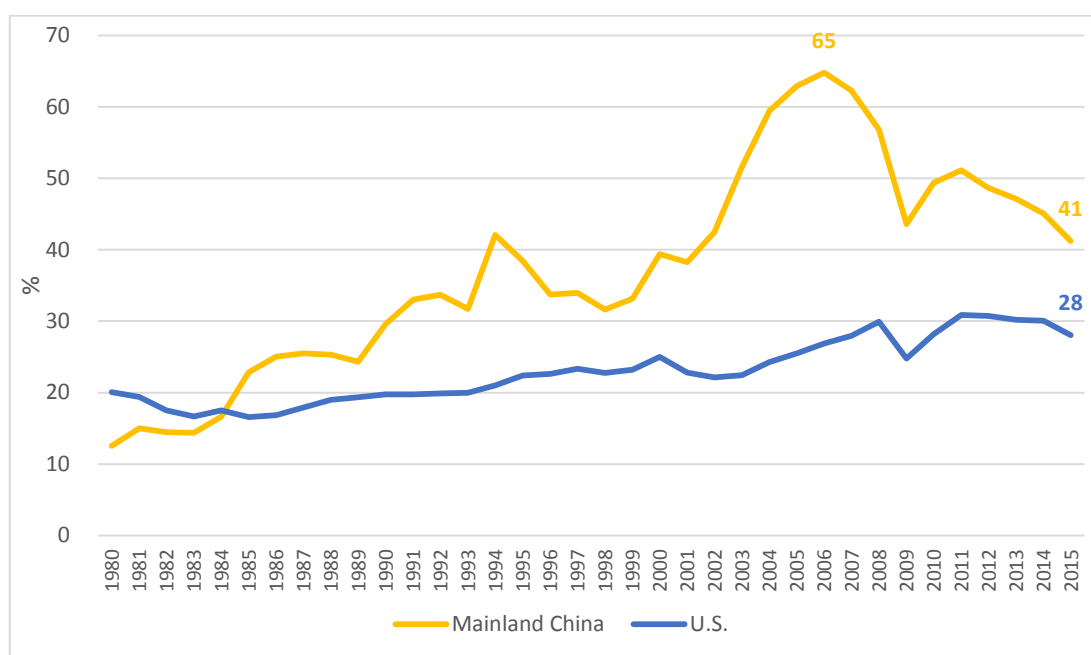
Small economies need to be open in order to be successful economically. Economies of scale lower the average cost of production but large scale production is economical only if there is sufficient final demand for the output. The domestic demand of small economies with less than 10 million people is usually too small to support large scale domestic production. However, foreign demand can make up for the deficiency. Provided that the small economies are open to trade, their products and services can be sold internationally to meet the global market demand. Hence from the supply side of productivity due to economies of scale in production to the demand side due to the access to the global market, openness is essential to the GDP growth of small economies. Openness also has other advantages in bringing in foreign investments, technology, ideas and skills, all of which promote economic growth.

In fact, medium to large economies also have to be open to international trade and investment in order to maintain their economic growth, even though in comparative terms, they depend less on openness than the small economies. The legendary export-led growth of the four little Asian Dragons in the second half of the twentieth century is premised on openness to trade and investment. Among the four,

Korea and Taiwan are medium-sized economies. (The other two, Hong Kong and Singapore are small open economies). They have a total trade to GDP ratio of 84.8% and 119% respectively. To a different extent, even the largest two economies (in terms of GDP) in the world, the U.S. and China, are open economies. The U.S.'s capital account is open; the US dollar is the predominant international currency and its total trade to GDP ratio is about 30% (see **Figure 3**). Mainland China's economic growth since the economic reform in 1978 was mainly driven by the external trade and foreign direct investment in the early years. Being the World's Factory in the 1990s and 2000s, Mainland China's trade to GDP ratio grew to 65% at 2006. Although the Chinese Government introduced economic rebalancing and intended to restructure from an export-driven economy to a domestic consumption-led economy in the Eleventh and Twelfth Five-Year Plans, total trade to GDP ratio still remained above 41% in 2015 (see **Figure 3**). At the same time, the Chinese Government is gradually opening up its capital account and internationalising its currency.

To summarize, openness is essential to growth for economies of all sizes. It is especially critical to small economies because of their limitation in the scale of production and the deficiency in domestic demand.

Figure 3: Total Trade to GDP Ratio of United States and Mainland China, 1980-2015

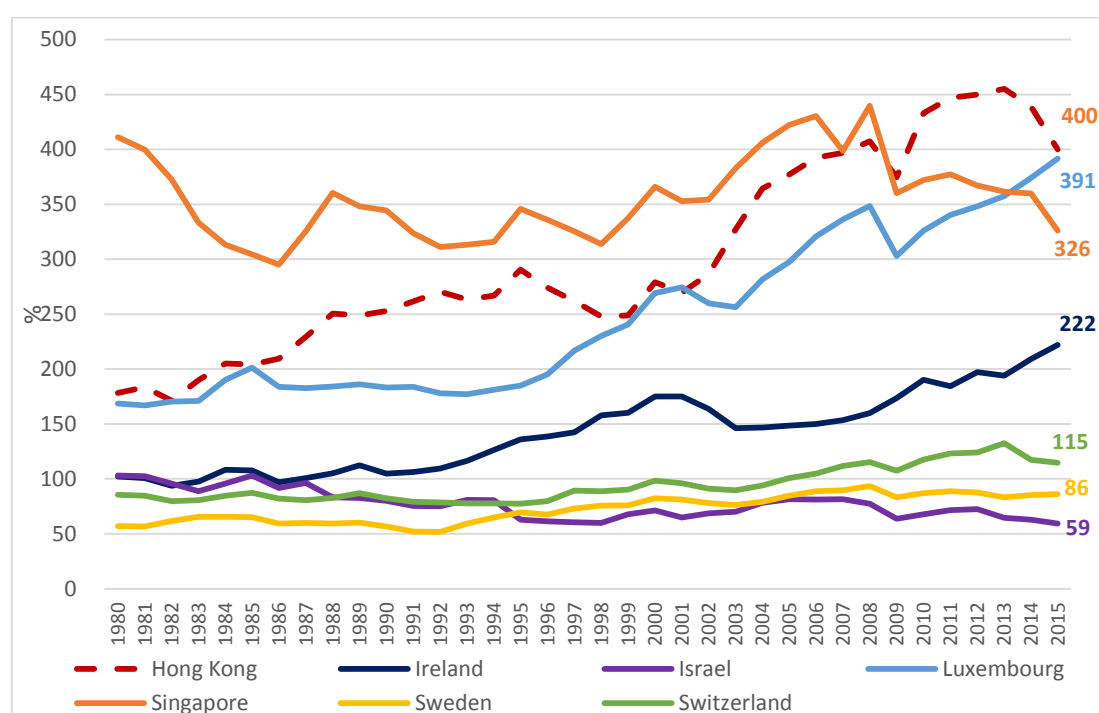


Source: *The World Bank*

1.3 Implications from Other Small Open Economies

Among the four factors of the Open Markets Index, openness to trade is the key to an open market and the ratio of total trade to GDP is a commonly used measure. Of the seven small economies we mentioned earlier, Hong Kong, Luxembourg and Singapore are extremely open to trade, with a very high total trade to GDP ratio of 400%, 391% and 326% respectively in 2015. Even though by comparison the other four small economies are not as open as the first three, their total trade to GDP ratios are still very high with 222% for Ireland and 115% for Switzerland, and quite high with 86% for Sweden and 59% for Israel (see **Figure 4**).

Figure 4: Total Trade to GDP Ratio of Hong Kong, Ireland, Israel, Luxembourg, Singapore, Sweden and Switzerland, 1980-2015



Source: *The World Bank*

In terms of exports, Hong Kong and Singapore mainly depend on re-export trade and trade-related services and financial services. Luxembourg is renowned for its financial services, accounting for over 50% of its total trade in services in 2015. The Luxembourg Stock Exchange is one of Europe's major stock exchanges and is largest in terms of international bond listings.

Switzerland has both financial services and technology as pillar industries. It has a long-established banking and insurance sector with well-known financial institutions, such as Credit Suisse, UBS and Swiss Re. At the same time, chemicals and allied industries as well as the machinery and electrical industry contribute to over 40% of its exports of goods in 2015. According to the Global Innovation Index 2016, Switzerland was ranked first as the most innovative economic entity.

Israel, Ireland and Sweden focus more on technology industries. Israel is well-known for its technology innovations and high expenditure on R&D⁴. Ireland is one of the world's largest exporters of telecommunications, computer, and information services which contribute to nearly 50% of its total commercial services exports in 2015. Ireland is also one of the leading locations for the pharmaceutical industry in Europe with 9 of the 10 World's largest pharmaceutical companies⁵ setting up plants in the country. Sweden is a hotbed of technology and innovation. As highlighted in the Report of Our Hong Kong Foundation entitled "The Ecosystem of Innovation and Technology in Hong Kong" (2015), a number of successful internet unicorns, such as Skype, MySQL, Klarna and Spotify, were founded in Sweden. Swedish technology helps boost the country's trade in commercial services as well. The country was ranked second in the Global Innovation Index in 2016. Charges for the use of intellectual property and telecommunications, computer, and information services contribute to more than a third of total commercial service exports of Sweden in 2015.

The above seven economies illustrate several economic models that a small economy can follow, in order to maintain economic growth and a high living standard. A small economy can choose to follow the model of Hong Kong and Singapore with extremely high openness in trade, investments and financial services, or follow Luxembourg to focus and develop almost exclusively its financial service industry. It can follow the strategy of Israel, Ireland and Sweden to establish and enhance its technology and innovation industries. It can also choose to follow the path taken by

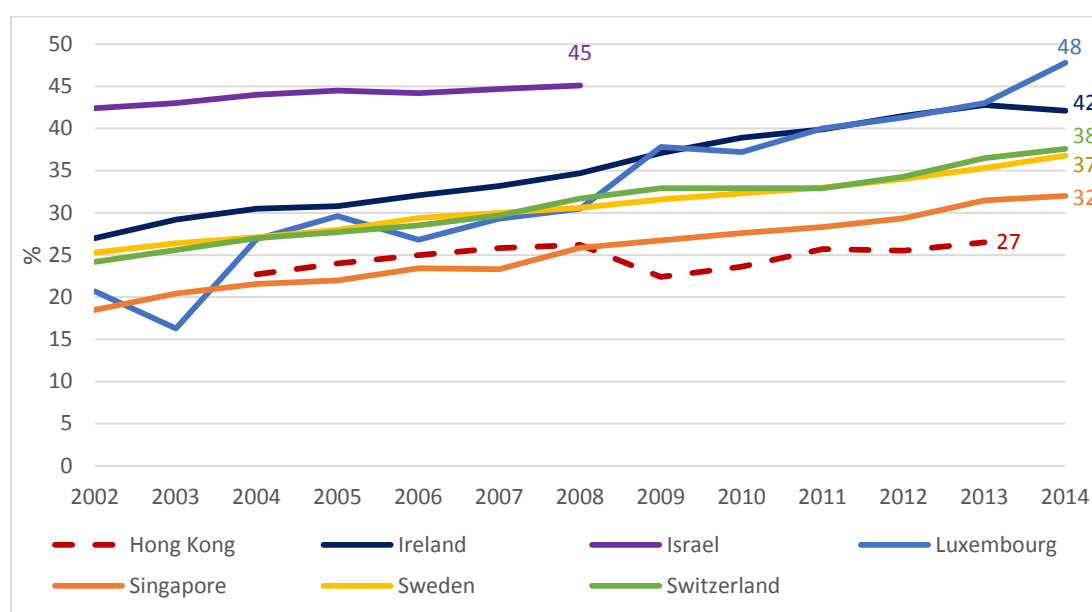
⁴ In 2014, total R&D investment in Israel was around 4.1% of GDP, which was one of the highest in the world.

⁵ The 9 pharmaceutical companies are Johnson & Johnson, Novartis, Pfizer, Roche, Merck, Sanofi, GlaxoSmithKline, Abbott and Amgen, according to the Irish Pharmaceutical Healthcare Association.

Switzerland to have both financial services and technology as pillar industries.

It should be pointed out that even if a small economy chooses to focus on technological development as its economic strategy, openness is still essential, (though not to the same extent as those economies that focus on trade and investment) as they have to rely on trade to export its products and services. Another point to note concerning technological development is that it requires a number of success factors, one of which is human capital endowment. High-valued production in technological products and services is only possible if there is a highly skilled labour force. Ireland, Israel, Sweden and Switzerland which are relatively less dependent on trade activities but more on technology and innovation have high human capital endowments. They have higher percentages of the labour force with tertiary education, ranging from 37% to 45%, than Singapore (32%) and 27% in Hong Kong (27%) (see **Figure 5**).

Figure 5: Percentage of Labour Force with Tertiary Education of Hong Kong, Ireland, Israel, Luxembourg, Singapore, Sweden and Switzerland, 2002-2014



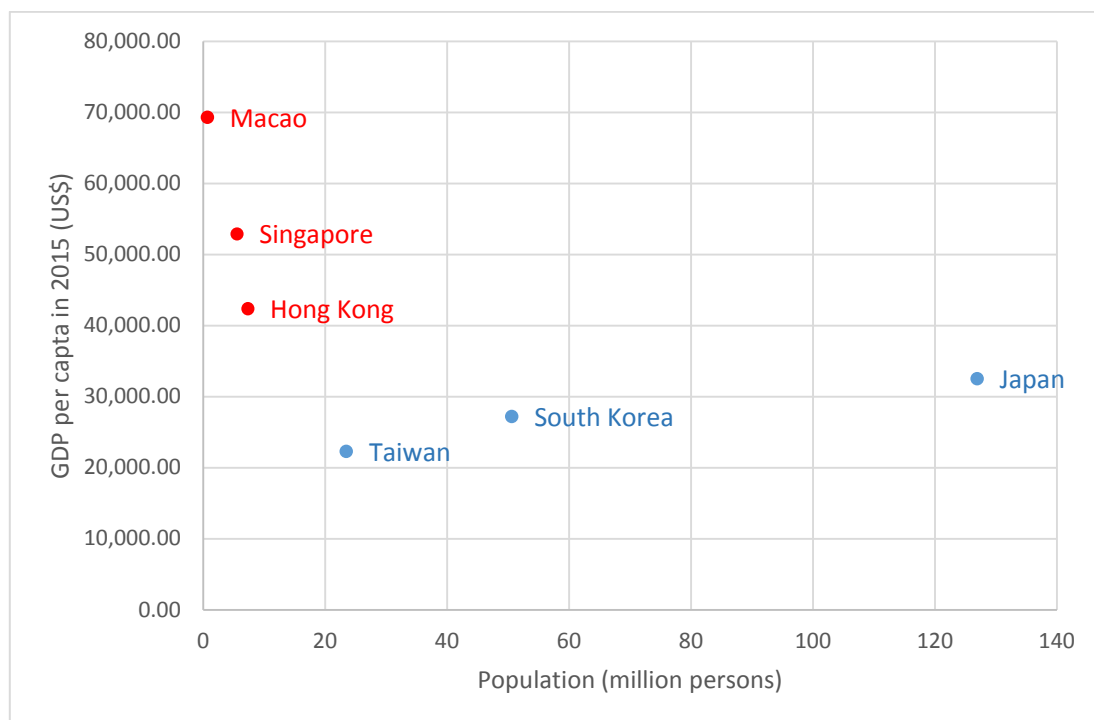
Sources: The World Bank, Ministry of Manpower in Singapore

1.4 Positioning of Hong Kong

Hong Kong has always positioned itself as a small and very *open* economy. This positioning has served Hong Kong very well as Hong Kong evolved in the 1950's from an entrepot to a manufacturing centre, and now a financial and service centre for China and the world. It has brought a high standard of living to the people of Hong

Kong. At a per capita GDP of US\$42,000, Hong Kong together with Singapore and Macao are the only three small Asian economies that have no natural resources but have achieved such a high level of affluence, a level that exceeds that of the larger, also successful but relatively less open Asian economies of Japan (GDP per capita US\$32,000), South Korea (GDP per capita US\$27,000) and Taiwan (GDP per capita US\$22,000) (see **Figure 6**).

Figure 6: Total Population vs GDP Per Capita of Hong Kong, Japan, Macao, Singapore, South Korea and Taiwan, 2015



Source: *International Monetary Fund*

Looking ahead, Hong Kong must continue to be very open to the world to remain successful and to stay ahead in competitiveness. International competition in trade, finance and technology is very intense. There are other Asian cities that aspire to replace Hong Kong as Asia’s premier trading, financial and business service centre. History is replete with trading cities and ports that went into decline. The most notable example is Venice. Venice was once the premier trading, financial and political centre in the Mediterranean in the 15th century⁶. It is now little more than a tourist attraction. The many historical ruins of the once thriving trading cities along

⁶ As mentioned in the article “3 career lessons from 15th-century Venice” written by Peter Vanham, Senior Media Manager, World Economic Forum.

the Silk Route also attest to the rise and fall of cities. The decline of these cities were due to war, famine as well as changes in the trade routes. Hong Kong must learn the lesson and remain vigilant to changes in global trading partnership and shifting comparative advantages. The last thing that Hong Kong people should do is to turn inward-looking, to ward off outsiders and to lure ourselves into believing that we can grow our economy in isolation because that will lead Hong Kong down the road of decline.

1.5 Concluding Remarks

To sum up, the lesson for Hong Kong as a small economy is that it has to maintain its extremely high openness to trade and financial services or develop its technology innovations or both in order to maintain sustainable economic growth. However, no matter which direction is chosen, the economic relationship of Hong Kong and China is indivisible. Mainland China is the largest trading partner of Hong Kong; the performance of Hong Kong's trading industry depends on the production and demand of Mainland China. To further develop its financial services, Hong Kong can take advantage of the opportunities of intermediating the increasing savings and wealth of the Mainland and the internationalization of its currency. To develop the technology innovations, as suggested by the Report of Our Hong Kong Foundation entitled "The Ecosystem of Innovation and Technology in Hong Kong" (2015), Mainland China can be the hinterland to resolve the problem of land shortage in Hong Kong and the market for the industrial, business and consumer demand for innovative products and services. In the next chapter, the economic interdependence of Hong Kong and the Mainland China and its changes with time are analysed.

2. Economic Interdependence of Hong Kong and Mainland China Over Time

2.1 Importance of Mainland China to Hong Kong

Mainland China has played an important role in the different phases of the economic development of Hong Kong, from the early years as its partner in entrepot trade and supplier of food and water, to the later years as its hinterland in industrial production and consumer market. Following the economic reform in China and its increasing market openness and rapid rise to become the second largest economy in the world, the importance of the Mainland to Hong Kong's economy grows significantly in various aspects.

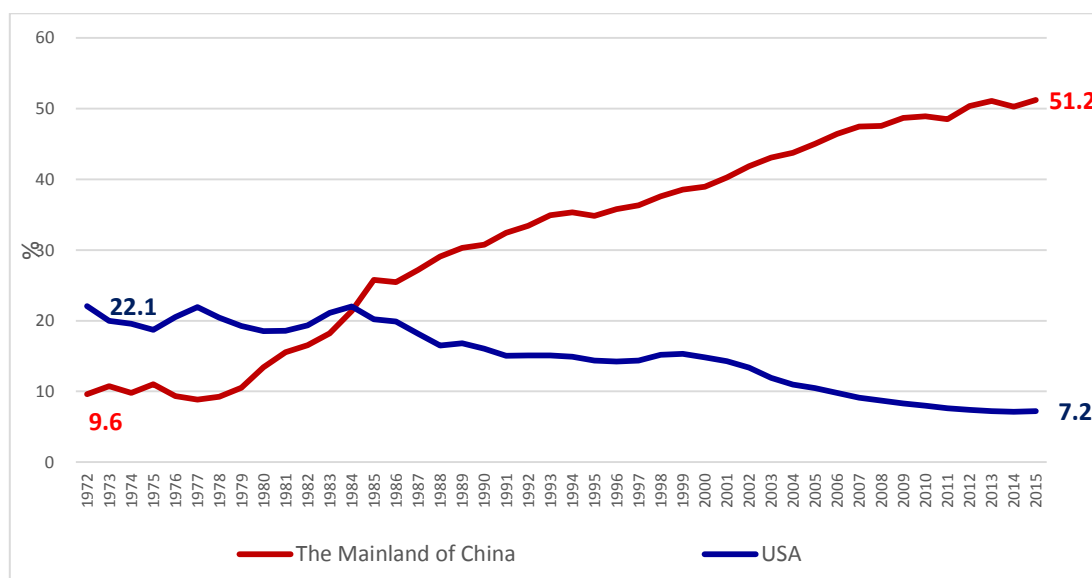
2.1.1 As the Largest Trading Partner

Until 1985 the U.S. was the largest merchandise trading partner of Hong Kong, contributing to 22% of Hong Kong's merchandise trade in 1972. Our economy was then very much affected by the movement of the U.S. economy. There was a saying then that if the U.S. economy sneezed, Hong Kong would catch pneumonia. The U.S. influence on Hong Kong's economy was so large that when Hong Kong adopted the currency board system in October 1983, it linked its currency to the U.S. dollar as an anchor at the fixed rate of 7.8, thereby tying Hong Kong's economic fortune to the vicissitude of U.S. economic and monetary policies.

The prominent position of the U.S. as Hong Kong's largest trading partner was supplanted by Mainland China in 1985. The U.S. contribution to Hong Kong's merchandise trade shrank to 7.2% in 2015, whilst Mainland China's share increased dramatically from 10% in 1972 to 51% in 2015 (see **Figure 7**). In fact, Mainland China also surpassed the U.S. as the world's largest merchandise trading nation⁷, contributing to 11.9% of the global merchandise trade in 2015 (see **Table 2**).

⁷ According to World Trade Organisation, Mainland China is the world's largest exporter and the world's second largest importer of merchandise goods in 2015.

Figure 7: Share of Mainland China and the U.S. in Hong Kong's Total Merchandise Trade, 1972-2015



Source: Census and Statistics Department

Table 2: Leading Countries in World Merchandise Trade, 2015

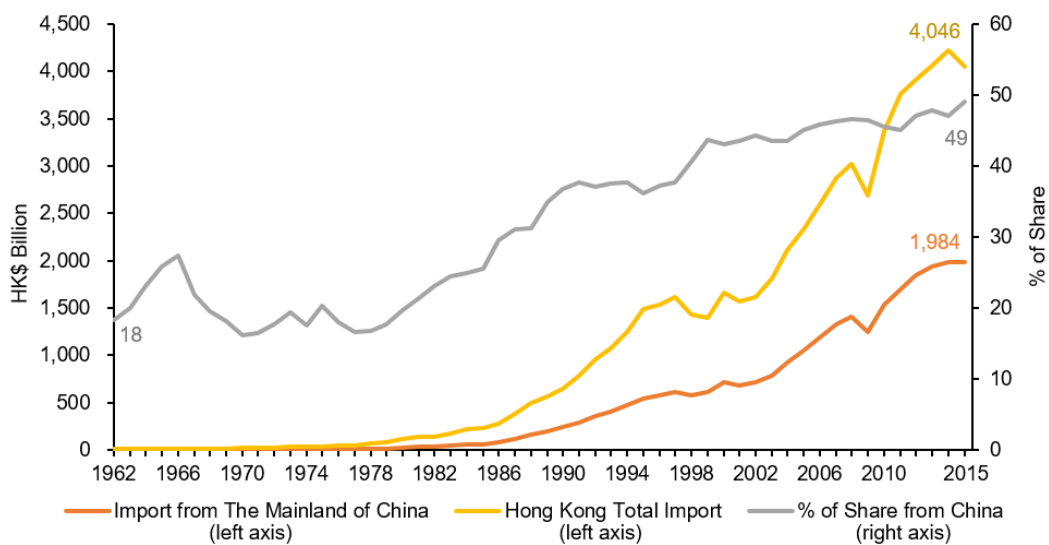
Rank	Total Merchandise Trade	Value (Billion USD)	Share (%)
1	Mainland China	3,956.9	11.9
2	United States	3,812.9	11.5
3	Germany	2,379.5	7.2
4	Japan	1,273.4	3.8
5	France	1,078.6	3.3

Sources: World Trade Organisation, Our Hong Kong Foundation

Mainland China has long been a major supplier of Hong Kong's imports in foodstuff, water and basic necessities. In 1962 even during the Great Leap Forward when there was widespread shortage, it contributed to 18% of Hong Kong's merchandise import. This percentage rose gradually to 49% in 2015. The trend of Mainland share in Hong Kong's exports, on the other hand, started later and rose more sharply. Before the opening up of Mainland China in 1978, Hong Kong's export to the Mainland was negligible. After the reform and opening up, Mainland's share of Hong Kong merchandise exports rose rapidly to 54% in 2015. Much of the Hong Kong's exports to the Mainland are merchandise re-export and not Hong Kong's domestic export. In fact in value term, Hong Kong's domestic export to the Mainland has been declining since 1997, in sync with the decline of Hong Kong's total domestic export

as manufacturers relocated their production facilities across the border to the Pearl River Delta. The decline in the value notwithstanding, the Mainland imported an increasing share of Hong Kong's total domestic export, reaching 44% in 2015. The importance of the Mainland to Hong Kong's merchandise trade is indisputable and rising. **Figure 12** shows that the growth rate of Hong Kong's merchandise export tracks that of Mainland China, showing the close relationship between the two, since most of Hong Kong's exports are re-exports from the Mainland.⁸

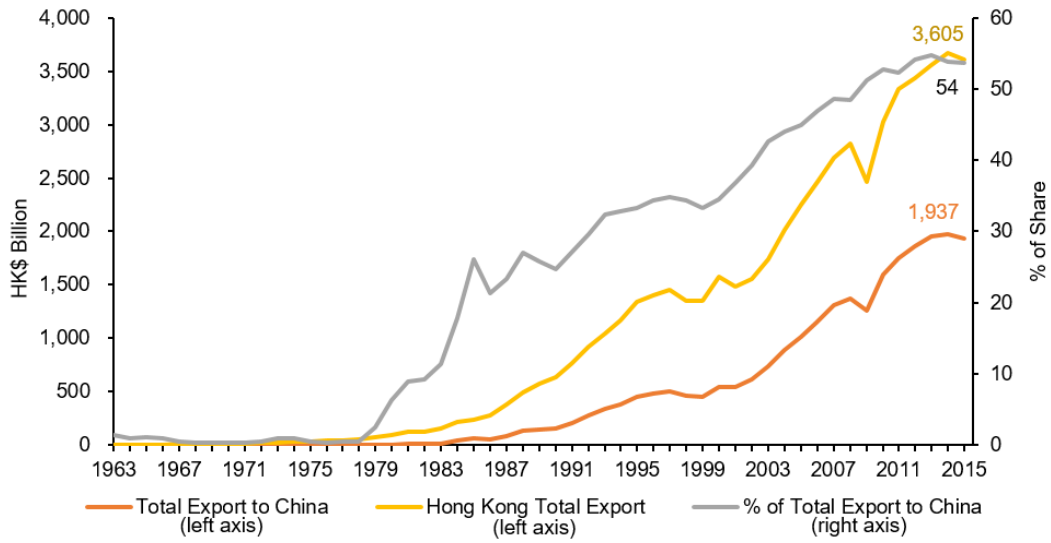
Figure 8: Merchandise Import of China in Hong Kong, 1962-2015



Source: Census and Statistics Department

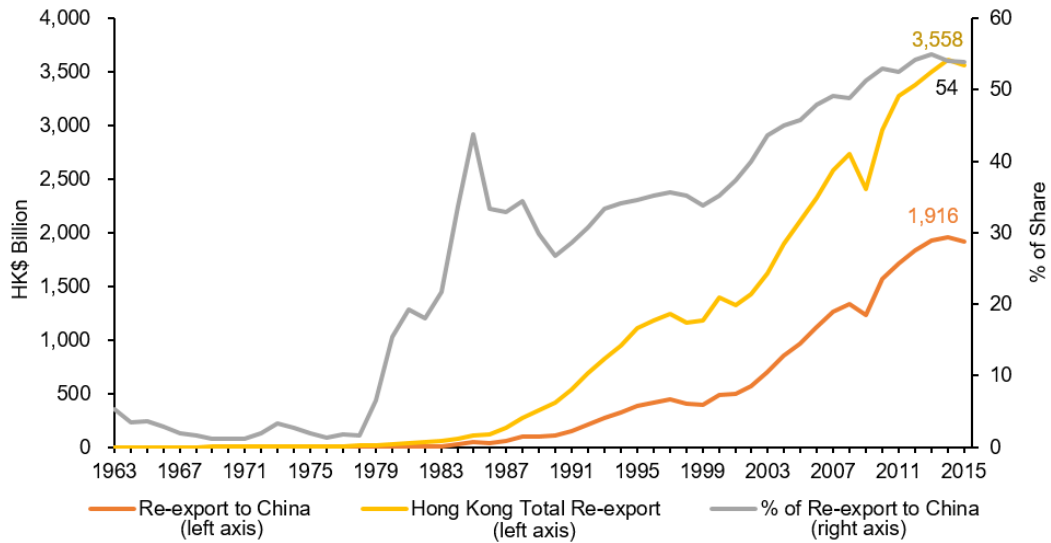
⁸ The correlation coefficient of Hong Kong and Mainland China merchandise export from 1979 to 2015 is 0.63.

Figure 9: Total Merchandise Export to China from Hong Kong, 1963-2015



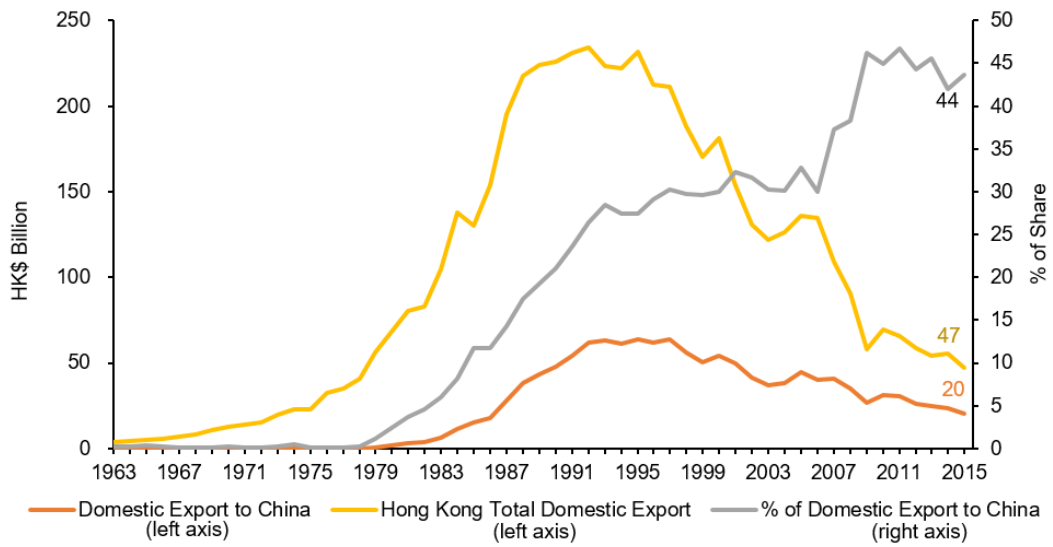
Source: Census and Statistics Department

Figure 10: Merchandise Re-export to China from Hong Kong, 1963-2015



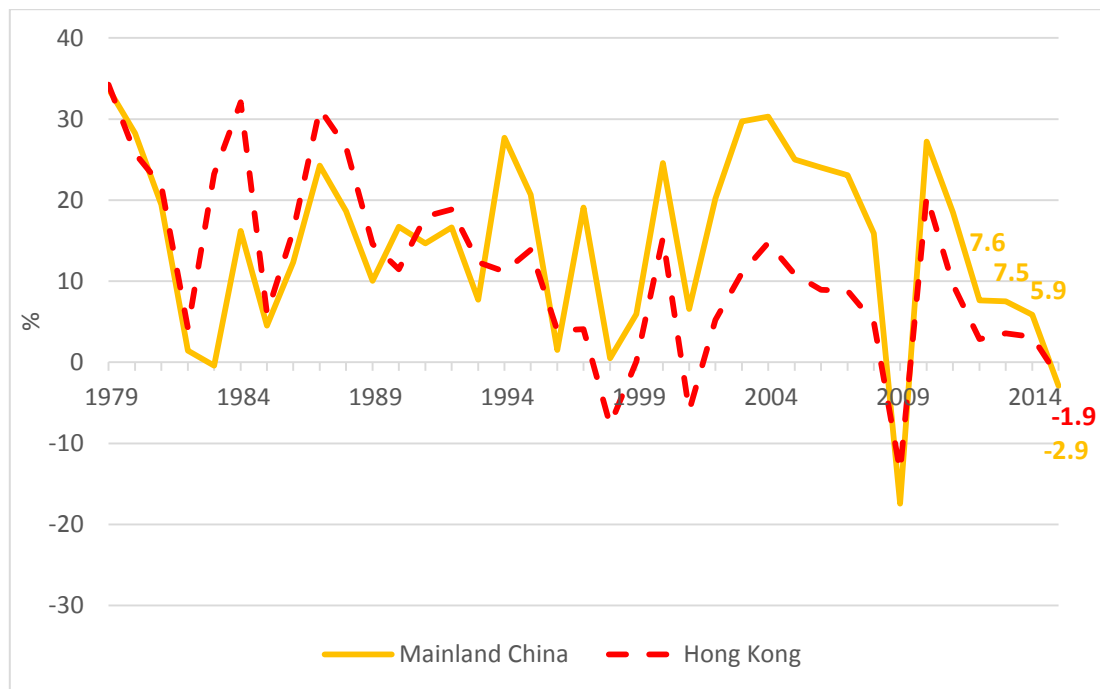
Source: Census and Statistics Department

Figure 11: Merchandise Domestic Export to China from Hong Kong, 1963-2015



Source: Census and Statistics Department

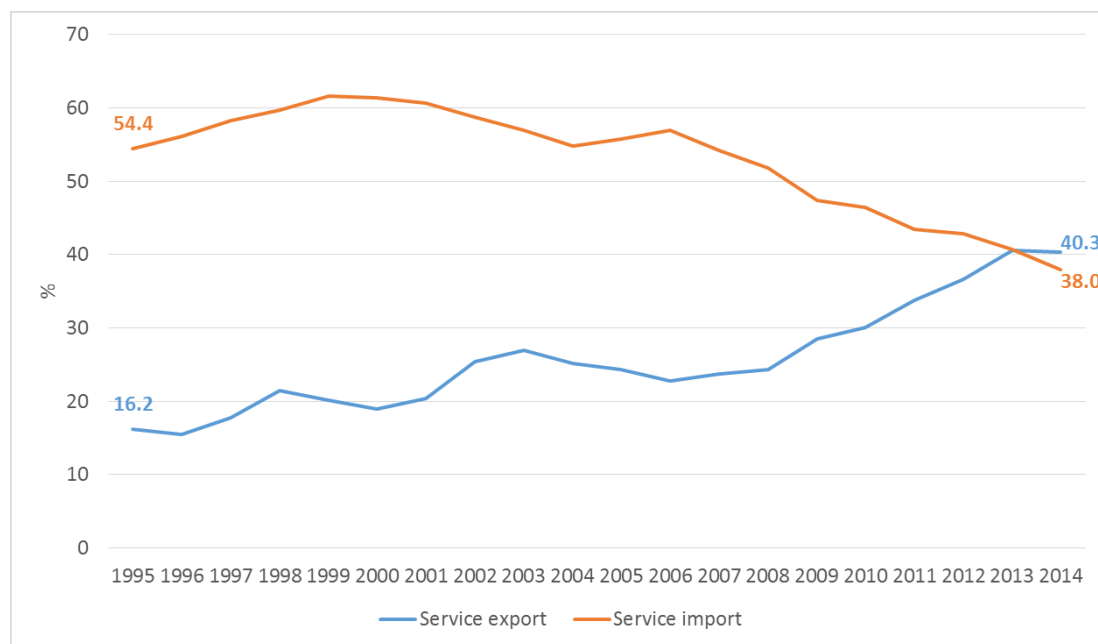
Figure 12: Annual Growth Rates of Merchandise Export of Hong Kong and Mainland China, 1979-2015



Source: CEIC Data

In terms of trade in services (sometimes known as invisible trade as opposed to merchandise trade which is also known as visible trade), Mainland China also takes up the largest share in Hong Kong's export and import of services.⁹ In 2014 Mainland China's percentage share of Hong Kong's total service exports was 40.3%, which has increased from 16.2% in 1995, whereas coincidentally its share of Hong Kong's import of services was almost the same at 38.3% in 2014 (see **Figure 13**).

Figure 13: Share of Hong Kong's Total Service Exports to and Imports from Mainland China, 1995-2014



Source: Census and Statistics Department

Among the categories of Hong Kong's export of services to the Mainland China, travel services¹⁰ are predominantly the largest component, accounting for as high as 73% of all service exports to Mainland China in 2014 (see **Figure 14**), or 29% of Hong Kong's total export of services to the world. It should be pointed out that Mainland China's share of Hong Kong's total export of travel services increased nearly 3 times from 20% in 1995 to 79% in 2014, thanks to the Mainland and Hong

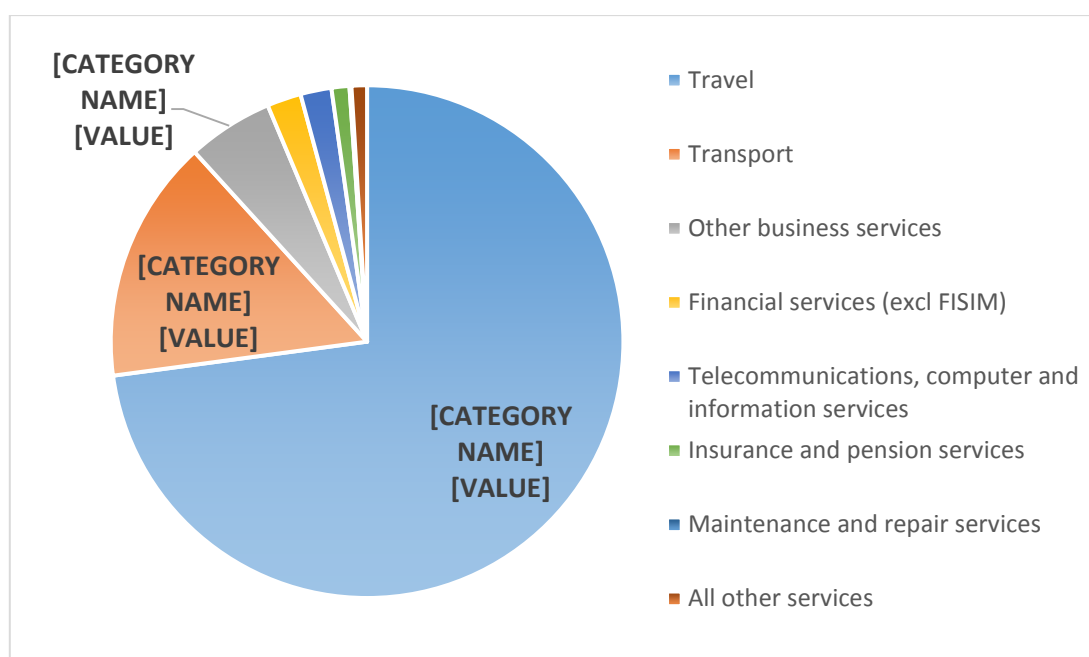
⁹ Examples of Hong Kong's export of services to the Mainland will be the provision of business and professional services for Mainland enterprises, insurance service for Mainland clients, and the provision of transport, lodging and tourism services for Mainland travellers in Hong Kong. An example of Hong Kong's import of service from the Mainland will be the service Hong Kong tourists pay for in the Mainland.

¹⁰ Travel services cover expenditure on all goods and services acquired by travellers for business and personal purposes. It includes study, for personal use in Hong Kong such as expenditure on lodging, meals, entertainment, and transportation within Hong Kong.

Kong Closer Economic Partnership Arrangement (CEPA) or, more specifically, the Individual Visit Scheme (IVS).

Another category of export of service in which the Mainland's percentage share is quite large is insurance and pension services. It grew from 14% to 39% in the same period (see **Figure 15**). Despite Mainland restrictions on Mainland residents travelling to Hong Kong to buy insurance by Union Pay card, Hong Kong insurance products remain popular. In the first half of 2016, the insurance premium of new policies purchased by Mainland visitors in Hong Kong was HK\$30.1 billion, a year-on-year increase of 1.2 times. The increase in the second quarter was 28% over the first quarter.¹¹ It is expected that Mainland's share in Hong Kong's export of insurance and pension services will further increase.

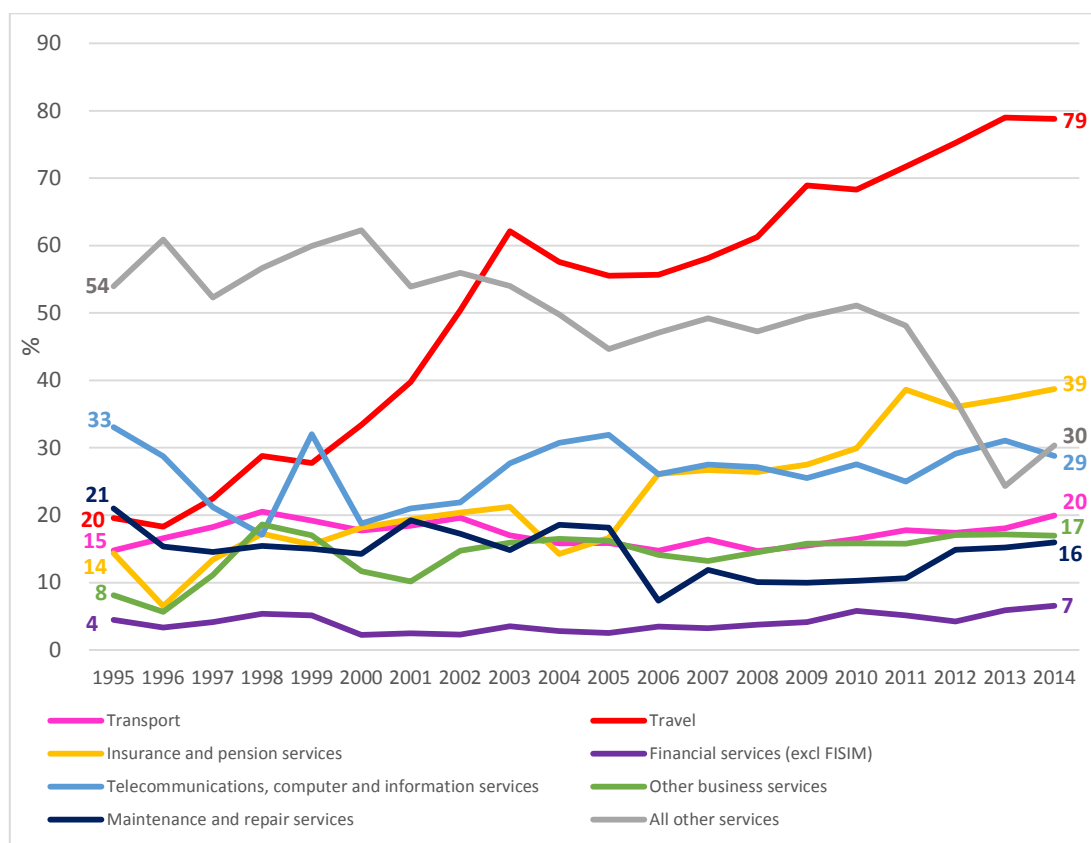
Figure 14: Percentage Distribution by Components of Hong Kong's Total Services Exports to Mainland China, 2014



Note: Since data on the geographical breakdown of financial intermediation services indirectly measured (FISIM) is not available, the figures in respect of FISIM are not included.
Source: Census and Statistics Department

¹¹ Singtao Daily (2016, August 31) 內地客來港買保險 上半年投保總額增逾倍. Retrieved from <http://std.stheadline.com/instant/articles/detail/217764-%E9%A6%99%E6%B8%AF-%E5%85%A7%E5%9C%B0%E5%AE%A2%E4%BE%86%E6%B8%AF%E8%B2%B7%E4%BF%9D%E9%9A%AA+%E4%B8%8A%E5%8D%8A%E5%B9%B4%E6%8A%95%E4%BF%9D%E7%B8%BD%E9%A1%8D%E5%A2%9E%E9%80%BE%E5%80%8D>

Figure 15: Share of Hong Kong's Total Services Export to Mainland China by Services Component, 1995-2014



Note: Since data on the geographical breakdown of financial intermediation services indirectly measured (FISIM) is not available, the figures in respect of FISIM are not included.
Source: Census and Statistics Department

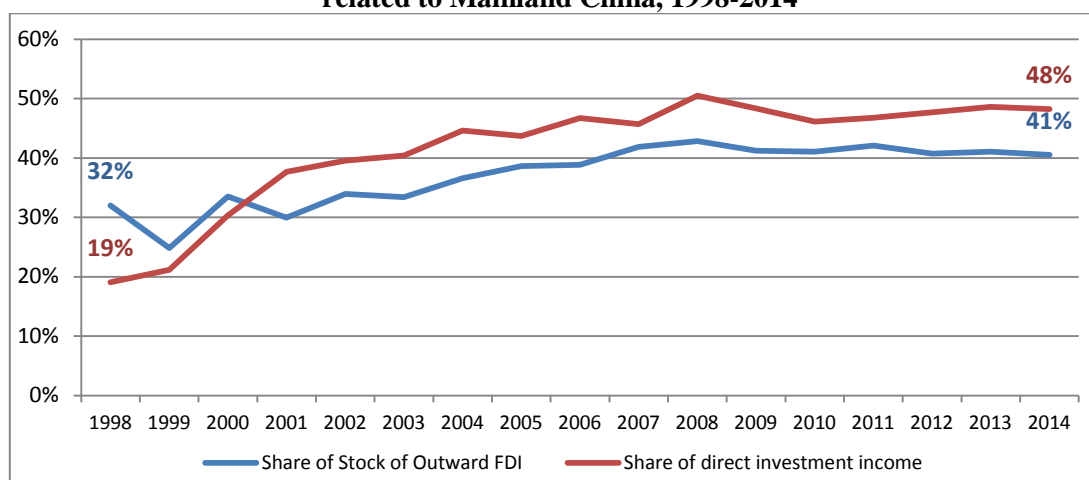
Export of services does not only contribute to economic growth. It also plays a greater role in generating employment than merchandise export because service provision is typically more labour-intensive. Sung et al. (2015) estimated that in 2013 all visitors, Mainland visitors, IVS visitors, and visitors of Multiple Entry Individual Visit Endorsements (M-Permit) respectively generated 4.2%, 2.6%, 1.6%, and 0.3% of Hong Kong's GDP, but the contribution to total employment is higher at 6.4%, 4.5%, 2.7%, and 0.5% respectively.¹² The employment opportunities mainly refer to the tourism-related sectors, such as retail, restaurants, transportation and accommodation, without counting the indirect contribution to other industries. Hence, the estimated contribution to economic growth and employment is just the lower bound.

12. Sung et al. (2015) estimated that for every thousand M-Permit visitors, non-M-Permit IVS visitors, non-IVS Mainland visitors, and non-Mainland visitors, 1.67, 5.33, 4.96 and 5.17 jobs respectively are created in Hong Kong.

2.1.2 As a Destination and Source of Capital Flow

Mainland China is both a major destination of Hong Kong's outward direct investment (ODI) and an important source of its inward foreign direct investment (FDI). In 2014 Hong Kong's stock of outward investment in Mainland China amounts to \$4,560 billion, or 41% of its total outward direct investment stock, yielding a direct investment income of \$450 billion, or 48% of Hong Kong's total investment income from abroad.

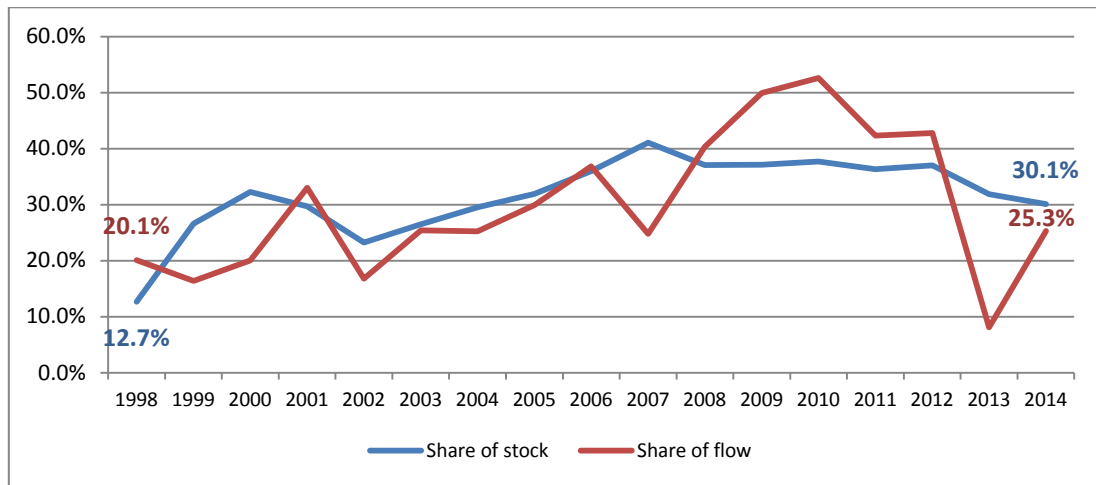
Figure 16: Percentage share of Hong Kong's Outward Foreign Direct Investment (ODI) related to Mainland China, 1998-2014



Source: Census and Statistics Department

At the same time Mainland China is a major source of Hong Kong's inward FDI with a percentage share of around 30% of the stock. Other countries have also been increasing their investments in Hong Kong over time, presumably to take advantage of Hong Kong's unique position as a gateway to Mainland China but Mainland's share remains at about 30% (see **Figure 17**).

Figure 17: Percentage Share of Hong Kong's Inward Direct Investment Flow and Stock Related to Mainland China, 1998-2014



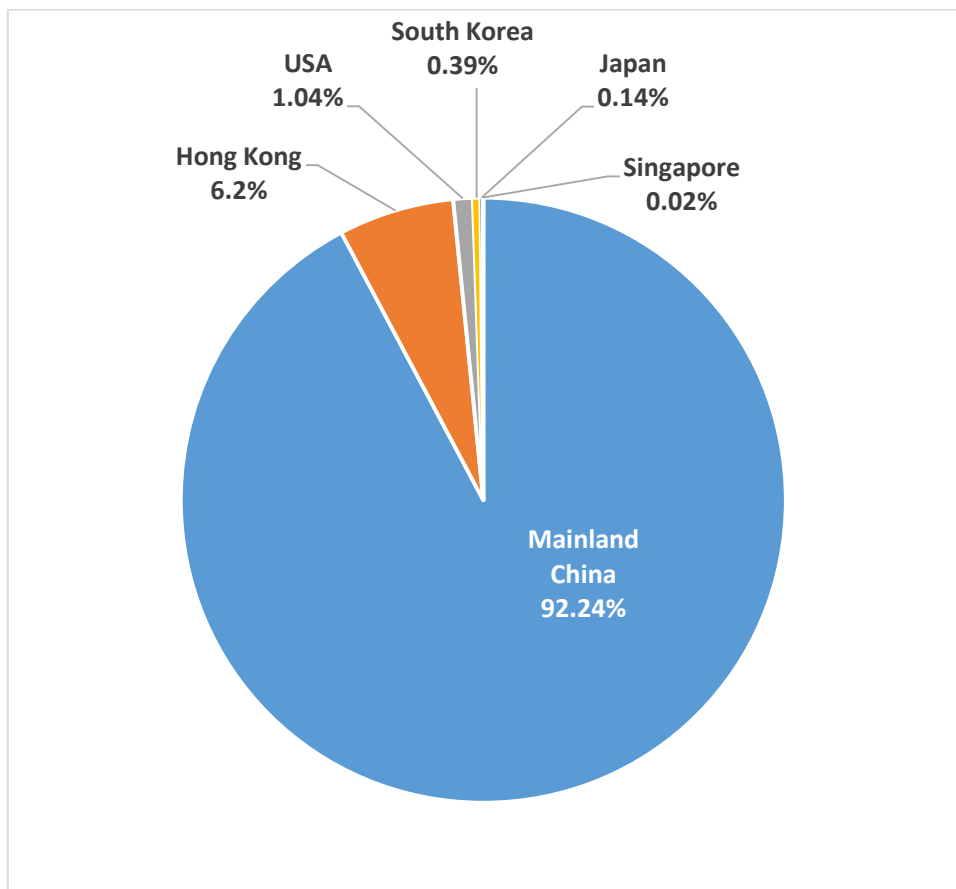
Source: Census and Statistics Department

In addition, Mainland China is a major contributor to Hong Kong's internationally recognised stock market. Over the past few years, Hong Kong's stock exchange has been ranked within the world's top 5 exchanges in terms of IPO fund raising¹³. In 2015 Mainland enterprises took the largest share of Hong Kong's IPO fund raising, constituting 92% of the IPOs in Hong Kong while Hong Kong enterprises accounted for just 6% (see **Figure 18**). Trading in Hong Kong's stock market is increasingly dominated by trading in shares of listed Mainland enterprises. From 1997 to 2015, the share of Mainland enterprises' trading turnover in the total annual trading turnover of Hong Kong's stock market nearly doubled, from 38% to 73% (see **Figure 19**). The increasing market presence of Mainland enterprises is also evident from their share of market capitalization.¹⁴ It increased from 16% in 1997 to 62% in 2015 (see **Figure 20**). It is fair to say that were it not for the listing of Mainland enterprises, Hong Kong's stock market would be much smaller in trading turnover and market capitalization.

¹³ According to Hong Kong Exchanges and Clearing Limited, the Historical IPO rankings of HKEx are: 2015 (1st); 2014 (2nd); 2013 (4th); 2012 (4th), 2011 (1st).

¹⁴ Market capitalization refers to the total market value of the shares outstanding of a publicly traded company.

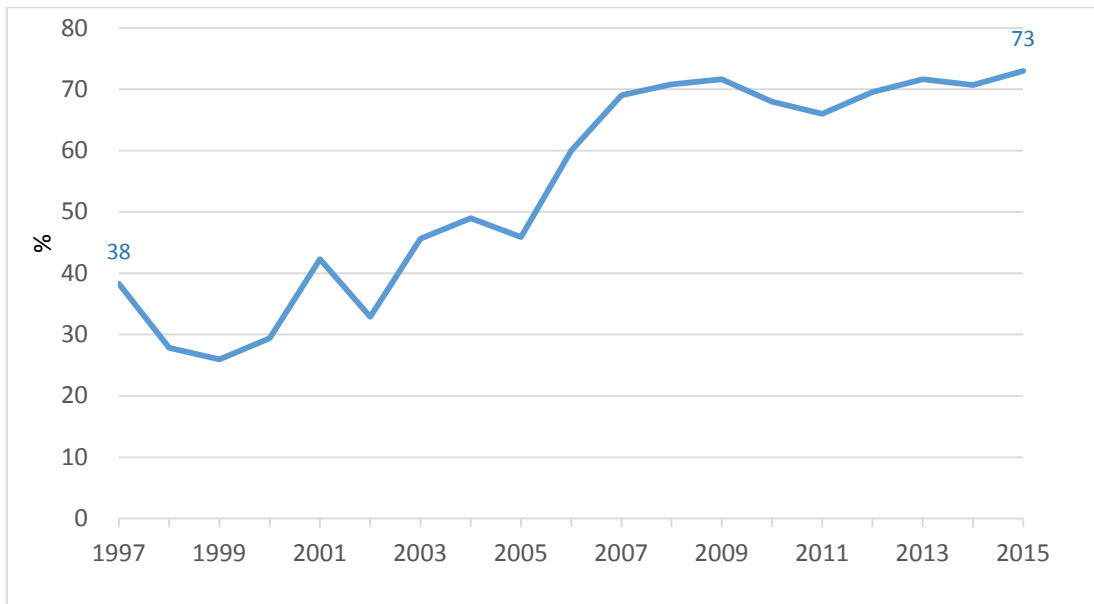
Figure 18: IPOs Raising Fund in Hong Kong by Territories of Companies, 2015



Note: Mainland enterprises include H-share companies, red chip companies and Mainland private enterprises

Source: Hong Kong Exchanges and Clearing Limited

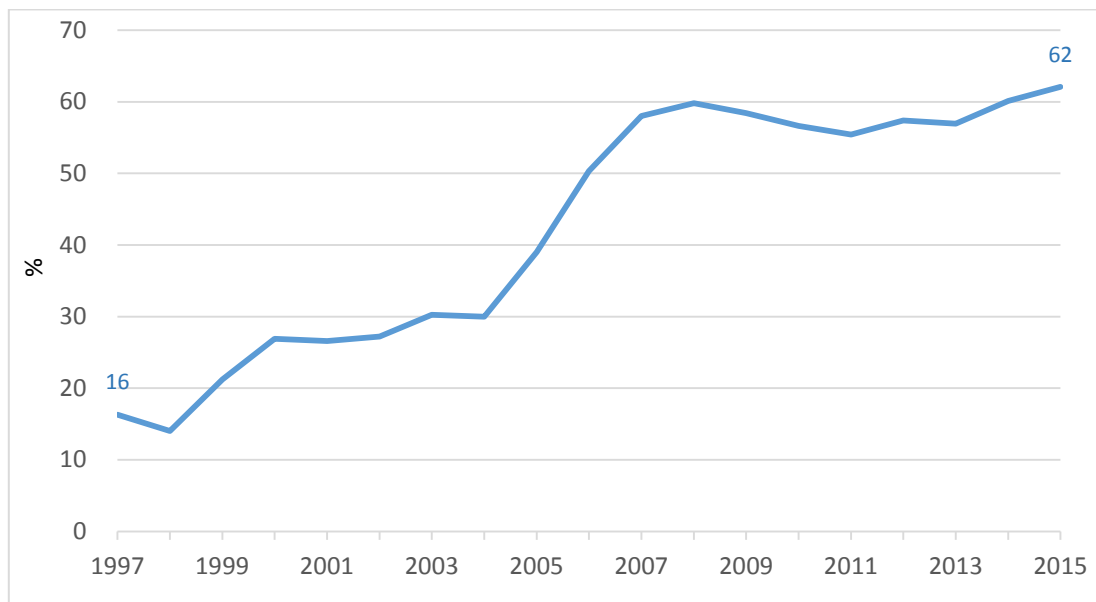
Figure 19: Share of Mainland Enterprises' Total Annual Trading Turnover in the Total Annual Trading Turnover of Hong Kong's Stock Market, 1997-2015



Note: Mainland enterprises include H-share companies, red chip companies and mainland private enterprises

Source: Hong Kong Exchanges and Clearing Limited

Figure 20: Share of Mainland Enterprises' Market Capitalization in Hong Kong's Total Market Capitalization, 1997-2015

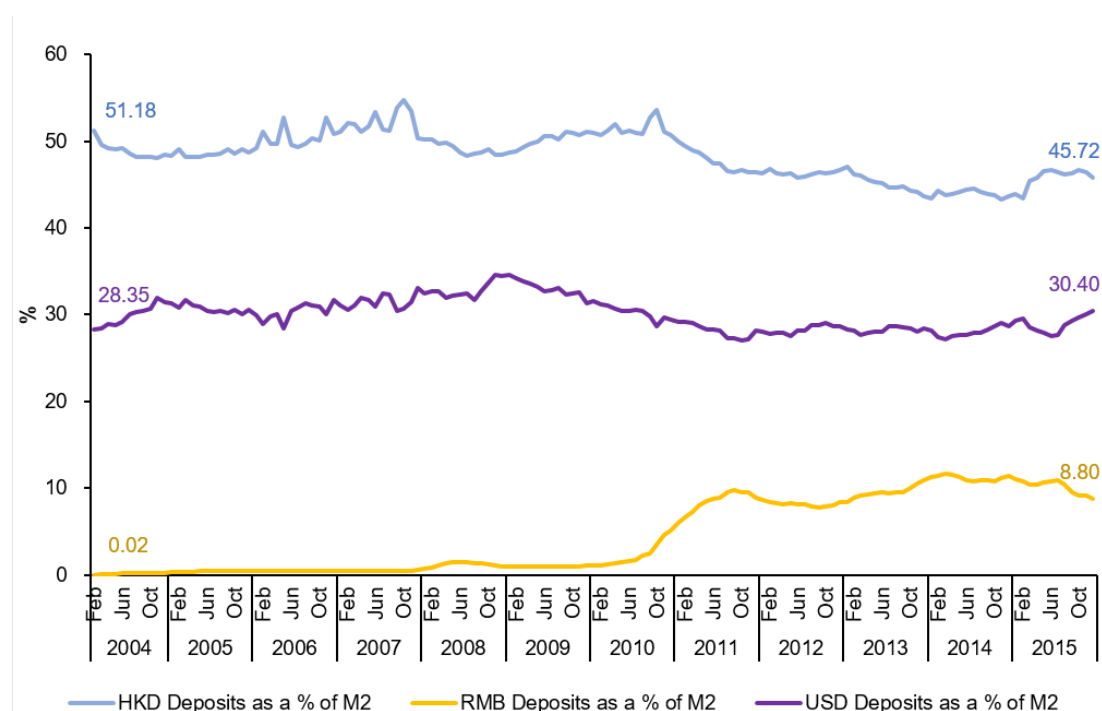


Note: Mainland enterprises include H-share companies, red chip companies and Mainland private enterprises.

Source: Hong Kong Exchanges and Clearing Limited

The internationalization of RMB is China's national policy. Hong Kong capitalises on the opportunities and establishes itself as the leading offshore RMB centre. The RMB is gradually gaining acceptance in the Hong Kong currency market. The share of RMB deposits consisting of time deposits, demand deposits and saving deposits, in Hong Kong's money supply M2¹⁵ increased from 0.3% in 2004 to 11.4% in 2014. Despite the fact that the share then dropped to 8.8% in Dec 2015 due to a sharp RMB depreciation in the same year, it remains the second largest foreign currency deposit in M2, after the U.S. dollar (see **Figure 21**). Hong Kong has the largest pool of offshore RMB liquidity. This creates abundant opportunities for Hong Kong's financial service industry in offering RMB-denominated products like shares, dim sum bonds and RMB loans. The internationalization of RMB holds the promise of further propelling Hong Kong to become the leading international financial centre. More discussion on this will be deferred to Chapter 5.

Figure 21: Share of RMB and US Dollar Deposits in Hong Kong's Money Supply M2



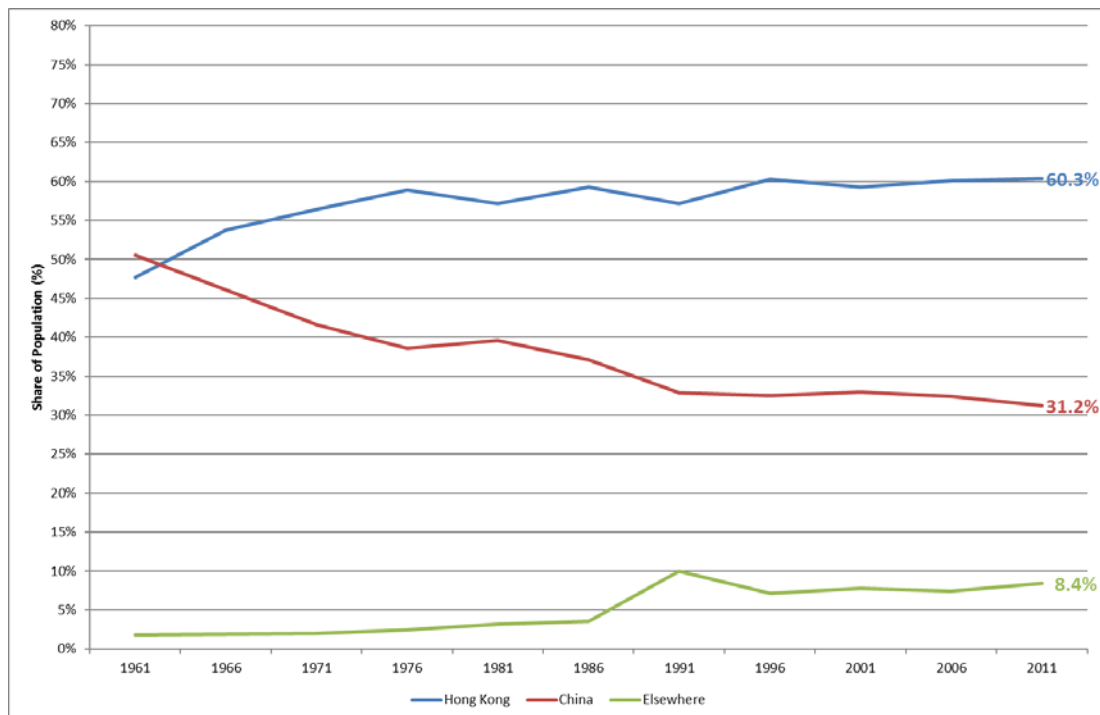
Sources: Hong Kong Monetary Authority, CEIC Data, Our Hong Kong Foundation

¹⁵ M2 money supply includes cash and checking deposits (M1) as well as saving deposits, money market mutual funds and other time deposits.

2.1.3 As a Source of Immigrants and Human Capital

Mainland China has always been the major source of immigrants for Hong Kong. Until the 1960's, Hong Kong was an immigrant society; more than half of the people in the population were born outside of the territory who migrated to Hong Kong at a certain stage of their lives. Over the decades the percentage of Mainland immigrants in the population has slowly declined, albeit a continuous flow of immigrants from Mainland China has kept the percentage above 30% (see **Figure 22**).

Figure 22: Hong Kong Population by Place of Birth, 1981 – 2011



Source: Census and Statistics Department

(a) Mainland Immigration and Hong Kong Population: A Brief History¹⁶

After the Second World War, there was a wave of return migrants from the Mainland, those who earlier fled to the Mainland to evade Japanese occupation in Hong Kong. From 1949 to early 1950's another wave of immigrants who fled the communist rule on the Mainland arrived in Hong Kong. Hitherto movement across the border between Hong Kong and the Mainland was uninhibited but after these waves of immigrants, a quota was imposed to control immigration in 1950. The

¹⁶ For more details of Chinese immigration in Hong Kong, read Lam and Liu (1998), pp. 7-17.

failure of the Great Leap Forward on the Mainland in the early 1960's brought the first wave of illegal immigrants after the imposition of border control. From 1959 to 1962, 142,000 illegal immigrants crossed the border. By 1961 as many as 50.3% of Hong Kong's population were born in Mainland China. In 1979-80 a second wave of illegal immigration arrived Hong Kong. Following the opening up and reform in China, greater geographical mobility of people was made possible by the weakened control on household registration. Within two years, over 300,000 crossed the border, accelerating Hong Kong's population growth to 5% p.a.. This led to the abolition of the so-called "touch-base" policy by the Hong Kong Government in October 1980, closing the door to illegal immigrants from the Mainland. It should be noted that in between the illegal immigration waves and before the abolition of the "touch-base" policy, there had been a continuous but smaller flow of illegal immigrants who crossed the border as well as legal immigrants admitted under the quota.

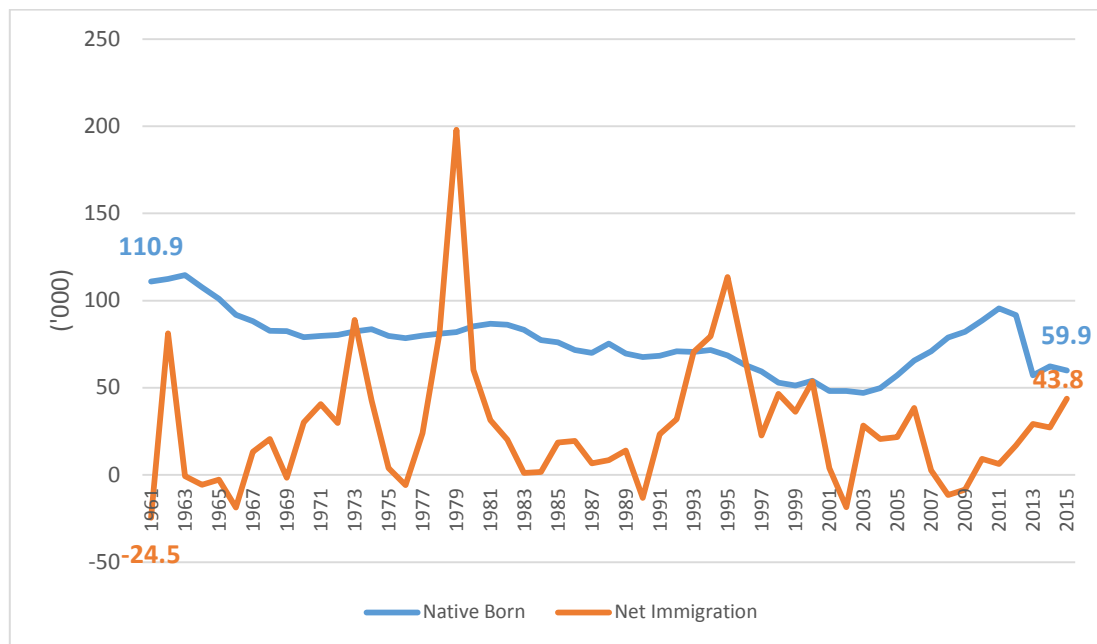
After the door was closed in October 1980, illegal immigrants were no longer issued Hong Kong identity cards and could not be legally employed. Henceforth Mainland immigrants can only migrate to Hong Kong legally under a daily quota agreed between the Hong Kong and the Chinese governments. To clear the backlog of Mainland spouses and children of Hong Kong residents who would have the right of abode in Hong Kong under the Basic Law that would take effect in 1997, the daily quota of 75 was increased to 105 in 1993 and again to 150 in 1995. This has been the daily quota up to present.

The end of the waves of legal and illegal immigration changes fundamentally the composition of the Hong Kong population. The number of native born in the population started to outstrip the number of immigrants as documented in the 1966 census. Hong Kong has changed from basically an immigrant society into an indigenous society. It should be noted, however, that even though the native born are now the majority of the population, a significant percentage of them actually have Mainland immigrant parents. Though not immigrants themselves, they are the so-called second-generation immigrants. The 1991 census shows that among young adults age 20-25, second-generation immigrants constitute as many as 57% of that age

cohort. In the 2011 census this percentage fell to 30% whilst the percentage of first-generation immigrants in the age cohort was 19%,¹⁷ i.e. nearly half of the age cohort are either Mainland immigrants themselves or second-generation immigrants with Mainland immigrant parentage.

In any case Mainland immigration has been an important factor in sustaining Hong Kong's population growth. **Figure 23** shows that the number of child births has been falling for half a century as Hong Kong's female total fertility rate declines. Population growth (projected to turn negative in 2043) has been slowing down. Net immigration (arrivals net of departures) with arrivals mainly from the Mainland has been crucial in slowing down the decline in population growth rate, and as we will demonstrate in Chapter 6, critical in preventing Hong Kong's population from shrinking in the future.

Figure 23: Number of Native Born and Net Immigration in Hong Kong, 1961 – 2015



Note: Net immigration is immigration net of out-migration.

Source: Census and Statistics Department

¹⁷ See Kit-Chun Lam and Pak-Wai Liu, "Intergenerational Educational Mobility in Hong Kong: Are Immigrants More Mobile Than Natives?" revised version of Working Paper 42, Lau Chor Tak Institute of Global Economics and Finance, The Chinese University of Hong Kong, June 2016.

(b) Immigration as a Source of Human Capital

Overseas and Mainland talents can enter Hong Kong to work and/or stay as immigrants through various schemes, namely General Employment Policy (GEP), Admission Scheme for Mainland Talents and Professionals (ASMTP), Capital Investment Entrant Scheme (CIES), Quality Migrant Admission Scheme (QMAS), Immigration Arrangements for Non-local Graduates (IANG) and Admission Scheme for the Second Generation of Chinese Hong Kong Permanent Residents (ASSG). Persons admitted under these schemes are usually skilled workers with good education background. They are allowed to apply for the right of abode in Hong Kong after seven years of continuous residence. These schemes are important channels for attracting overseas and Mainland talents to come as a supplement to Hong Kong's human capital stock and to diversify its labour supply. Besides the above schemes for educated and skilled immigrants, overseas and Mainland persons can also enter and stay in Hong Kong as dependants of admitted persons or, in the case of Mainland persons, granted one-way permits (OWP) for the purpose of family reunion. **Table 3** summarises the objectives and the eligibility of the eight schemes under which admitted persons can apply for the right of abode after seven years of continuous residence. These schemes provide a stream of potential immigrants and human capital for Hong Kong.

Table 3: Objective and Eligibility of Chinese Residents of the Mainland in Different Immigration Schemes of Hong Kong

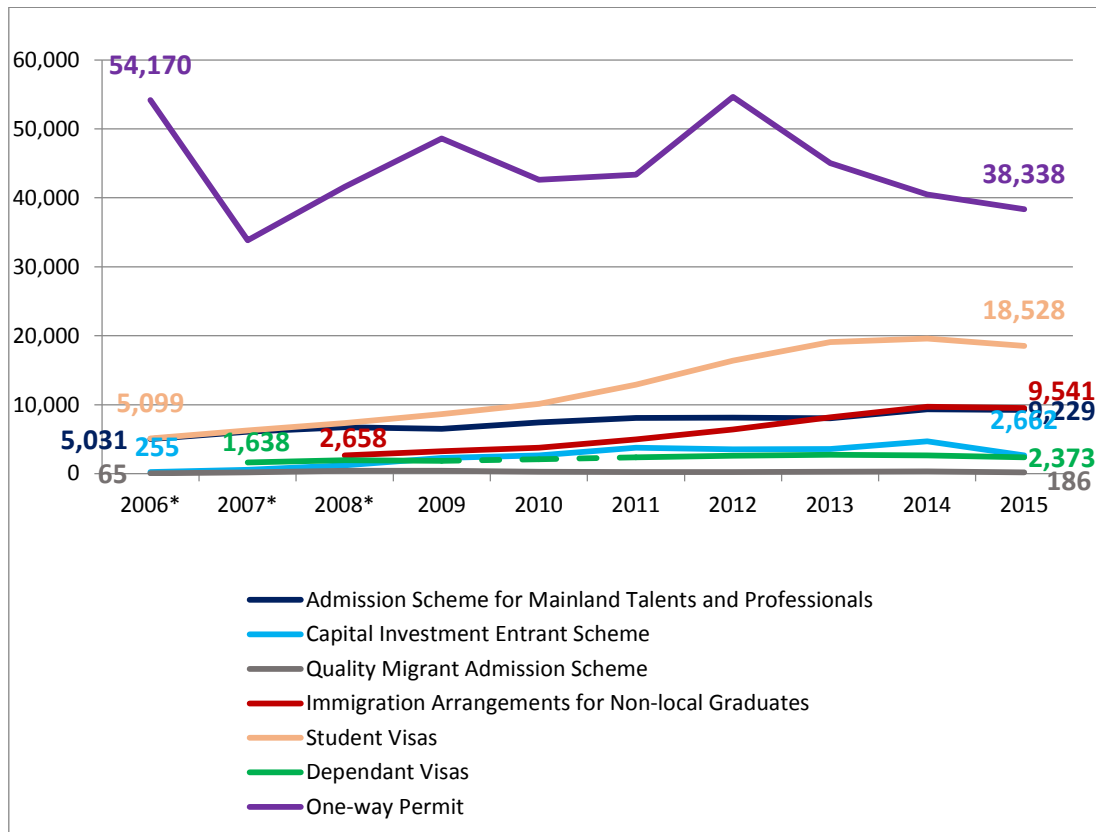
Hong Kong's Immigration Scheme	Objectives	Eligibility of Chinese residents of the Mainland
General Employment Policy (GEP)	For employment as professionals.	No
Admission Scheme for Mainland Talents and Professionals (ASMTP)	For employment as professionals.	Yes
Capital Investment Entrant Scheme (CIES)	For persons who make capital investment in Hong Kong.	Yes
Quality Migrant Admission Scheme (QMAS)	For attracting highly skilled or talented persons without requiring an offer of local employment.	Yes
Immigration Arrangements for Non-local Graduates (IANG)	For non-local graduates to stay/return and work in Hong Kong.	Yes
Admission Scheme for the Second Generation of Chinese Hong Kong Permanent Residents (ASSG)	For the second generation of emigrated Chinese Hong Kong permanent residents from overseas to return and work in Hong Kong.	No
Dependant Visas	For immediate family members of persons who are: (i) Hong Kong permanent residents; or (ii) residents who are not subject to a limit of stay or (iii) employed; or (iv) studying in a local degree-awarding institution; or (v) admitted into Hong Kong under specific entrant schemes (e.g. CIES, QMAS).	Yes
One-way Permit	For allowing Mainland China residents to come to Hong Kong for the purpose of family reunion.	Yes

Note: Employment visas issued for short-term employment under GEP and ASMTP are included.

Sources: Immigration Department, Our Hong Kong Foundation

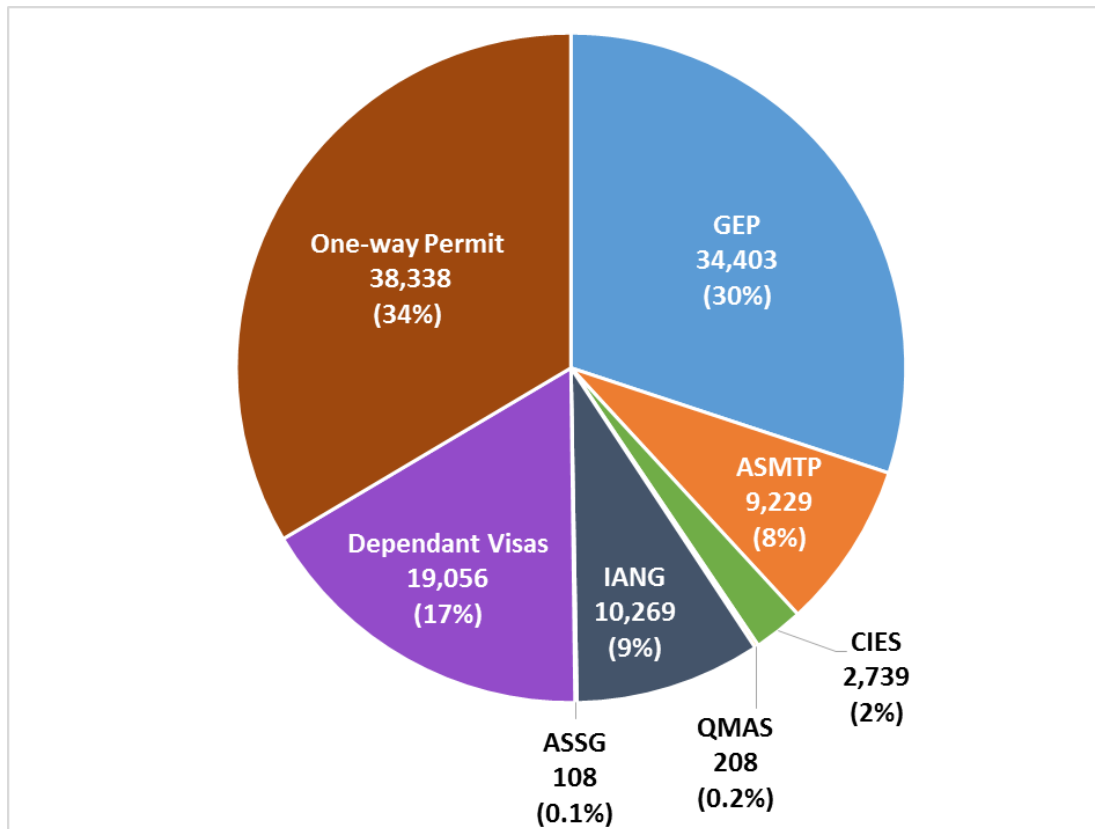
Figure 24 shows the number of Mainland persons admitted under the six schemes for which they are eligible as well as the number of student visas issued over time. Even though student visas do not entitle the holders to stay and work, their number is highly related to the number admitted under the IANG scheme as non-local students can find a job and stay after graduation. **Figure 25** shows the distribution of immigrants admitted under the six schemes in 2015.

Figure 24: Number of Selected Visas/Entry Permits Issued to Mainland Residents, 2006-2015



Notes: (*) Figures refer to fiscal year figures (except for one-way permit).
 (1) Quality Migrant Admission Scheme was implemented on 28 June 2006.
 (2) Immigration Arrangements for Non-local Graduates was implemented on 19 May 2008.
 (3) Number of "Dependant Visas" issued was not available in 2006 and 2010.
 Source: Immigration Department

Figure 25: Number of Selected Visas / Entry Permits Issued, 2015

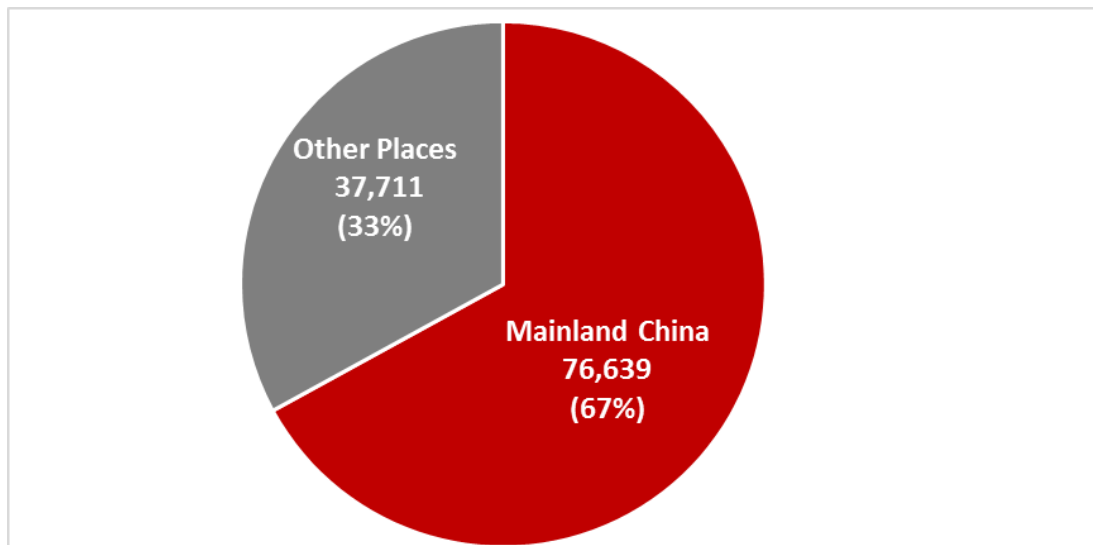


Note: Employment visas issued for short-term employment under GEP and ASMTTP are included.

Sources: Immigration Department, Our Hong Kong Foundation

In 2015 as many as 67% of the persons admitted under the eight selected entrant schemes in **Table 3** were from Mainland China (see Figure 26). It should be noted some of the overseas persons admitted under the General Employment Policy (GEP) are on short term employment contracts and many do not stay long enough to apply for the right of abode. When it comes to the Mainland percentage of persons admitted who apply for the right of abode, it will certainly be higher than two-third. Mainland China is undoubtedly the major contributor to Hong Kong's immigrant population.

Figure 26: Number of Persons Admitted in Selected Visas / Entry Permits by Place of Origin, 2015



Source: Immigration Department

2.2 Importance of Hong Kong to Mainland China

As Mainland China gradually opens its market to world trade through its accession to WTO and the signing of 13 Free Trade Agreements (FTA) with other countries/territories¹⁸, Hong Kong's intermediary role between Mainland China and the rest of the world has attenuated. Despite the declining importance of Hong Kong to Mainland China in trade, Hong Kong has played a critical role in helping the Mainland go global at different stages of its development and will continue to play a significant role in the years to come.

2.2.1 Hong Kong's Historic Role to Mainland China

In the early years of Mainland China's economic reform and opening up foreign investors lacked confidence in investing in the Mainland because they were concerned about the instability of China's investment environment and policy uncertainty, Hong Kong companies took the first move to invest in the Mainland. Examples of early Hong Kong investments are the first foreign funded factory, Xiangzhou Woollen Mill of Zhuhai, established in 1978; the first Sino-foreign joint venture, Beijing Air Catering Limited, established in 1980; and the first five-star hotel, White Swan Hotel,

¹⁸ According to China FTA Network, there are 13 Free Trade Agreements signed so far, which cover ASEAN, Pakistan, Chile, New Zealand, Singapore, Peru, Hong Kong, Macau, Costa Rica, Iceland, Switzerland, Korea, and Australia.

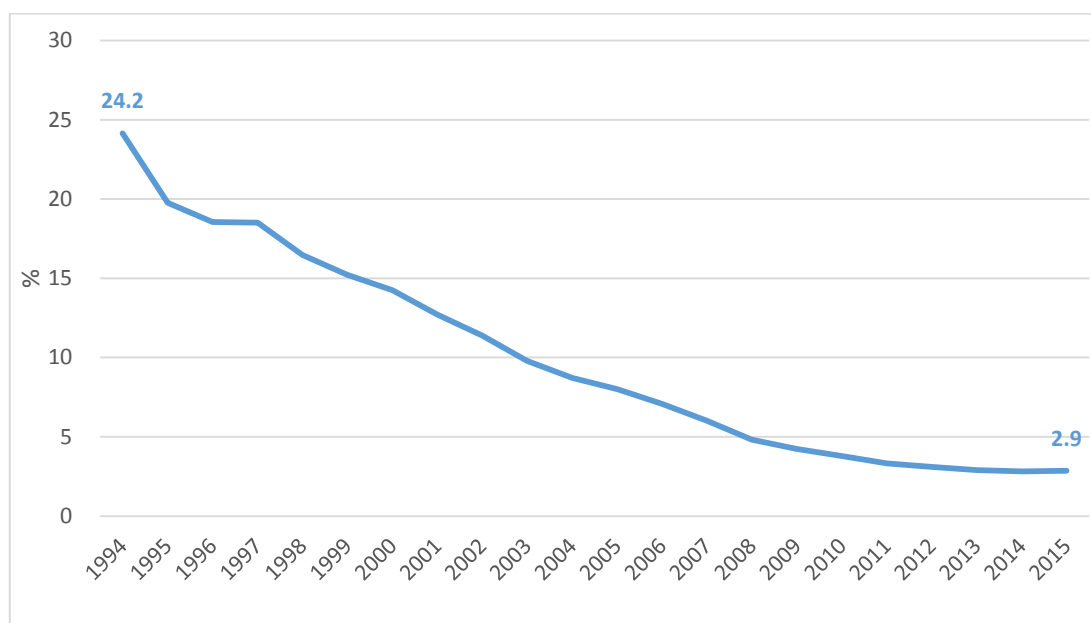
established in 1983. The Mainland's economic development took off and other foreign investors followed Hong Kong's lead and invested in Mainland China.

Besides direct investment, many Hong Kong manufacturers moved their production lines to Southern China and expanded their production capacity. During the 1990s, over 70% of Hong Kong's domestic exports to Mainland China, in terms of trade value, involved manufacturing processing in the Mainland. Hong Kong investors did not only bring in capital for the Mainland, but also modern management methods and information of the international market, which accelerated China's industrialisation and opening up. Furthermore, Hong Kong has long been a bridge between the Chinese market and the international market. It has been a stepping stone for Mainland enterprises going overseas, as well as a conduit for foreign investment entering Mainland China.

2.2.2 Current Importance of Hong Kong to Mainland China

One way to gauge the economic importance of Hong Kong to Mainland China is to compare the size of GDP of Hong Kong and Mainland China's. The ratio of Hong Kong's GDP to Mainland China's GDP dropped sharply from 24% in 1994 to below 3% in 2015 (see **Figure 27**). In fact, if we compare Hong Kong with other provinces, direct-controlled municipalities and autonomous regions in Mainland China, Hong Kong's GDP was higher than that of Inner Mongolia but lower than Anhui, which means the GDP of around half of the provinces and direct-controlled municipalities are higher than that of Hong Kong (see **Table 4**). This comparison illustrates the declining importance of Hong Kong to Mainland China in GDP as the Mainland grows rapidly over the decades.

Figure 27: Ratio of Hong Kong GDP to Mainland China GDP, 1994-2015



Notes: (1) GDPs of Hong Kong S.A.R., Macau S.A.R., and Taiwan are excluded from Mainland China's GDP.

(2) GDP is nominal GDP in US dollar. Only data after 1994 is shown. There was a great depreciation in RMB from 1979 to 1994 as a result of Mainland China's exchange rate policy. After 1994, RMB exchange rate became more stable.

Source: The World Bank

Table 4: Ranking of Mainland China's Gross Regional Product, 2014

Region	Share of total GDP in 2014	Rank in 2014	Region	Share of total GDP in 2014	Rank in 2014
Guangdong	9.9	1	Tianjin	2.3	17
Jiangsu	9.5	2	Jiangxi	2.3	18
Shandong	8.7	3	Guangxi	2.3	19
Zhejiang	5.9	4	Heilongjiang	2.2	20
Henan	5.1	5	Chongqing	2.1	21
Hebei	4.3	6	Jilin	2.0	22
Liaoning	4.2	7	Yunnan	1.9	23
Sichuan	4.2	8	Shanxi	1.9	24
Hubei	4.0	9	Xinjiang	1.4	25
Hunan	4.0	10	Guizhou	1.4	26
Fujian	3.5	11	Gansu	1.0	27
Shanghai	3.4	12	Hainan	0.5	28
Beijing	3.1	13	Ningxia	0.4	29
Anhui	3.0	14	Qinghai	0.3	30
Inner Mongolia	2.6	15	Tibet	0.1	31
Shaanxi	2.6	16			

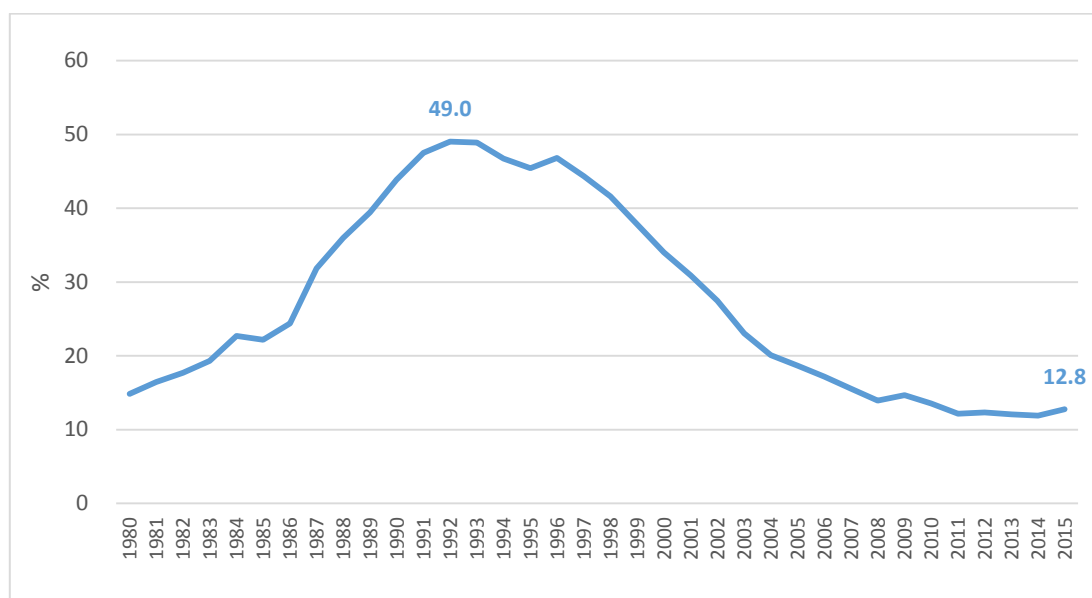
Notes: (1) Data of Hong Kong S.A.R., Macau S.A.R. and Taiwan are excluded from the statistics compilation.

(2) There are 4 direct-controlled municipalities (blue shaded) and 5 autonomous regions (yellow shaded).

Sources: National Bureau of Statistics of China, Our Hong Kong Foundation

In terms of its importance as a trading partner, Hong Kong remained the second largest trading partner of Mainland China in total merchandise trade in 2014, but it should be noted that the share of Hong Kong in Mainland China's total merchandise trade peaked in 1992 at 49% and dropped to 12.8% in 2015 (see **Figure 28**).

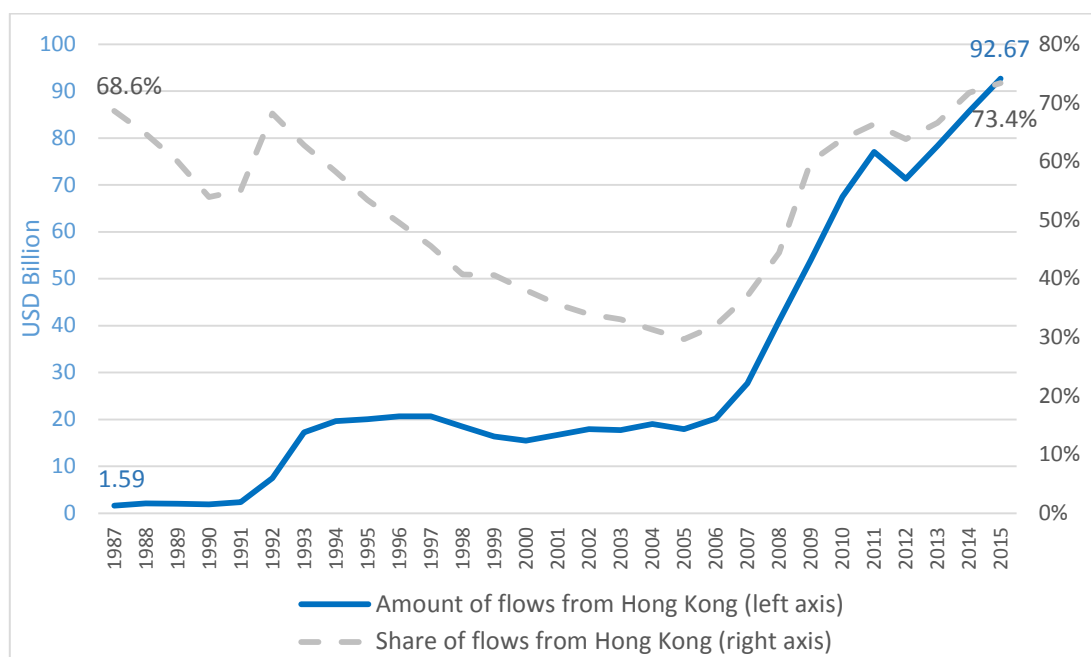
Figure 28: Share of Hong Kong in Mainland China's Merchandise Trade, 1980-2015



Sources: Census and Statistics Department (Hong Kong), National Bureau of Statistics of China, Our Hong Kong Foundation

Although the importance of Hong Kong to Mainland China as a trading partner has gradually declined, Hong Kong continues to play a critical role as a source of FDI and a destination of outward investment for the Mainland. Since the opening of China's market to foreign investment, Hong Kong, either as an investor or an intermediary, has been the largest source of China's Inward FDI amount. FDI into the Mainland from Hong Kong increased from not quite 1.6 billion US dollars in 1987 to 92.7 billion US dollars in 2015, accounting for over 73.4% of China's total Inward FDI in 2015. A sharp increase was also observed in the period of 2006 to 2015, where FDI into the Mainland from Hong Kong grew more than 3 times (see **Figure 29**). Hong Kong is also the largest recipient of outward direct investment (ODI) from the Mainland. The amount of Mainland's outward foreign direct investment flow to Hong Kong has risen to 70.9 billion US dollars, accounting for over 57.6% of China's total ODI in 2014 (see **Figure 30**).

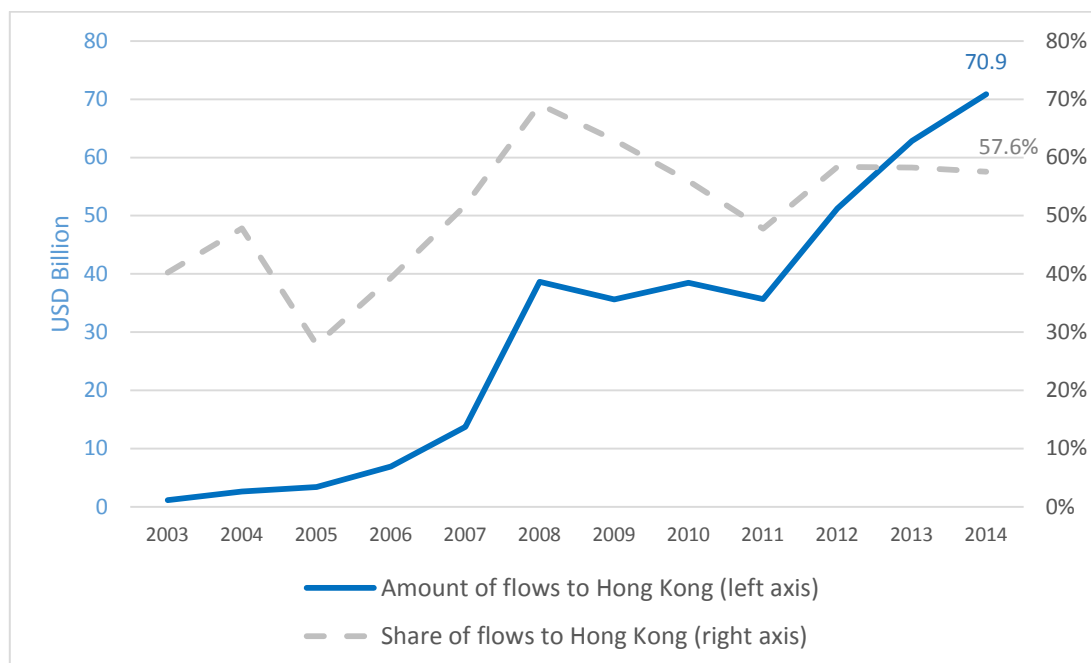
Figure 29: China's Annual Inward FDI from Hong Kong, 1987-2015



Note: In accordance with international standards, FDI statistics are presented by immediate source of investment.

Sources: Ministry of Commerce of the People's Republic of China, National Bureau of Statistics of China

Figure 30: China's Annual ODI to Hong Kong, 2003-2014

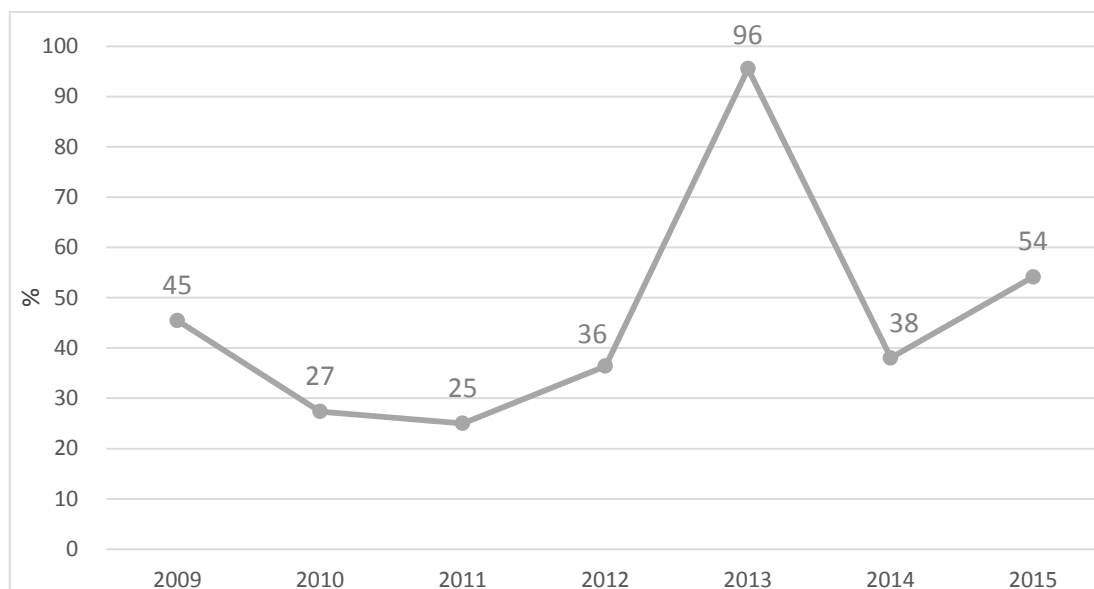


Note: In accordance with international standards, ODI statistics are presented by immediate destination of investment.

Source: Ministry of Commerce of the People's Republic of China

Moreover, Hong Kong is one of the major financial markets for Mainland China's companies to raise fund through initial public offering (IPO). From 2009 to 2015, over a quarter of IPO funds raised by Mainland China's companies were from Hong Kong Stock Market¹⁹. The importance of Hong Kong to Mainland China's IPO fund raising was highlighted in 2013, when Chinese government suspended listings in Mainland China for 13 months, from November 2012 to December 2013. As a result, Hong Kong Stock Market contributed to over 90% of total IPO fund raised by Mainland China's companies in that year (see **Figure 31**). Hong Kong provides an alternative to Mainland China's companies to raise fund through IPO, especially when financial control measure is implemented in Mainland China. Besides IPO, Mainland China's companies can also raise funds through bank loans or issuing bonds in Hong Kong. In the past few years, the RMB financial platform in Hong Kong has grown. The outstanding amount of RMB bank loans in 2015 was almost 10 times as that in 2011, and the outstanding amount of RMB bonds also increased over 1.5 times during the period (see **Figure 32**).

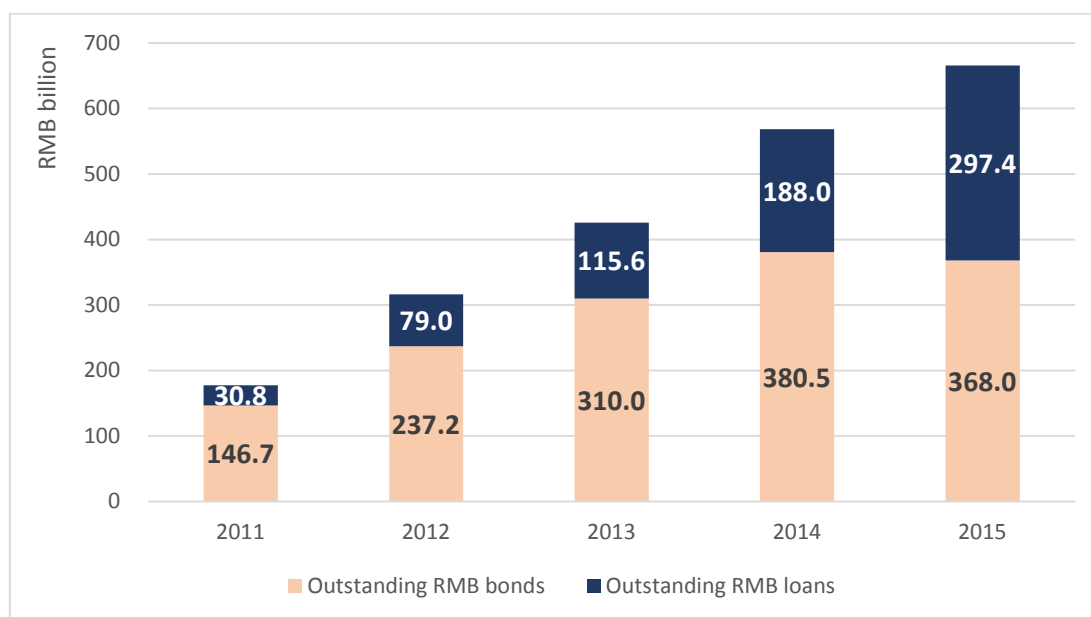
Figure 31: Percentage of Overseas IPOs Fund Raised in Hong Kong to Total IPOs Fund Raised by Mainland China's Companies, 2009-2015



Source: Zero2IPO Research

¹⁹ In 2014, Alibaba listed in the US and the IPO fund raised accounted for nearly 35% of annual total IPO fund raised by Mainland China's companies. In the same year, 38% of IPO fund raised by Mainland China's companies was through Hong Kong (see Figure 32).

Figure 32: Outstanding Amount of RMB Loans and RMB Bonds, 2011 – 2015



Source: Hong Kong Monetary Authority

Besides the importance to Mainland China in respect of the flow of trade and capital, Hong Kong becomes the pilot testing ground for Chinese Government's open market policy in recent decades, such as signing the first Free Trade Agreement (FTA) of CEPA with Mainland China, becoming the first RMB offshore centre with a clearing bank in RMB, launching the first RQFII programme and issuing the first overseas sovereign RMB bond and corporate dim sum bond. In addition, Shanghai-Hong Kong Stock Connect was a pilot programme that, for the first time, international investors will be able to directly access China's biggest stock market in Shanghai exclusively through HKEx. After accumulating experience through the pilot programmes in Hong Kong, Chinese government would modify the policy and further expand the programmes to other regions (see **Table 5**).

Table 5: China's Pilot Programmes in Hong Kong and Implementation in Other Countries/Territories

	Hong Kong	Other Territories
Trade	CEPA was first signed in 2003.	From 2004, Mainland China signed 12 free trade agreements with other territories: ASEAN, Pakistan, Chile, New Zealand, Singapore, Peru, Macau, Costa Rica, Iceland, Switzerland, Korea and Australia.
Capital	Bank of China (Hong Kong) Limited was appointed the first RMB offshore clearing bank in December 2003.	There are 20 RMB offshore clearing banks appointed as at 2015, including in Macau, Taiwan, Singapore, UK and Korea.
	First overseas sovereign RMB bond was issued in Hong Kong in 2009.	UK issued sovereign RMB bond in 2014.
	RQFII program was first launched in Hong Kong in 2011.	Mainland China expands RQFII program to 17 countries/territories, including U.S., Thailand, Malaysia, Singapore, U.K. and Korea.
	Shanghai-Hong Kong Stock Connect was launched in November 2014 and Shenzhen-Hong Kong Stock Connect in late 2016.	The feasibility of Shanghai-London Stock Connect and Shanghai-Taipei Stock Connect are being studied.

In the coming Thirteenth Five-Year Plan China will be further integrating its economy with the global economy, opening up its capital account, internationalizing its currency, re-orienting towards domestic consumption, restructuring its economy with a greater emphasis on the tertiary sector, and driving its economic growth with productivity-enhancing innovation and technology. As an international business and financial centre, Hong Kong will continue to play an important role as China's gateway to the world as it internationalizes. Hong Kong's mature free market economy and institution will serve as a reference for the Mainland as it builds its own institutions. Hong Kong's strengths in its service industries will assist the Mainland to further develop its tertiary sector. Hong Kong will be a model for Mainland China in management, corporate governance and business practices as it modernises its enterprises.

2.3 Concluding Remarks

To conclude, the importance of Mainland China to Hong Kong has been growing significantly in the past decades, and so had been the importance of Hong Kong to the Mainland's economic development in the early years of its reform. However, times have changed; the overall importance of Hong Kong to Mainland China has been declining gradually since the 1990s. The relative size of the two economies changes as Mainland China grows rapidly to become the second largest economy in the world. Hong Kong's share of Mainland's external trade has also dwindled as China becomes the largest trading nation in the world. However, Hong Kong remains important to the Mainland as China opens up its capital account, internationalises its currency and further integrates its economy with the global economy. In view of these changes, Hong Kong should look for opportunities to get strategically connected with Mainland China again to try to play a significant role in its next phase of development. Hong Kong should position itself to become a relevant and significant partner of Mainland China as it enters a new era of economic growth to share the benefits of its growth.

In the following chapter, general growth policies will be reviewed. Specific policy suggestions on the cooperation between Hong Kong and Mainland China in the area of trade flow, capital flow, people flow will be discussed in Chapters 4-6.

3. Economic Growth and the Mainland China Factor

3.1 Driving Forces of Economic Growth

One can look at what contribute to economic growth or what economic growth is made up of through three perspectives. The first is the supply perspective. Economic growth as represented by the growth in GDP is constrained by the growth in the supply of inputs like capital, land and labour and their total factor productivity. This perspective is relevant if the government adopts policies to increase the supply of these productive factors and to increase their productivity. The second is the demand perspective. GDP growth is due to the growth in aggregate demand made up of consumption, investment, government expenditure and net export. This perspective is relevant if the government wants to promote growth by stimulating one aspect of aggregate demand or the other. The third is the industrial structure perspective. GDP growth can be decomposed into the contribution to growth of different industries, such as primary, secondary and tertiary industries, or at a more disaggregate level, manufacturing, logistic, tourism, financial services, business services etc. This perspective is relevant to government policies which promote some industries but not the others.

Conventional economic growth models are built on the supply side. The maximum amount of output that can be produced by a given amount of inputs is known as the *potential GDP*. It is the maximum level of GDP achievable when capital and labour are fully employed and operating at the current state of technology and efficiency, in other words at the efficiency frontier. In the short run, it is possible to achieve economic growth by utilizing hitherto under-utilized resources and move to the efficiency frontier. In the long run, however, economic growth (or increase in potential GDP) is possible only if there is growth in capital, labour and total factor productivity. Therefore, the driving forces of economic growth are an increase in investment to enhance the capital stock and the stock of land, an increase in the labour force through population growth and raising the labour force participation rate, an increase in human capital to raise the knowledge and skill of the labour force, and an increase in R & D, innovation and technological advancement to raise the factor productivity. To expand the capacity of the economy to achieve a higher potential GDP growth, government must take a medium to long term perspective in formulating

policies on land, infrastructure, population, immigration, education, and innovation and technology.

In the short run, short of a supply side shock, GDP growth is largely determined by the growth in the aggregate demand for goods and services of consumers, investors, the government and foreigners. Government policies in stimulating consumption, promoting trade and attracting foreign investments provide the impetus for economic growth from the demand side. They may include tax policies that stimulate consumption and investment and trade agreements with other countries to reduce trade barriers.

Economic activities take place within industries and markets. Government often seeks to target specific industries for growth. Within this framework of economic growth through promoting certain industries, government may formulate policies to build a friendly environment for investors, to enable the supply of inputs for these industries, and promote the market for their products. Even if government targets industries for growth, ultimately economic growth cannot be divorced from an increasing supply of inputs and demand for the products.

3.2 Mainland China Support for Hong Kong's Development

The importance of Mainland China to Hong Kong's economy has been highlighted in Chapter 2. It is inevitable that Mainland China will figure prominently in economic policies that will give impetus to Hong Kong's growth. The Chinese Government continues to show great support for the development of Hong Kong in major national policies. Hong Kong should capitalise on its own advantages and takes up a major role in key state policies.

As mentioned in the Thirteenth National Five-Year Plan, the Chinese Government supports Hong Kong to consolidate and enhance its role as the international financial, transportation and trade centre. It also expresses clear support to Hong Kong in developing its innovation and technology industry and becoming the international legal and dispute resolution services in the Asia-Pacific region. During

the Belt and Road Summit in May 2016, top China official Zhang Dejiang²⁰ stated that the central government would bolster Hong Kong's role in the Belt and Road Initiative in the areas of professional services, financial services, talent and cultural exchanges and cooperation with Mainland China to develop markets along the belt and road routes. On a regional basis the Framework Agreement on Hong Kong/Guangdong Co-operation, the Memorandum on Closer Co-operation between Hong Kong and Shenzhen, the Overall Development Plan of Hengqin stated that the government would fully support the development of transport infrastructure, including Hong Kong-Zhuhai-Macau Bridge and Guangzhou-Shenzhen-Hong Kong Express Rail Link, to improve the infrastructure connecting Guangzhou and Hong Kong, and facilitate border crossing by building the Liantang-Heung Yuen Wai Boundary Control Point. The Mainland government would also implement the CEPA agreement on trade in services nationally. In regional development it encourages the regional cooperation of Guangdong and Hong Kong which, among other projects, include collaboration in the development of Qianhai, Nansha and Hengqin. In the long term there is a grand vision of developing of a Guangdong-Hong Kong-Macao Bay Area.

3.3 Policy Premises

Whilst there are different policies that may promote Hong Kong's economic growth, we will only focus on those in which Mainland China is an important factor. In what follows we propose a set of supply, demand and industry-specific policies that will drive the growth of the Hong Kong economy in the years to come. They are proposed on the following premises buttressed by our historical and contemporary success experience:

1. Hong Kong has a very open economy and its continual success depends on its remaining open; inward-looking and isolationist tendencies will emaciate the economy;
2. Hong Kong must remain friendly and welcoming to its trading partners, overseas investors and visitors;

²⁰ Member of the Standing Committee of the Political Bureau of the Communist Party of China Central Committee and Chairman of the Standing Committee of the National People's Congress.

3. Hong Kong has a small economy; its economic fortune inevitably rises and falls with its largest trading partner and investor, Mainland China;
4. Hong Kong must manage well its economic inter-dependent relationship with the Mainland; while leveraging on the Mainland economy for its own economic benefits, Hong Kong must remain relevant and a valuable asset to the Mainland for the win-win relationship to be sustainable.

The Mainland-Hong Kong economic relation is underpinned by the Basic Law and the “One Country Two Systems” constitutional arrangement. The “One Country Two Systems” arrangement is unique. It enables both Mainland China and Hong Kong to derive much benefits out of the relationship. Without this arrangement, Hong Kong will not be different from other major Chinese cities. It is imperative for the future development of Hong Kong that both parties honour and strengthen this arrangement and uphold the Basic Law which provides the legal framework for this relationship.

4. Whither Hong Kong's External Trade

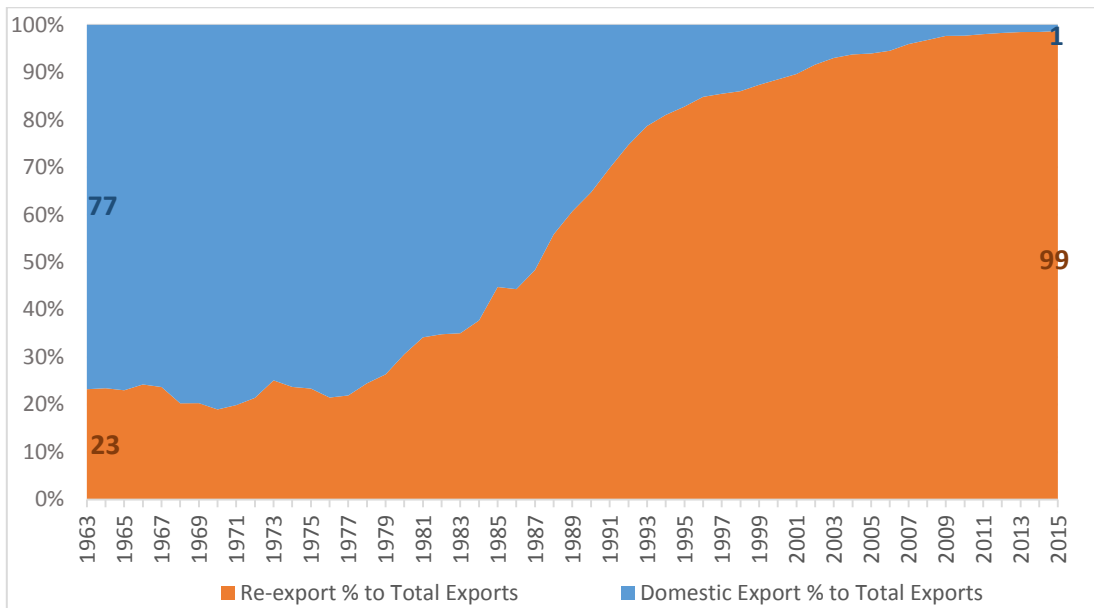
4.1 Preamble

Hong Kong began as a trading outpost on the coast of Guangdong Province. Over time it has developed into the 7th largest trading entity in the world²¹. It has gone through different stages of changes in the structure of its external trade. Total external trade consists of merchandise trade (also referred to as trade in goods or visible trade) and trade in services (also referred to as invisible trade), and both of them consist of the exports and imports. In particular, merchandise exports consist of domestic exports and re-exports.

The structure of Hong Kong's merchandise trade has been changing. The dominant role of domestic exports was replaced by re-exports in the 1980s. From 1950s to 1970s, making use of the abundant labour supply of immigrants from Mainland China, domestic production of light industries including textile, clothing, toys and watches boosted the domestic exports of Hong Kong to around 80% of its total exports. In the late 1970s, the prosperity of light industries in Hong Kong faded as manufacturers relocated their production across the border following Mainland China's economic reform in 1978. The Hong Kong economy re-structured from exporting domestically manufactured products to become oriented to re-export trade (or more specifically in recent years, offshore trade and transshipment). The proportion of re-exports in total merchandise exports was around 20% in the 1960s (see **Figure 33**). By 2015, they contributed to 99% of the total but domestic exports accounted for only 1%.

²¹ According to the World Bank, the 7 largest trading entities are U.S., China, Germany, U.K., Japan, France and Hong Kong.

Figure 33: Percentage Share of Hong Kong's Domestic Merchandise Export and Re-export to Total Merchandise Export, 1963-2015



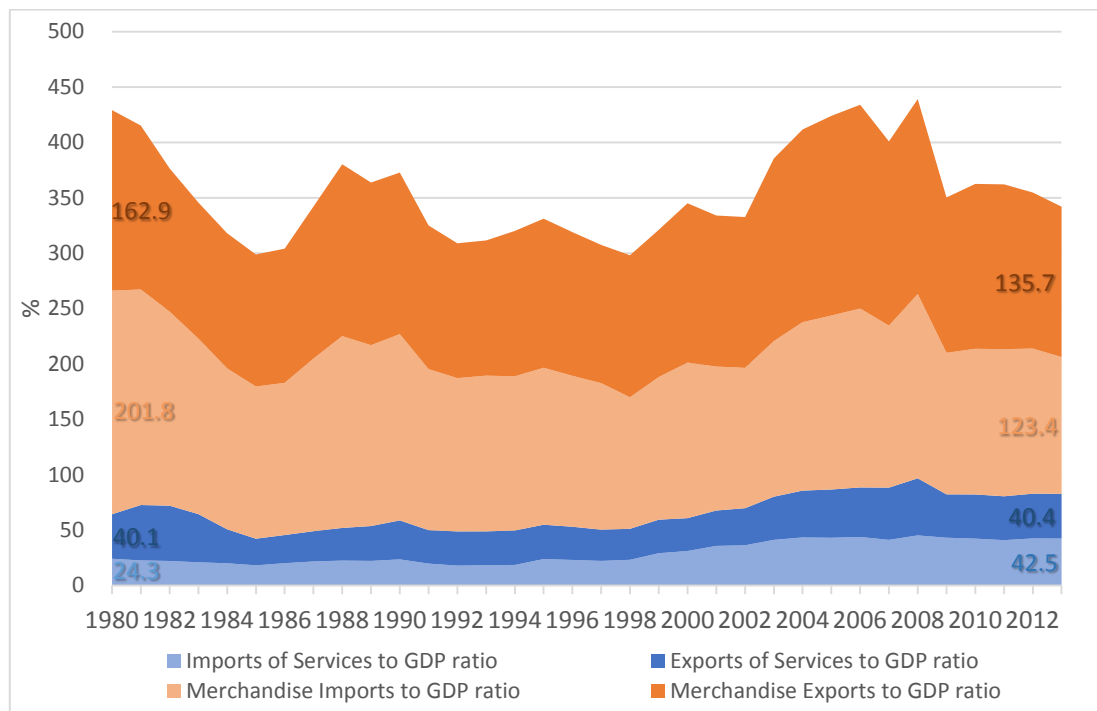
Source: Census and Statistics Department

From its beginning years as an entrepot for Guangdong, Hong Kong's external trade depends heavily on serving its hinterland. Its merchandise re-export trade is now facing a major challenge as China is restructuring its economy to rely less on external demand to be more domestic demand-oriented. In which direction will Hong Kong's external trade go? Where are the future opportunities?

4.2 From Merchandise Trade to Services Trade

Singapore and Hong Kong are two very open small economies. The components of their trade have been changing over time. In Singapore, despite the fact that merchandise trade remains a dominant component of trade, its relative importance as a percentage to Singapore's GDP has gradually declined from 365% in 1980 to 259% in 2013, while its trade in services to GDP ratio increased from 64% to 83% (see **Figure 34**).

Figure 34: Singapore's Trade to GDP Ratio by Components, 1980-2013

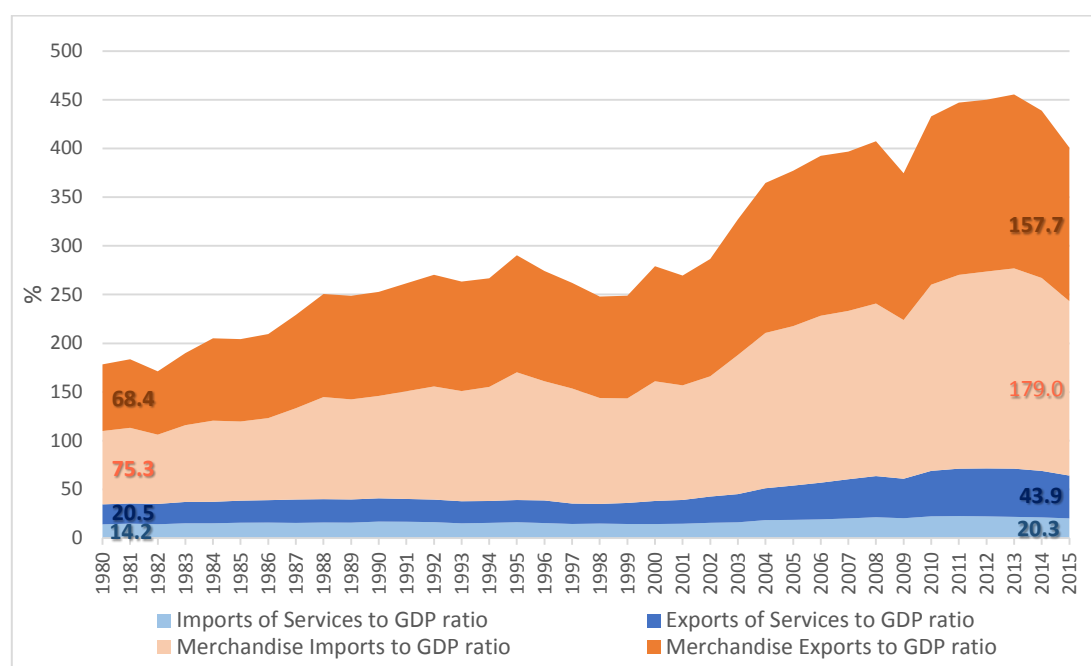


Sources: *The World Bank, World Trade Organisation, Our Hong Kong Foundation*

Comparing to Singapore, Hong Kong has a larger component of merchandise trade relative to trade in services. From 1980 to 2015, the merchandise trade to GDP ratio of Hong Kong increased from 144% to 337%, whereas its trade in services to GDP ratio increased only from 35% to 64%. In the last decade, while the export of services has increased significantly as a percentage of GDP, the percentage of the import of services remains nearly the same due to the contraction of manufacturing services²² from Mainland China (see **Figure 35**). This may account for the slower growth in trade in services in Hong Kong. In comparison to Singapore and Luxembourg, there is room for the trade in services to expand as a percentage of GDP.

²² Manufacturing services refer to manufacturing activities such as processing, assembly, labelling and packing that are undertaken by processing entities but the entities do not own the goods concerned.

Figure 35: Hong Kong's Trade to GDP Ratio by Components, 1980-2015



Source: Census and Statistics Department

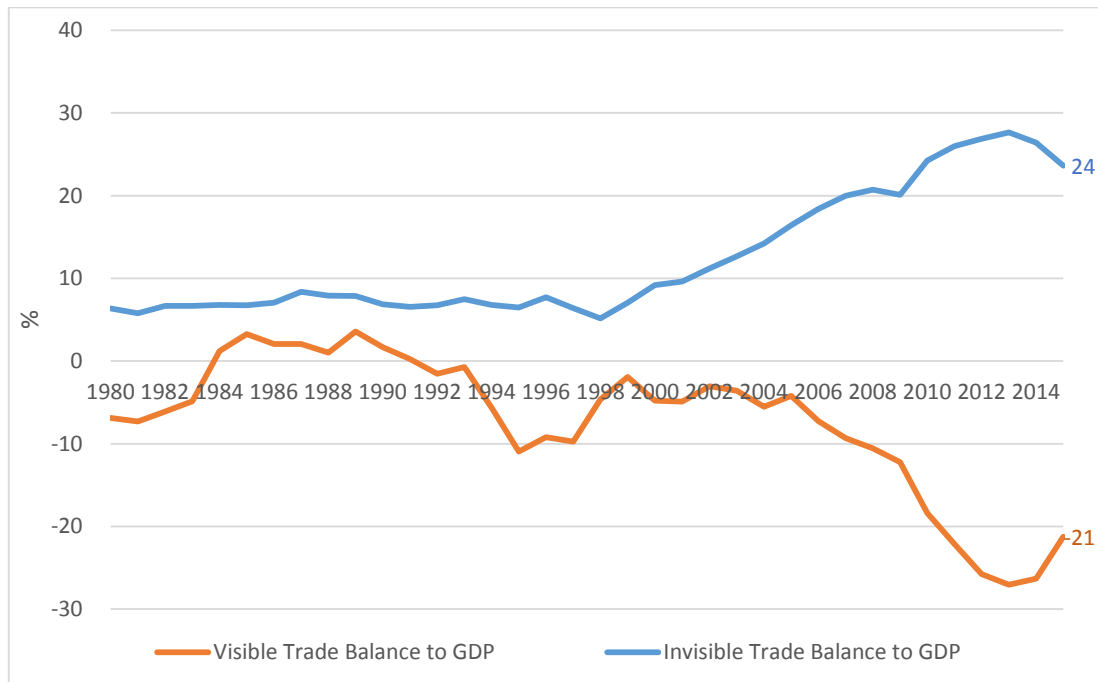
4.3 Importance of Balance to Trade to Hong Kong

As Hong Kong is a small economy lacking natural resources, most of the locally consumed goods, including food and clothing, are imported from other regions. Domestic exports have been in decline following the contraction of the manufacturing industry in Hong Kong. Despite the rise in re-exports over time, Hong Kong is not able to offset the value of its increasing merchandise imports by the value of its merchandise exports. As a result, Hong Kong has been continuously running a visible trade deficit²³ since 1992 (see **Figure 36**). Fortunately, Hong Kong has a surplus in invisible trade balance²⁴ since 1961. The visible trade deficit reached -21% of nominal GDP in 2015, and the invisible trade surplus which increased over time also reached 24% of nominal GDP in the same year (see **Figure 36**). In other words, the surplus from the trade in services totally offset the deficit of trade in goods, yielding a small balance in Hong Kong's total trade in 2015.

²³ A negative trade balance, i.e. the value of imports larger than the value of exports

²⁴ A positive trade balance, i.e. the value of services exports larger than the value of services imports

Figure 36: Hong Kong's Nominal Visible and Invisible Trade Balance to Total Nominal GDP, 1980 – 2015

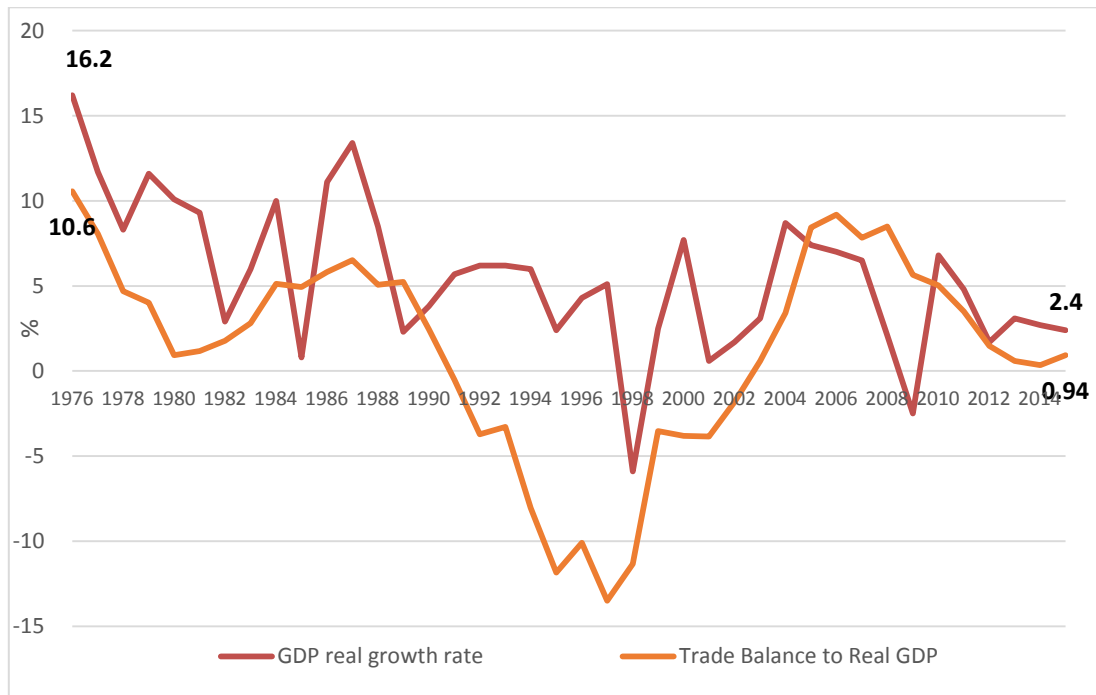


Sources: Census and Statistics Department, Our Hong Kong Foundation

Since Hong Kong is such an externally-oriented economy, total trade deficits over time are always accompanied by economic recessions or slowdowns. For instance, as the total trade deficit ballooned to over 10% of real GDP from 1995 to 1998, Hong Kong's economic growth fell significantly from a high of 4% to 5% to a low of -6% (see **Figure 37**). The correlation coefficient²⁵ from 1976 to 2015 is 0.44, indicating a positive relation between total trade balance and real GDP growth rate. It is important for Hong Kong to maintain a favourable or positive balance in total trade.

²⁵ Correlation coefficient is between -1 and 1, -1 means two variables are perfect decreasing (inverse) linear relation, 1 means they are perfect increasing (direct) linear relation, while 0 means they are independent.

Figure 37: Hong Kong's Balance in Total Trade (in real terms) and Real GDP Growth Rate, 1976-2015



Note: The percentages of total trade balance to GDP over time are different from the percentages shown in Figure 37, because Figure 37 uses the nominal value while Figure 38 uses the real value, of which price effects (including effect of change in exchange rate and change in product price) have been removed.

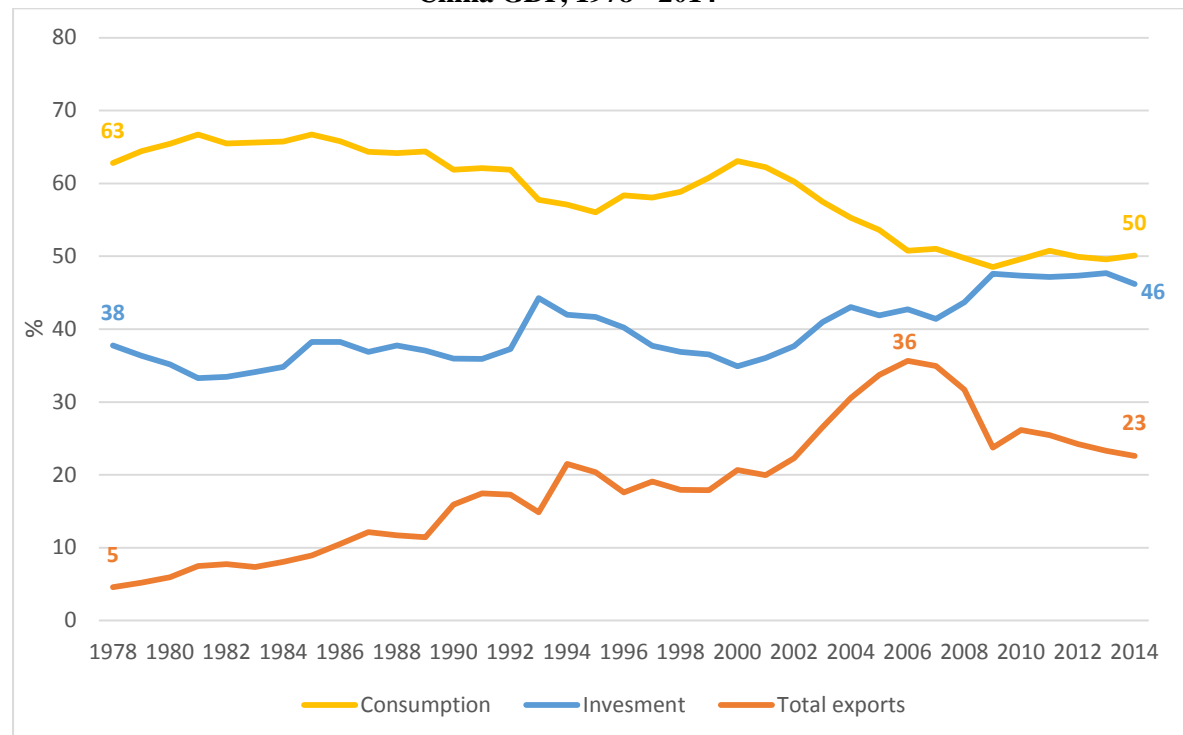
Sources: Census and Statistics Department, Our Hong Kong Foundation

4.4 Changing Macroeconomic Environment in Mainland China

Over the past decades and especially after its accession to WTO in 2001, Mainland China took advantage of the free trade environment and its low manufacturing costs and became the “World’s Factory”. The rapid growth of external trade catalysed its economic development. However, as the manufacturing costs rose and RMB appreciated in the past decade, Mainland China’s manufacturing is gradually losing its competitive advantage. Many production lines moved away from Mainland China and relocated to lower-cost Southeast Asia countries. China can no longer rely on manufacturing exports to drive its economic growth. Starting from The Eleventh Five-Year Plan (2006-2011), Mainland China introduced economic reform to restructure from an export-oriented economy to a domestic consumption-driven economy. The GDP percentage share of total exports declined from the highest point of 36% in 2006, to 23% in 2014 (see **Figure 38**). According to the preliminary estimation of National Bureau of Statistics of China (2016), the final consumption expenditure, consisting of both household and government consumption expenditure,

contributed to 66% of the GDP growth in 2015, 15.4 percentage points higher than the previous year. At the same time, the tertiary sector²⁶ (also known as the services sector) becomes more and more prominent in Mainland China. Although the contribution of the secondary sector to GDP remains at over 40%, the percentage contribution of the tertiary sector has grown from a quarter in 1978 to over a half in 2015 (see **Figure 39**). The services sector is becoming the pillar sector that supports the economic growth of Mainland China.

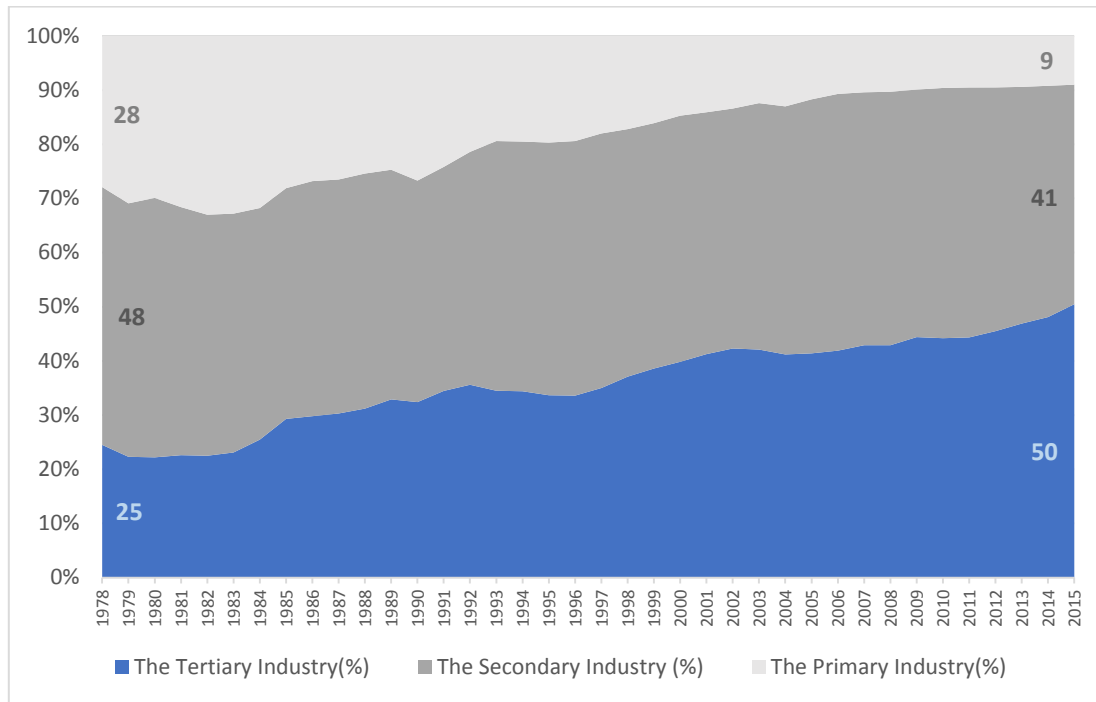
Figure 38: Percentage Share of the Selected Expenditure Components of Mainland China GDP, 1978 - 2014



Source: *The World Bank*

²⁶ Primary sector includes the extraction of raw materials. Secondary sector includes the manufacturing of goods from raw or intermediate materials. Tertiary sector includes the services provided for consumers and businesses.

Figure 39: Composition of GDP (%) by the Three Industry Tiers, 1978 – 2015



Note: Preliminary figures in 2015.

Source: National Bureau of Statistics of China

As shown in **Figure 12** in section 2.1.1 the growth of Mainland China’s merchandise exports slowed down continuously from 2010 and had four consecutive years of only single digit or negative growth from 2012 to 2015. For only the second time since the economic reform in 1978 (the first time was due to the Global Financial Crisis 2007-08), Mainland China’s merchandise exports experienced negative growth of -2.9% in 2015. Mainland China’s external trade has not yet recovered from its doldrums in 2016. Negative year-on-year growth continued in both merchandise imports and exports in the first two quarters of 2016.²⁷

4.5 Export of Services to Mainland as the Driver for Economic Growth

As the merchandise re-exports from China have been a dominant part of Hong Kong’s merchandise exports, Hong Kong’s merchandise exports also contracted and suffered a negative growth of -1.9% in 2015 (see **Figure 12**)²⁸. With the restructuring of Mainland China’s economy and the continual shift to rely more on internal demand,

²⁷ National Bureau of Statistics of China

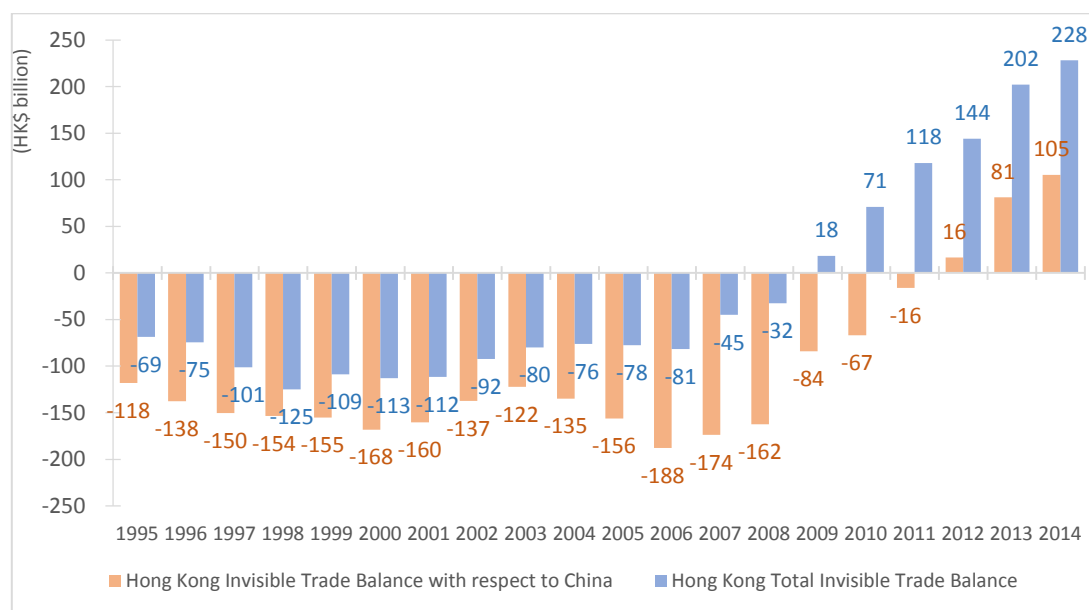
²⁸ The correlation coefficient of Hong Kong and Mainland China merchandise export from 1979 to 2015 was 0.63.

the period of high double-digit growth in Hong Kong's merchandise trade is probably over. Hong Kong's economy must re-orient to this "New Normal" and rely less on merchandise trade and find new opportunities in services trade as the main driver for economic growth.

There has been a rising trend in Hong Kong's trade in services; the percentage share of services exports in Hong Kong's GDP more than doubled from 20% in 1998 to 48% in 2014. Excluding the amount of trade in financial intermediation services indirectly measured (FISIM)²⁹, Mainland China is the largest trading partner of Hong Kong in services trade. After the Financial Crisis of 2007-08, factories in Mainland China faced a continuing shakeout. Hong Kong's manufacturing services imported from Mainland China decreased from the peak in 2006. With the continuing increase in services exports to Mainland China, especially tourism services, and the decrease in manufacturing services imported from Mainland China, Hong Kong's services trade balance with respect to Mainland China turned from a deficit into a surplus in 2012 (see **Figure 40**).

²⁹ The geographical breakdown of FISIM is not available.

Figure 40: Services Trade Balance of Hong Kong with Respect to Mainland China, 1995 – 2014



Note: (1) Since the data on geographical breakdowns of financial intermediation services indirectly measured (FISIM) is not available, figures in respect of FISIM are not included.

(2) Figures presented in **Figure 40** are based on the Sixth Edition of Balance of Payments and International Investment Position Manual (BPM6) while that in **Figure 36** are based on the Fifth Edition (BPM5). Hence, these figures should not be directly compared to each other.

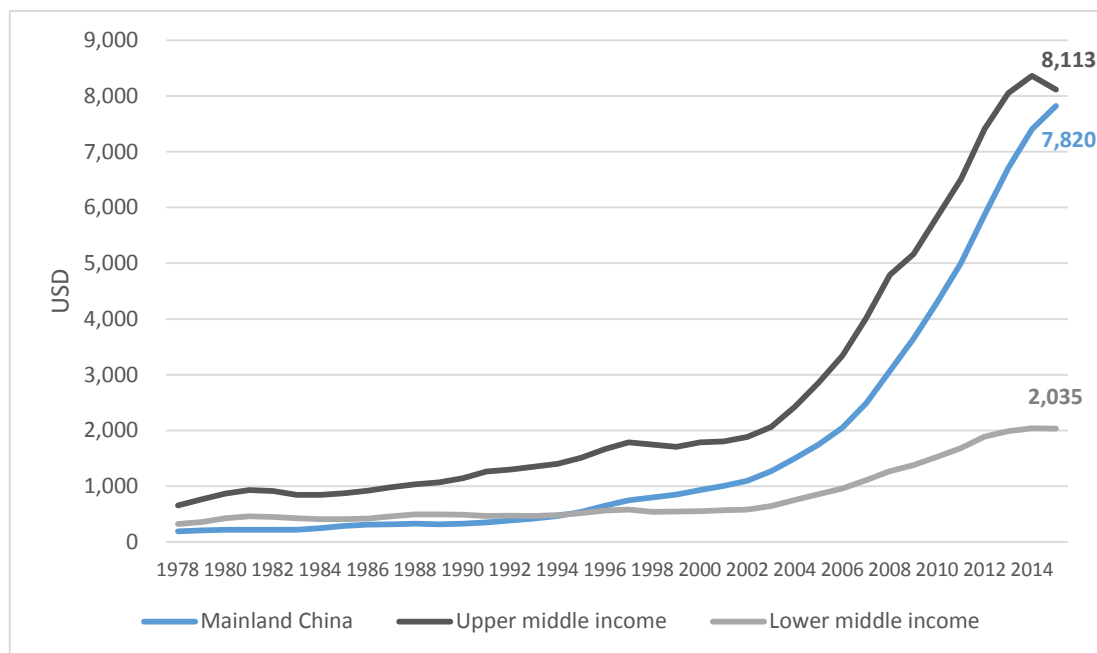
Source: Census and Statistics Department

4.6 Growing Spending Power in Mainland China

Looking ahead, Mainland China's consumption of services provided by Hong Kong will increase because of the growing spending power of its population. According to The World Bank, Mainland China is classified as an upper-middle-income country with a Gross National Income (GNI) per capita of US\$7,820 in 2015 (see **Figure 41**). The proportion of urban population in Mainland China grew from 18% in 1978 to 56% in 2015, bringing the urban population to 771 million (see **Figure 42**), whereas the target urbanisation rate is 60% by 2020 according to the "National New-Type Urbanisation Plan (2014-2020)". The per capita annual disposable income of the urban household reached RMB\$29,000 in 2014, more than threefold from 2002 whilst the per capita annual disposable income of the top 20% income group even reached RMB\$62,000 (see **Figure 43**). The aggregate spending power of the urban population will be enormous.

Consumption studies of all countries show that the higher the income of a consumer, the larger will be the proportion of his expenditure on high-value goods rather than necessary goods. Mainland China will not be an exception. As the spending power in the Mainland grows, the composition of the consumption expenditure will shift towards high-value services. **Figure 44** shows that the proportion of consumer expenditure on necessities like food and clothing declined from 50% and 14% respectively in 1993 to 35% and 11% in 2013, whereas the proportion of expenditure on high-value services such as health care & medical services, transport & communications, and education, culture & recreation increased from 2.7%, 3.8% and 9.2% respectively in 1993 to 6.2%, 15.2% and 12.7% in 2013. People purchase more for health care & medical services because of an increase in health awareness that comes with greater affluence and ageing. The increase in spending on transport and communications can be explained by the increase in penetration of internet and mobile communication. As consumers are more well off, they are more willing to spend on tourism, travelling, education, culture and recreation activities.

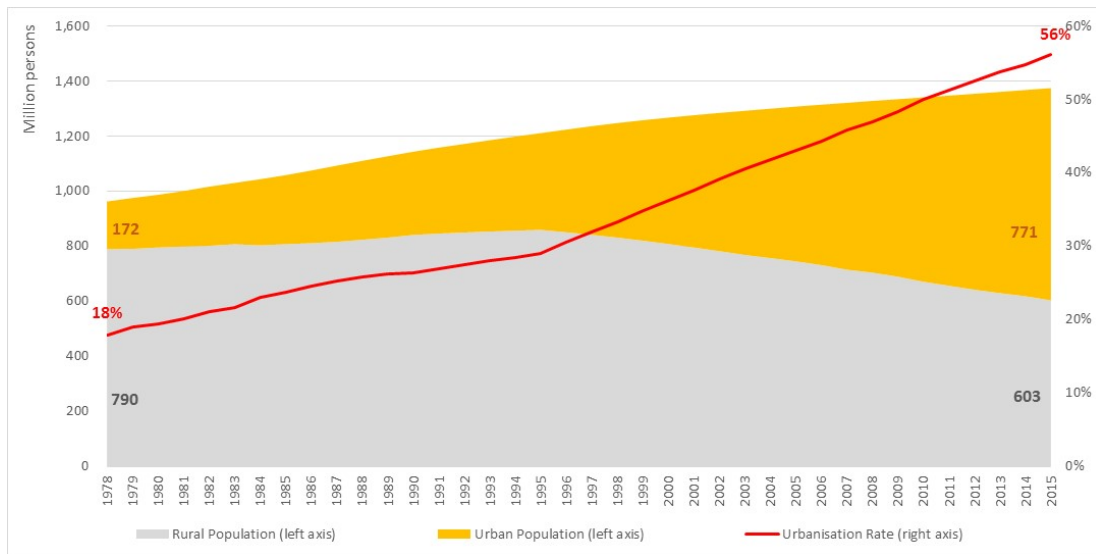
Figure 41: Nominal Gross National Income Per Capita of Mainland China, Upper-Middle-Income Countries and Lower-Middle-Income Countries, 1978 - 2015



Note: Upper middle income economies are those in which 2015 GNI per capita was between US\$4,036 and US\$12,475. Lower middle income economies are those in which 2015 GNI per capita was between US\$1,026 and US\$4,035.

Source: The World Bank

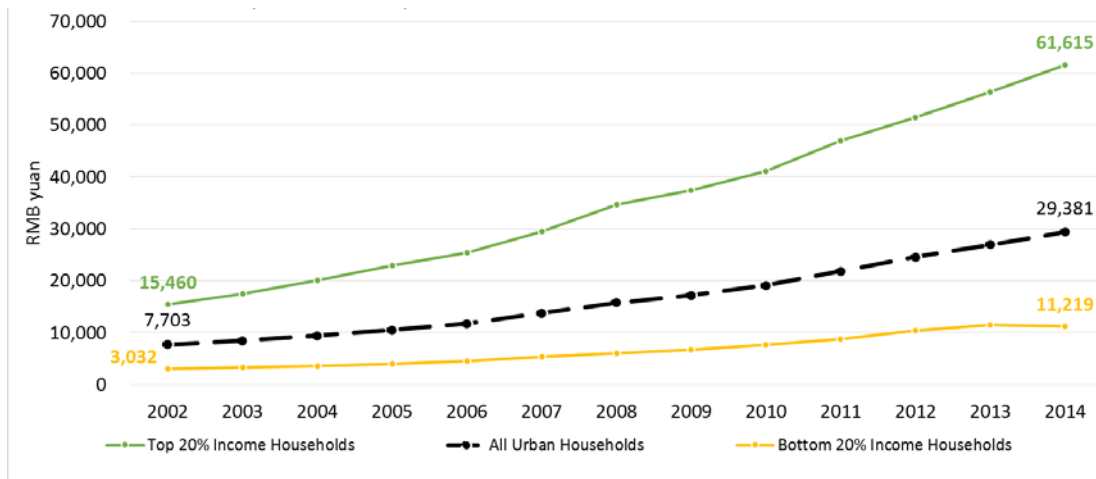
Figure 42: Urbanisation Rate, Urban Population and Rural Population of Mainland China, 1978 - 2015



Note: Military personnel of Chinese People's Liberation Army are included and classified as urban population in the item of population by residence.

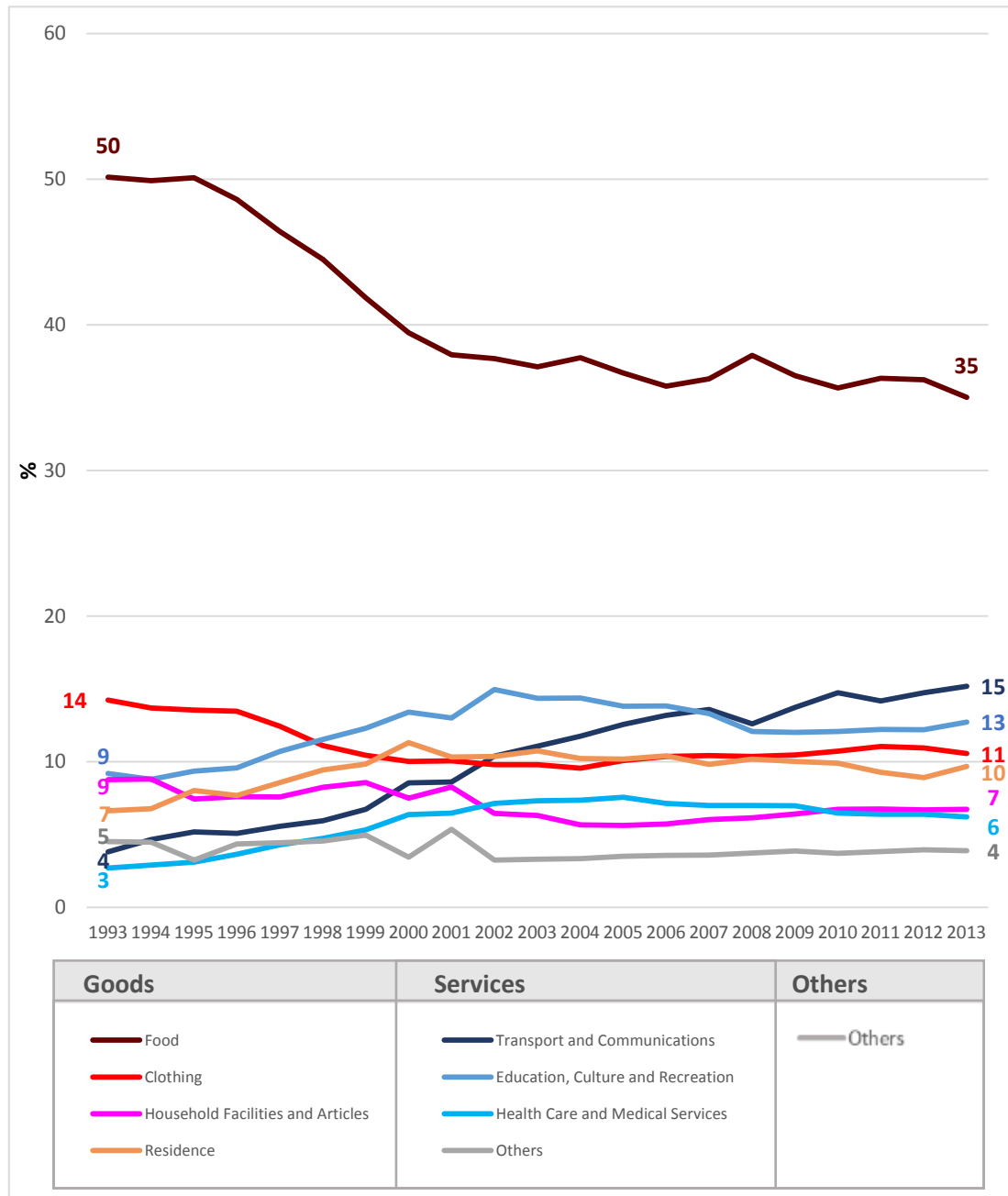
Source: National Bureau of Statistics of China

Figure 43: Average Per Capita Annual Disposable Income of Urban Households, 2002 – 2014



Source: National Bureau of Statistics of China

Figure 44: Composition of Per Capita Annual Cash Consumption Expenditure of Urban Households, 1993 – 2013



Source: National Bureau of Statistics of China

The change in spending habit indicates that people in Mainland China become more and more willing to make discretionary purchases and pursue higher quality of living. The rising urban population and household income will continue to contribute to the rapid growth in the demand for high-value products and services in Mainland

China. Hong Kong is a service-oriented economy with the services sector contributing to 92.7% of GDP.³⁰ With the long-standing trading partnership with Mainland China, Hong Kong can seize the opportunity to provide high-value services for Mainland China.

4.7 High-Value Services Opportunities

Well-developed infrastructure, good reputation, professionalism and safety are Hong Kong's strengths as a provider of high-value services. Thanks to its geographical location, Hong Kong is in a unique position to meet Mainland China's burgeoning demand for high-value services. Moreover, Hong Kong people are familiar with Putonghua and the community's culture is a fusion of the East and the West. Business travellers and tourists from Mainland China would find the language and the culture less of a barrier. The high-value services offered by Hong Kong can be developed in 4 directions: high-end tourism, professional services, audiovisual services and financial services.

4.7.1 High-End Tourism

Tourism is a long-established industry and one of the four pillar industries of Hong Kong. In 2014, Hong Kong attracted 28 million overnight visitors and was ranked 1st in the Top City Destinations Ranking³¹ by Euromonitor International for the sixth consecutive year. Including the same-day in-town visitor arrivals, total visitor arrivals in Hong Kong in 2014 reached 61 million.³² Same-day in-town visitors accounted for 54% of total visitor arrivals in 2014, but their per-capita spending was less than one-third of that of overnight visitors. In 2014, 52% of all tourists visited Hong Kong through the Individual Visit Scheme (IVS). Their spending, especially the M-permits visitors, was heavily on retail, but shopping generated limited value-added for Hong Kong as most of the consumer goods are imported.³³

³⁰2014 figure provided by Census and Statistics Department, 2016.

³¹Top City Destinations Ranking is released by Euromonitor International annually. The ranking covers 100 world's leading cities in terms of international tourist arrivals, excluding day trippers and domestic visitors.

³² According to the Hong Kong Tourism Board.

³³ Sung et al. (2015)

In order to bring more economic benefits and impose less stress on the infrastructure, Hong Kong's tourism industry should move up the high-value added ladder. Apart from recreational travel, Hong Kong is well-equipped to develop high-end tourism, such as medical and beauty care tourism, cruise travel, meetings, incentives and conferencing and exhibitions tourism (MICE).

(a) *Medical Tourism*

Medical services³⁴ was first identified as one of the Six Industries³⁵ in the 2009-2010 Policy Address. However, the development of medical services as a key industry has been slow: its contribution to GDP stagnated at 1.4% to 1.6% from 2008 to 2014 (see **Figure 45**). In view of the increasing spending power in Mainland China on the one hand, and population ageing and the one-child policy on the other, there will be a rising demand of the Mainland urban population for quality medical care and services. Medical tourism is the process of traveling outside the country of residence for the purpose of receiving medical care, and the word "tourism" refers to the fact that people often stay in the foreign country for a while after the medical procedure (Meštrović 2014). Having the world class medical facilities and healthcare personnel, Hong Kong has the potential to develop medical tourism. The medical schools of University of Hong Kong and The Chinese University of Hong Kong offer first-rate professional training to healthcare personnel in Hong Kong. The two universities are ranked within the top ten Asian universities for medicine³⁶ in QS World University Rankings 2016. In the area of surgical technology, Hong Kong has a leading role as well. For instance, the CUHK Jockey Club Minimally Invasive Surgical Skills Centre, which was established in 2005, was the first accredited robotic surgery training centre in Asia.

Nevertheless, the tension in the supply of medical professionals in the public hospitals is an issue that needs to be addressed. The capacity of the medical sector,

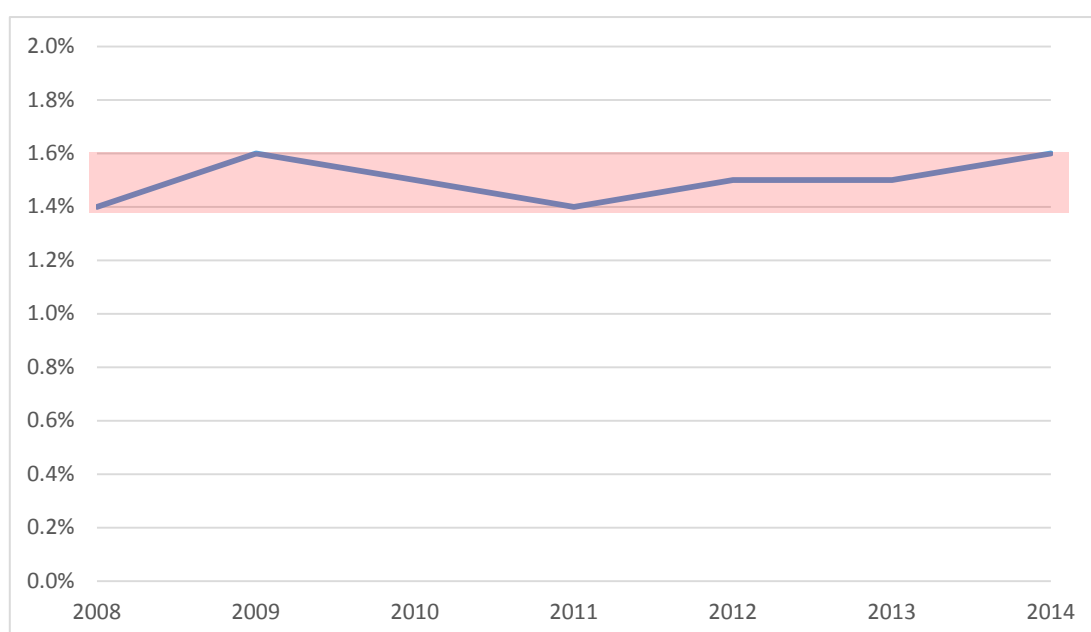
³⁴ Medical services cover services provided by private hospitals, clinics, medical and dental practitioners; nursing and residential care for the elderly and persons with substance abuse and disabilities; and medical-related activities including retail sales of medical products and medical insurance.

³⁵ The Six Industries are cultural and creative industries, education services, medical services, environmental industries, innovation and technology, and testing and certification services.

³⁶ The top 2 Asian medical schools in 2016 QS World University Rankings for Medicine are National University of Singapore and the University of Tokyo.

both in terms of facilities and personnel, must be thoroughly assessed. In developing medical tourism, the adverse impact on the medical services for local residents should be minimised and a balance must be struck between providing medical services for local people and catering for medical tourists. Therefore, medical services provided for foreign patients are recommended initially to be in areas where there is surplus capacity, for example, physical check-up services and follow-ups offered by private clinics and hospitals.

Figure 45: Value Added of Medical Services as Percentage of GDP in Hong Kong, 2008 to 2014



Source: Census and Statistics Department

(b) Beauty Care Tourism

The demand for beauty care services in Mainland China is rising. According to the Hong Kong Economic & Trade Association (2013) the average annual growth rate of Mainland China's beauty care services was 20% in the past five years by 2013. In December 2015, eight beauty industry associations jointly launched the "Beauty Industry Professional Development Charter", with the aim of enhancing the professionalism in the industry. Moreover, Hong Kong Government implemented a qualifications framework for the beauty and hairdressing industry. The quality assurance framework of Hong Kong's beauty care services should give confidence to the beauty services consumers from Mainland China. Besides traditional facial or

body treatments by hand, technologies-assisted beauty care will probably be the future trend in Hong Kong. According to the Trade Development Council (2013), consumers tend to associate hi-tech beauty instruments, such as ultrasound and nano ion, with high quality and good results, and they are willing to pay a higher price for better performance.

(c) Cruise Tourism

Cruise Lines International Association (2015) reported that Mainland China's annual passenger growth rate from 2012 to 2014 was 79%, the highest among Asian markets. In 2014, the Mainland China market accounted for as much as half of the passenger volume for Asia with 679,000 passengers. Mainland China tourists' rising interest in cruise vacation provides an opportunity for Hong Kong's cruise tourism. Hong Kong is well-equipped to be a hub of cruise tourism. The related facilities in Hong Kong have improved in recent years. The Kai Tak Cruise Terminal, commissioned in 2013, is able to accommodate mega cruise ships with a maximum tonnage of 110 thousand, whereas the Ocean Terminal can only accommodate cruise ships of less than 50 thousand tons. The facilities in the Kai Tak Cruise Terminal greatly increase Hong Kong's capacity to receive cruise passengers. As the transportation hub of Asia and Asia's top travel destination, Hong Kong can serve as a home port or port of call in cruise tours. Besides short cruises, following the Belt and Road strategy, cruise tourism can also be encouraged by extending cruise journeys to countries along the Maritime Silk Road.

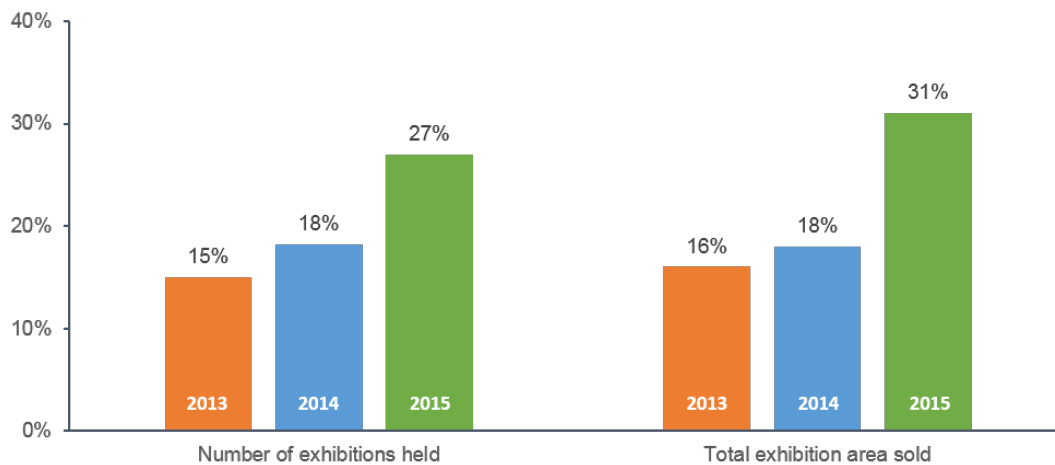
(d) Meetings, Incentives, Conferencing and Exhibitions Tourism (MICE)

According to the Annual Report on China's Exhibition Industry (2015) released by China Council for the Promotion of International Trade, the number of exhibitions held in Mainland China has been increasing gradually from 2012. Compared with 2012, there has been a 27% increase in number of exhibitions held and a 31% increase in total exhibition area sold in 2015 (see **Figure 46**). Besides the demand for domestic exhibition facilities, Mainland China's exhibitors are holding overseas exhibitions as well in order to globalise their enterprises and business. Although affected by the global economic situation, the number of overseas exhibitions held by Mainland China's organisers stayed at above 1,300 each year in 2010-2015 while the size of the overseas exhibitions in terms of the number of participating exhibitors grew gradually

(see **Figure 47**).

With the growing demand for exhibitions in Mainland China, Hong Kong should attract Mainland China's exhibitors and organisers to come and participate in international exhibitions in Hong Kong. According to Hong Kong Trade Development Council (2016), in terms of the hardware, Hong Kong has over 50 exhibition and convention venues of various sizes with more than 150,000-square-meter of exhibition space. As for software, Hong Kong's free port policy is welcoming to participants worldwide and convenient to exhibitors. Taking advantage of its close geographical location, and the bi-literate and tri-lingual environment, Hong Kong can act as a window for Mainland China's enterprises to go global and meet worldwide potential customers. However, in developing as a city for MICE, Hong Kong will be facing competitions from other Asian countries, such as Singapore and South Korea. Therefore, a long-term development plan for MICE should be set up by the Government, for example, to further enhance the business facilities around exhibition venues, especially the Asia World-Expo (AWE).

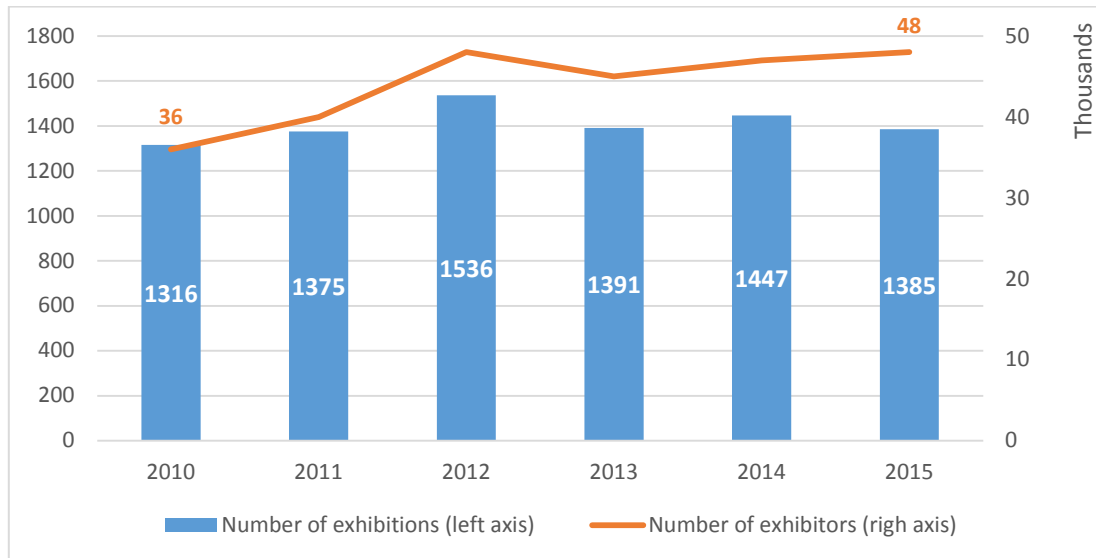
Figure 46: Cumulative Growth of Number of Exhibitions Held in Mainland China and Total Exhibition Area Sold, 2013-2015



Note: Figures cover exhibitions and fairs on trade, personnel recruitment and commodity sales held in major exhibition cities, and other genres exhibitions held in specialized exhibition venues.

Source: China Council for the Promotion of International Trade

Figure 47: Mainland China's Overseas Exhibitions, 2010 – 2015



Source: China Council for the Promotion of International Trade

4.7.2 Professional Services

As mentioned in 4.1, as Mainland China's tertiary industry continues to grow in line with national policy, the service sector is becoming a pillar sector. The market for professional services and business opportunities in Mainland China will further expand. Besides offering direct professional services for Mainland clients, Hong Kong can assume the role of middleman in bridging Mainland China producers and consumers to the rest of the world, for example, through providing consulting, market research, talents hunting and legal support services.

Following the Belt and Road strategy, economic cooperation and interaction between Mainland China and the countries along the Belt and the Road will become more frequent. Hong Kong's world-class professional services and international network can offer support for the parties involved, in areas such as arbitration, accounting, financing and insurance services.

Hong Kong can also offer professional training for Mainland professionals as well as enterprises in the form of corporate training. Nowadays, the quality expectation of Mainland China's customers is rising and a further growth in Mainland's service sector must be supported by high quality standard. International standard widely adopted by Hong Kong's professional service providers can give confidence to the clients. Training and certificate programmes offered in Hong Kong

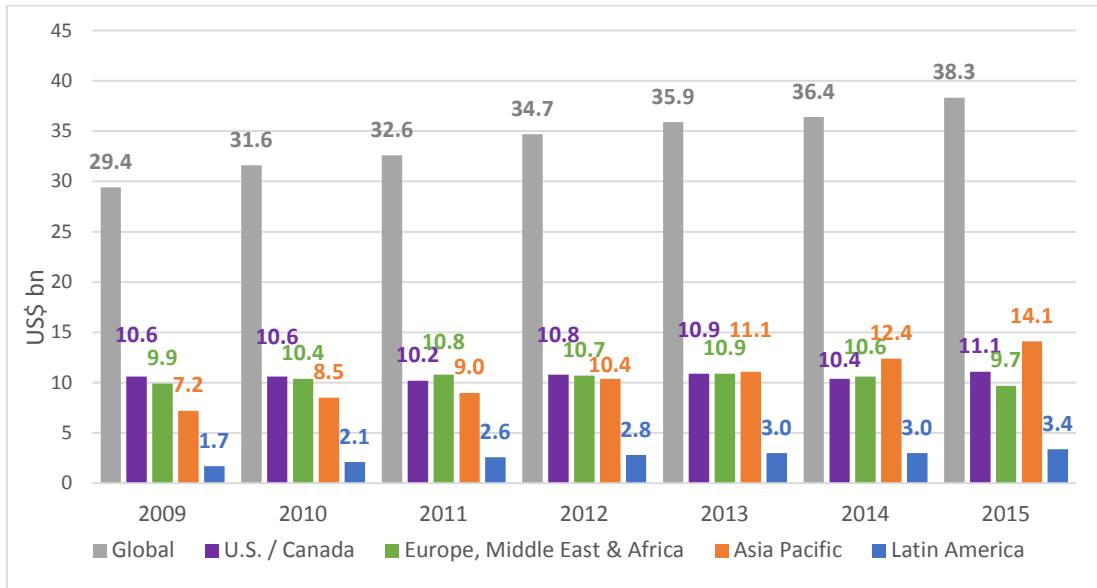
can help Mainland China's enterprises improve their service quality and provide a recognised accreditation for their professional services. As an international city which welcomes talents around the world, Hong Kong can offer a platform which attracts expertise from Mainland China and the rest of the world to assemble. Training programmes, professional forums and talents exchange activities can be conducted through this platform. This can enhance knowledge sharing and bridge the gap between Mainland China's professional practice and international standards.

CEPA facilitates Hong Kong service providers to set up businesses in Mainland China through various preferential treatments for market entry, including allowing wholly-owned operations, relaxing restrictions on equity shareholding, reducing registered capital requirements, relaxing restrictions on geographical location and business scope. CEPA gives great opportunity for Hong Kong service providers to extend their business to Mainland China. Hong Kong can be the support centre for those professional services that are being provided in Mainland China through CEPA arrangements. Hong Kong Government should encourage Hong Kong service providers to relocate or outsource part of their business in Mainland China to Hong Kong. Being the back-end support centre, employment opportunities can be generated in Hong Kong so that the economic benefits brought by CEPA can be further extended to a wider range of beneficiaries in Hong Kong.

4.7.3 Film and Audiovisual Services

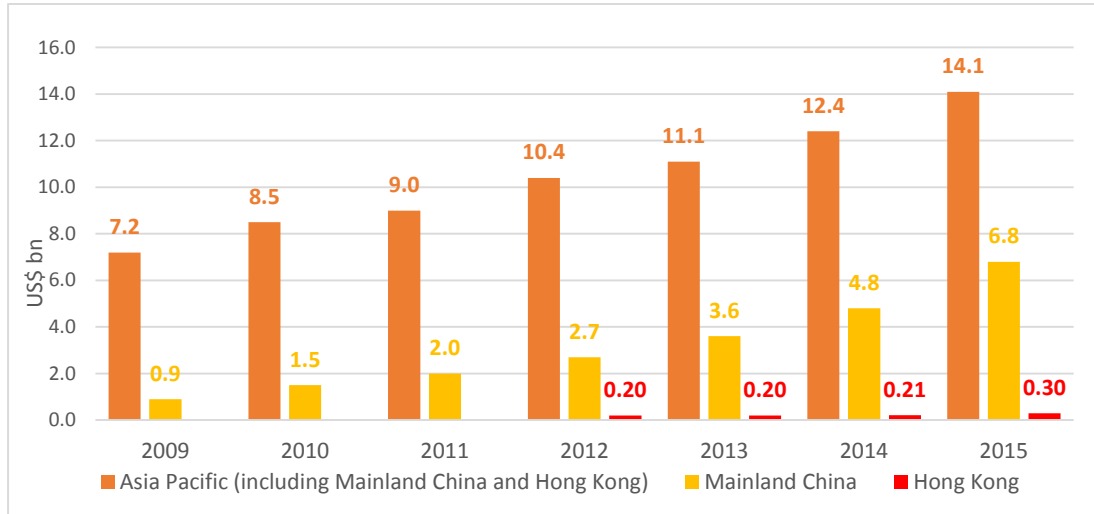
Since 2010 the box office revenue has been increasing rapidly in the Asia Pacific film market while the rest of the world has stagnated. The Asia Pacific region supplanted U.S./Canada as the largest film market in 2013 (see **Figure 48**). Within the region, Mainland China contributed to 48% of total box office in 2015. Its annual box office revenue grew rapidly, increasing by 6.5 times from 2009 to 2015 (see **Figure 49**).

Figure 48: Annual Box Office of Global, U.S./Canada, Europe, Middle East & Africa, Asia Pacific and Latin America, 2009 – 2015



Source: Motion Picture Association of America

Figure 49: Annual Box Office of Asia Pacific, Mainland China and Hong Kong, 2009 – 2015



Notes: (1) Mainland China box office excludes Hong Kong, Macau and Taiwan.

(2) Hong Kong figures are only available from 2012.

Source: Motion Picture Association of America

The film market in Mainland China is huge and expanding. Hitherto it has been dominated by imported foreign films and co-production films³⁷, more specifically, films co-produced by Mainland China and Hong Kong. Imported foreign films,³⁸ which are limited by a quota of around 60 films³⁹ per year, grossed 45% of the box office revenue in 2014. Hong Kong films and co-productions with the Mainland, less than 30 in number⁴⁰, took 14% of the box office while over 200 films solely produced by Mainland China (according to Entgroup (2016)) had only 41% of the market share. Until recently more than half of the top ten box office films are either foreign imports or co-productions with Hong Kong. It has not been easy for locally produced films to be placed within the top ten box office in the Mainland (see **Table 6**).

Hong Kong has rich experience and expertise in Chinese language film production in both Putonghua and Cantonese. Both Hong Kong films and co-productions with the China always do well at China's box office, accounting for 14% to 22% of Mainland China's total box office in 2012 to 2014 (see **Figure 50**). Specifically in 2016, the box office revenue of "The Mermaid" (美人魚) directed by Stephen Chow hit over 3.39 billion yuan, the highest box office ever in China. Co-production films, "The Monkey King" (西遊記之大鬧天宮), "From Vegas to Macau II" (賭城風雲 II) and "Monster Hunt" (捉妖記) ranked in the top ten box office revenues in Mainland China in recent years. Hong Kong filmmakers should cooperate with Mainland China's counterparts to produce more high quality Chinese language films. Talent and knowledge can be exchanged between two regions' film entertainment industry. With the close affinity of language and culture between Hong Kong and China, Hong Kong is familiar with the taste and interest of the Chinese audiences. Through co-production films, Hong Kong filmmakers have contributed a lot to the flourishing of Mainland China's film market. To capture the opportunities

³⁷ Co-production film refers to the film that involves two or more production companies.

³⁸ Foreign films can enter Chinese film market through revenue-sharing films (分賬片), flat-fee films (批片) and co-production films (合拍片). Revenue-sharing film refers to a film of which the foreign filmmaker receives a percentage of the theatrical box office revenue; flat-fee film refers to a film for which the local movie company pays an up-front lump sum amount of money, without remitting box office receipts, to the foreign filmmaker for the right to distribute the film.

³⁹ From 2012, the annual quota of foreign revenue-sharing films is 34, and that of flat-fee films is around 30.

⁴⁰ Figure is extracted from "A Collection of Information about Hong Kong Film Industry" published by Hong Kong Film Development Council.

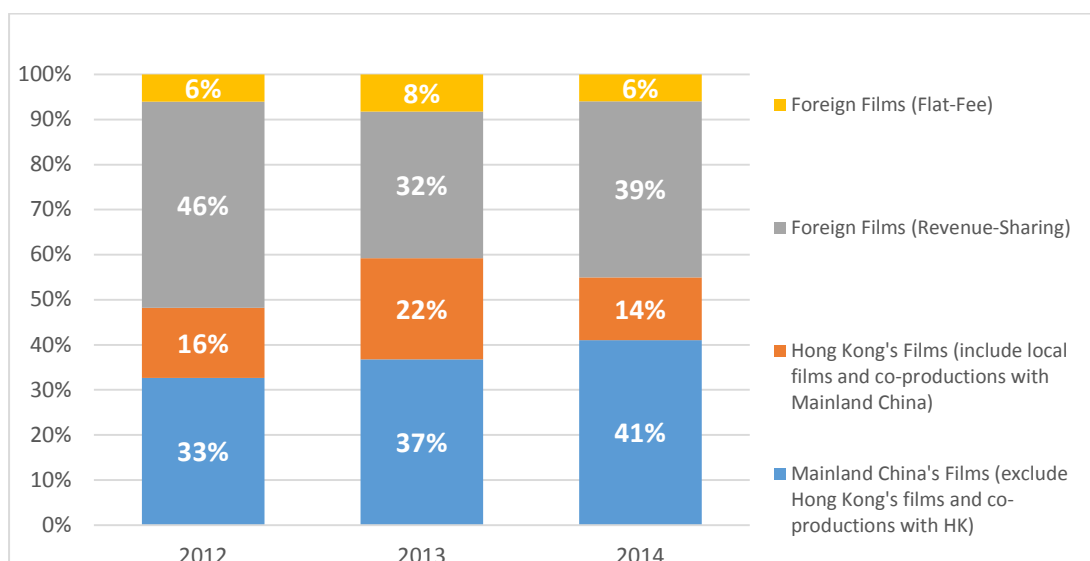
emanating from the rapid expansion of this market and share the fruits, we should further strengthen the policy for nurturing Hong Kong filmmakers and other relevant professionals, to enable them to continue to actively take part in the Mainland China's market.

Table 6: Top Ten Films in Box Office Revenue in Mainland China, 2012 – 2015

		Mainland China's Film	Co-production with Hong Kong	Imported Foreign Film
2012	Number of films	1	2	7
	Total box office (RMB\$ billion)	1.2	1.6	4.1
	% to total box office of the top ten films	17.9%	22.9%	59.2%
2013	Number of films	5	3	2
	Total box office (RMB\$ billion)	3.0	2.4	1.5
	% to total box office of the top ten films	43.5%	35.0%	21.5%
2014	Number of films	3	2	4
	Total box office (RMB\$ billion)	2.5	1.9	4.9
	% to total box office of the top ten films	27.2%	20.6%	52.2%
2015	Number of films	5	2	3
	Total box office (RMB\$ billion)	6.7	3.4	5.3
	% to total box office of the top ten films	43.7%	21.8%	34.5%

Sources: *Dou ban*

Figure 50: Mainland China's Box Office by Types of Films⁴¹, 2012 – 2014



Sources: *Entgroup, Hong Kong Film Development Council, Our Hong Kong Foundation*

Apart from facilitating the performance of Chinese language films in the Mainland China market, Hong Kong could also take up the role of bringing Chinese language films into the spotlight of the world. Hong Kong film entertainment industry has been gaining international recognition. For example, “The Grandmaster” (一代宗師) won the Best Film Award in the 8th Asian Film Awards, and Wong Kar-wai and Zhang Ziyi were named the Best Director and Best Actress respectively with the film. “Port of Call” (踏血尋梅) won the Bucheon Choice Award at the Bucheon International Fantastic Film Festival, which is Korea’s largest genre film festival. Besides theatrical distribution, Hong Kong films also attract overseas producers to acquire the rights to remake. For example, Hollywood's “The Departed” was a remake of “Infernal Affairs” (無間道風雲).

In 2015, Flagship Entertainment, a joint venture film production company between China Media Capital, Warner Bros. and TVB, was established and headquartered in Hong Kong. The Group is aiming to produce Chinese films for audiences around the world. This shows that international filmmakers cast a vote of

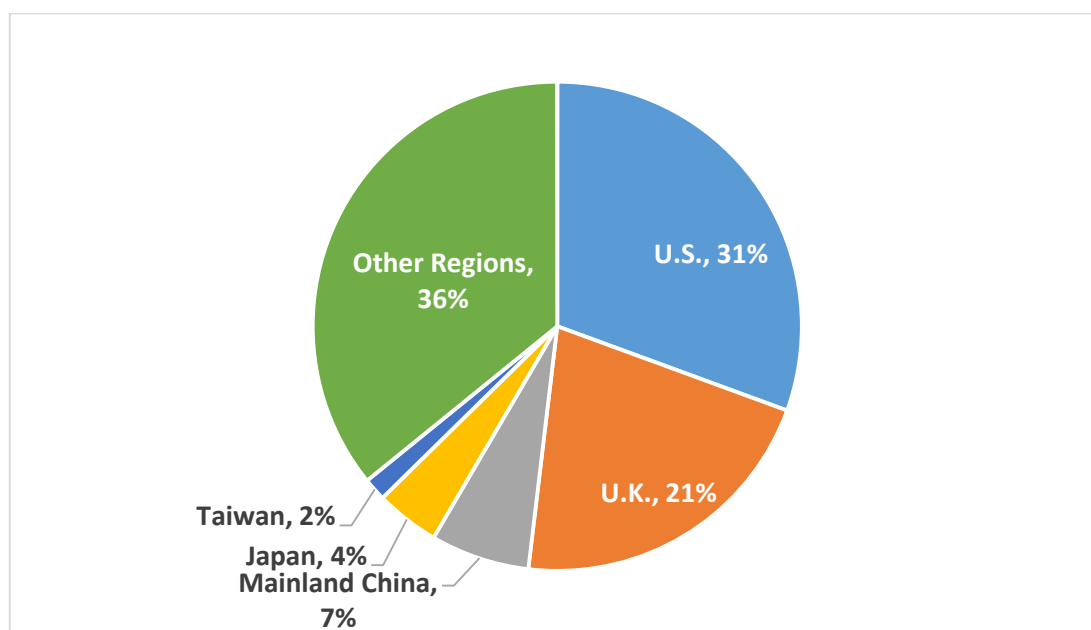
⁴¹ Revenue-sharing film refers to a film of which the foreign filmmakers receives a percentage of the theatrical box office revenue; Flat-fee film refers to the film for which the local movie company pays a specific amount of money, which is not related to the box office performance in the territory, for the rights to distribute the film in the territory;

confidence in Hong Kong's film entertainment industry on bringing Chinese films to the world. At the same time, the preferential access under CEPA allows Hong Kong-produced Chinese language films, after being vetted and approved from Chinese authorities, to enter Mainland China unrestricted by the import quota of foreign films. Whether facilitating the distribution of Chinese language films in Mainland China market or the global market, government support is essential. To support the development of Hong Kong's film industry, Hong Kong government injected HK\$300 million and HK\$200 million in 2007 and 2015 respectively to the Film Development Fund which was set up in 1999. The 2016-17 Budget Speech also announced the injection of an additional HK\$20 million. The sustained injection of fund into the Film Development Fund and the investment in the movie industry must be strengthened to give more support to the industry for the distribution of Hong Kong's films in Mainland China.

4.7.4 Financial Services

According to the trade in services statistics released by Census and Statistics Department in 2014, Mainland China only contributed to 7% of Hong Kong's total exports of financial services (excl. FISIM), while U.S. and U.K. contributed to 31% and 21% respectively (see **Figure 51**). There remains considerable room for Hong Kong to further expand the financial services exports to Mainland China. The details of the policy recommendations regarding financial services will be discussed in Chapter 5 "Hong Kong as a Gateway for Two-Way Capital Flow".

Figure 51: Percentage Share in Hong Kong's Financial Services Exports (excl. FISIM) by Major Trading Partners, 2014



Source: Census and Statistics Department

4.8 Concluding Remarks

As China restructures its economy towards internal demand as the driving force in economic growth and places more emphasis on the development of the tertiary sector, it is expected that the growth rate in China's merchandise exports will slow down. Inevitably Hong Kong's merchandise exports (which depend heavily on re-exports to and from the Mainland) and export-related industries like transport and logistics will also experience slow growth rate in the coming years. The era of double-digit high growth of Hong Kong's re-exports and together with it the logistics industry is probably over. A new era in the demand for high value services in the Mainland has begun. Hong Kong must re-orient to the "New Normal" and focus more on trade in services for economic growth and employment. In 2015 Hong Kong's merchandise trade deficit is just offset by its services trade surplus, giving an overall balance in trade. In the context of balance of trade, services exports to the Mainland assume particular importance, as Mainland is the largest importer of our services. Hong Kong must rely on providing high value services that are not necessarily related to merchandise trade, such as high-end tourism, professional services, audiovisual services and financial services as the driving force for its economic growth.

5. Hong Kong as a Gateway for Two-Way Capital Flow

5.1 Preamble

Hong Kong is an international financial centre, ranked among the top 3-5 in the world by different ranking agencies. A financial centre's role is to intermediate between those who have savings and those who have use of the funds through various financial institutions, and to provide a platform for managing assets and pricing risks. From its humble beginning as a Pearl River Delta port that finances the entrepot trade of South China and intermediates the remittances from overseas Chinese to their relatives in their home villages in China, Hong Kong has grown into a premier international financial centre. It is worth noting that even from the beginning, Hong Kong's financial services have been offered to an international clientele, albeit that it is much smaller in size and geographical coverage than today. The increasing global reach of its financial centre is expected as Hong Kong positions itself as a small open economy. As we have reasoned in Chapter 1, a small open economy survives by and thrives on serving its neighbouring countries and beyond. Over the decades the growth of the Hong Kong financial centre has been underpinned by the development of its hinterland - Mainland China. The Chinese economy is the second largest in the world but its financial services sector is relatively underdeveloped. As it continues to grow at a medium to high speed, there will be plenty of opportunities in financial services for all. Hong Kong must seize the opportunities and flourish by intermediating between Mainland China and the rest of the world.

As an open economy with a British colonial heritage and a contemporary "One Country Two Systems" arrangement with China, Hong Kong has many unique strengths as an international financial centre. Unlike any Mainland Chinese city, its capital market is completely open with unrestricted flow of funds (subject to money laundering and other prudential regulations). The Hong Kong dollar is linked to the U.S. dollar at an exchange rate which has not been changed since it was fixed in 1983, enabling market participants to minimise exchange risk in holding the currency. Its profit tax rate is low and there is no capital gain tax and estate tax, making it an attractive jurisdiction for asset management. Hong Kong is in the same time zone as

Shanghai/Beijing but 7 hours and 12 hours⁴² respectively ahead of London and New York, allowing trading before the London and the New York markets open. It has a bilingual culture with a common law tradition which is the dominant legal framework for international financial markets. Hong Kong is a suitable gateway to Mainland China for the West and to the West for Mainland China in capital flow. What Hong Kong needs to do is to consolidate its position, build on these strengths and look for opportunities emanating from China's economic growth.

We will focus on three unfolding opportunities that will propel Hong Kong's premier international financial centre to new heights. Hong Kong can be (1) an international financial centre for the intermediation of Mainland China's enormous savings and wealth; (2) a premier offshore Renminbi centre as the currency internationalizes; and (3) a financial hub for the "One Belt One Road" (OBOR) countries.

5.2 Gateway for Two-Way Capital Flow to and from Mainland China

A. Two-Way Flow of Direct Investment

Like many developing countries, China was labour-abundant but capital-poor before its opening up and reform in 1979. After the opening up, foreign direct investment (FDI) was welcome in China and as mentioned in Chapter 2, Hong Kong played a major role in bringing foreign investment into the Mainland, initially in manufacturing. In 1987 as many as 69% of China's annual FDI inflows were from Hong Kong. This percentage dropped to 30% in 2005 but increased again to 73% in 2015 (see **Figure 29**). Not all these investment flows are due to local Hong Kong enterprises; many were from foreign countries using Hong Kong as a gateway to China. Historically Hong Kong has been an important source of inward FDI for the Mainland, both as an originating investor as well as a portal for overseas investors, and the Mainland is the major destination of Hong Kong's ODI.

Whilst the trend of FDI into China continues unabated and China becomes the second largest recipient country of FDI, a counterbalancing trend is rapidly emerging

⁴² Refers to summer time. Hong Kong does not use summer time. It would be 8 hours and 13 hours in standard time.

as China's ODI grows. This opens a new opportunity for Hong Kong to serve as the gateway for the outflow of domestic capital from China.

China is a high-saving country. **Figure 52** shows the national saving rate and household saving rate of the Mainland. It has run a persistent balance of trade surplus for decades (see **Figure 53**) and accumulated a huge foreign exchange reserve (see **Figure 54**). Chinese enterprises are starting to look for investment opportunities overseas to deploy their surpluses profitably. They become very visible investors in the international markets, acquiring infrastructure and manufacturing facilities, communication and software companies, energy assets, mines and even football teams and cinema chains. **Figure 55** shows the rising trend of China's annual ODI flows and stock. The annual flow has been growing at an average annual rate of 36% p.a. in the last 13 years. Many people are not aware that the annual flow of China's ODI (US\$145.7 billion) exceeded the annual inflow of FDI (US\$ 135.6 billion) in 2015(**Figure 56**). China has become a net exporter of capital. China's outward direct investment (US\$145.7 billion) in 2015 was 9.9% of the world total flow. China overtook Japan as the second largest exporter of capital in the world, behind the U.S.. Even though the stock of China's ODI of US\$1.1 trillion was only the 8th largest in 2015, we expect that given China's high saving rate and its perennial trade surplus, in no time China will also overtake the other countries ahead of it. ⁴³

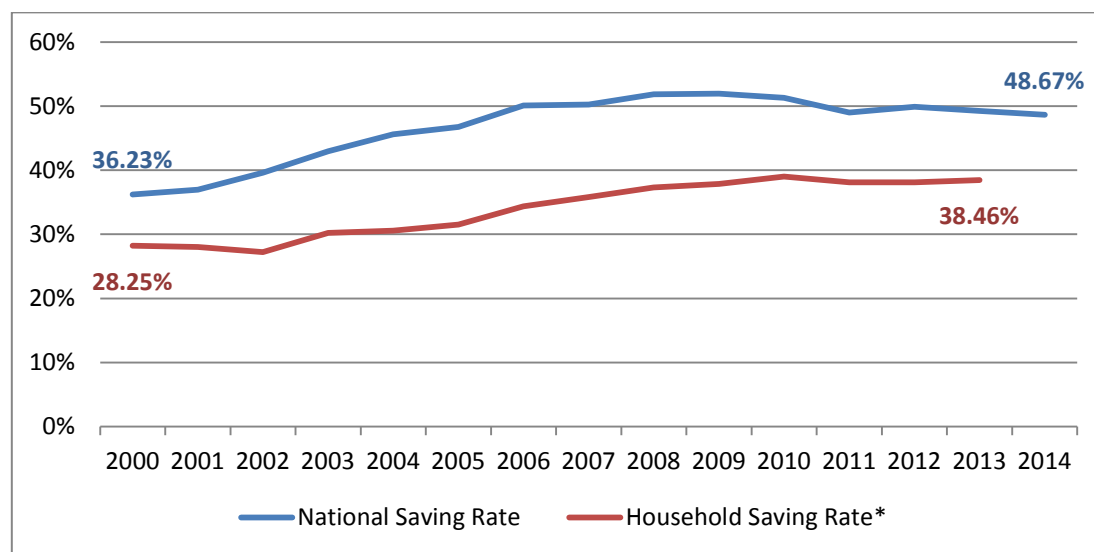
As China's gateway to the world, Hong Kong takes up a lion share of Mainland China's ODI, as much as 58% of both the flow and the stock in 2014 (see **Figure 57**). It is not clear how much of these ODI from the Mainland stay in Hong Kong as the final destination and how much use Hong Kong as a stepping stone for investments overseas. In recent years Mainland enterprises, initially banks and financial institutions, become more visible in Hong Kong in setting up operation in the territory, and making high profile acquisition of businesses and blocks of office building. At any rate, even for the 40% or so China's ODI which go overseas, Hong Kong can play an intermediary role in consulting, connecting with overseas businesses and financing.

⁴³ The State Council Information Office, P.R.C.. (2016, September 22). 商务部、国家统计局、国家外汇管理局联合发布《2015年度中国对外直接投资统计公报》. Retrieved from <http://hzs.mofcom.gov.cn/article/date/201609/20160901399201.shtml>

It has been estimated that about 32% of the mergers and acquisitions of Chinese enterprises overseas are financed offshore. This is an area in which the Hong Kong international financial centre has a lot of strengths in talents, expertise and liquidity.

To summarise, Hong Kong has been a major source of inward FDI for the Mainland as well as a major destination of Mainland's ODI. Mainland's percentage share of the stock of Hong Kong's inward direct investment stays at around 30%, since other countries have also been increasing their investments in Hong Kong, presumably to take advantage of Hong Kong's unique position as a gateway to Mainland China. Historically, FDI into China is the dominant trend but with the rapid growth of the Chinese economy and its savings, ODI of China assumes increasing importance, and therein lies the growing opportunities for Hong Kong.

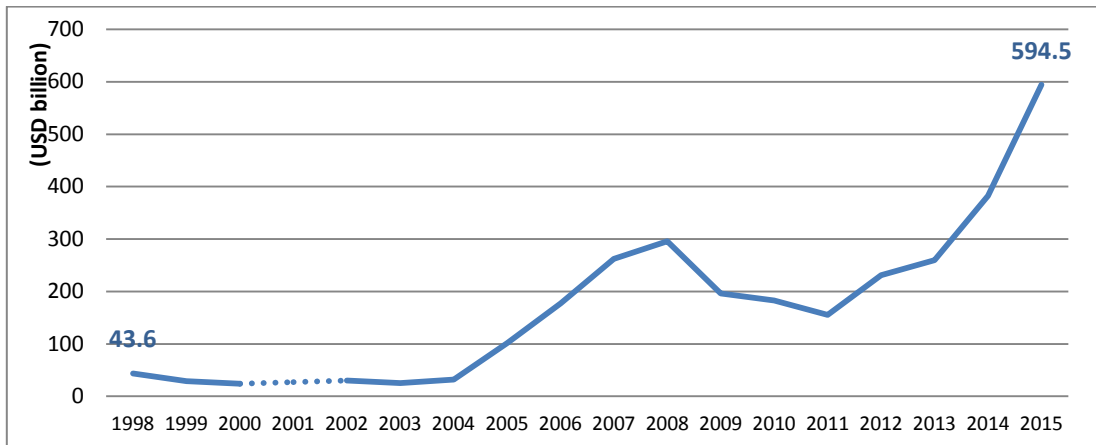
Figure 52: National Saving Rate and Household Saving Rate of China, 2000-2014



Note: The 2014 household saving rate is not available.

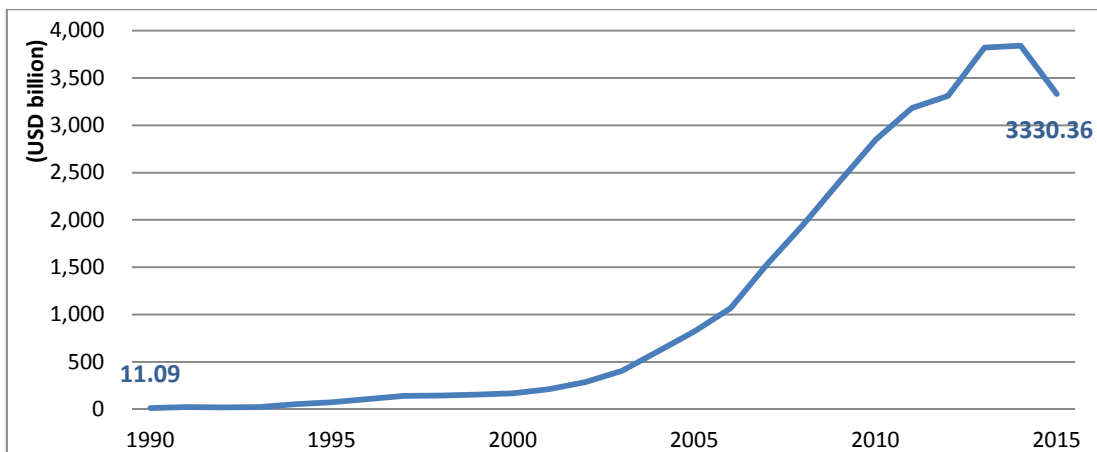
Sources: OECD, World Bank

Figure 53: Trade Surplus of China, 1998-2015



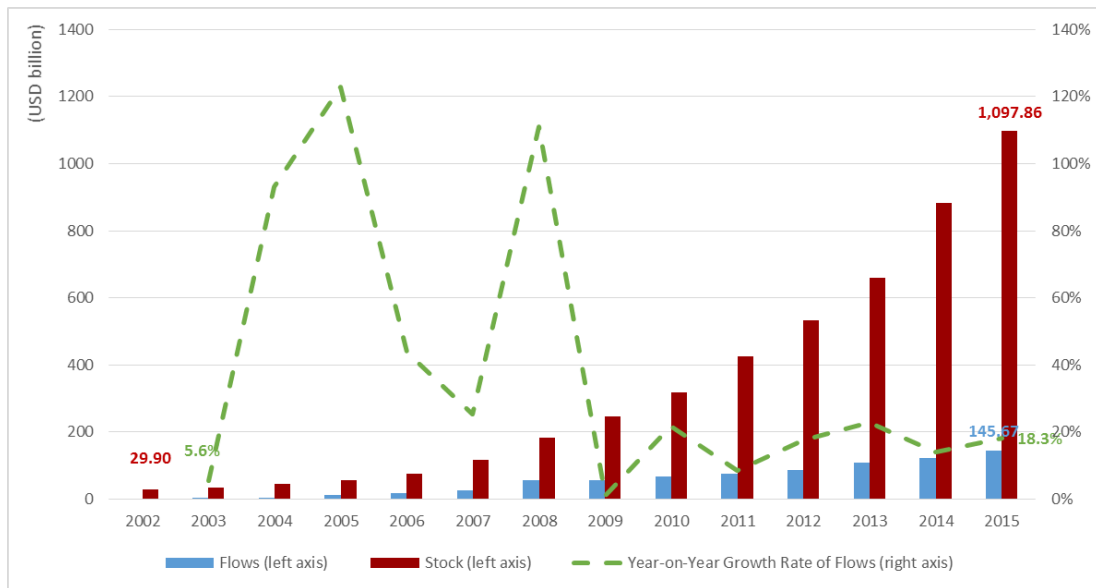
Sources: Ministry of Commerce of the People's Republic of China, National Bureau of Statistics of China

Figure 54: Foreign Exchange Reserve of China, 1990 – 2015



Source: State Administration of Foreign Exchange (China)

Figure 55: China's Annual ODI Flow and Stock since the Establishment of ODI Statistics System, 2002 – 2015

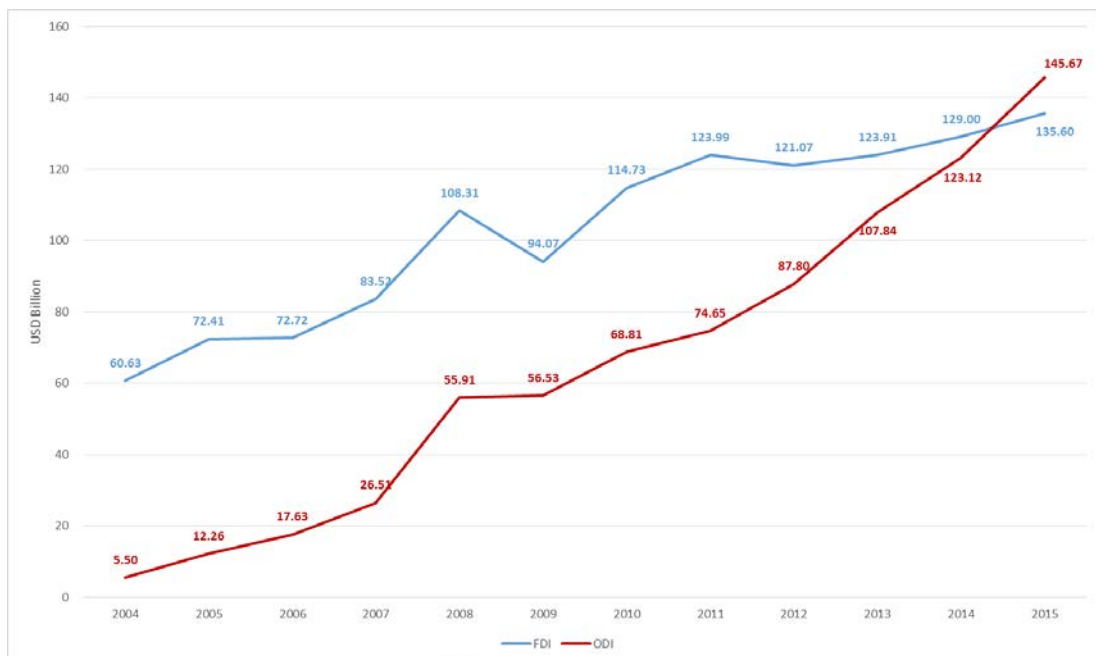


Note: (1) Data for 2002-2006 includes only non-financial ODI, and data for 2007-2015 includes ODI in all industries.

(2) Annual growth rate for 2007 refers to that of ODI in all industries.

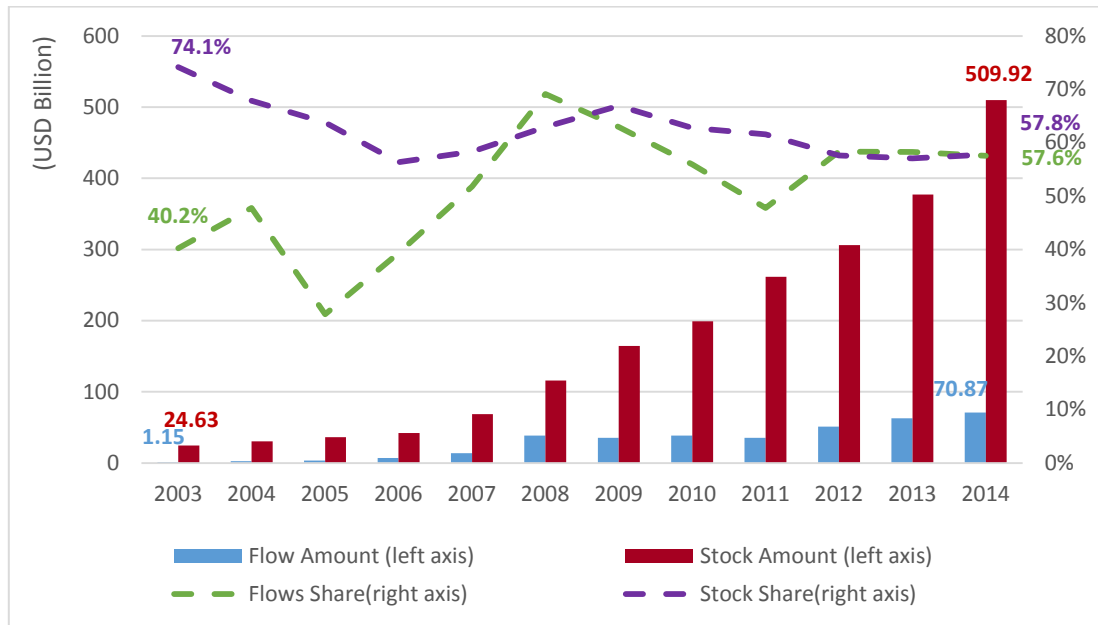
Source: Ministry of Commerce of the People's Republic of China

Figure 56: Amount of Flow of China's ODI and FDI, 2004 – 2015



Source: Ministry of Commerce of the People's Republic of China

Figure 57: China's Annual ODI Flow and Stock in Hong Kong, 2003 – 2014



Note: Data for 2002-2006 includes only non-financial ODI, and data for 2007-2014 includes ODI in all industries.

Source: Ministry of Commerce of the People's Republic of China

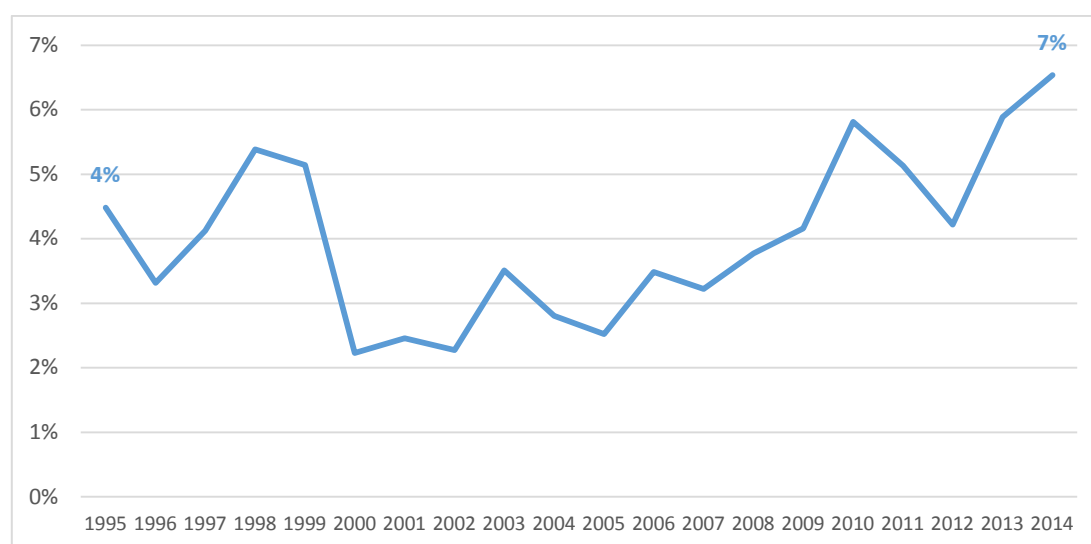
B. Two-Way Flow of Portfolio Investments

Hitherto the two-way flow of capital is mainly for direct investment. As China begins to relax its control on capital flow and opens up its capital account, portfolio investments will become increasingly prominent. A two-way flow of portfolio investments will be the ascendant trend for the future. On the one hand, foreign investors (including Hong Kong investors) are increasingly interested in hitching a ride on China's fast moving economic growth train and investing in Chinese equities and debts. On the other hand, Mainland investors are just as eager to find overseas investment opportunities for their accumulated wealth to diversify their portfolios.

Hong Kong is the ideal location to intermediate the supply and demand for these portfolio investment funds. This process has already been going on. Without fully opening up its capital account, starting from 2002 China has allowed qualified foreign institutional investors (QFII) to invest in Mainland financial assets, subject to an annual quota of USD 1.7 billion in 2003 which increased to US\$1.1 billion in 2015. Since 2006, its own citizens are allowed to invest overseas through qualified domestic institutional investors (QDII) funds, also subject to an annual quota. Foreign banks are allowed to participate in China's interbank bond market starting in 2010. In 2011 the

QFII scheme was enhanced to become the RQFII scheme, allowing the use of the Renminbi. In 2014 the Shanghai-Hong Kong Stock Connect was launched, enabling Mainland investors to purchase Hong Kong shares through the Shanghai Stock Exchange and overseas investors to invest in Shanghai A-shares through the Hong Kong Stock Exchange. The Shenzhen-Hong Kong Stock Connect is expected to be launched in November 2016. Hong Kong is an ideal location for treasury operations of Chinese enterprises and wealth management of well-off Chinese entrepreneurs. So far the Mainland's percentage share of Hong Kong's export of financial services (excluding financial intermediation services indirectly measured, FISIM) is rather small, at about 7% of the total financial services export (see **Figure 58**). The room for expansion of direct financial services for the Mainland clients is huge.

Figure 58: Percentage Share of Financial Services (excl. FISIM) Export to Mainland China by Hong Kong, 1995 – 2014



Notes: (1) Figures have incorporated the latest international recommendations given in the Manual on Statistics of International Trade in Services 2010, including the services classification and compilation methods, and adopting the change of ownership principle in recording goods sent abroad for processing and merchanting.

(2) Since data on geographical breakdowns of financial intermediation services indirectly measured (FISIM) are not available, the Figures in respect of FISIM are not included.

*(3) For the percentage share of financial services (excl. FISIM) to other trading partners in 2014, please refer to **Figure 51**.*

Source: Census and Statistics Department

As China's capital account becomes more open, the volume of the flow of portfolio investment in both directions will increase. Hong Kong will benefit as the intermediary and gateway in both directions. How well will Hong Kong play this role

and seize the growing opportunities will determine Hong Kong's status as the premier international financial centre in the years to come.

The Our Hong Kong Foundation report on “Yes, Hong Kong CAN!” by Professor Lawrence Lau, Kenny Shui and Professor Yanyan Xiong contains a comprehensive analysis of the strengths and weaknesses of Hong Kong as an international financial centre in comparison to its competitors, New York and London.⁴⁴ It proposes that Hong Kong should target the huge savings pool of China and East Asia and establish itself as the bonds and stocks market for the entire East Asia region. Enterprises and governments of East Asia (not just China) will come to Hong Kong to raise capital and issue equity and debt, and investors worldwide will come to invest in the fast growing East Asian economies in bonds, public and private equities. The policy recommendations of the report are very much in line with our theme of Hong Kong as an intermediary and gateway to a two-way flow of capital. Without replicating the detail findings, we summarize the key recommendations of the report by Lau, Shui and Xiong (September 2016) on the flow of capital as follows:

1. Developing a Deep and Liquid Bond Market

- (a) Hong Kong must develop a deep and liquid market for sovereign and corporate bonds with short and long maturities in three currencies: Hong Kong dollar, U.S. dollar and Renminbi.
- (b) To build an almost risk-free yield curve in Hong Kong dollar as a benchmark for pricing other bonds, Hong Kong SAR government should issue more general bonds of different maturities. The government should encourage the quasi-government organizations to issue long-term infrastructure bonds for the Third Runway and the High Speed Railroad Link, and the Hong Kong Mortgage Corporation to issue long-term (35 years) fixed rate bonds to purchase owner-occupied residential mortgage loans. This will fill the void of long-term bonds in the Hong Kong market.
- (c) The Central Government and its quasi-sovereign organizations like the China Development Bank, China Export-Import Bank and the newly established

⁴⁴ Lau, L. J., Shui, K., & Xiong, Y. Y. (2016). *Yes, Hong Kong CAN!*. Hong Kong: Our Hong Kong Foundation.

BRICS Development Bank and the Asian Infrastructural Investment Bank (AIIB) can be encouraged to be more active in issuing Renminbi bonds of all maturities in Hong Kong to establish an offshore Renminbi risk-free yield curve.

- (d) Having established a yield curve in Hong Kong dollar (which is equivalent to the U.S. dollar through the linked exchange rate) and a yield curve in Renminbi, Hong Kong SAR government and the Central Government can encourage supranational organizations such as the World Bank, the Asian Development Bank (ADB), the Asian Infrastructure Investment Bank (AIIB) and the BRICs Development Bank, as well as Mainland enterprises, to issue bonds in U.S. or Renminbi in Hong Kong.
- (e) The availability of debt securities in three currencies of different maturities will make up for Hong Kong's shortfall in the bond market and strengthen its position as a premier international financial centre in attracting international asset managers, sovereign fund managers, pension funds and insurance companies to set up treasury operations in Hong Kong.

2. Developing a Large, Liquid Regional Stock Market

- (a) Besides being a major stock market for listing Mainland corporations, the Hong Kong Stock Exchange should attract East Asian blue chip companies to come to Hong Kong for primary listing or secondary listing (in the form of Hong Kong Depository Receipts) in three currencies.
- (b) Mainland and overseas asset managers can come to Hong Kong to trade in East Asian blue chip stocks to benefit from the fast growing economies in the region.
- (c) Hong Kong should expand the capacity of the Shanghai-Hong Kong Stock Connect and the soon to open Shenzhen-Hong Kong Stock Connect to enable overseas investors to buy A-shares direct from Hong Kong.

3. Developing a Regional Re-Insurance Market

- (a) Hong Kong is already a major insurance centre for the Mainland but it can scale up to be a re-insurance centre for East Asia, capitalizing on the rapidly rising demand for all forms of insurance, including life, property, casualty, liability and maritime insurance, arising from economic growth and the OBOR Initiative.

- (b) The high saving rate of the East Asian economies provides a source of risk capital. Major international insurance companies can be attracted to come to Hong Kong to diversify their risks through re-insurance.
- (c) Hong Kong should first target the largest Mainland re-insurance companies to establish its regional headquarters in Hong Kong, which will create economies of agglomeration. The benefits of economic agglomeration will then attract insurance companies worldwide to use Hong Kong re-insurance services.

4. Developing a Venture Capital Centre

- (a) Hong Kong can create a nurturing domestic eco-system for innovation and technology by investing more in research and development, leveraging on the technological base in Shenzhen. International venture capital can be attracted to invest in these projects with IPO in the Hong Kong Stock Exchange. The recently established Hong Kong X-Tech Startup Platform in July with the participation of Sequoia Capital is a good start.
- (b) The government of Hong Kong should increase the R&D expenditure. For example, subsidizing the full salary and related costs of the principal investigators on government-funded research projects; expanding the scope of the R&D projects; and increasing R&D investment at local universities to develop a hub for R&D in the same way that the Silicon Valley developed around Stanford University.

5.3 Hong Kong as the Premier Offshore Renminbi Centre

The internationalization of the Renminbi provides a golden opportunity for the development of Hong Kong as a premier international financial centre. Hong Kong is the first and the largest offshore Renminbi centre in the world. It has the largest pool of Renminbi liquidity (751 billion yuan of deposit and certificates of deposit in July 2016) outside of the Mainland. It has the first offshore Renminbi payments system, the Real Time Gross Settlement (RTGS), which is linked up with China's National Advanced Payment System (CNAPS), enabling Renminbi transactions with the Mainland. It is also linked to the U.S. dollar and Euro payment systems, thereby allowing cross currency transactions. RTGS enables PvP (payment versus payment) forex transactions and DvP (delivery versus payment) transactions in bonds and securities. In operation since 2007, the daily turnover of Renminbi through the RTGS

overtook the transaction volume of Hong Kong dollar turnover in 2013, amounting to 947 billion yuan in 2015 a day. According to RMB Tracker released by Society for Worldwide Interbank Financial /Telecommunication (SWIFT), in April 2016 the RTGS of Hong Kong processed 72.5% of Renminbi payments globally. At the end of 2015, 219 banks worldwide participated in the Renminbi RTGS system and over 1,500 other banks open correspondent banking accounts with the participating banks to settle Renminbi payments. Around 97% of Mainland's cross-border trade invoiced in Renminbi is settled in Hong Kong. In Chapter 2, some of the offshore Renminbi business that Hong Kong pioneers in retail and corporate banking, capital markets, money and forex market are also highlighted. As China further opens up its capital account and internationalises its currency, Hong Kong will be the major offshore beneficiary.

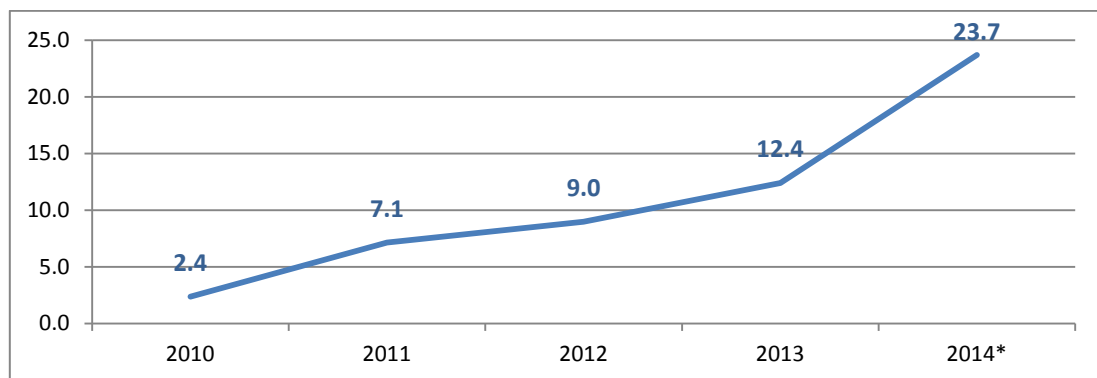
5.3.1 Renminbi as Trading Currency

For Renminbi to become an international currency, it has to become a currency for international trade, a currency for international investment and a reserve currency. These three steps, though not exactly one after the other, is the sequence of progress towards internationalisation of a currency. There are cogent economic reasons why China would want its currency to be international. If Renminbi is widely used as an international currency, it will eliminate the exchange rate risk and the transaction cost that Chinese traders incur in their exports and imports being invoiced in a foreign currency, say the US dollar. It will increase the Mainland's bargaining power in price setting for commodities. It will raise the efficiency in financing and facilitate overseas investment. Furthermore, it will reduce the need for the central bank to hoard foreign exchange reserve and reduce the exposure to currency depreciation of its reserve assets. Last but not the least, China will benefit from the seigniorage of printing money, as the U.S. has enjoyed over the decades because the US dollar is a widely used international currency.

Since the accession to the World Trade Organization (WTO), China's foreign trade has grown leaps and bounds. China is the largest exporter of merchandise and the second largest importer in the world in 2015. In total merchandise trade, China leads the U.S. as the largest trading nation, contributing to 11.3% of global trade. Despite the fact that China has opened up its current account long ago to facilitate

international trade, the use of the Renminbi to invoice and settle cross-border trade is a recent development. Starting from the settlement of 2% of Mainland China’s trade in Renminbi in 2010, the use of the currency for trade settlement has grown very rapidly to 24% in 2014 (see **Figure 59**). This percentage is still rather small compared with the use of other international currencies for trade. **Figure 60** shows that the Euro Zone, Britain and Japan use their own currencies to invoice 30-60% of their trade in goods. The Euro, British Pound Sterling and the Japanese Yen are the three international currencies ahead of the Renminbi in international payment, besides the US dollar. One can expect that it will not take long that before 40-50% of Mainland China’s trade will be invoiced and settled in Renminbi. Given that the country is the largest trading nation in the world, the amount of the use of Renminbi in trade will increase tremendously. As the largest offshore Renminbi centre, Hong Kong must take advantage of the opportunity of benefiting from settling a large proportion of the trade in Renminbi.

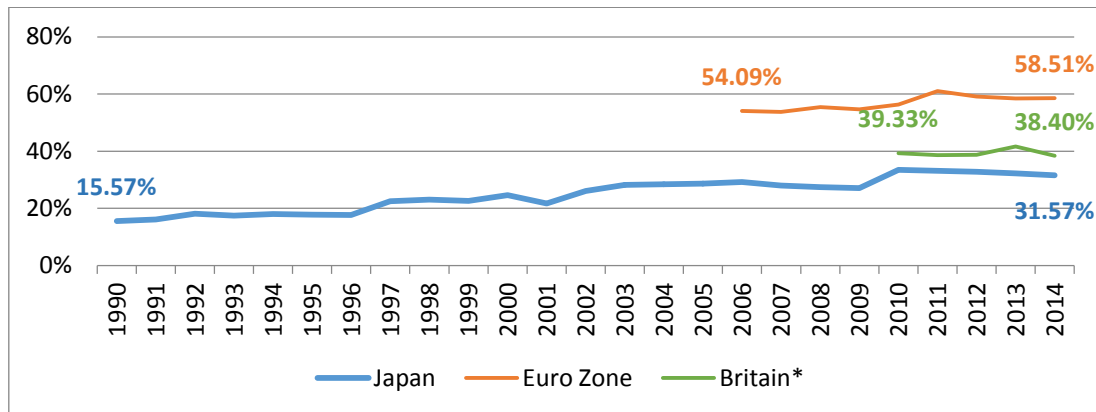
Figure 59: Trade in Goods of China Settled in Home Currency, 2010 – 2014



*Note: *Re-export trade without declarations was included in Trade in Services in 2009-2013, and was adjusted to Trade in Goods in 2014.*

Sources: The People's Bank of China, State Administration of Foreign Exchange

Figure 60: Trade in Goods of Japan, Euro Zone and Britain Settled in Home Currency, 1990 -2014



Note: *Exclude trade where there is no currency declared. The currency of invoice for UK trade with countries outside the EU has been collected under EU legislation since 2010.

Sources: European Central Bank, HM Revenue & Customs (United Kingdom), Bank for International Settlements, Statistics Bureau of Japan, Our Hong Kong Foundation

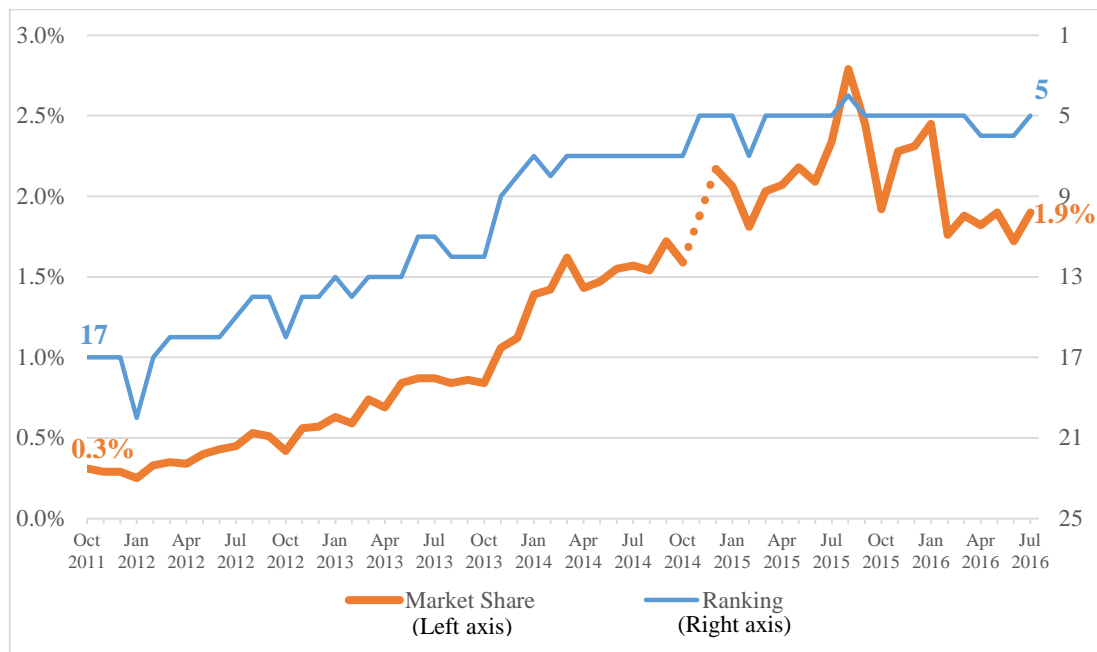
5.3.2 Renminbi as Investment Currency

As Renminbi is increasingly used in trade, international access to the currency will increase. Foreigners holding Renminbi balances will have to put it to use by investing in assets denominated in the currency. International asset managers will also be interested in investing Renminbi assets to benefit from economic growth of China. As China's capital account gradually opens up, Renminbi will see greater use as an investment currency. It is estimated that only 13% of inward FDI and 4% of China's ODI are settled in Renminbi. Since China is both the second largest recipient country of inward FDI as well as the second largest source country of ODI, the room for expansion in the use of its currency in investment is huge. In August 2015, the use of Renminbi as a world payment currency rose to 2.79%, from a miniscule 0.31% in October 2011. It became the 4th most used international currency after the US dollar, the Euro, and the British Pound. With the recent depreciation, the Renminbi has slipped to the 5th place after the Japanese Yen as a world payment currency with a usage of 1.9% in July 2016 (see **Figure 61**). Whilst the increase in the use of Renminbi in world payment from a low base is rapid, there exists huge discrepancy between the percentage of its usage and China's 11.3% share of world trade in goods. Furthermore, its use for investment in Renminbi-denominated asset is just in the very early stage. (see **Figure 62**). The prospect for the use of Renminbi as a world payment currency is great.

In terms of foreign currency transactions in the global foreign exchange (forex) markets, the daily transaction volume involving Renminbi and another currency increased 68% in three years from 120 billion (measured in US dollar) in 2013 to 202 billion in 2016. 95% or 192 billion of these transactions were foreign exchange with the US dollar, of which 76 billion took place in the Hong Kong market. Renminbi forex transactions now constitute 4% of global forex transactions. It is the 8th most traded currency in the world.⁴⁵

Hong Kong's offshore Renminbi market is a platform for the Mainland to experiment with different measures in opening the capital account and pilot testing the offering of Renminbi-denominated investment products. Hong Kong must position itself as an offshore supermarket of a wide range of Renminbi-denominated equities and debts with deep liquidity for international investors.

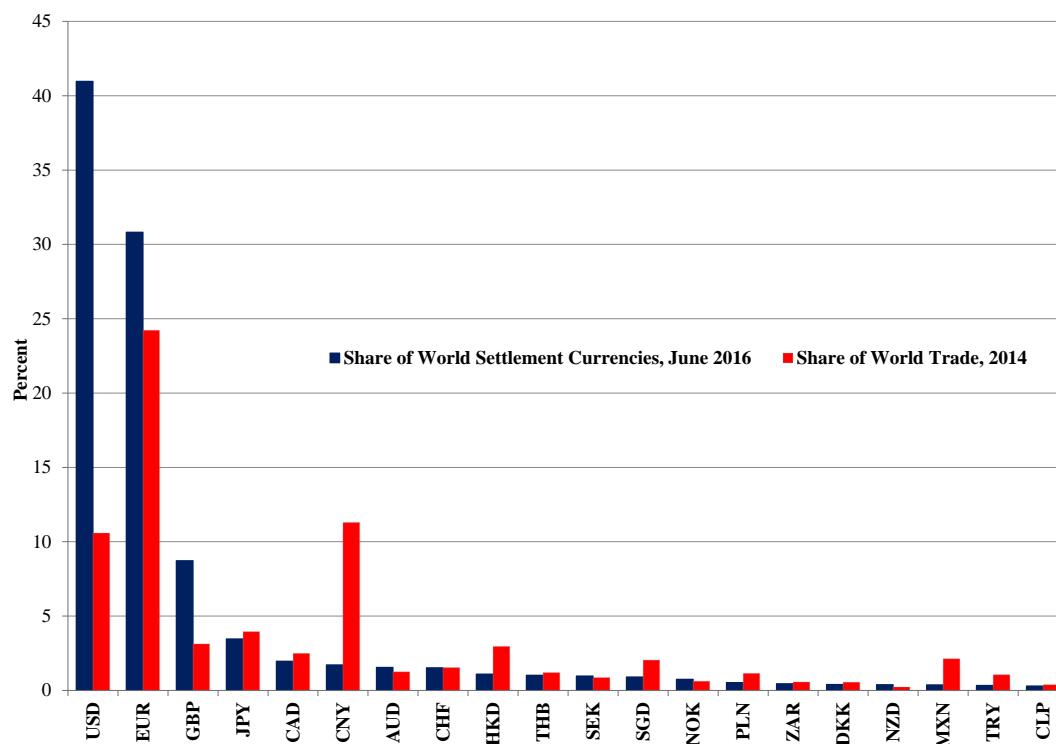
Figure 61: RMB as World Payment Currency through SWIFT at Value, Oct 2011 - Jul 2016



Sources: SWIFT, Wind

⁴⁵ After US dollar, Euro, Yen, Pound Sterling, Australian dollar, Canadian dollar and Swiss franc. (Bank for International Settlements. (2016). *Triennial Central Bank Survey of foreign exchange and OTC derivatives markets in 2016*.)

Figure 62: The Share of World Settlement Currencies and the Share of World Trade, June 2016



Source: Lau, L. J., Shui, K., & Xiong, Y. Y. (2016). *Yes, Hong Kong CAN!. Hong Kong: Our Hong Kong Foundation.*

5.3.3 Renminbi as Reserve Currency

The last stage for a currency to become truly international is that it will be accepted by central banks of different countries as a reserve currency, in which case financial instruments denominated in that currency will form part of their foreign exchange reserves. That stage has begun in 2009 when Russia became the first country to announce it would hold Renminbi in its foreign exchange reserve, and later followed by Japan and South Korea. In 2010-2012 twenty central banks signed a currency-swap agreement with the People’s Bank of China. In April 2013 Australia announced that 5% of its foreign exchange reserve was in Renminbi. In June, Bank of England became the first European central bank to sign a currency swap agreement (200 billion RMB) with the People’s Bank of China. A survey of HSBC of 77 central banks show that 32 of them have investments in onshore and offshore Renminbi assets, whereas in 2012, there were only 3.⁴⁶ In November 2015, IMF announced that

⁴⁶ Ho, K. (2016, September 2). 人幣入籃在即 國際化邁向新里程. *Hong Kong Economic Journal*. Retrieved from <http://www1.hkej.com/dailynews/investment/article/1382141/人幣入籃在即 國際化>

the Renminbi would be incorporated into the basket of currencies of the Special Drawing Rights (SDR) from 1st October 2016. This act will certainly increase the demand for Renminbi as a reserve currency and raise its status as an international currency. At present Renminbi constitutes about 1.9% of all international foreign exchange reserve.⁴⁷ According to the HSBC report of the market forecast, in the next 3-5 years, the share of Renminbi in international reserve currency will increase to 4-5%, and a survey of central banks indicate that by 2025, as high as 6.7% of their reserve will be in Renminbi assets.

Even though Hong Kong does not play a large role in central banks' management of foreign exchange reserves, it will benefit from the increase use of Renminbi in world payment. It can serve the investment needs of sovereign wealth funds which will want to include Renminbi-denominated assets in their portfolios.

5.3.4 Hong Kong as a Premier International Financial Centre

The internationalisation of Renminbi will elevate Hong Kong's status as an international financial centre. Hong Kong has been ranked within the top 3-5 financial centres in the world by different ranking agencies. It is pertinent to note that Hong Kong's accomplishment as an international financial centre has little to do with Hong Kong's domestic investment demand and its domestic currency. Hong Kong earns its current status by serving as a gateway to the flow of funds to and from the Mainland, which until recently was almost exclusively in currencies other than the Renminbi. With the rise of the Renminbi as a major international currency, the offshore Renminbi centre will propel Hong Kong's international financial centre to new heights, in much the same way that the Eurodollar market in London enables the city to maintain its position as the top one or two financial centre in the world, despite the decline of the Pound Sterling as an international currency after World War II.

The collapse of the Bretton Woods system in 1973 and the persistent and large American balance of payment deficits made the US dollar readily available overseas. Onshore interest rate ceiling regulations in the U.S. pushed American investors to

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⁴⁷ 人幣納 SDR 儲備需求升 中銀料 10 年內「三分天下」。 (2016, September 26). *MingPao*, p. B4.

deposit offshore, building up a large pool of US dollars held outside the country. The Cold War caused the communist countries and those not friendly to the U.S. to keep their dollar deposits and assets outside the U.S., for fear of being sequestered by the U.S. government in a cold war crisis (Einzig, 1970; Kindleberger, 1973). The pool of US dollar liquidity turned London into the largest offshore US dollar market. At the end of 2008, London claimed the largest share (20%) of the total offshore dollar deposits outside the U.S. (He and McCauley, 2010). Together with other Eurocurrency markets, Euronotes and Eurobond markets, London consolidated its position as a leading international financial centre in which the Pound Sterling plays only a minor role.

In this connection, it should be pointed out that Hong Kong was already a leading international financial centre prior to the internationalisation of the Renminbi. Now it can draw on the experience of London and strengthen its position with the offshore Renminbi market. The pool of liquidity in the offshore Renminbi market will not be as deep as the offshore US dollar market because China will not run a persistent balance of payment deficit like the U.S.. Nevertheless, with the increasing international use of the currency in trading, investment and reserve, the offshore Renminbi liquidity pool will grow to be large enough to support the offshore Renminbi markets. After all, China is the largest trading nation in the world with a high saving rate and therefore has plenty of funds to invest overseas. Hong Kong must continue to consolidate its position as the leading and largest offshore Renminbi centre. As of 2015, there are 20 offshore Renminbi centres with clearing banks in the world. There will be competition from London, Singapore and Taipei for the top few leading positions.

5.3.5 Impact of Convertibility of Renminbi

When China's capital account is fully open and the Renminbi becomes convertible, Hong Kong's offshore market will face a new challenge. The advantage it currently enjoys over Shanghai's onshore Renminbi market in currency convertibility will be lost. However, with full convertibility, Renminbi deposits and denominated assets overseas will expand tremendously and Hong Kong will benefit from the larger pie. It is true that the Hong Kong's offshore market will have to compete with the Shanghai's onshore market on equal term as far as convertibility is concern but Hong

Kong still has other advantages. After all, the London Eurodollar market thrives even though the US dollar is freely convertible and there is a strong competing onshore US dollar market in New York.

A study by He and McCauley (2010) shows that non-US residents have a strong preference for doing their dollar business outside the U.S.. Official reserve managers also prefer to place US dollar deposits outside the country. **Table 7** shows that in 2008, as high as 62% of the official dollar reserves of banks were held offshore outside the U.S.. For non-US banks the percentage is even higher at 82%.

Table 7: Official Dollar Deposits by Location and Nationality of Banks (US\$ Billion), December 2008

Nationality of banks	Location of deposit		
	U.S.	Offshore	Total
U.S.	127.6	32.5 (20.3%)	160.1
Other	59.7	269.4 (81.9%)	329.1
Total	187.3	301.8 (61.7%)	489.2

Source: He, D., & McCauley, R. N. (2010). Offshore markets for the domestic currency: Monetary and financial stability issues. BIS Working Papers No 320. Bank for International Settlements.

Investors may prefer to hold the currency in an offshore market so as not to be exposed to the country risk of the issuing country. Onshore regulatory controls, reserve requirements may add to the domestic funding cost, reducing the efficiency of financial intermediation onshore and driving funds to the offshore market.⁴⁸ Wong and Chan (2013) find that the quality of the legal system, regulatory framework, foreign exchange market turnover, inflows of portfolio investments and trade linkage with the U.S. contribute positively to the offshore centres' shares of US dollar deposits. Location in a distant time zone from New York, however, does not confer an advantage to the offshore centre. In fact there is a benefit to be in a similar time zone with overlapping trading hours with the onshore market.

⁴⁸ Choi, R. "Offshore RMB development in Hong Kong: A Look into the Eurocurrency Experience" Economic Analysis and Business Facilitation Unit, Hong Kong SAR Government.

When the Renminbi becomes fully convertible, Hong Kong's offshore centre will continue to have an advantage over Shanghai's onshore centre in its soft infrastructure which includes a low profit tax rate, zero capital gain tax, a low salary tax rate for the professional employees, a predictable and transparent regulatory regime, a robust judicial system and an independent court using common law, the legal tradition adopted in international financial transactions. These soft strengths of an international financial centre takes time to build up. It cannot be acquired or replicated by Shanghai in a short period of time. In much the same way that London continues to be the top one or two international financial centre of the world, Hong Kong can build on the strength of its offshore Renminbi centre, leverage on the rise of Renminbi as a major international currency, and consolidate its position, and even move ahead, as a leading international financial centre.

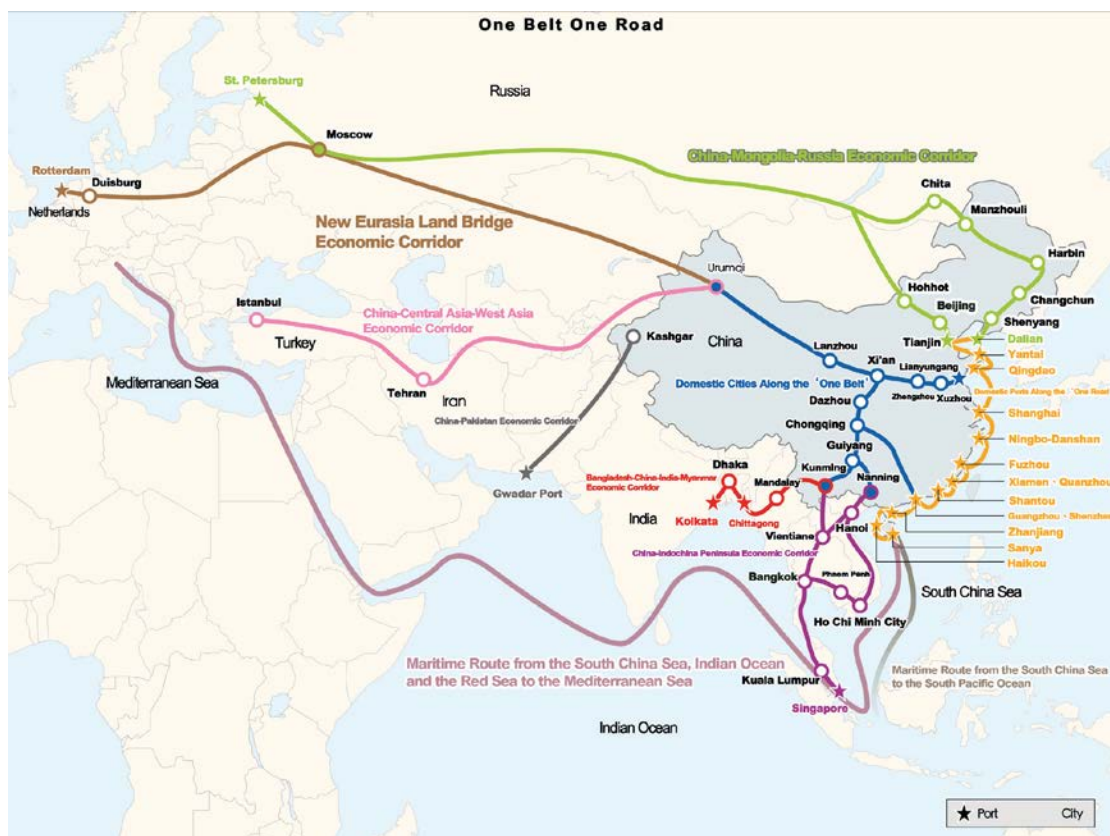
5.4 Hong Kong as the Financial Centre for the “One Belt, One Road” Initiative

Historically Hong Kong's claim as an international financial centre is largely premised on its financial intermediary role between Mainland China on the one side, and U.S., Europe, Japan and, to a lesser extent, Southeast Asia on the other. China's “One Belt, One Road” (OBOR) Initiative creates a new opportunity for Hong Kong to intermediate between the savings of China and the advanced countries on the one hand, and the investment needs of developing countries on the other. Hitherto many of these developing countries, in particular, the Central Asian countries along the land Silk Road Belt, are not connected to the global financial markets. If the OBOR Initiative is successful and Hong Kong plays its role well, Hong Kong can truly claim to be a global financial centre.

The OBOR Initiative involves 66 countries covering 63% of the world population and 30% of the global GDP (see **Figure 63**). According to a 2009 report of the Asian Development Bank (ADB), the demand for funds for infrastructure investments in the Asian countries alone will amount to US\$750 billion a year starting from 2020. It is estimated that the ADB and the World Bank together can provide only about US\$30 billion a year. The huge funding shortage has to be met elsewhere. That explains partly why there is such an enthusiastic response to join the AIIB proposed by China. As many as 57 countries, some of them not among the OBOR countries, joined as founding members in 2015. But AIIB is capitalized at only

US\$100 billion, and even together with the new BRICS Development Bank and the Silk Road Fund, there will not be sufficient funds from the development banks on their own. They will have to rely on leveraging and public-private partnership for financing. The OBOR infrastructure projects are mostly huge in size. For instance, the announced OBOR infrastructure projects under planning or construction include high speed rail (Eurasia Rail, Central Asia Rail, Pan-Asia Rail and the Jakarta-Bandung high speed rail), port development (Sri Lanka Port and Pakistan’s Gwadar Port), cross-border oil and gas pipeline (The West-East Gas Pipeline, Central Asia-China and China-Russia gas pipeline), nuclear power (Pakistan) and telecommunication links (Myanmar-China, Tajikistan-China and Pakistan-China optic link, and submarine optical fibre cable in Southeast Asia).

Figure 63: Map of “One Belt One Road”



Source: Our Hong Kong Foundation

Hong Kong can provide both a US dollar and a Renminbi financing platform to fill in the funding gap. AIIB and the Silk Road Fund can be requested to set up a branch or its treasury fund management centre in Hong Kong. They can tap into the US dollar and Renminbi liquidity in Hong Kong by issuing bonds. This in turn will

help to establish a yield curve for the Hong Kong bond market. OBOR projects can be financed by debt or equity. The securities can be listed in the Hong Kong as a primary listing or secondary listing. As mentioned earlier, Hong Kong must build up the depth of liquidity in the currency market, especially in offshore Renminbi, as some of the OBOR projects which have direct links to China, will likely be funded in that currency. Hong Kong should offer a wide range of financial instruments to cater for the demand for yields and risk diversification. An example of a new investment product is the “sukuk” which is a debt-like instrument that complies with the Islamic law of many Islamic countries along the Silk Road Belt. Hong Kong has started to develop such a market for sukuk. There is potential for widening and deepening the market to meet the demand of OBOR project-linked investments. Banks and financial institutions from the OBOR countries could also be encouraged to set up branches in Hong Kong to manage OBOR-related business. To facilitate local currency financing and trading, Hong Kong’s RTGS could be broadened to cover other international currencies that may be used in the OBOR countries.

Hong Kong can be made an even more attractive location for the provision of financial services if it can be packaged with other professional services for the OBOR projects. Hong Kong can offer accounting services and insurance services besides project financing. Hong Kong can provide legal and arbitration services. OBOR-related disputes could be between sovereign entities. It would be an ideal location for arbitration because of its common law tradition and its independent judiciary. Hong Kong can also offer construction and management consultancy services, airport, port and railway management expertise.

5.5 Concluding Remarks

Hong Kong has grown into a leading international financial centre mainly serving as a gateway for the flow of FDI into China. The rapid growth of the Chinese economy, its high saving rate and accumulated wealth presents a growing opportunity for Hong Kong to intermediate Chinese savings and the West’s demand for funds, as well as providing a platform for the West to invest in Chinese assets as China’s capital account opens up. Hong Kong has become a two-way gateway for the flow of capital. China’s policy to internationalise its currency and its OBOR Initiative open up more opportunities and create the possibility for Hong Kong to develop into a truly

global financial centre. These opportunities can only be possible if Mainland China takes into account Hong Kong's position in its national development policy. Hong Kong must seize the opportunities and foster a constructive win-win partnership with the Mainland.

6. Immigrants and Human Capital from Mainland China

6.1 Preamble

As a small open economy, it is important that Hong Kong remains open to a free flow of people who come to Hong Kong for business and pleasure. Hong Kong should facilitate the flow of visitors by simplifying border entry procedures, building more efficient transport infrastructure such as border crossing and the third airport runway, and providing more conference, exhibition, cultural, tourist and shopping facilities to make Hong Kong more attractive to visitors.

The free flow of people coming to work and to settle as immigrants, however, is an entirely different matter. Hong Kong is a small territory situated next to the great land mass of Mainland China. The differential in wage and standard of living between the two places is large. Unrestricted movement of people across the border to work and live will be disastrous to Hong Kong. The European Union (EU) is one of the rare examples that allow free movement of people to work and settle across nations. The EU's differences in size and standard of living across national boundaries are much smaller than the case of Hong Kong and the Mainland. Even then, free movement of workers and immigrants are very controversial and divisive in the EU. It is one of the principal reasons behind Britain's vote to exit the Union. Whilst a free flow of immigrants into Hong Kong⁴⁹ is neither feasible nor desirable, we argue that a controlled flow of immigrants is important to Hong Kong, in terms of enhancing the human capital stock, rejuvenating the ageing population, and averting the decline of the labour force.

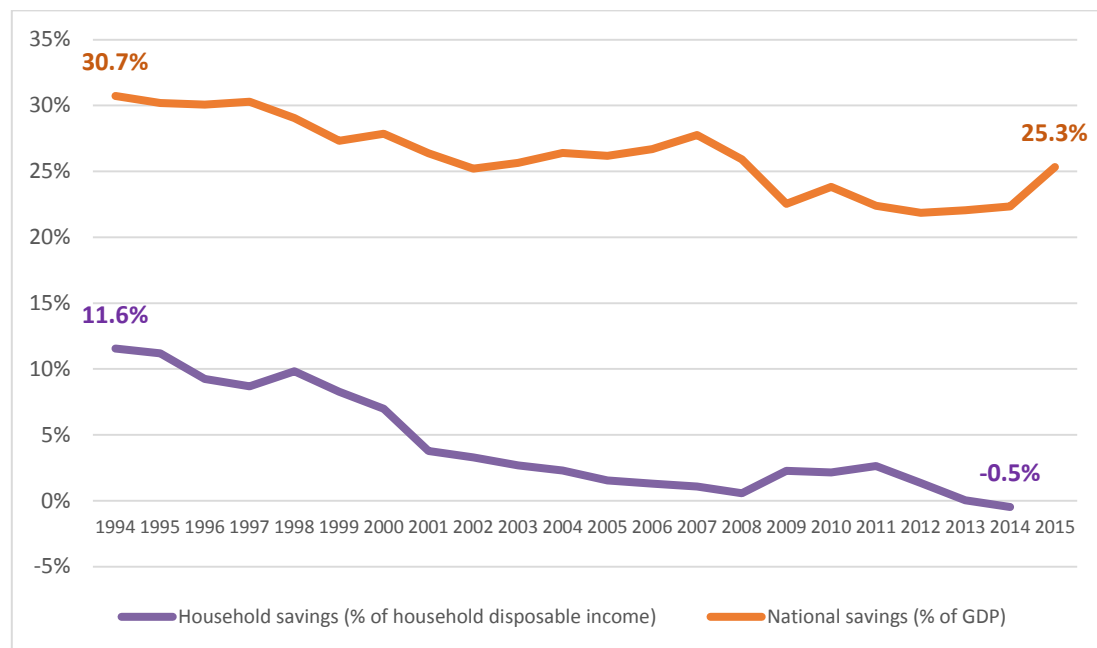
6.2 Population Ageing and Economic Growth

Population ageing has serious implications on economic growth. First, retirees tend to be more careful on spending as they prepare for their old age. Their weaker consumption demand tends to slow down economic growth from the demand side. This effect increases gradually as the proportion of the old age population increases. Second, old age people tend to dissave, depleting their savings gradually. With a

⁴⁹During the colonial days of Hong Kong, entry into Hong Kong from the Mainland had been unrestricted up to May 1950. For details, see Lam and Liu (1998), pp. 7-8.

lower saving rate, an ageing society tends to discourages investment and capital formation, inhibiting the growth of potential GDP. A case in point is the decline the saving rate of Japan as its population ages over the last few decades (see **Figure 64**). Third, as the population ages, the elderly dependency ratio worsens.⁵⁰ An increasing proportion of fiscal resources will have to be diverted towards old age welfare and health care. The proportion of fiscal resources that will be devoted to investing in education, technology, and infrastructure to enhance productive capacity will decrease, thereby slowing down the growth in total factor productivity and, ipso facto, economic growth. Fourth, as the population ages, the working population will eventually shrink. Unless the reduction is offset by a commensurate increase in labour force participation rate, labour supply will decline, causing a direct drag on economic growth from the supply side.

Figure 64: Household Saving and National Saving Rates of Japan, 1994 – 2015



Sources: OECD, International Monetary Fund

The effect of population ageing on economic growth can be estimated using growth accounting. GDP growth can be decomposed into contributions of labour, capital accumulation and total factor productivity. The Conference Board estimates

⁵⁰ Elderly dependency ratio refers to the number of persons aged 65 and over per 1 000 persons aged between 15 and 64.

that for the 55 countries under study which has an average annual growth rate of 2.9% from 1990 to 2005, ageing will reduce the annual GDP growth by 0.4 percentage point during 2014-19, and by a larger cut of 0.9 percentage point during 2020-25 as the population ages further.⁵¹

Population ageing and decline caused by low fertility and high life expectancy are modern phenomena. Historically, population decline had been caused by war, famine, pestilence, natural disaster or outmigration. Though the outcome is not as abrupt and the process is gradual and drawn out, the long term economic consequences of ageing on population decline can be just as debilitating.

6.3 A Tale of Two Aged Societies

The United Nations (UN) defines an “ageing” society as one in which at least 7% of the population are elderly (age 65 or above), an “aged” society which has at least 14% elderly in the population, and a “super-aged” society which has more than 20%.⁵² In 2015 Japan is on the top of the list of the super-aged societies (26.4% elderly), followed by Italy, Germany, Finland and Greece. Almost all European and North American countries are aged societies. Among the Asian economies, Japan is number one as a super-aged society. Hong Kong is in the second-place, as the only aged society in Asia (15% elderly). Other Asian countries including Korea, Singapore, Thailand and China are, by UN definition, ageing but not yet aged societies.

Hong Kong has all the fundamental factors that contribute to the making of an aged society. Like Japan, Hong Kong’s total fertility rate is among the lowest, and life expectancy among the highest in the world. Hong Kong’s total fertility rate has fallen below and has since remained below that of Japan since the early 1980’s (see **Figure 65**). The life expectancy of its population, 81.24 years for male and 87.32 years for female in 2016, is higher than that of Japan (80.79 for male and 87.05 for female)⁵³. Were it not for the generation of the post-war baby boomers, the pre-1980 waves of massive immigration and the post-1980 steady flow of immigrants from the Mainland,

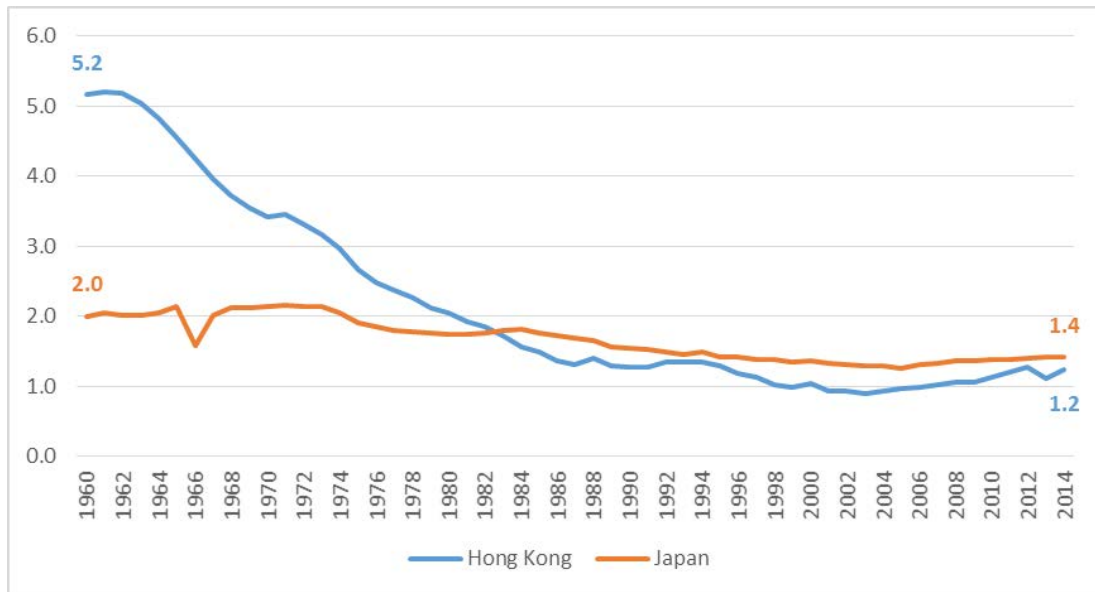
⁵¹ Erumban, Abdul Azeez, Klaus de Vries and Bart van Ark, “New Measures of Global Growth Projections for the Conference Board Global Economic Outlook 2014”, The Conference Board, 2013.

⁵² Report on World Population Aging, United Nations, 2013.

⁵³ Retrieved from Ministry of Health, Labour and Welfare, Japan.

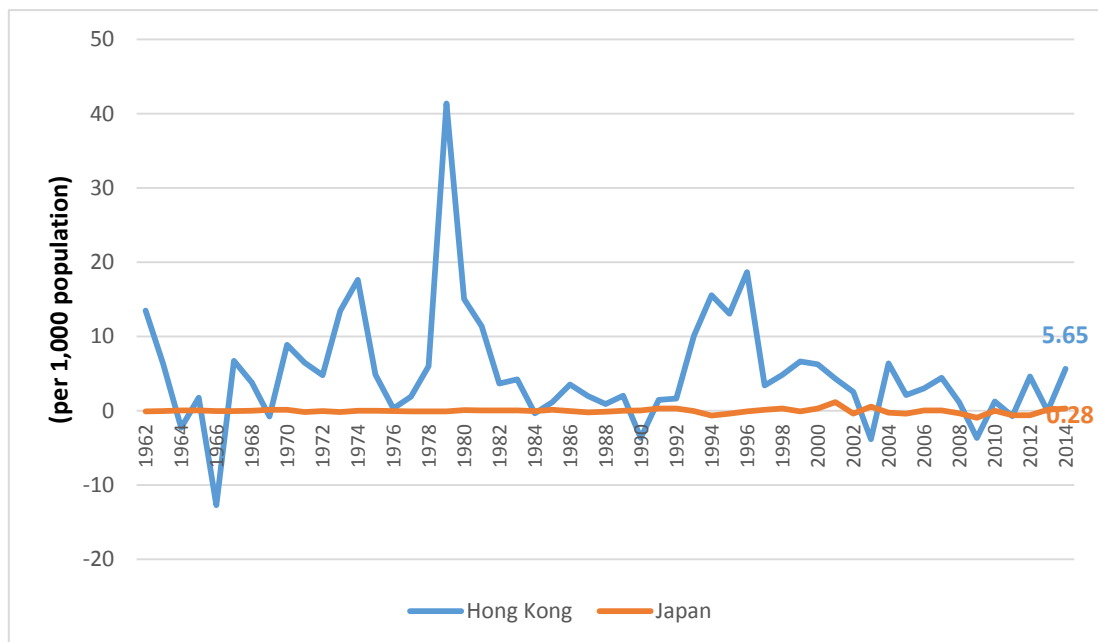
Hong Kong's ageing problem could be as advanced as Japan's (see **Figure 66**). Nevertheless, Hong Kong's population is ageing rapidly (see **Figure 67**).

Figure 65: Total Fertility Rates of Hong Kong and Japan, 1962 – 2014



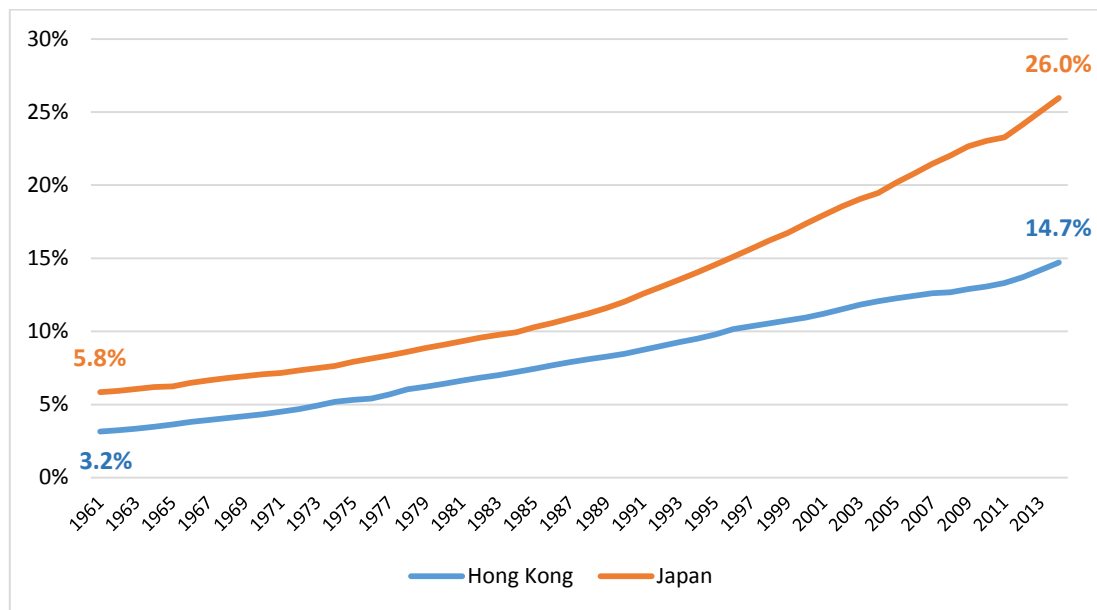
Source: *The World Bank*

Figure 66: Net Migration Rates of Hong Kong and Japan, 1962 – 2014



Sources: *Census and Statistics Department (Hong Kong), Statistics Bureau (Japan)*

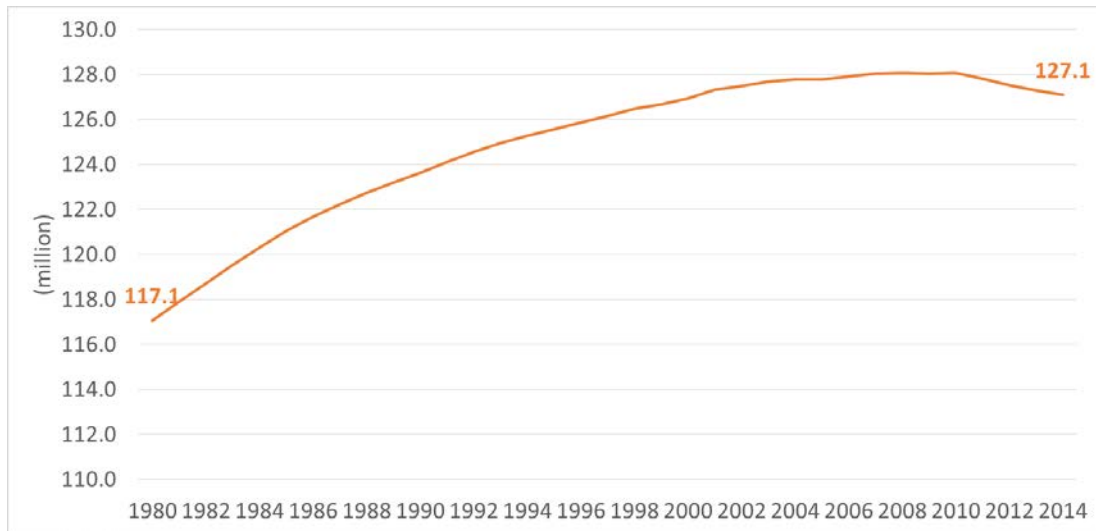
Figure 67: Proportion of Population Aged 65+ in Hong Kong and Japan, 1961 – 2014



Sources: Census and Statistics Department (Hong Kong), CEIC Data

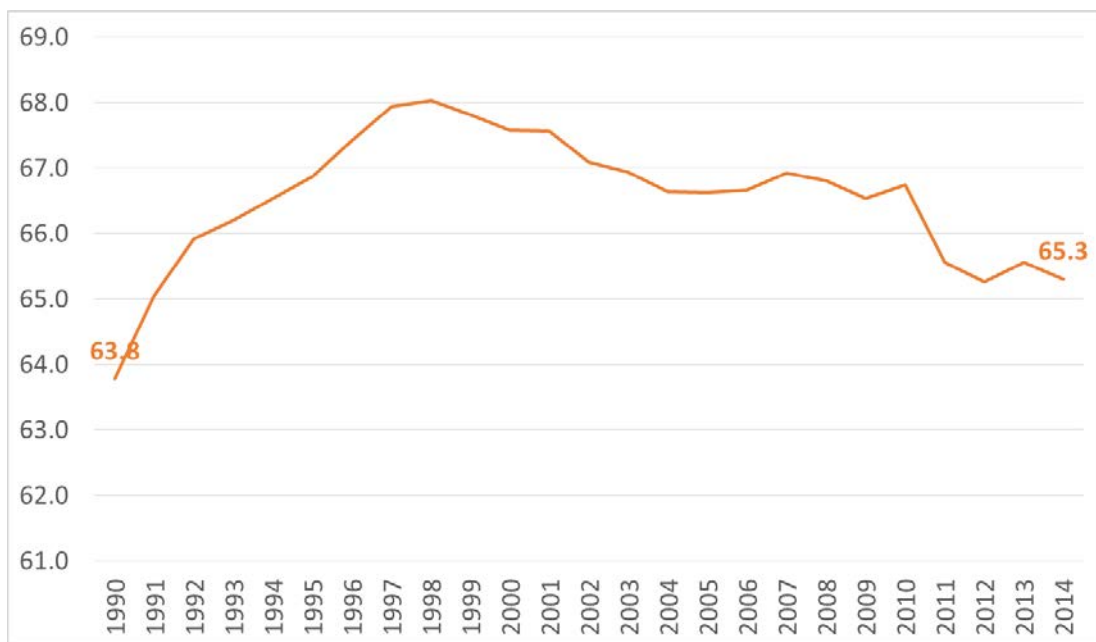
In this connection, it is pertinent to point out that Japan's population peaked in 2008 at 128 million. Today Japan has 1 million fewer people than in 2008 (see **Figure 68**). Its labour force peaks earlier and shrinks even faster. After peaking in 1998, it is now smaller by 3 million (see **Figure 69**). The decline in the labour force is an important factor behind the stagnation and anaemic growth of the Japanese economy in the last two decades (see **Figure 70**). In fact Japan's per capita nominal GDP (in U.S. dollar) has fallen behind that of Hong Kong since 2013 (see **Figure 71**). Even though the depreciation of the yen against the U.S. dollar plays a part in this comparison, the extended period of slow growth of the Japanese economy compared to Hong Kong is an underlying factor.

Figure 68: Japan's Population, 1980 – 2014



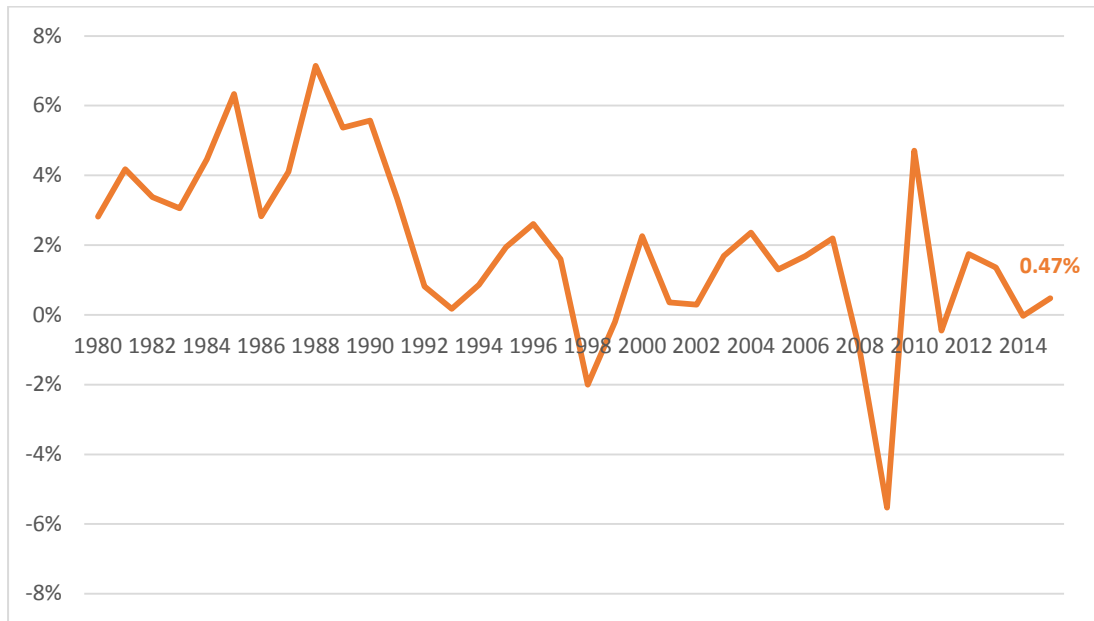
Source: *The World Bank*

Figure 69: Japan's Labour Force, 1990 – 2014



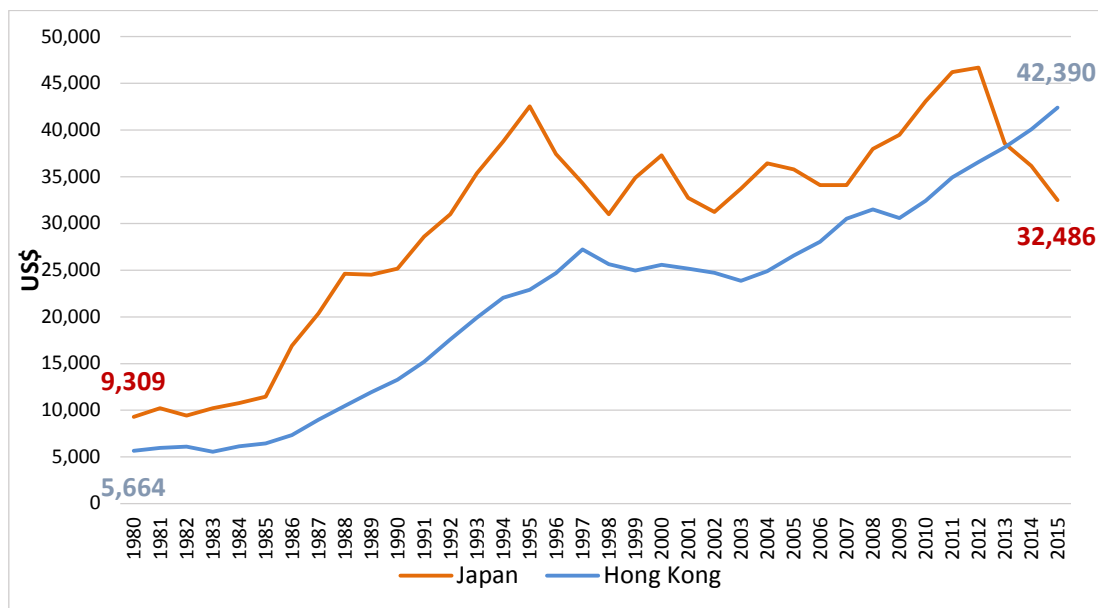
Source: *The World Bank*

Figure 70: Japan's Real GDP Growth Rate, 1980 – 2015



Source: World Bank

Figure 71: Nominal GDP Per Capita of Japan and Hong Kong, 1980 – 2015



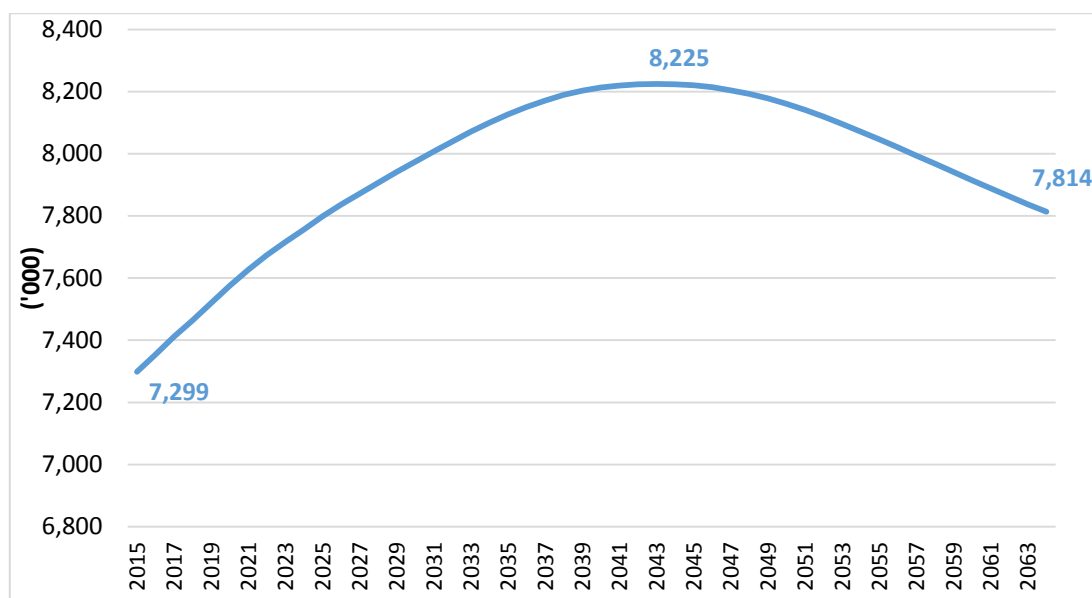
Source: CEIC Data

Based on a set of assumptions on fertility, mortality, life expectancy, net migration and the number of visas and entry permits, Census and Statistics Department forecasts that Hong Kong's resident population will peak at 8.225 million

in 2043 and decline thereafter⁵⁴ (see **Figure 72**). The annual number of deaths will outstrip the number of births in 2026 and the natural increase in population will turn negative. The net inflow of residents arising from a positive balance in arrivals and departures of immigrants and those with entry visas will still manage to compensate for the loss of population due to natural causes. It will contribute to a positive population growth up to 2043. After 2043 the population is forecast to shrink (see **Figure 73**).

Meanwhile the growth in Hong Kong's labour force has been slowing down over the years, along with the slowdown in population growth (see **Figure 74**). This coincides with a decrease in the proportion of Chinese immigrants in the labour force. In 1981, the proportion is close to 50%, and it is down to about 25% in 2011 (see **Figure 75**). The effect of the slowdown in population growth on the labour force is exacerbated by a secular decline in the labour force participation rate (see **Figure 76**). Hong Kong's labour force is forecast to peak at 3.663 million in 2019 and then decline, reducing GDP growth by 0.3% p.a. by 2022.⁵⁵

Figure 72: Projected Population of Hong Kong, 2015 – 2064



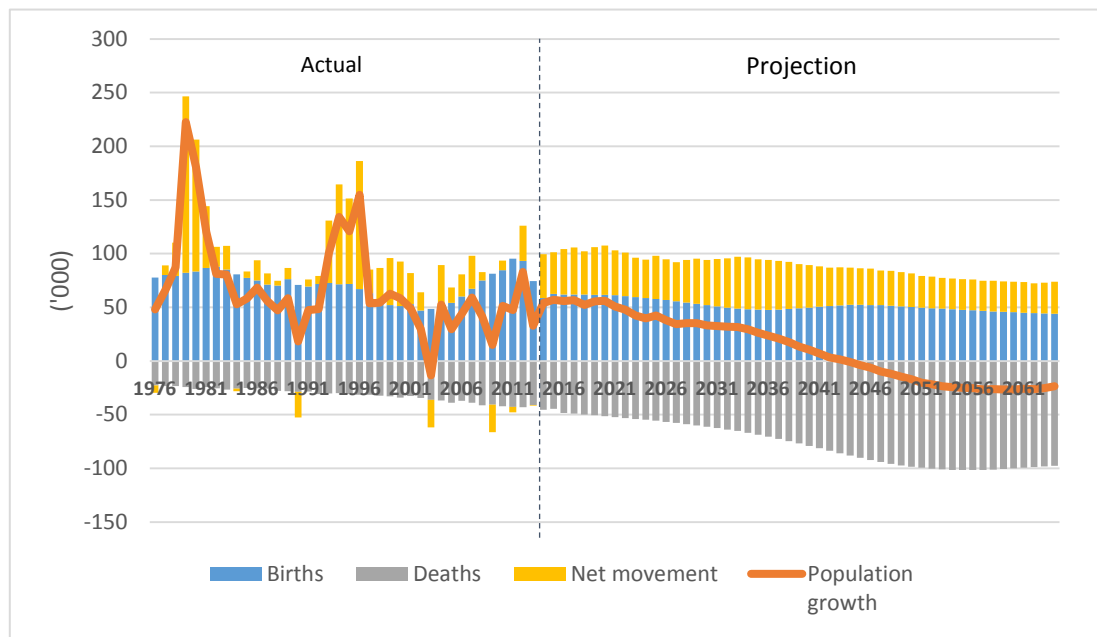
Note: Mid-year population.

Source: Census and Statistics Department

⁵⁴ Hong Kong Population Projections, 2015-2064, Census and Statistics Department, HKSAR

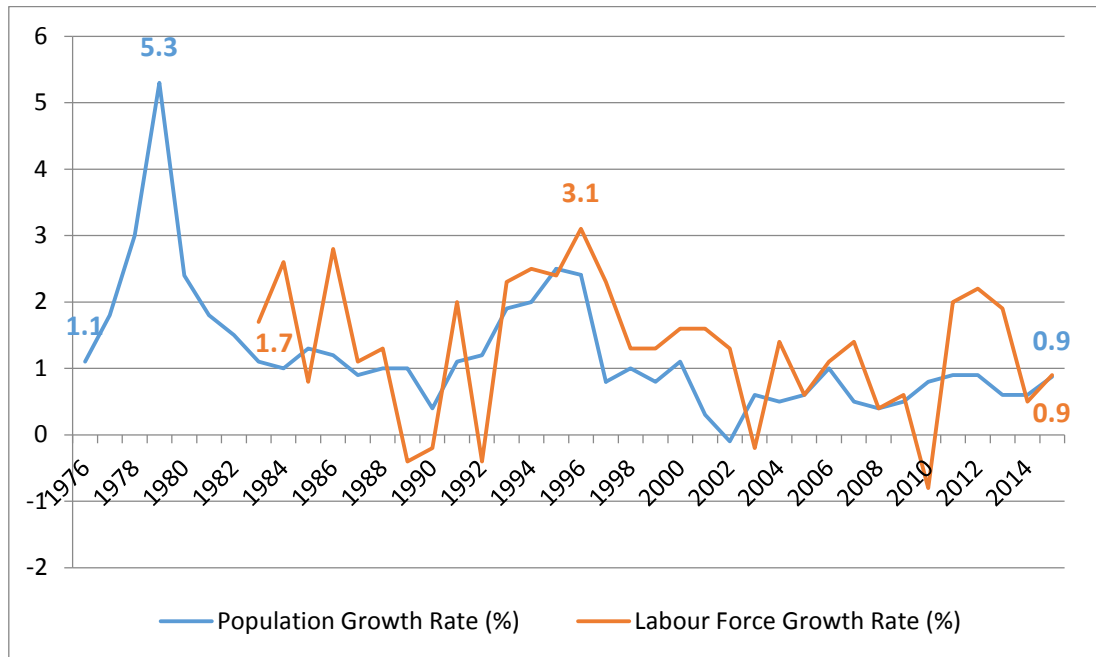
⁵⁵ Report of the Working Group on Long Term Fiscal Planning, 2013.

Figure 73: Components and Projection of Population Growth in Hong Kong, 1976 - 2064



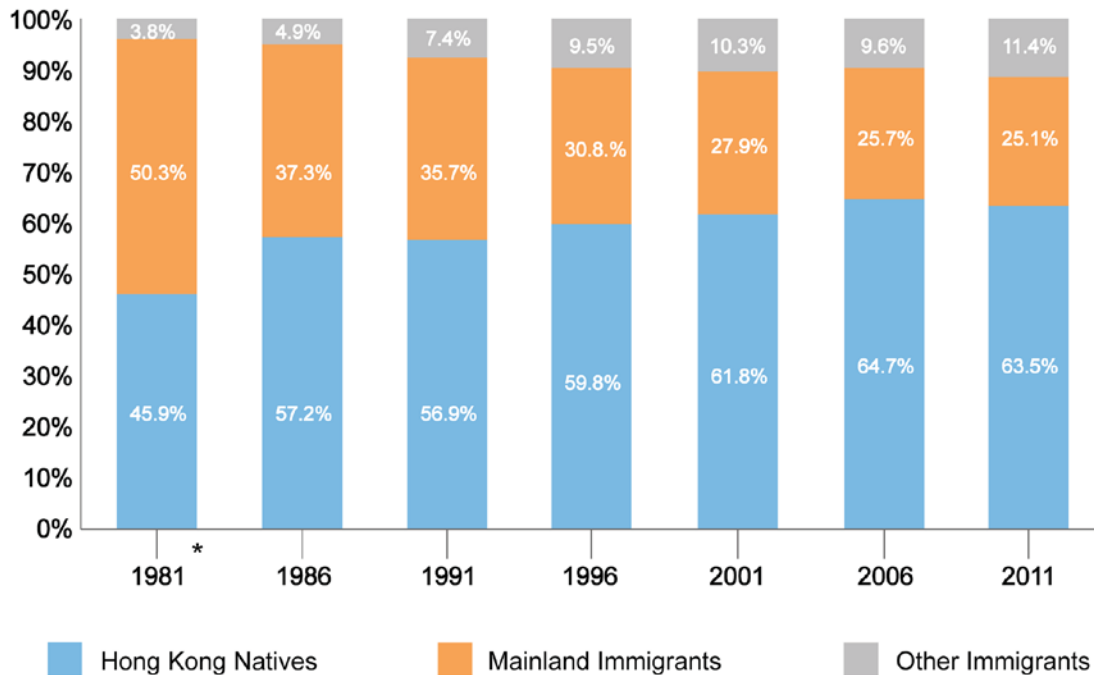
Note: The figures before 1995 are compiled based on the “extended de facto” method and those from 1996 onwards are compiled based on the “resident population” method. Under the “extended de facto” method, the population base includes persons who are physically in Hong Kong as well as Hong Kong residents who are working in Mainland/Macao and those who are usually living in Hong Kong but in Mainland/Macao for short trips at the census moment. Sources: Census and Statistics Department, Our Hong Kong Foundation

Figure 74: Growth Rates of Population and Labour Force in Hong Kong, 1976 – 2015



Note: The figures before 1995 are compiled based on the “extended de facto” method and those from 1996 onwards are compiled based on the “resident population” method. Under the “extended de facto” method, the population base includes persons who are physically in Hong Kong as well as Hong Kong residents who are working in Mainland/Macao and those who are usually living in Hong Kong but in Mainland/Macao for short trips at the census moment. Source: Census and Statistics Department

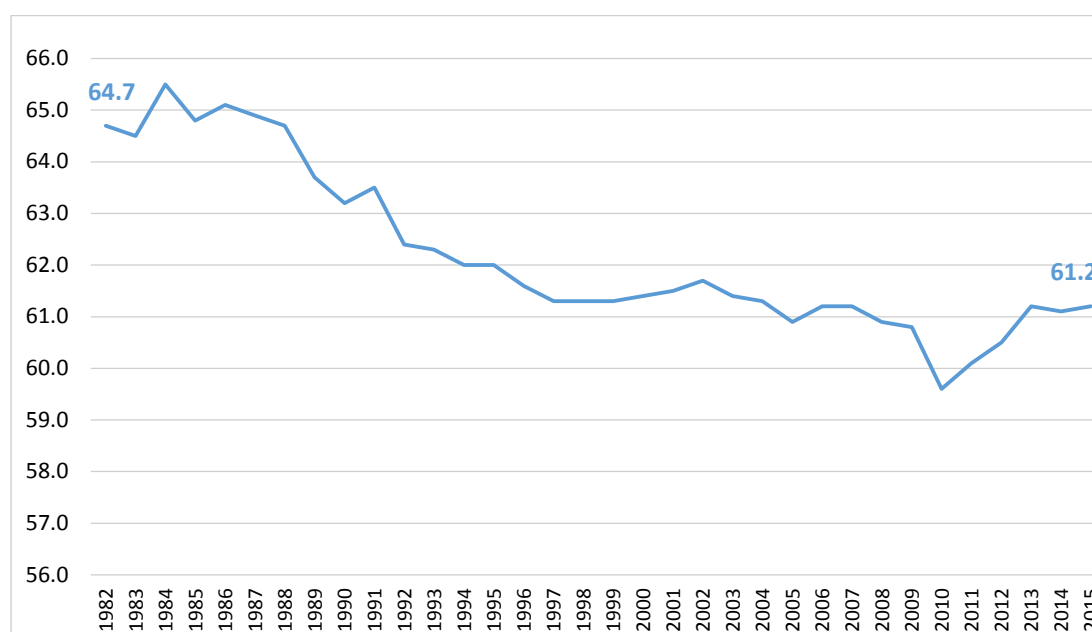
Figure 75: Proportion of Immigrants in Hong Kong’s Labour Force, 1981 – 2011



Note: Chinese Immigrants in 1981 include also individuals from Macao due to the definition of Chinese Immigrants used in that particular census.

Sources: Census and Statistics Department, Our Hong Kong Foundation

Figure 76: Labour Force Participation Rate in Hong Kong, 1982 – 2015



Notes: (1) Starting from 2001, annual figures are compiled based on data collected in the General Household Survey from January to December of the year concerned as well as mid-year population estimates by District Council districts compiled jointly by the Census and Statistics Department and an inter-departmental Working Group on Population Distribution Projections.

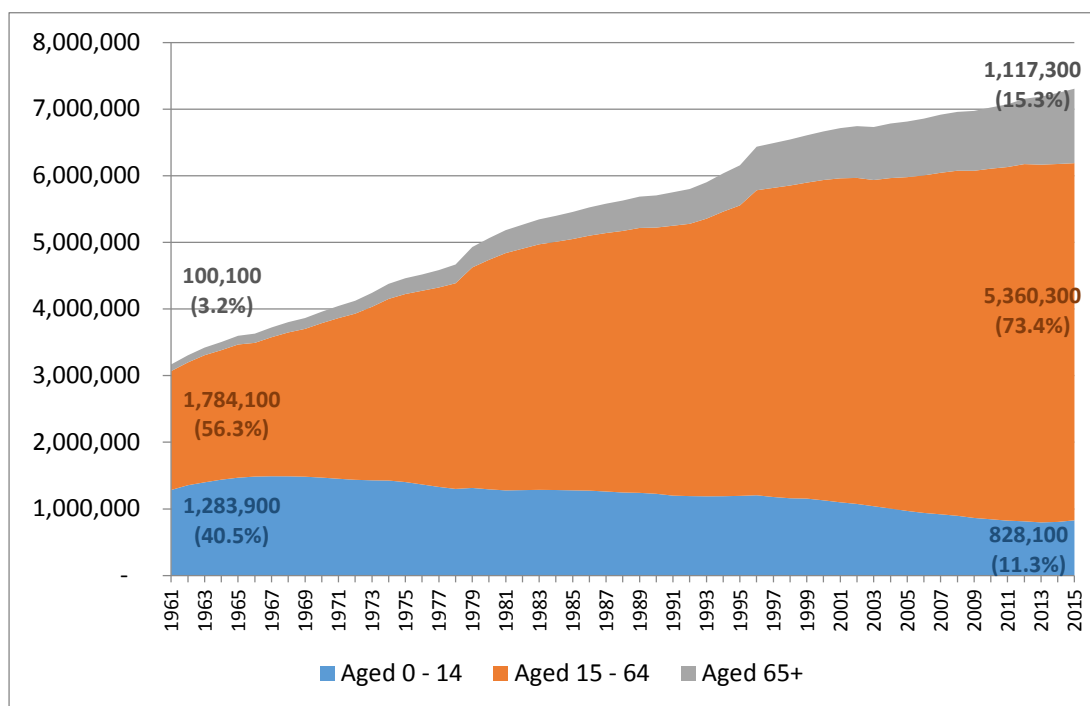
(2) The labour force participation rate refers to the proportion of labour force in the total land-based non-institutional population aged 15 and over.

Source: Census and Statistics Department

The rapid increase in the proportion of the elderly population (defined as age 65 or above) and the decline in the proportion of the working age population (defined as age 15-64) are symptomatic of the ageing problem. Besides slowing down the growth in the labour force and economic growth, the composition of the ageing population poses a grave problem of the financial support of the elderly in the future. The increase in the elderly population accelerated at the turn of the century as an increasing number of the baby boomers began to enter old age (see **Figure 77**). In 2015 there were 1.123 million elderly people, representing 15% of the population. By 2064, the number will more than double to 2.582 million, or 33% of the population and Hong Kong will be very aged by UN definition. Meanwhile the proportion of working age population of 15-64 will decrease from 73% to 58%. The elderly dependency ratio, defined as the elderly population per 1,000 working age population, will rapidly rise from 208 in 2015 to 489 in 2039 and 567 in 2064 (see **Figure 78**). These figures portend serious issues of provision of economic support for the elderly population at both the societal, governmental and household level. At present, 4.8

persons potentially work for an income and pay tax for each elderly person who is likely retired and economically inactive. By 2064, the ratio will deteriorate to 1.8 to 1 (unless there are drastic changes to the retirement practices). The picture is more bleak than what is indicated because not everyone in the working age population actually works in the labour market; the labour force participation rate is currently only 61%. Moreover, those working will also have to support the children population (age 0-14). Together with the child dependency ratio⁵⁶, the overall dependency ratio⁵⁷ in 2064 is projected to be 716. Hong Kong is following Japan's footsteps in becoming a super-aged society, albeit the progress is slower mainly because of immigration.

Figure 77: Age Composition of Hong Kong Population, 1961 – 2015



Notes: (1) Mid-year population.

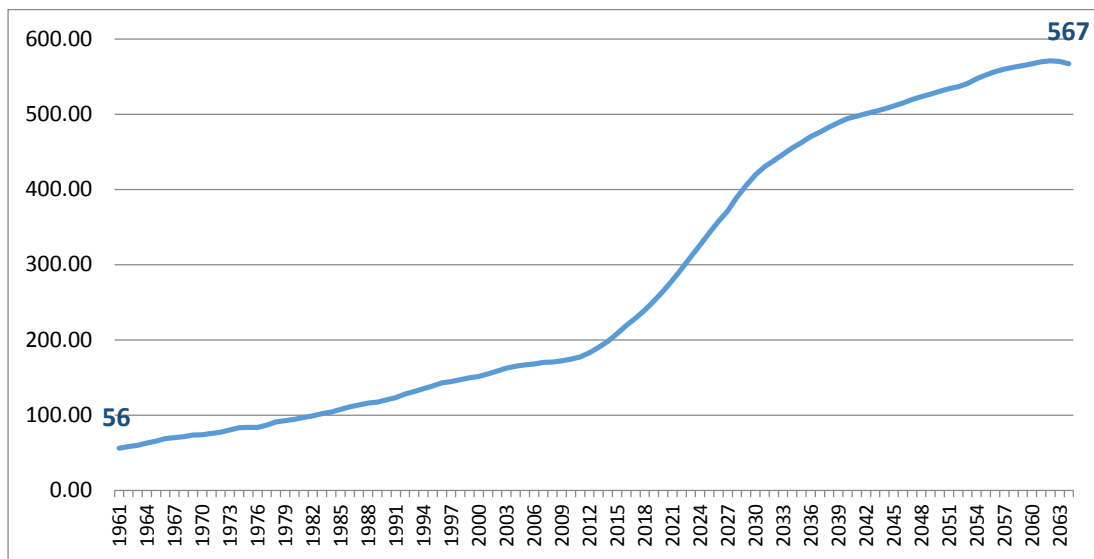
(2) The figures from 1961 to 1995 are compiled based on the "extended de facto" method and from 1996 onwards based on the "resident population" method. Under the "extended de facto" method, the population base includes persons who are physically in Hong Kong as well as Hong Kong residents who are working in Mainland/Macao and those who are usually living in Hong Kong but in Mainland/Macao for short trips at the census moment.

Source: Census and Statistics Department

⁵⁶ Child dependency ratio refers to the number of persons aged under 15 per 1 000 persons aged between 15 and 64.

⁵⁷ Overall dependency ratio is the sum of elderly and child dependency ratio, i.e. the number of persons aged under 15 and those aged 65 and over per 1 000 persons aged between 15 and 64.

Figure 78: Elderly Dependency Ratio, 1961 – 2064



Note: The elderly dependency ratio before 1996 are derived from mid-year figures based on the "extended de facto" method since year-end figures under the "resident population" method prior to April-June 1996 are not available.

Source: Census and Statistics Department

Further lengthening of life expectancy is to be expected due to advances in medical care delivery and technology, but no advanced country has been successful in raising their total fertility rate to the population replacement level of 2.1 to counterbalance population ageing. Receiving a sizeable inflow of immigrants seems to be the only viable option if an advanced country wants to slow down population ageing and preventing it from shrinking in the long run. Japan, the most aged country, has virtually no immigration to speak of (see **Figure 66**). Politically and culturally, the Japanese society is not ready to accept a significant number of immigrants. The Japanese government recognizes the importance of bringing in more immigrants. Recently it introduces a new regulation on immigrant control relaxing the length of the stay requirement for talents and professionals to apply for permanent residence from 5 years to 3 years⁵⁸. This relaxation, though positive in encouraging foreign professionals to stay, will be far from sufficient in bringing in a large enough number of immigrants to attenuate ageing. Without a major change in immigration policy to enable a sustained and substantial inflow of immigrants, there does not appear to be any solution to Japan's population ageing problem.

⁵⁸Please refer to Ministry of Justice of Japan. (2014, June 18). 出入国管理及び難民認定法の一部を改正する法律案.

The populations of many western European countries are also ageing but the problem is less severe than Japan because it is mitigated by a large influx of immigrants from Eastern Europe, North Africa and the Middle East. However, besides being socioeconomically disadvantaged, these immigrants are different ethnically, culturally and have different religions from the indigenous population. Economic assimilation, social integration and inclusion of these immigrants pose thorny problems to the recipient countries in Western Europe. In this regard, Hong Kong is fortunate to have Mainland China as its major source of immigrants because Mainland immigrants share the same ethnicity and language as the indigenous Hong Kong born.

6.4 Economic Assimilation of Immigrants

There have been many success stories of immigrants who have made it to the top echelons of the Hong Kong society. What is more important is statistically whether immigrants and their second generation in general assimilate well into society economically, educationally and culturally. There have been numerous studies on the economic assimilation of immigrants in different countries. In most countries that receive a substantial flow of immigrants, whilst immigrants on average earn less than the natives, they are able to narrow the earnings gap over time. Immigrants bring with them human capital that may be specific to their countries of origin which is non-transferable to the recipient countries (Lam 1986). After arrival they may acquire country-specific skills in the recipient countries, such as knowledge of the local language and the market (Chiswick, 1978; Borjas, 1985). Furthermore, immediately after arrival immigrants tend to accept any available job but over time they may find a better match with local employers, causing returns to their imported or acquired skills to rise (Eckstein and Weiss, 1998). Given time immigrants are able to narrow the earnings gap with respect to the natives in a process of economic assimilation.

Based on the 1981 and 1991 census data, Lam and Liu (2002), however, find that over the decade the mean earnings of male immigrants (age 20-64) actually fell further behind those of male natives in Hong Kong, with the earnings gap widening from 11.3% to 25.5%.⁵⁹ Earnings divergence (instead of convergence) is rather

⁵⁹ Lam, K. C., & Liu, P. W.. (2002). Earnings Divergence of Immigrants. *Journal of Labor Economics* 20(1), 86-104. The gap is measured by the mean of log earnings of Mainland immigrants minus the

unusual among countries that receive many immigrants. In Hong Kong the divergence of earnings between immigrants and natives from 1981 to 1991 is mainly due to a divergence in the returns in schooling. The skills that immigrants acquired from their schooling in the Mainland are probably more productive in labour-intensive manufacturing but not so much in high value-added service industries. As Hong Kong restructured from a manufacturing economy to a service economy in the 1980s, interpersonal skill and language proficiency, especially in English, are valued more in the market for services, causing the rate of return to schooling of Mainland immigrants to increase at a slower rate than the natives.

The situation has changed since 2001. Extending the previous analysis on earnings gap to the 2001 and 2011 censuses, we find that the mean earnings gap of male Mainland immigrants with respect to the natives continues to widen from 25.5% in 1991 to 31.6% in 2001, but begins to narrow to 30.2% in 2011. If we analyse the earnings distribution, the improvement of male immigrant earnings relative to the natives from 2001 to 2011 is clearer. **Table 8** shows the percentage of male immigrants earning less than the male natives by percentile of natives' earnings from 1991 to 2011. After a slight deterioration from 1991 to 2001, the immigrants' relative earnings position has improved from 2001 to 2011 across the earnings distribution, with the improvement more pronounced in the lower half of the distribution. For example, in 2001 18.8% of the male immigrants have earnings less than that of a male native who is at the bottom 10% of the male native earnings distribution; by 2011 that percentage has gone down to 16.8%.

mean log earnings of natives, expressed in percentage (subject to log approximation). Only male earnings are analysed because male employees are more likely to be full-time workers than females. The monthly earnings statistics that are available more accurate in reflecting male workers' earnings capacity. There are no statistics on hourly wage in the censuses.

Table 8: Male Mainland Immigrants Earning Less than Natives by Percentile, 1991 -2011

Percentile of native distribution	1991	2001	2011
	(%)	(%)	(%)
10	19.3	18.8	16.8
25	40.2	40.7	38.8
50	67.4	71.8	69.5
75	88.7	90.8	89.2
90	95.6	96.5	95.8

Source: Calculated from the 1991, 2001 and 2011 Census.

The improvement in the immigrants' relative earnings position is mainly due to a larger increase in their rates of return to schooling than the natives. **Table 9** shows the estimated rates of return to schooling of immigrants and natives by cohorts of labour market entry which control for the years of work experience. The rate of return to schooling is the estimated coefficient of a conventional Mincerian earnings regression which represents the proportionate increase in earnings due to one additional year of schooling. For instance, natives who enter the labour market in 1996-2000 have a rate of return to schooling of 14.7% in 2001, increasing to 16.7% in 2011. Across all labour market entry cohorts, the rates of return to schooling of natives are higher than the immigrants. What is relevant to the relative earnings position of immigrants versus natives is the relative change in the rates of return over time. **Table 9** shows that from 2001 to 2011, the rates of return of all immigrant labour market entry cohorts (except for the 1981-1985 cohorts) either increase more or decrease less than the natives. This result is consistent with most of the literature on immigrant economic assimilation pointing towards earnings convergence. The divergent trend observed earlier in the 1991 and 1981 census (Lam and Liu, 2002) has been reversed as Hong Kong's economic restructuring has been completed by the 1990s.

Table 9: Returns to Schooling of Male Natives and Immigrants and Intercensal Change, 2001 – 2011

Year of Labour Market Entry	Natives			Immigrants		
	2001	2011	Intercensal Change (2011-2001)	2001	2011	Intercensal Change (2011-2001)
1996-2000	0.147	0.167	0.020	0.117	0.137	0.020
1991-1995	0.145	0.167	0.022	0.116	0.141	0.025
1986-1990	0.160	0.169	0.009	0.101	0.116	0.015
1981-1985	0.159	0.165	0.006	0.091	0.092	0.001
1976-1980	0.140	0.137	-0.003	0.068	0.080	0.012
1971-1975	0.124	0.097	-0.027	0.070	0.053	-0.017
1966-1970	0.106	0.057	-0.049	0.064	0.038	-0.026

Source: Calculated from 2001 and 2011 Census.

The gain in the relative earnings position of the immigrants is also partly due to the improvement in the education and skills of the recent immigrant cohorts. In the literature this is known as the cohort effect. **Figure 24** in Chapter 2 shows that while the number of entrants under the OWPS remains relatively stable (subject to the 150 daily quota), the number of entrants under ASMTTP and IANG have increased in recent years. The latter entrants are mostly university-educated and have professional jobs. Moreover, within the cohort of OWPH of age 15 or above, the percentage who have post-secondary or tertiary education has increased from 5% in 1998 to 21% in 2015 (see **Figure 80**). Also a substantial percentage of the recent cohorts arrived Hong Kong at a younger age as dependants for family reunion under OWPS.⁶⁰ They acquire more of their schooling in Hong Kong after immigration, in comparison to earlier cohorts of adults (including the illegal immigrants) who acquired most of their education in the Mainland. We can compare the mean earnings of new male immigrants (defined as new arrivals within 5 years of the census) with the mean earnings of male natives. The earnings gap narrows substantially from 48.4% in 2001 to 27.6% in 2011. This is a clear indication that after 2001, the cohorts of new immigrants are of different quality.

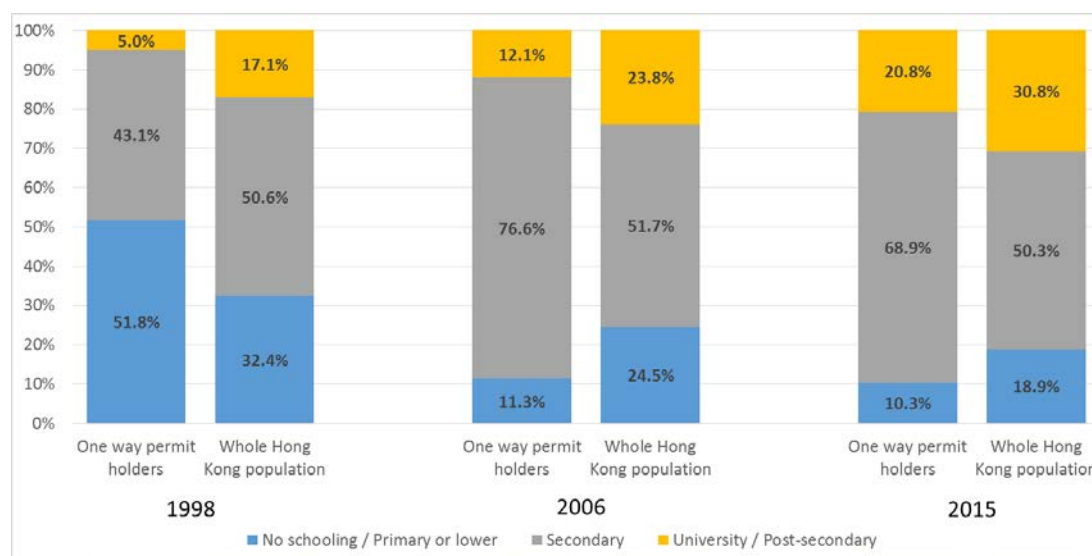
⁶⁰ In 1998, 54% of OWPH were aged 0-14. In 2014, 19% (see **Figure 84**)

To summarize, after 2001 the Mainland immigrants' earnings gap with respect to the natives is narrowing, a phenomenon typical in an economic assimilation process commonly observed in many countries that receive a large number of immigrants. The gap, however, is still substantial but with the improvement in the educational background of the recent Mainland immigrant cohorts, the gap will narrow faster in the future, in particular, when an increasing number of Mainland immigrants arrive with a university degree or acquire a first degree or postgraduate degrees in Hong Kong under the Immigration for Non-local Graduates Scheme (IANGS). We will return to this issue later.

6.5 Intergenerational Educational Mobility of Immigrants

Education has been touted as the great social equalizer. Free or heavily government subsidized schooling is provided for all citizens up to the secondary level and the university level (for those admitted) to equalize as much as possible the human capital investment in children from different socioeconomic background. If financial capital cannot be equalized, then perhaps equal opportunity in human capital investments should be provided to put children from different socioeconomic background on the same starting line. By and large Mainland immigrants who came under the One-Way Permit Scheme in the earlier years were from low socioeconomic background in the Mainland with low educational attainment (see **Figure 79**). The question is whether education holds the promise of upward mobility for immigrants and their children in Hong Kong and therefore promotes the assimilation of immigrants into society.

Figure 79: One-Way Permit Holders and Whole Hong Kong Population by Educational Attainment, 1998, 2006, 2015



Sources: Home Affairs Department, Census and Statistics Department

A recent study on the intergenerational educational mobility in Hong Kong shows that immigrants have actually higher mobility than the Hong Kong born.⁶¹ In the Hong Kong census the child-parent relation can only be identified if the parents and the child live in the same household as defined in the census. The study uses data sets of young adults aged 20 to 25 who co-reside with their parents at the time of the census in 1991, 2001 and 2011 to analyse the child-parent schooling relation. Three child-father groups according to their immigrant status are studied: both generation Hong Kong born, child Hong Kong born and father Mainland immigrant (second-generation Mainland immigrant), and both generation Mainland immigrant. The study measures intergenerational educational mobility in three ways: elasticity of the child schooling with respect to the father's schooling, the percentage of children who have more schooling than their fathers, and the change in the relative probability of the children attending university across their fathers' schooling level. The results show that by international standard, there is a high degree of intergenerational educational mobility in Hong Kong. Specifically, the study finds that whilst young adults who are Mainland immigrants have less years of schooling and lower probability of attending university than the Hong Kong born, they are very upward

⁶¹ Lam, K. C., & Liu, P. W.. (2016). *Intergenerational Educational Mobility in Hong Kong: Are Immigrants More Mobile Than Natives?* revised version of Working Paper 42. Lau Chor Tak Institute of Global Economics and Finance, Chinese University of Hong Kong.

mobile in education: their percentage of intergenerational upward mobility has caught up with young adults who have Hong Kong born parents. Furthermore, controlling for parental educational background, family size and gender, adult children of Mainland immigrants (most of them are actually Hong Kong born⁶²) are in fact ahead of the children of Hong Kong born parents in years of schooling as well as the probability of university attendance. They are the second-generation immigrants and they have higher educational attainment as well as intergenerational educational mobility than the both generation Hong Kong born.

The finding that the second-generation immigrants fare better than the native born in educational attainment and intergenerational educational mobility is not unique to Hong Kong. Studies in the U.S. (Card et al. 2000), Denmark (Nielsen et al. 2003), Switzerland (Bauer and Riphahn, 2007) and Britain (Dustmann and Theodoropoulos, 2010) have similar findings. We may conclude that whilst the first-generation Mainland immigrant young adults have lower educational attainment than the Hong Kong born, they have taken advantage of the educational opportunity in Hong Kong to surpass their parents in educational achievement. The second-generation, born in Hong Kong, is especially successful in educational attainment and mobility.

To summarise, education is the major channel of upward mobility for immigrants. Like immigrants in other advanced countries, Mainland immigrants and their second generation work hard and are generally successful. Schooling prepares the immigrants for better jobs and earnings. Equally important, it is a process through which they become gradually acculturated and assimilated into the Hong Kong society.

6.6 Value Integration of Mainland Immigrants in Hong Kong Society

In terms of social, cultural, political and ethical values, Mainland immigrants have also integrated reasonably well into the Hong Kong society. We can draw on the findings of the World Values Survey.⁶³ The World Value Survey is a global research project on values and beliefs based on nationally representative surveys of individuals

⁶² 85.3% in 1991, 75.4% in 2001 and 61.3% in 2011.

⁶³ World Value Survey, WVS6 Results, Hong Kong 2013, Technical Record, 2015.04.18.

aged 18 or above in almost 100 countries conducted by a worldwide network of social scientists. The sample size for most surveys is about 1,000 to 2,000. The standardized structured questionnaire, broadly common in all countries, contains well over 200 interview questions on views and attitudes towards work, family, life, children, ethics, trust, religion, freedom, politics, democracy, environment, culture, race, gender, ethnic minorities, foreigners, tolerance, national identity, security and subjective well-being. Wave 6 of the survey was conducted in Hong Kong in 2013. The publicly available survey data do not contain information on whether the respondents are Hong Kong born or Mainland Chinese immigrants but they contain information on whether their parents are Hong Kong born or Mainland immigrants. It should be noted that those who have Hong Kong born parents are most likely themselves Hong Kong born but those who have immigrant parents can be either immigrants themselves but are more likely Hong Kong born.⁶⁴ For every question asked in the survey, we test statistically hypotheses on the responses of the two groups (presented in percentages or scores): (1) individuals with Hong Kong born parents; and (2) other individuals with either parent being born in Mainland. The null hypothesis is that the responses of the two groups are the same. For most questions the null hypothesis cannot be rejected statistically at the 5% significance level. Out of the 270 questions asked, the responses of individuals with Hong Kong-born parents (group 1) and individuals with Mainland immigrant parents (group 2) are statistically different in only 37 questions. Even then, the differences in the percentages or mean scores of these responses are generally small in magnitude.

For instance, compared with group 1, a slightly lower percentage of group 2 (73.6% vs 82.2%) think that work is very important in their lives. However, their attitude towards the importance of family, friends, leisure, politics, religion as well as the qualities they want to encourage their children to learn at home, such as thrift, perseverance, religious faith, unselfishness, obedience and self-expression are not statistically different. Statistically they hold the same view on religion, old people as well as gender issues, such as women working for pay instead of being housewives, the acceptability of women as leaders, bosses, and earning more than their husbands, and the importance of university education to girls. The two groups' levels of trust in

⁶⁴ The proportion of both generation Mainland immigrants in the population is very small.

their family, neighbour, people they know personally or those they meet for the first time, people of different religion and nationality are statistically the same. With the exception of unmarried couples living together, their degrees of preference for having different types of people such as drug addicts, people of a different race, a different religion or a different language, people with AIDs, immigrants, homosexuals and heavy drinkers as neighbours are the same. Socially and ethically, the two groups have the same level of agreement on whether the following actions are justified or not justified: claiming government benefits to which you are not entitled, cheating on tax, homosexuality, divorce, suicide, man beating his wife, parents beating children and violence against other people. However, group 2 finds avoiding a fare on public transport, stealing property, or accepting a bribe slightly more objectionable but prostitution, abortion and euthanasia less objectionable.

Statistically the same high percentage (over 70%) of both groups have a great deal or quite a lot of confidence in charitable, environmental and women organizations, universities, banks, the police and the court. About 50-70% have confidence in the church, major companies, armed forces, the civil service and HKSAR government. They have the same low percentage (below 50%) with confidence in the press, television, labour unions, legislative bodies and the Mainland government. Political parties score the lowest; only 30% of group 1 and 23% of group 2 have confidence in political parties.

Individuals in group 2 are more proud of their nationality and place a slightly higher importance to living in a country governed democratically. Their socio-political views are statistically the same as group 1, like whether they classify themselves as politically left or right; whether incomes should be made more equal; whether government should take more responsibility to ensure everyone is provided for; whether competition is harmful, and whether people can only get rich at the expense of others. Statistically they share the same assessment with group 1 as to the degree of democracy and respect for human rights in Hong Kong, and the same level of agreement that the essential characteristics of democracy include people choosing their leaders in free election, government taxing the rich to subsidize the poor, people receiving government aid for unemployment, government making people's income equal and women having the same rights as men. They share the same belief in the

importance of honest elections and the same agreement as to the degree of fairness of election in Hong Kong, like whether opposition candidates are prevented from running; voters are bribed; elections are bought by rich people and voters are threatened with violence at the polls. However, individuals in group 2 have a slightly stronger belief that voters are offered a genuine choice in election; election officials are fair; votes are counted fairly, and journalists provide a fair coverage of elections. Even though they are slightly more active in voting, their levels of interest in politics are statistically the same as the individuals in group 1, so are their levels of participation or non-participation in political actions like signing a petition, joining in a boycott, a strike or other acts of protest, with the exception that individuals in group 2 are slightly more active in attending peaceful demonstrations.

To summarize, individuals with Mainland parents are in general very similar to individuals with Hong Kong born parents in social, cultural, political and ethical values. It is revealing to do a similar statistical analysis on the difference in values between the World Value Survey of Hong Kong, 2013 and the World Value Survey of China, 2012.⁶⁵ With a few exceptions, the responses to almost all the questions in the survey for Hong Kong and China are statistically different, at the 5% significance level. We can further compare the survey results between Hong Kong and the subsample of Guangdong and Fujian in the China survey. The differences in values, though still rather wide, are considerably less than with the national Chinese sample. We may conclude that immigrants from Guangdong and Fujian from where Hong Kong derives most of its immigrants⁶⁶ have values somewhat closer to Hong Kong than the rest of China before immigration. After migration to Hong Kong, their second generation (mostly born in Hong Kong) integrate into the Hong Kong society and essentially share the same values as the indigenous both generation Hong Kong born population.

Immigration will inevitably cause some strain to the infrastructure, housing, schools and social services and create some social tension in the receiving society.

⁶⁵ World Value Survey, WVS6 Results, China 2012, Technical Record, 2015.04.18.

⁶⁶ As many as 92% of the one-way permit holders who migrated to Hong Kong are from these two provinces in 1998, even though the percentage has fallen to 60-70% since 2007.

Historically, Hong Kong has coped successfully the several waves of massive influx of immigrants prior to the abolition of the touch-base policy in 1980 and the controlled flow of legal immigrants thereafter. All in all, Mainland immigrants, especially the second generation, have assimilated into the Hong Kong society. Provided that the increase is not too large, Hong Kong should, and indeed has the capacity to receive a larger number of immigrants to slow down the ageing of its population.

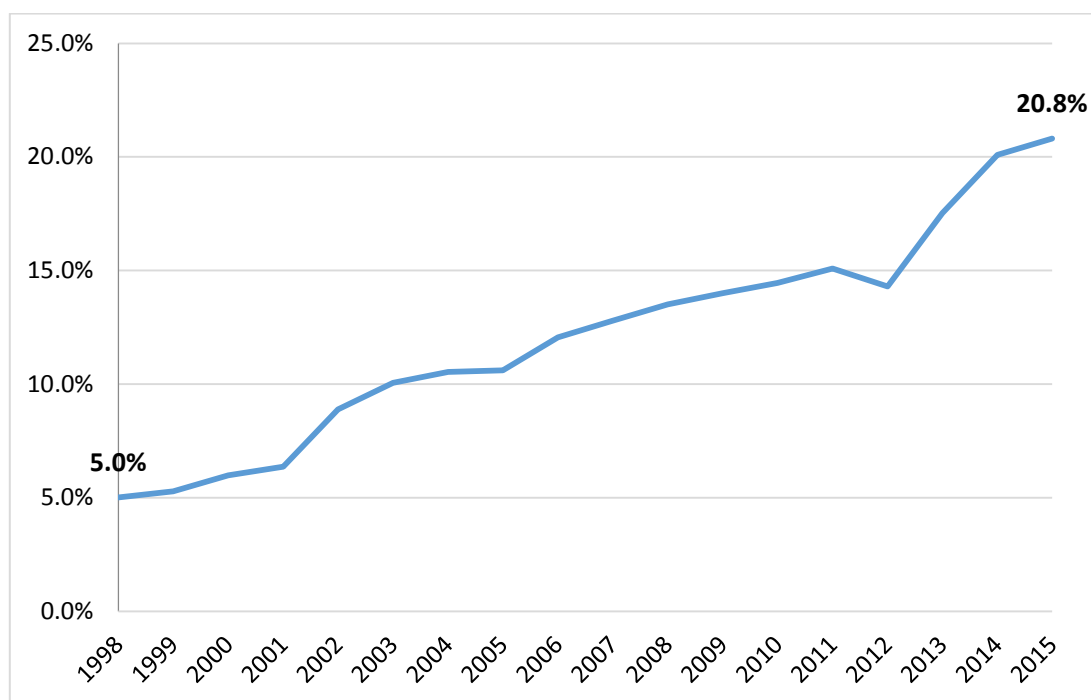
6.7 Changing Characteristics of Mainland Immigrants

The demographic and socioeconomic characteristics of Mainland immigrants in Hong Kong have been changing since 1997. The change is in a direction that will mitigate the stress and strain of immigration on the social services of Hong Kong. Lam and Liu (1998) documents in detail the change in the characteristics of recent Mainland immigrants before the changeover of sovereignty in 1997, using the 1981, 1991 and 1996 Census and By-census. As illegal immigrants gave way to legal immigrants after 1980, the proportion of children immigrants (aged 0-14) increases substantially, as a consequence of focusing the immigration policy in favour of family reunion of children eligible for the Certificate of Entitlement (CoE) through the One-Way Permit Scheme (OWPS). In 1981 the gender ratio of recent immigrants was 58% to 42% in favour of men because most illegal immigrants who arrived before 1980 were male. In 1996 the gender ratio is exactly the reverse when most of the legal adult immigrants were Mainland wives of Hong Kong men and their children. The labour force participation rate of recent female immigrants also fell dramatically from 70% in 1981 to 48% in 1996, substantially lower than the 61% of the native women, a reflection that most of them came as homemakers. The average year of schooling of the recent immigrants (7.4 years) is also lower than the Hong Kong natives (8.3 years). The provision of schooling for immigrant children, family support for single-parent families and social security assistance for non-working immigrants and public housing for immigrant families have been controversial issues in Hong Kong.⁶⁷

⁶⁷ For a detailed analysis of the costs and benefits to Hong Kong of OWP immigrants, read Bacon-Shone, Lam and Yip (2008).

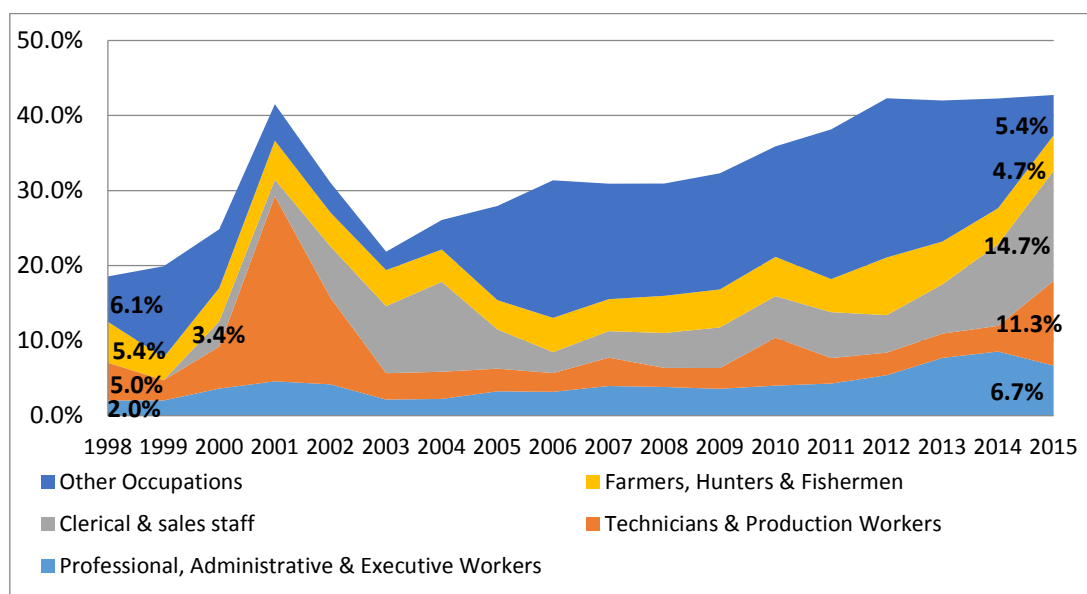
Since the changeover of sovereignty of Hong Kong in 1997, there have been significant changes to the composition of Mainland immigrants. The largest component of Mainland immigrants is one-way permit holders (OWPH). Among them the percentage of those aged 15 and above who attained post-secondary or university education increased from a low of 5% in 1998 to 21% in 2015, with the steepest increase in the last few years (see **Figure 80**). The percentage who had employment in the Mainland before migration increased from 19% to 42% whilst the percentage of homemakers fell from 59% to 36%. In terms of the occupation they held in the Mainland, there has been a steady increase of professional, administrative and executive workers from 2% to 9% whilst the percentage of farmers, hunters and fishermen remains stable at about 5% (see **Figure 81**). The characteristics of the OWPS immigrants have been changing since 1997. The immigrants have more schooling and are more active economically. They should be able to integrate more easily into the Hong Kong labour market than their pre-1997 counterparts.

Figure 80: Proportion of One-Way Permit Holders with University/Post-secondary Educational Attainment (aged 15 and over), 1998 – 2015



Source: Home Affairs Department

Figure 81: Occupation of One-Way Permit Holders in the Mainland, 1998 – 2015



Note: The numbers of OWP working as clerical & sales staff in 1998 and 1999 are not available.

Source: Home Affairs Department

6.8 Mainland Immigration Schemes

As discussed in Chapter 2, there are currently 6 main schemes of Mainland immigration: One-Way Permit Scheme (OWPS), Admission Scheme for Mainland Talents and Professionals (ASMTP), Capital Investment Entrant Scheme (CIES), Quality Migrant Admission Scheme (QMAS), Immigration Arrangements for Non-local Graduates (IANG), and Dependant Visas. The objective of the first scheme is family reunion of spouses and children of Hong Kong residents. Schemes 2-5 aim to bring human and financial capital to Hong Kong, and the last scheme is for dependants of those eligible under schemes 2-5.

6.8.1 One-Way Permits Scheme (OWPS)

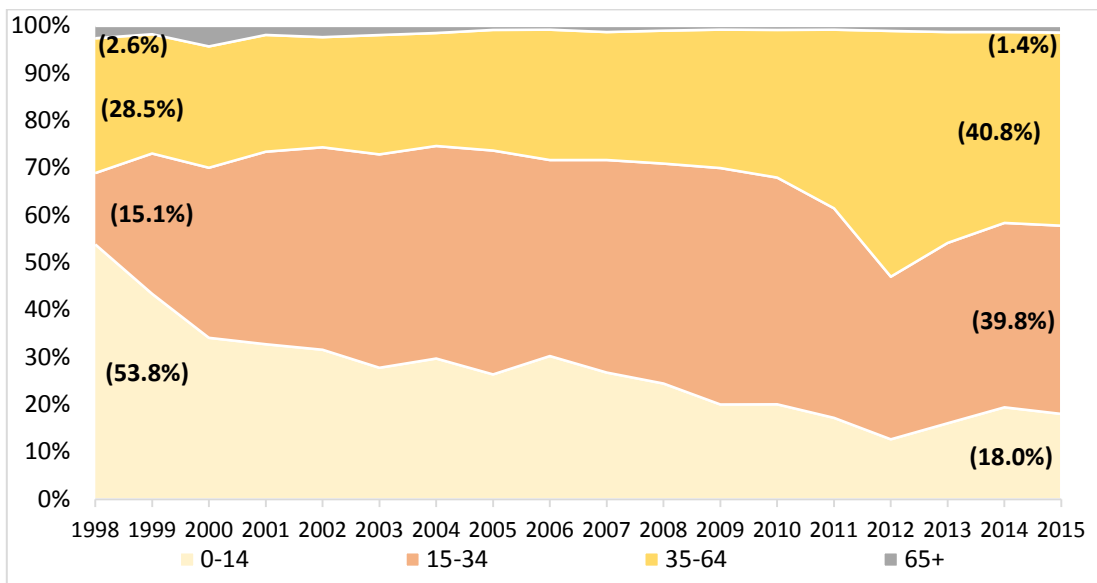
The largest component of the Mainland immigrants is the one-way permit holders. **Figure 82** shows that since 2002, with the exception of 2003, 2005 and 2012, the number of Mainland arrivals with the OWP falls far below the annual quota of 54,750 (or 150 a day). In fact the number has gradually declined to 38,338 in 2015. The percentage of children (age 0-14) among the OWPH dropped from 54% in 1998 to below 30% in 2003 and 18% in 2015 (see **Figure 83**). The drop in the percentage in the initial years after 1997 reflects the clearing of the backlog of children waiting to come to Hong Kong for family reunion with their parents.

Figure 82: Number of One-Way Permit Holders, 1998 – 2015



Source: Home Affairs Department

Figure 83: Age Breakdown of One-Way Permit Holders, 1998 – 2015

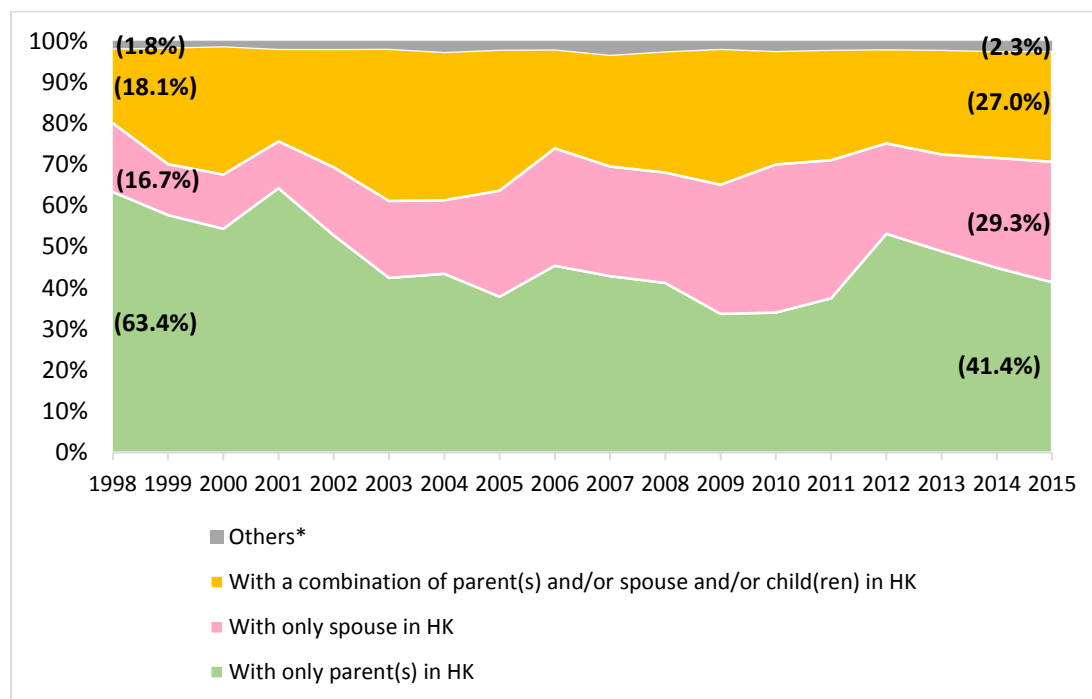


Source: Home Affairs Department

The change in the distribution of the types of relatives with whom the OWPH come to Hong Kong for reunion also reveals a change in composition (see **Figure 84**). The percentage of OWPH for reunion with their spouses only has increased from 17% in 1998 to 29% in 2015. This percentage is expected to increase further as there is now a rising and different trend of cross-border marriages. In the 1980s and 1990s, many cross-border marriages involve Hong Kong men who years ago came to Hong Kong (most likely as illegal immigrants) returning to their home villages on the

Mainland to get married. Their children born in the Mainland have the right of abode in Hong Kong after 1997; they formed the queue waiting for one-way permits to come to Hong Kong alone or with their mothers for family reunion with their fathers.

Figure 84: Type of Relatives of One-Way Permit Holders in Hong Kong, 1998 – 2015



Note: (*) Include those OWPB who have only child(ren) in Hong Kong and those who have no next of kin in Hong Kong.

Source: Home Affairs Department

The current trend of cross-border marriages is different. Since 1997 the number of cross-border marriages registered in the Mainland has been declining whilst the number registered in Hong Kong is on the rise (see **Figure 85**). In 2014, out of the total 25,731 cross-border marriages, 20,698 (80%) were registered in Hong Kong, only 5,033 in the Mainland whereas in 1997, 87% of the 20,168 cross-border marriages were registered in the Mainland. Instead of Hong Kong men returning to their home villages to get married, Hong Kong residents are now marrying Mainland spouses in Hong Kong. Among the marriages registered in Hong Kong, the percentage of Hong Kong brides marrying bridegrooms from the Mainland is also increasing, from 14% in 1997 to 27% in 2015 (see **Figure 86**).⁶⁸

⁶⁸ Cross-border marriages registered in Hong Kong now constitute about 35% of all marriages registered in Hong Kong.

We have only limited information on the socioeconomic characteristics of the bridegrooms and brides in the cross-border marriages. It is likely that compared with previous cross-border married couples, more of them are young well-educated professionals who met their future spouses at work or in school either in Hong Kong or the Mainland. Information from the Hong Kong Marriage Registry show that the educational attainment of Mainland brides marrying Hong Kong bridegrooms in Hong Kong have been rising since 2001. The percentage of Mainland brides with post-secondary or above education increased from 1.5% in 2001-2005, to 4.7% in 2006-2010 and 12.5% in 2011-2014.⁶⁹ The spouses of these Hong Kong residents and their children will, in time, apply for OWP to settle in Hong Kong. With the annual number of cross-border marriages registered in Hong Kong at 18,000 and rising, it is expected that spouses and children of these marriages will form the bulk of the applicants for the OWP in the future.

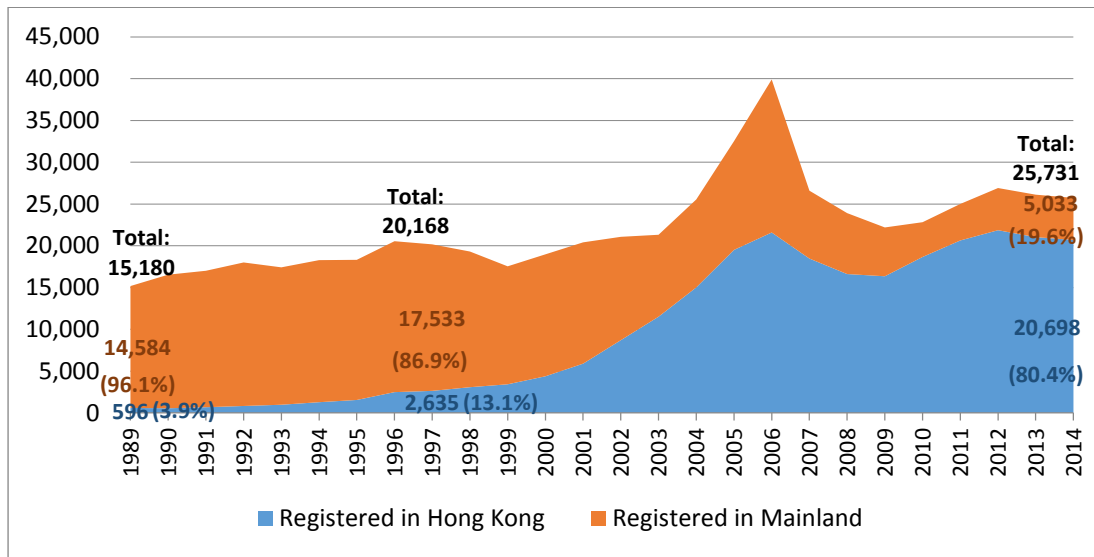
There is therefore a reason to keep the annual quota of 54,750 OWP with the expectation that there will be an increasing uptake of the quota. The new trend of cross-border marriages may bring to Hong Kong more immigrants who are young, better educated and economically active who will add to the human capital stock of Hong Kong and help to rejuvenate the ageing population. Since there has been a substantial number of unused OWP quota in recent years, there is a strong reason to negotiate with the Mainland authorities to shorten the prevailing four year waiting period of Mainland spouses for OWP.⁷⁰ Priority should be given Mainland spouses who marry Hong Kong residents in Hong Kong and who have children from the marriage. This priority criterion will hopefully not increase the incentive for bogus cross-border marriages.⁷¹

⁶⁹ Data from Marriage Registry of HKSAR provided by courtesy of Professor Richard Wong.

⁷⁰ In many countries, the waiting period for processing immigrant visas of newly-wed spouses of citizens from a foreign country is much shorter, e.g. the U.S..

⁷¹ According to the Official Record of Proceedings of the Legislative Council, 20 March 2013, in reply to a question from Mr. Chung Kowk-Pan, Legislative Councilor, the Secretary for Security reported that 1,000 people involving in bogus marriages were arrested in 2012. He also admitted that verifying that the marriages were genuine could be rather difficult.

Figure 85: Number of Cross-border Marriage Registered in Hong Kong and in Mainland, 1989 – 2014



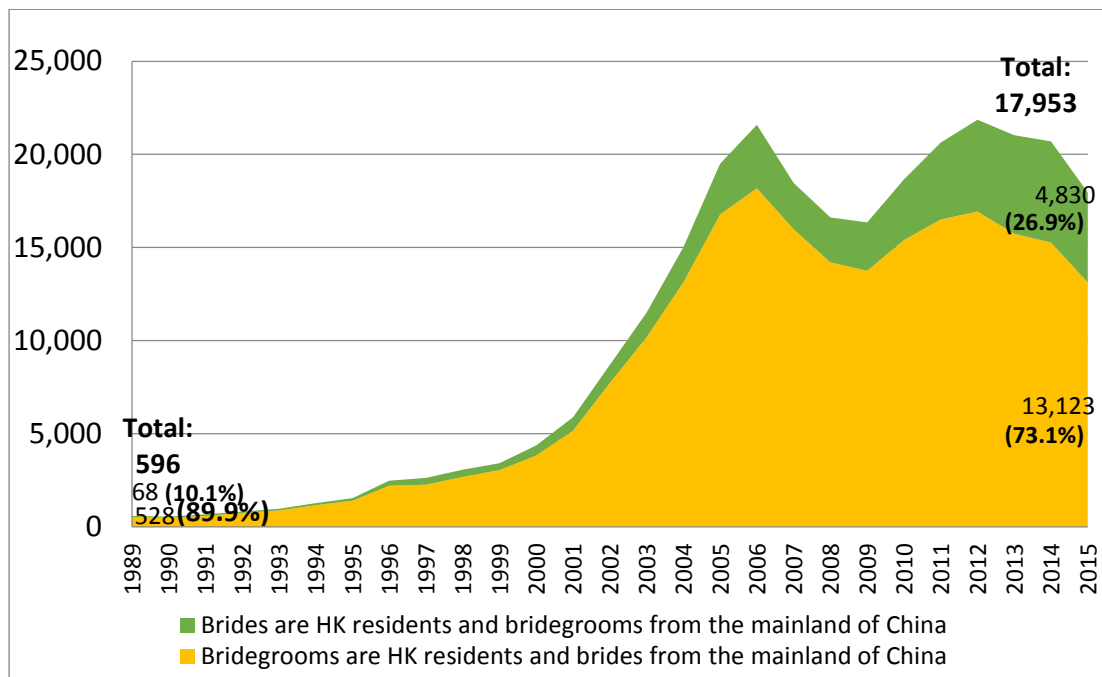
Notes: (1) Before the reference year of 2010, the figures of bridegrooms/brides from the Mainland China are estimated with reference to two data items in the individual registered marriage records provided by the Immigration Department on a monthly basis, viz. “place of previous residence” being in Mainland China and “duration of stay in HK” being less than one year. The figure thus compiled might have included OWPB entering HK and getting married in less than one year. Nevertheless, it still provides a good proxy indicator to cross-boundary marriage statistics. Since the reference year of 2010, besides the above two data items, more information (e.g. holding of travel document type) is used to enhance the estimates of bridegrooms/brides from Mainland China.

(2) Figures of cross-border marriage with bridegrooms/brides separately from Hong Kong and Macao are not available from 1989 to 1998. The subtotal of cross-border marriage with bridegrooms/brides from Hong Kong and Macao is presented from 1989 to 1998.

(3) Includes number of marriage registered in Mainland with bridegrooms/brides from Macao.

Sources: China Civil Affairs' Statistical Yearbook, Census and Statistics Department (Hong Kong)

Figure 86: Number of Marriages Registered in Hong Kong with Bridegrooms/Brides from Mainland China, 1989 – 2015



Note: Before the reference year of 2010, the figures of bridegrooms/brides from Mainland China are estimated with reference to two data items in the individual registered marriage records provided by the Immigration Department on a monthly basis, viz. “place of previous residence” being Mainland China and “duration of stay in HK” being less than one year. The figure thus compiled might have included OWPB entering HK and getting married in less than one year. Nevertheless, it still provides a good proxy indicator to cross-boundary marriage statistics. Since the reference year of 2010, besides the above two data items, more information (e.g. holding of travel document type) is used to enhance the estimates of bridegrooms/brides from Mainland China.

Source: Census and Statistics Department

There are also suggestions that the Mainland should permit OWPB who migrate to Hong Kong to either retain or re-establish their household registration in their home towns/villages in case they need to return migrate, if they find Hong Kong is not suitable for them or if they cannot support themselves financially after a marriage breakup. This backup option is not only beneficial to the immigrants concerned but also to Hong Kong as it will alleviate its burden of supporting immigration misfits. A policy to this effect will be very appreciated in Hong Kong. Much depends on the flexibility of Mainland’s household registration policy in giving exceptions to one-way permit holders.

6.8.2 Immigration Arrangements for Non-local Graduates (IANG)

The second largest source of Mainland immigrants are the non-local Mainland students who stay behind after graduation to work in Hong Kong. Under the immigration arrangement, non-local graduates (including those from other countries) are granted an initial stay of 12 months to look for employment in Hong Kong after graduation. Upon applying for extension of stay, they are required to have secured an offer of employment which is at a level commonly taken up by degree holders and the remuneration package is at market level. Returning non-local graduates, on the other hand, are required to secure an offer of employment upon application. After a continuous residence of not less than seven years in Hong Kong, they may apply for the right of abode. The seven years of residence include their years of study in Hong Kong.

Among the Mainland graduates who stay in Hong Kong, most of them are graduates of self-financed taught postgraduate programmes offered by universities in Hong Kong. **Figure 87** shows the enrolment of Mainland students in UGC-funded and accredited self-financing programmes in Hong Kong. The largest and fastest growing component in enrolment is the self-financed taught postgraduate programmes. They bulk of the non-local graduates come from these programmes each year.

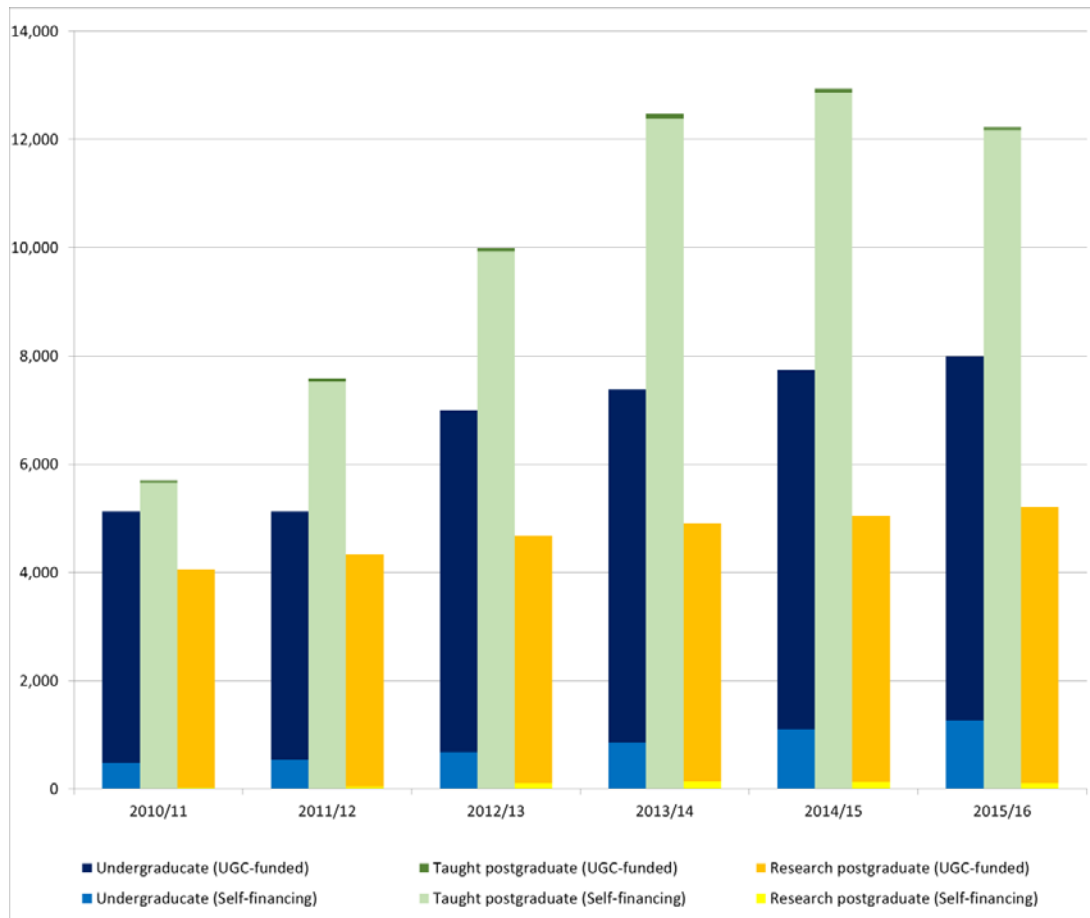
It should be noted that the total enrolment of UGC-funded full-time undergraduates from the Mainland is only 6,726 in 2015/16, implying an annual output of only about 1,680 graduates. The non-local students constitute only 8% of the total UGC-funded undergraduate enrolment, substantially below the 20% allowed by UGC. In this connection it should be pointed out that the 20% non-local student quota is outside the UGC-funded quota for local undergraduate students. An increase in non-local students to take up the unfilled quota will not affect the enrolment opportunity of local students.

There are cogent arguments in favour of enrolling more non-local students to fill the permitted undergraduate quota. Compared with the non-local taught postgraduates, they are younger when they arrive and at a younger age, they probably learn the Cantonese dialect faster. They usually live in the university dormitories with local students whereas self-financed non-local postgraduates have to live in rental housing

on their own. They have four years to be acculturated before they graduate. Presumably their transition into the Hong Kong society after graduation should be easier and smoother. Unfortunately, the enrolment of non-local undergraduates increases very slowly and is far below the allowed percentage.

Universities in Hong Kong are not short of quality Mainland undergraduate applicants. Rather, they are concerned with a balance between non-local students from the Mainland and from other countries. They should be encouraged to be more active in recruiting undergraduate students in countries other than from the Mainland. Another bottleneck is the shortage of student hostel places. A sizeable increase in non-local undergraduate enrolment is only possible if UGC relaxes its formula in computing hostel places for all students, or if there are sufficient private fundings for constructing more student hostels.

Figure 87: Enrolment of Full-time Students from Mainland China by Level of Study, 2010/11 – 2015/16



Note: (1) Both full-time and part-time are included. Data broken down by mode of study are not available.

Sources: The University Grants Committee, Education Bureau

In contrast to the OWPH, the non-local graduate immigrants all have a first degree or higher qualification from a Hong Kong institution.⁷² They are young and possess skills that are demanded in the market and they are gainfully employed. They are a welcome addition to Hong Kong’s human capital stock and they have less issues of integrating into the Hong Kong community. The number of entry permits granted under the IANG scheme increases from 2,658 in year 2008 to 9,541 in year 2015, representing a 3.5-fold increase. In 2015 it amounts to more than half of the student visas issued in that year. An increase in their flow should be a key link in a population policy that promotes economic growth and slows down ageing.

⁷² Non-local graduates of sub-degree programmes are not eligible for IANG.

Whilst increasing the intake of non-local undergraduate students, the government should also consider increasing the enrolment of local undergraduates. Through appropriate curriculum and training, local young people should be educated and prepared to be more competitive in the new era, thereby enhancing the local human capital stock.

6.8.3 Other Mainland Immigration Schemes

The Admission Scheme for Mainland Talents and Professionals (ASMTP) is also important in bringing to Hong Kong much needed talents and expertise. While the entrants are originally from the Mainland, many may have been educated and have worked overseas. In general, they are highly educated and skilled. The overtime increase in inflow under this Scheme is gradual but steady, as candidates have to be offered employment before they can apply for entry.

Another scheme of similar nature is the Quality Migrant Admission Scheme (QMAS) which targets highly skilled or talented persons for admission without requiring an offer of local employment. When it was first introduced, QMAS was widely acclaimed. There was the expectation that it would bring international and world class talents to Hong Kong. However, its success is limited as it is bringing only a few hundred migrants each year. It is also not clear how many actually stay in Hong Kong to work after gaining residency status.

The Capital Investment Entrant Scheme (CIES) has its controversy. Until the rules are changed in recent years, it had attracted Mainland investors who met the entry qualification by purchasing luxury properties in Hong Kong, bidding up their prices. Arguably what Hong Kong needs is human capital, not so much financial capital especially when it is injected into the overheated property market.

6.9 Return Migration

Over the decades, hundreds of thousands of Hong Kong residents have migrated overseas to study, to work and to live, mainly in the U.S., Canada, U.K., Australia and Europe. They form a highly educated, experienced and skilled pool of talents with expertise in all professions. Many of their children may have grown up and have had schooling in Hong Kong before emigrating with their parents. Both the first

generation emigrants and their second generation may still have attachments to Hong Kong. If Hong Kong can attract some of them to return, it will be a big boost to the human capital stock, especially in areas where there is a shortage of expertise.

The importance of such a pool of potential return migrants cannot be overstated. A case in point is the return of the Jewish diaspora to Israel. Under the “Law of Return” in 1950, every Jew from anywhere in the world has the right to migrate to Israel. Over the decades, there have been waves of return migration. One wave that is worth mentioning is the return of the Russian Jews. In 1969, Jews who lived in the then USSR appealed to the UN Committee for Human Rights and were given permission by the Soviet Union to emigrate. A total of 150,000 Russian Jews migrated to Israel, many of whom were scientists and engineers. At that time, the population of Israel was less than 3 million. Together with other returnees, they formed the human capital base that kick-started Israel’s technological development.

There is currently an Admission Scheme for the Second Generation of Chinese Hong Kong Permanent Residents (ASSG) for those who do not have Hong Kong ID cards to return from overseas to work in Hong Kong. To attract a larger return flow of the Hong Kong diaspora, the government can be more active in promoting Hong Kong as a land of opportunity situated next to the fast-growing economy of the Mainland. It should be more reassuring in assuaging them of their concern about the local political development. The many overseas Economic and Trade Offices in North America and Europe can be more aggressive in engaging Hong Kong professionals and students. Besides promoting Hong Kong to foreigners, they should be also given the mission of promoting Hong Kong to the diaspora. The active approach of Singapore in attracting talents from overseas is something Hong Kong can learn from.⁷³ Equally important are policies to facilitate their return to settle, such as recognition of overseas degree and professional qualifications in medicine, law, accounting and engineering, breaking down occupational entry barriers and tackling the housing situation.

⁷³ Singapore has a long history of sending its students on scholarship to UK elite universities and requiring their return after graduation for service. Government overseas offices are also active in promoting Singapore to overseas and foreign students in countries where they are located.

6.10 Enhancing Immigration as a Source of Human Capital and an Alleviation to Population Ageing

To address the demographic challenges of Hong Kong ahead, HKSAR Government formed a Steering Committee on Population Policy which released a report on “Population Policy: Strategies and Initiatives” in January 2015. In the report the Steering Committee proposes a host of measures to increase the quantity and quality of the labour force, such as extending working life, raising the retirement age, strengthening training, helping women to balance family and work commitments, enhancing child care and after-school care services etc. Among all these measures, the most direct and effective is the importation of talents and immigrants. The report, however, comes short of making any specific recommendation on enhancing the inflow of immigrants.

As discussed above, the various schemes for bringing in talents, professionals and non-local graduates from the Mainland enhance the human capital stock in Hong Kong. The OWPS, whilst catering to family reunion, is also bringing in an increasing number of immigrants who have post-secondary or tertiary education. Besides, most of the Mainland immigrants are younger than the average Hong Kong population. They have the effect of lowering the average age of Hong Kong.

Table 10 shows the average age of Mainland persons who have resided in Hong Kong for less than 7 years according to the 2001, 2006 and 2011 census and by-census. They are 11-13 years younger than the local Hong Kong population (foreign domestic workers excluded). Without their presence, the average age of the Hong Kong population would have been higher by 0.33 to 0.48 year, depending on the census year. If we extend the period of residence of Mainland immigrants to 20 years, their presence would have lowered the average age of the Hong Kong population by 0.68 year in 2011. This is only the direct and first-round effect. The total effect on slowing down population ageing is somewhat larger because the immigrants, being younger, will have higher average fertility than the native population and they will produce a larger cohort of the young second generation.

Table 10: Average Age of Population (Excl. Foreign Domestic Helpers) and Sub-population

	2001	2006	2011
A. Residents from Mainland (<7 years)	27.14	27.86	30.11
B. Population minus residents from Mainland	38.78	41.31	43.20
C. Full population	38.30	40.87	42.87
D. Lowering of average age (B – C)	0.48	0.44	0.33

Source: Calculated from 2001, 2006 and 2011 Census and By-Census.

To summarize, the magnitude of the effect on alleviating population ageing, though not huge, is significant. Ultimately it depends on the size of the inflow of immigrants targeted by the immigration policy. The lowering of the average age of the population is just one impact of immigration. The other relevant demographic consequences of immigration are its effects on the growth rate of the population, the labour force, the age composition and the elderly dependency ratio.

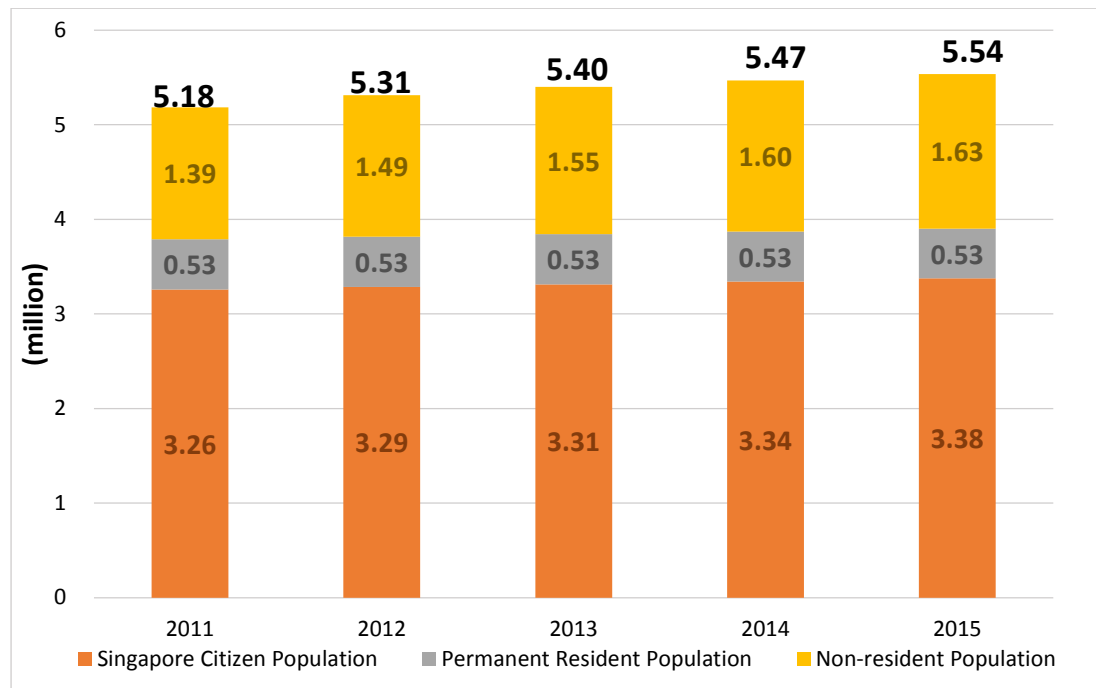
6.11 Scenarios of Population and Immigration Projections

The question remains: what should be the size of the annual immigrant inflow? To address this question, we can take reference of Singapore's immigration policy.⁷⁴ Singapore's total population is made up of three categories: citizens, permanent residents (PRs) and non-residents. Non-residents arrive in Singapore under different categories of employment/entrepreneurial pass, dependant's pass and work permit. Only the first two types of pass holder are eligible to apply for permanent residence. Those who hold work permits, including the foreign domestic workers (227,100 in 2015) and the construction workers (322,400 in 2015) are not eligible to apply for permanent residence. PRs who have been in Singapore for two years are eligible to apply for citizenship. Singapore government is careful in managing the size of the PR population. It grants about 30,000 PRs each year to maintain the PR population at between 0.5-0.6 million to give a stream of good quality candidates for citizenship (see **Figure 88**). To stop its citizen population from shrinking and to sustain it with a stable age distribution, Singapore will take in between 15,000 to 25,000 new citizens each year from the pool of PRs and to replenish the PR pool with new immigrants.

⁷⁴ Singapore Government, Population White Paper, January 2013.

With this controlled immigration rate, the citizen population is projected to be between 3.6 and 3.8 million by 2030. (see **Figure 89**).

Figure 88: Singapore's Total Population by Residency Status, as of June, 2011 – 2015

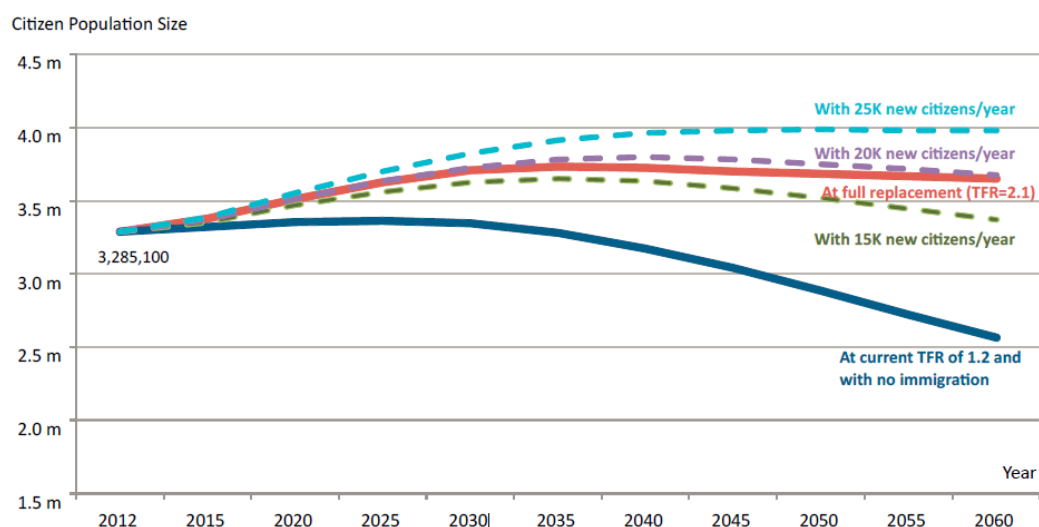


Notes: (1) Total population comprises Singapore citizens, permanent residents & non-residents. Data are based on de jure concept and the register-based approach, and exclude residents who are overseas for a continuous period of 12 months or longer as at the reference period.

(2) Non-resident Population comprises foreigners who are working, studying or living in Singapore but not granted permanent residence, excluding tourists and short-term visitors.

Source: Department of Statistics (Singapore)

Figure 89: Citizen Population Size under Various Immigration Scenarios in Singapore



Source: Department of Statistics, Singapore

Hong Kong’s resident population is made up of the “Usual Residents”⁷⁵ and the “Mobile Residents”.⁷⁶ The population projection of the Department of Census and Statistics up to 2064 is based on the following assumptions on fertility, mortality and migration during the projection period:

Fertility Assumptions:

- Fewer women will get married during their child-bearing age
- Marital fertility rate will remain steady
- Total fertility rate will be between 1.15 and 1.21 throughout
- There will be 5,500 Type I babies per year according to past trend but zero Type II babies in future⁷⁷

⁷⁵ “Usual Residents” refer to (a) Hong Kong Permanent Residents who have stayed in Hong Kong for at least 3 months during the 6 months before or during the 6 months after the reference time-point, regardless of whether they are in Hong Kong or not at the reference time-point; and (b) Hong Kong Non-permanent Residents who are in Hong Kong at the reference time-point.

⁷⁶ “Mobile Residents” are Hong Kong Permanent Residents who have stayed in Hong Kong for at least 1 month but less than 3 months during the 6 months before or during the 6 months after the reference time-point, regardless of whether they are in Hong Kong or not at the reference time-point.

⁷⁷ Type I babies refers to babies born in Hong Kong to Mainland women whose spouses are Hong Kong Permanent Residents. Type II babies refers to babies born in Hong Kong to Mainland women whose spouses are not Hong Kong Permanent Residents.

Mortality Assumption:

- Gradual continuation of decline in mortality rate but at a slower pace

Migration Assumptions:

- Some Type I and Type II babies will leave Hong Kong after birth but may return in subsequent years, say for schooling. All Type I and around 30% of Type II babies will settle in Hong Kong before the age of 21
- The number of OWP holders will increase from 119 per day to 130 per day in mid-2019, then gradually decline to around 100 as from mid-2027
- Other net movements are projected according to the historical trends

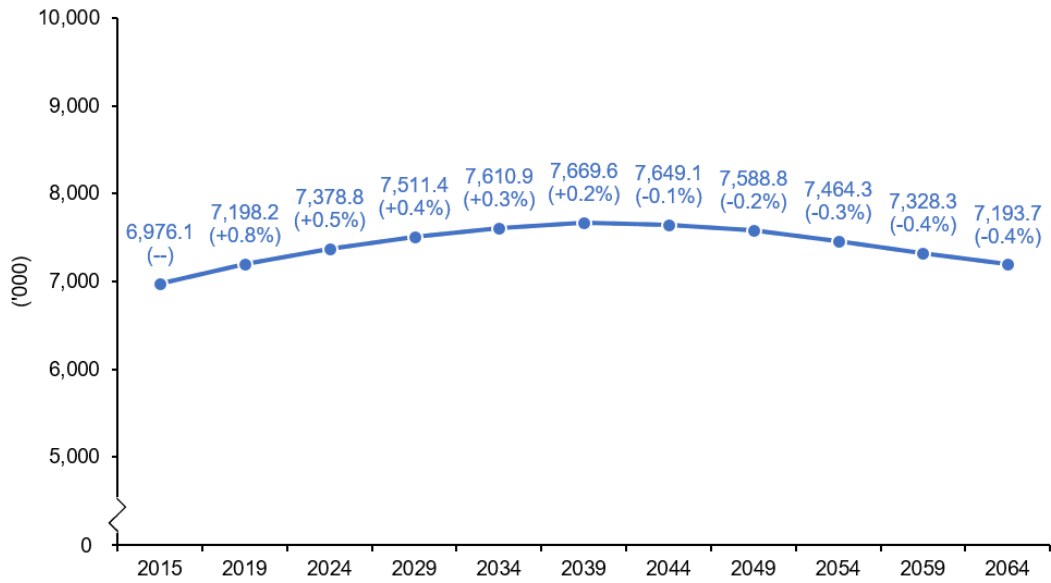
6.11.1 Scenario 0: The Baseline Scenario

Based on the assumptions of the Census and Statistics Department, we project in **Figures 90 to 93** Hong Kong's population and labour force, their age distribution and the overall dependency ratio up to 2064 with foreign domestic helpers excluded.⁷⁸ It is important to note that if there is no change in the population policy, the population will shrink starting from 2039 at an increasing rate, reaching 0.4% in 2064. The decline in the labour force begins earlier in 2019, and the overall dependency ratio rises to a high level 822. If Hong Kong keeps to its existing population policy, the demographic consequences of ageing are ominous.

The projections in **Figures 90 to 93**, which we call Scenario 0, provide the baseline for our immigration policy proposal.

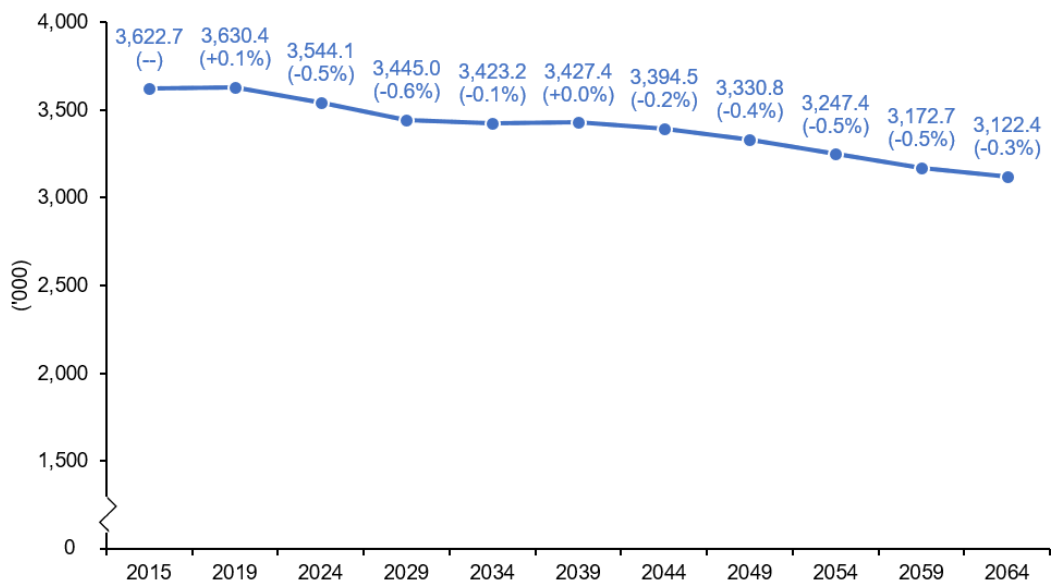
⁷⁸ Hong Kong Population Projections, 2015-2064, Census and Statistics Department, Hong Kong SAR Government, September 2015.

Figure 90: Projected Total Population (Excluding Foreign Domestic Helpers) Under Scenario 0, 2015 – 2064



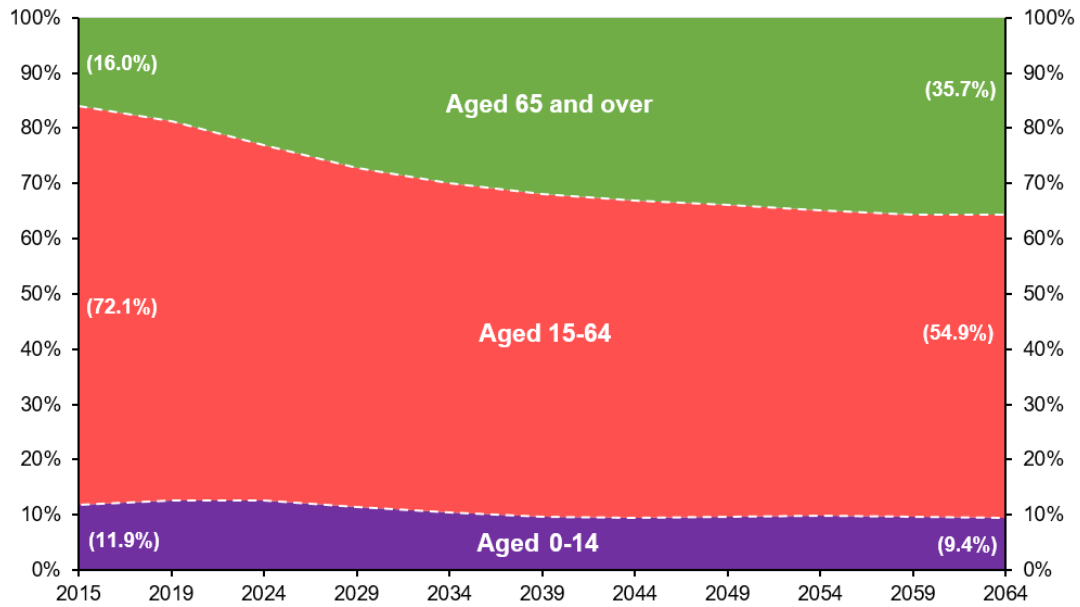
*Note: Figures in brackets refer to the annualised growth rate since the previous time point.
Sources: Census and Statistics Department, Our Hong Kong Foundation*

Figure 91: Projected Labour Force (Excluding Foreign Domestic Helpers) Under Scenario 0, 2015 – 2064



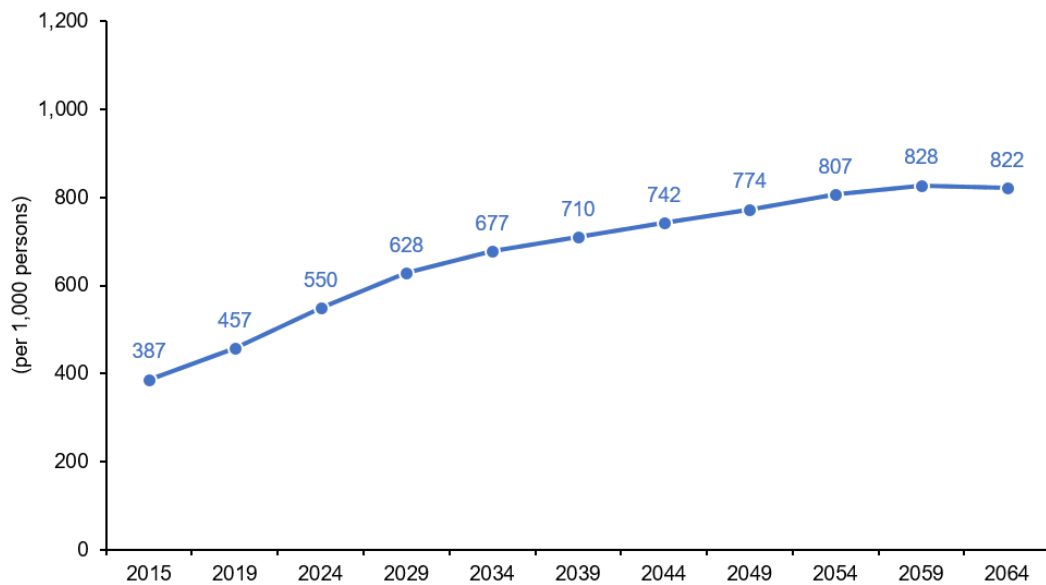
*Note: Figures in brackets refer to the annualised growth rate since the previous time point.
Sources: Census and Statistics Department, Our Hong Kong Foundation*

Figure 92: Projected Age Distribution (Excluding Foreign Domestic Helpers) Under Scenario 0, 2015 – 2064



Sources: Census and Statistics Department, Our Hong Kong Foundation

Figure 93: Projected Overall Dependency Ratio (Excluding Foreign Domestic Helpers) Under Scenario 0, 2015 – 2064

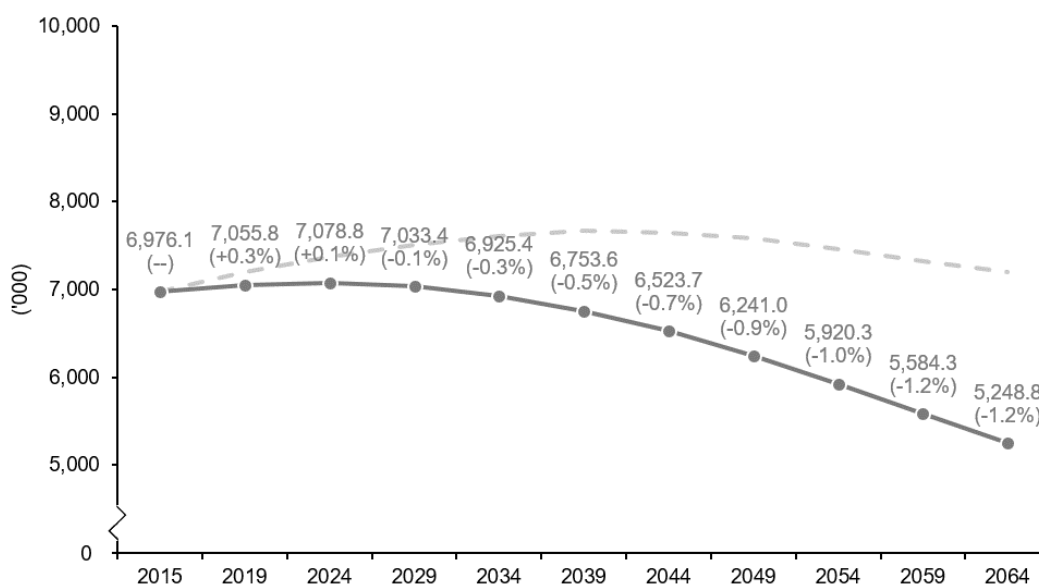


Sources: Census and Statistics Department, Our Hong Kong Foundation

6.11.2 Scenario 1: No Immigration

To highlight the demographic impact of immigration, or conversely zero immigration, we plot in **Figures 94 to 97** the demographic outcomes of Scenario 1. Under this scenario it is assumed that there will be no further inflow or outflow of immigrants starting from 2015.⁷⁹ The demographical consequences of this scenario are dire as the population and the labour force will start to decline almost immediately, sliding downward and reaching a negative growth rate of 1.2% and 1.3% p.a. respectively in 2064. The elderly will increase to 43.5% of the population in a super-aged society, and the overall dependency ratio will reach an unsustainable level of 1,145.⁸⁰ It is clear that without immigration, Hong Kong's labour force is doomed to shrink rapidly and its population age severely. As we have argued all along, these are the predicaments of Japan.

Figure 94: Projected Total Population (Excluding Foreign Domestic Helpers) Under Scenario 1, 2015 – 2064



Notes: The dash line refers to the baseline situation under Scenario 0.

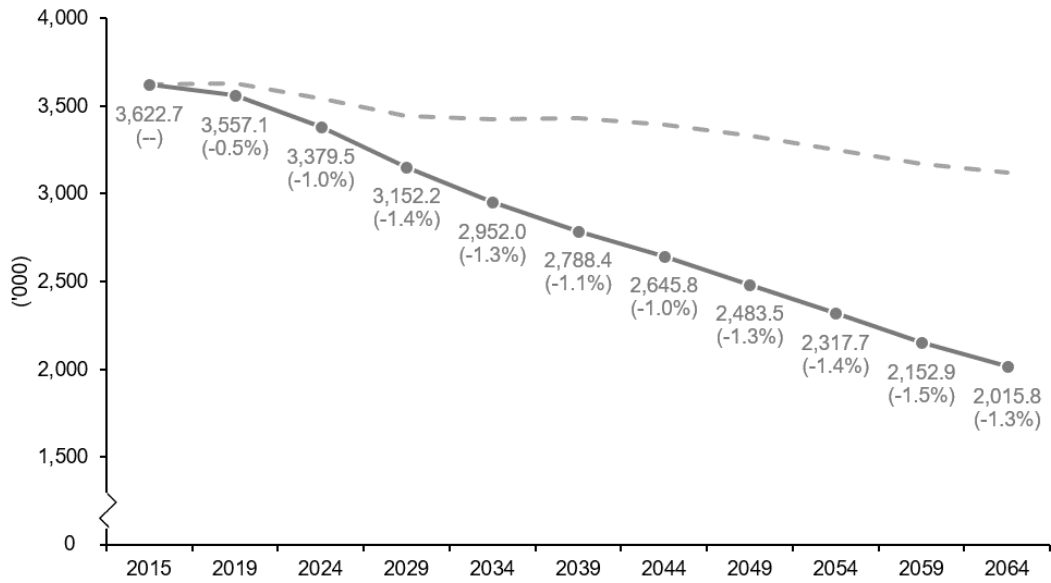
Figures in the brackets refer to the annualised growth rate since the previous time point.

Sources: Census and Statistics Department, Our Hong Kong Foundation

⁷⁹ Type II babies are included in the projection. They were born in Hong Kong and have the right of abode, and are therefore not immigrants.

⁸⁰ Projections of the population pyramid and labour force by age and gender are reported in the Appendix.

Figure 95: Projected Labour Force (Excluding Foreign Domestic Helpers) Under Scenario 1, 2015 – 2064

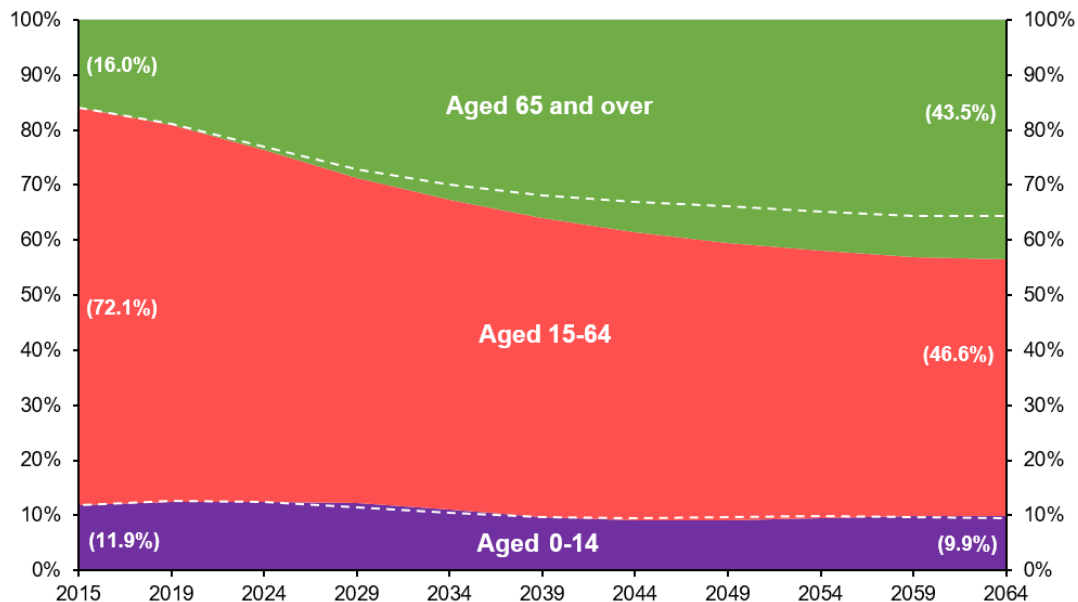


Notes: The dash line refers to the baseline situation under Scenario 0.

Figures in brackets refer to the annualised growth rate since the previous time point.

Sources: Census and Statistics Department, Our Hong Kong Foundation

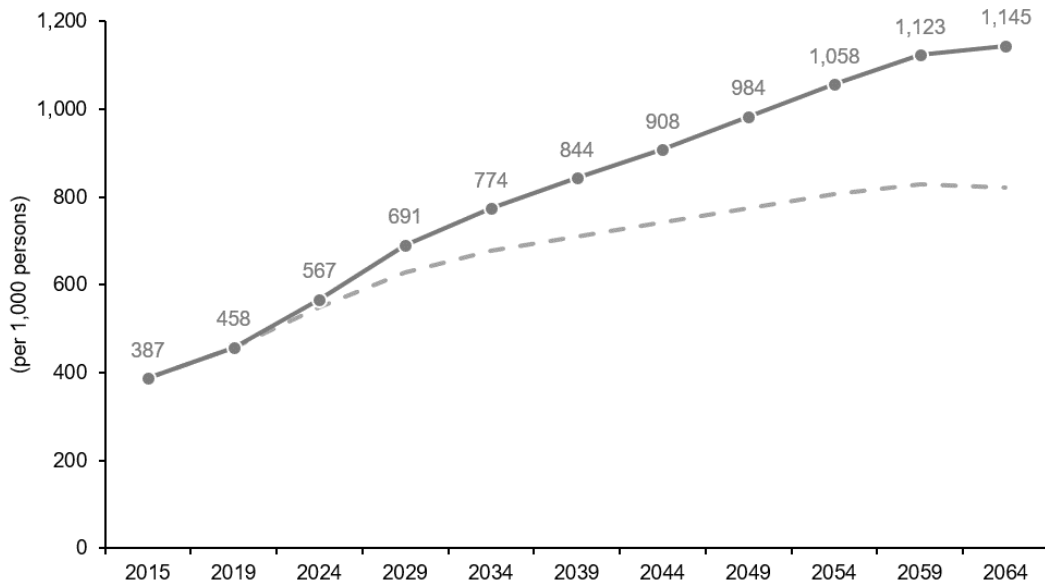
Figure 96: Projected Age Distribution (Excluding Foreign Domestic Helpers) Under Scenario 1, 2015 – 2064



Note: The dash lines refer to the baseline situation under Scenario 0.

Sources: Census and Statistics Department, Our Hong Kong Foundation

Figure 97: Projected Overall Dependency Ratio (Excluding Foreign Domestic Helpers) Under Scenario 1, 2015 – 2064



Note: The dash line refers to the baseline situation under Scenario 0.

Sources: Census and Statistics Department, Our Hong Kong Foundation

6.11.3 Scenario 2: Total Fertility Rate 2.1 and No Immigration

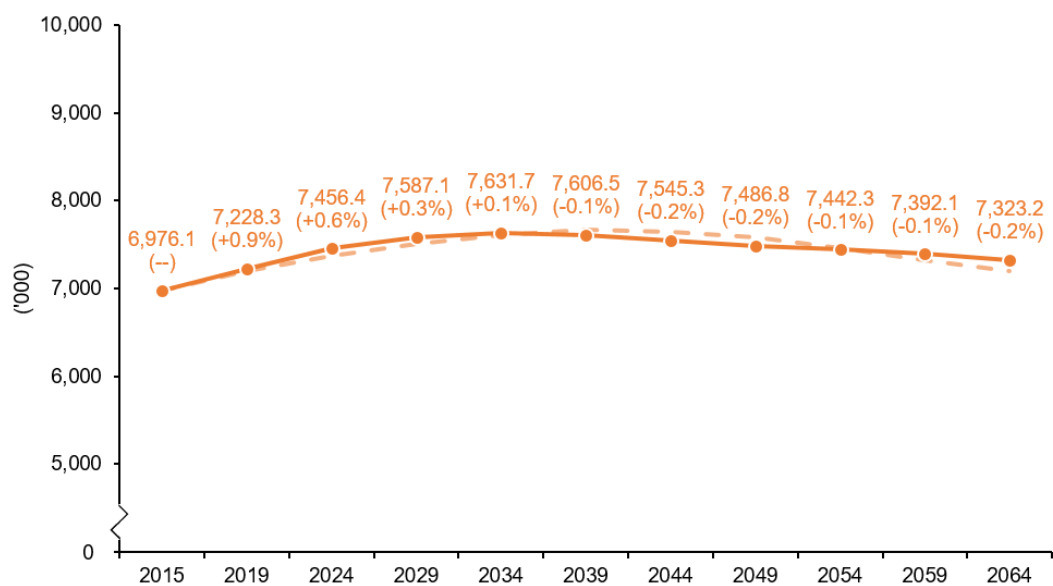
Another benchmark for comparison is Scenario 2 in which it is assumed hypothetically that there will be no net inflow or outflow of migrants but Hong Kong's total fertility rate (TFR) will be at the population replacement level of 2.1 starting from 2015. In a perfect world, if TFR is 2.1, in the long run the population will stabilise at a certain level and replace itself.⁸¹ There is no need to bring in immigrants to maintain population growth. Immigration will be only for the purpose of an infusion of human capital and needed skills.

We know that a TFR of 2.1 is not attainable now, nor is it attainable in the foreseeable future. As in the case of the Singapore's population policy, the population and labour force projection with a TFR of 2.1 serves as a useful benchmark for setting a target for immigrant inflow. **Figures 98 to 101** show that the demographic outcomes if the TFR is 2.1 will be much more desirable. To the extent that a TFR of 2.1 is not attainable, the admission of immigrants can be viewed as a means to make up for the shortfall in TFR. Within the period of our projection, the population size tracks the

⁸¹ A TFR of 2 will replace the married couple with their two children. The decimal of 0.1 will make up for infant mortality, early mortality as well as zero child-bearing, infertility and women staying single.

trend in Scenario 0 but decline at a more moderate rate. The population is younger compared with the baseline scenario. After an initial drop, the labour force will stabilise at a lower level than Scenario 0 when young adults derived from the increased fertility join the labour force.⁸² The elderly dependency ratio will continue to rise as the increase of TFR to 2.1 is assumed to begin only in 2015. It will take time for the age composition of the population to stabilize and the overall dependency ratio to improve.

Figure 98: Projected Total Population (Excluding Foreign Domestic Helpers) Under Scenario 2, 2015 – 2064



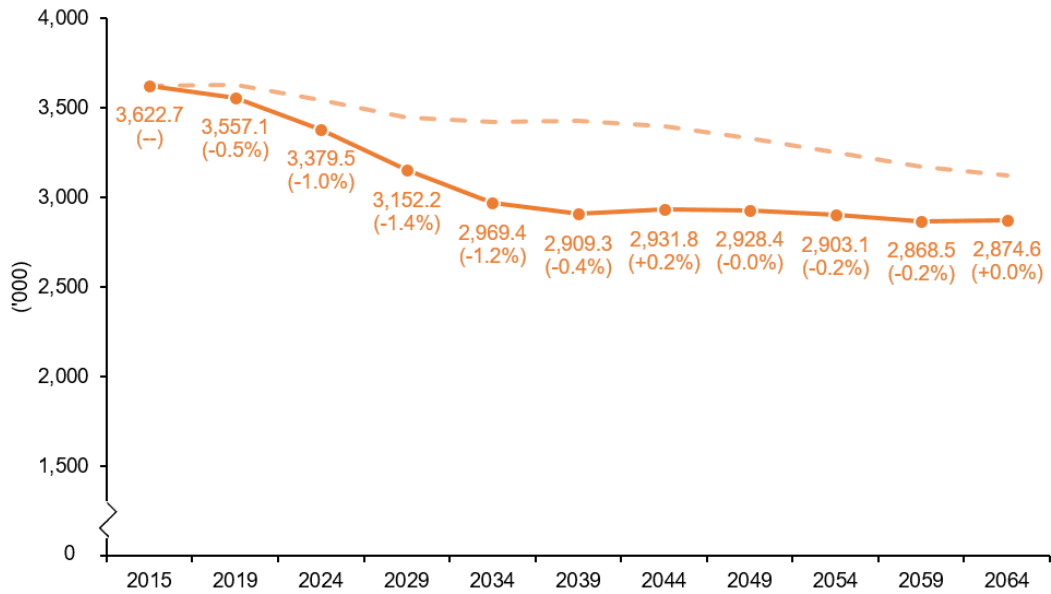
Notes: The dash line refers to the baseline situation under Scenario 0.

Figures in brackets refer to the annualised growth rate since the previous time point.

Sources: Census and Statistics Department, Our Hong Kong Foundation

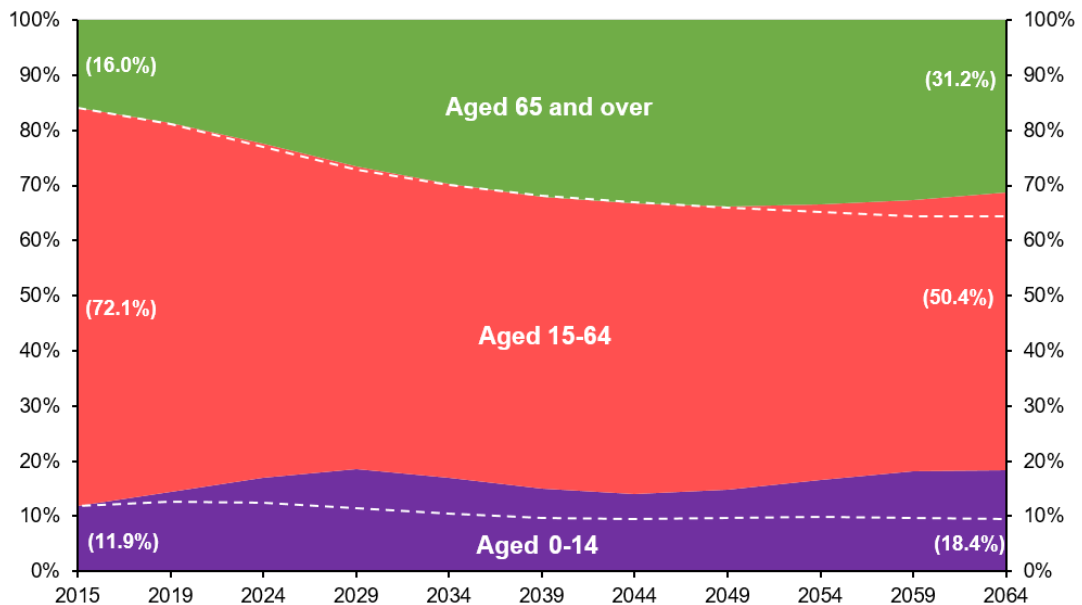
⁸² Projections of the population pyramid and labour force by age and gender are reported in the Appendix.

Figure 99: Projected Labour Force (Excluding Foreign Domestic Helpers) Under Scenario 2, 2015 – 2064



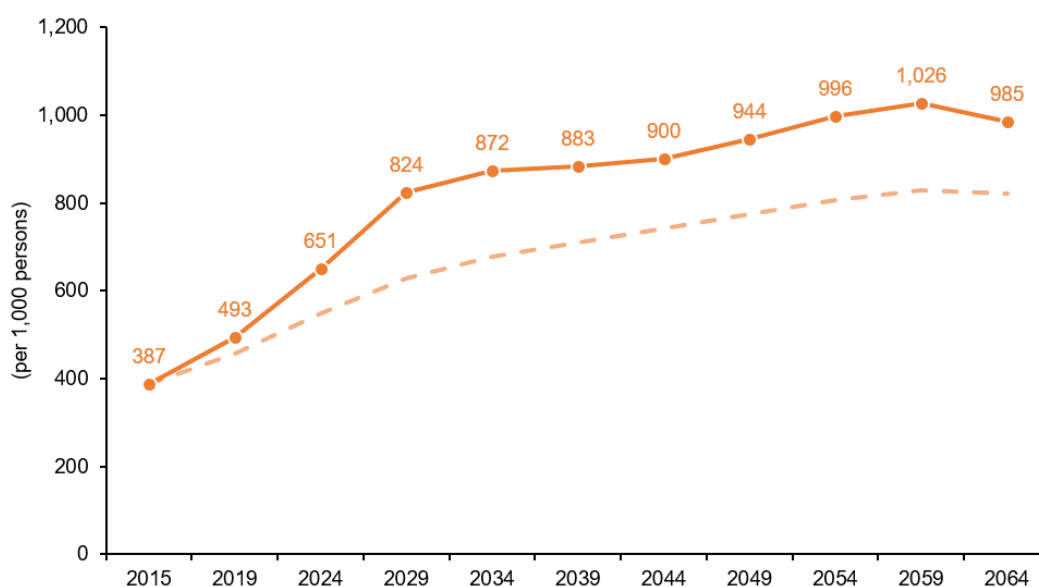
Notes: The dash line refers to the baseline situation under Scenario 0.
 Figures in brackets refer to the annualised growth rate since the previous time point.
 Sources: Census and Statistics Department, Our Hong Kong Foundation

Figure 100: Projected Age Distribution (Excluding Foreign Domestic Helpers) Under Scenario 2, 2015 – 2064



Notes: Dash lines refer to the baseline situation under Scenario 0.
 Sources: Census and Statistics Department, Our Hong Kong Foundation

Figure 101: Projected Overall Dependency Ratio (Excluding Foreign Domestic Helpers) Under Scenario 2, 2015 – 2064



Note: The dash line refers to the baseline situation under Scenario 0.

Sources: Census and Statistics Department, Our Hong Kong Foundation

6.12 Proposal on Increasing Immigration and Sources of Immigrants

The above three population projections illustrate three demographic outcomes under different population policies. Scenario 0 shows the demographic outcome if the current population policy remains unchanged. In Scenario 1, under zero immigrant inflow, the labour force will decline immediately and so will the population soon after. Hong Kong will become a super-aged society sooner. While in Scenario 2, although we may still have a relatively desirable total population size under zero immigration if we can successfully lift the TFR to 2.1 (which is not attainable, at least in the short term), the rise of the overall dependency ratio and the shrinkage in the labour force will be worse than Scenario 0 (see Figure 99).

With reference to the above three demographic models, we propose two simple objectives for considering the magnitude of the annual immigrant flow into Hong Kong. It should be sufficient (1) to stabilize the size of the population and the labour force at a certain level and prevent both from significant shrinking within the projection period; and (2) slow down the growth in the elderly dependency ratio and stabilize it at a certain level. These are rather modest demographic objectives.

Taking the population projection (with the fertility, mortality and migration assumptions) of the Census and Statistics Department as it is in Scenario 0, the baseline scenario, we propose to augment the inflow of immigrants to be phased in over a number of years subject to the capacity constraints in housing and infrastructure. Once a target for an augmented inflow of immigrants is chosen, the government should make long term planning for these facilities. The projected effect of the different number of additional immigrants on the size of the population and the labour force, the age composition and the dependency ratio will be presented in Scenario 3 under Section 6.13 later.

In line with the current situation of Hong Kong, we expect that most of the immigrants will probably be from Mainland China. Noting that the current number of OWP holders is 38,338 (2015 figure) which is projected to decline to around 36,500 in 2027 and thereafter, the proposed addition of immigrants (mainly from Mainland China) will only fill in partially the gap between the annual quota of 54,750 OWPH and the projected uptake of 36,500 after 2027. The increase is sustainable as Hong Kong has admitted up to the full annual quota of OWPH before. However, we propose that the additional immigrants should not be from the OWPS (After all, the OWPS quota has not been fully used up) but from the other schemes, such as Admission Scheme for Mainland Talents and Professionals (ASMTP), Immigration Arrangement for Non-local Graduates (IANG), admission scheme for the second generation of Chinese Hong Kong permanent residents (ASSG) and their dependants.

There is further room to expand the intake of non-local undergraduates by universities in Hong Kong as the permitted 20% quota is far from being filled up, but we need to remove the bottleneck of hostel places and build more student hostels. The supply of non-local students is almost unlimited. By non-local students we refer to students coming from all countries outside Hong Kong but realistically, in the foreseeable future, most of them will be from the Mainland. The talents and professionals scheme (ASMTP) has not grown significantly over time due to the requirement of the candidates having secured offers of employment in Hong Kong before coming to Hong Kong.

If the expansion of all the existing immigrant programmes does not yield the target increase of additional immigrants, Hong Kong may consider a limited version of the Diversity Immigrant Visa Program (DV Program) of the U.S.. Under the DV Program, the U. S. admits up to 50,000 immigrants each year from all over the world through random selection by lottery.⁸³ A quota is assigned to each country. Applicants are only required to have high school education or two years of work experience in a required occupation. The application process is done online. Randomly selected applicants will be interviewed at the local U.S. consular offices and given medical examinations before the visa is issued. Hong Kong can set its own target number and the qualifications for application under the scheme, including age brackets, educational attainment, work experience and no criminal record. Applications from the Mainland can be online. The selection will be by lottery if the number of applicants exceeds the quota. The selected applicants and their immediate family members will be admitted to Hong Kong as immigrants after an interview and medical examination. The operational details of such a scheme can be worked out with the Mainland authorities. The U.S. experience suggests that such a non-selective lottery scheme will be many times over-subscribed and can bring in any desired number of immigrants.

6.12.1 Implications on Growth and Earnings

One issue of concern is whether these additional new immigrants will affect the earnings and employment of the natives (the local population) through substitution. There has been a wide literature and numerous empirical estimates of the impact of immigration on the wages and employment of natives.⁸⁴ Most recently, a panel of economists, sociologists, demographers, statisticians and policy experts commissioned by The National Academies of Sciences, Engineering and Medicine of the U. S. released a 450-page reports on “The Economic and Fiscal Consequences of Immigration” on 22nd September 2016.⁸⁵ By and large the panel’s finding is consistent with previous findings that the impact of immigration on the wage and employment of

⁸³ It should be noted DV Program is only a supplementary programme for U.S. immigration. There are other more substantial programmes for family reunion and H1 visas etc.

⁸⁴ For a review of the economic consequences of immigration and international experience in the early literature, read Lam and Liu (1998), chapter 6.

⁸⁵ Blau, F., & Mackie, C.. (Eds.). (2016) *The Economic and Fiscal Consequences of Immigration*, National Academies of Sciences, Engineering and Medicine.

natives overall is very small. To the extent a negative wage and employment effect is found, the workers affected are those who are the closest substitutes of the new immigrants, such as the previous immigrants, or native-born high school dropouts who compete for the same category of jobs as the low-skilled immigrants. However, skilled immigrants have a positive wage and employment effect on both university and non-university educated natives because skilled immigrants are often complementary to native workers. Skilled immigrants enhance knowledge, innovate, raise productivity and contribute to aggregate demand. The Report concludes that immigration is integral to U.S. economic growth and helps the country to avoid the problem facing stagnant economies created by an ageing or even shrinking labour force, like Japan. The infusion of human capital from high-skill immigration enhances the country's capacity for innovation, entrepreneurship and technological change.⁸⁶

Our proposal of additional immigrants implies the infusion of say, roughly several thousand new skilled entrants into the labour market. (The balance is made up of spouses who may or may not be economically active and children.) These new entrants are mostly young and university-educated. They will bring with them human capital and skills. Besides slowing down ageing, they will add to the economic capacity of Hong Kong and contribute to growth and employment, in the same way that young skilled immigrants contribute to the growth of other recipient countries. This is generally known as the scale effect as the greater availability of productive inputs will encourage investment and production.

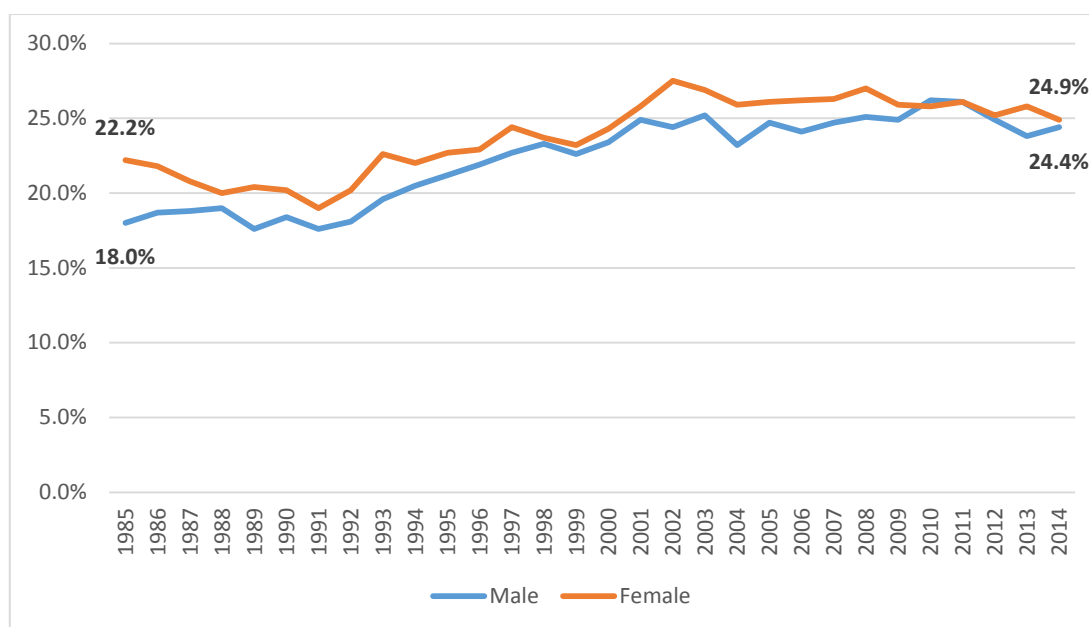
Empirically the wage and employment effect of additional new immigrants depends on whether the native workers are complements or substitutes of these new entrants. The university-educated and skilled new entrants are complementary to unskilled and less-educated native workers who will gain from the scale effect. Local university graduates who are substitutes to the new entrants may stand to lose if the substitution effect is larger than the scale effect. Data analysis shows that relative to the scale effect, the substitution effect in the labour market for university graduates in Hong Kong has not been large. Even during the period of rapid expansion of university enrolment in the 1990s, there was no significant increase in the

⁸⁶ Blau & Mackie (2016), pp 4-5.

unemployment rate of university graduates. The present proportion of the labour force with tertiary education (27%) is still low, in comparison with other advanced economies (See **Figure 5**), and the addition of several thousand to the labour force will not change the percentage in any significant way. In fact the Our Hong Kong Foundation report on “Yes, Hong Kong Can!” by Professor Lawrence Lau, Kenny Shui and Professor Yanyan Xiong proposes to increase the university enrolment to 40% if Hong Kong is to aspire to be an international financial and innovation centre. It is very unlikely that the new entrants proposed will displace local graduates in the labour market.

In support of this view we examine the rate of return to university education in Hong Kong over time. **Figure 102** shows that rate of return to schooling for university graduates by gender from 1985 to 2014.⁸⁷ The rates of return to schooling of 23-27% since 1997 are very high by international standard. It is unlikely they will be adversely affected in any significant way by the addition of the new entrants.

Figure 102: Rate of Return to School of University Graduates by Gender, 1985-2014



Source: Estimation by courtesy of Professor Richard Wong

Another way to look at the issue is to analyse the university earnings premium,

⁸⁷ The data are by courtesy of Professor Richard Y.C. Wong. The rates of return are estimated by the Mincerian earnings function based on the General Household Survey data.

defined as the ratio of average earnings of university graduates to secondary school graduates, by cohorts of labour market entry across census years. **Table 11** shows that based on census data, university graduates who entered the labour market in 1986-90 on average earned 2.3 times more than secondary school graduates in 1991. This market entry cohort of university and secondary graduates had 1-5 years of work experience in the census year 1991. In 1996 the ratio of average earnings of new entrants to the labour market with 1-5 years of experience (1991-95 market entry cohort) dropped slightly to 2.17. The surge of university graduates following the major expansion of first degree enrolment starting in 1990 could have a depressing effect on the earnings premium of new university graduates.⁸⁸ This ratio, however, started to increase again after 1996 and by 2011, it reached 2.41. To summarise, the university earnings premium of new and relatively inexperienced university graduates has been substantial. Despite a reversal due to a large increase in the output of graduates in the 1990s, it is increasing again. The earnings advantage of university graduates over secondary school graduates is even clearer if we trace the same market entry cohort over time as they gain more work experience. The 1991-95 market entry cohort of university graduates earned 2.17 times more than their secondary school counterparts in 1996, a relatively bad year for university graduates, but by 2011 they earned 3.42 times more when the cohort had been in the labour market for 16-20 years. The earnings differential between university graduates and secondary school graduates is sizeable and widening. It is little wonder that there is a strong incentive for secondary school graduates to try hard to gain entry to the university. The injection of several thousand additional immigrants with university education and different length of work experience into the Hong Kong labour force which has 1.14 million persons with tertiary education is not expected to have any significant adverse effect on the university earnings premium.

Table 11: Ratio of Average Earnings of University Graduates to Secondary School

⁸⁸The government dramatically increased university first degree intake from 7% of the relevant age cohort to 18% in response to the outflow of well-educated emigrants leading up to the changeover of sovereignty in 1997. Consequently university enrolment increased by over 110% before it levelled off in 1996.

Graduates, 1991 – 2011

Market Entry	1991	1996	2001	2006	2011
2006-10	-	-	-	-	2.41
2001-05	-	-	-	2.20	3.13
1996-00	-	-	2.26	2.68	3.42
1991-95	-	2.17	2.70	2.72	3.47
1986-90	2.30	2.65	3.01	2.75	3.33

Source: Computed from 1991-2011 Census and By-Census.

6.12.2 Implications on Social Welfare, Housing and Infrastructure

Another concern about admitting more immigrants is the impact on social welfare. Since almost all of these additional immigrants are university-educated and some will have work experience and presumably savings, their admission is not expected to impose pressure on the social welfare system, unlike the OWPH.

The additional immigrants are likely to generate more demand for private housing but not public housing. Depending on the family size of these new entrants, the additional demand for private housing per year could be several thousand. The housing target of the government Long Term Housing Strategy could be updated to accommodate this anticipated demand over time. The government should plan ahead of time the additional housing and infrastructure like transport, education and health facilities in line with its chosen additional immigrant target. The increase in immigrants can be phased in over a number of years in sync with capacity expansion. There is no immediate urgency in achieving the target. After all population ageing is a long drawn out process. It should be pointed out that capacity expansion to accommodate the additional immigrants is feasible as the rate of population growth in the next three decade will be lower than the population growth rate of the previous decades.

The issues of the housing market and land formation are analysed in Our Hong Kong Foundation Report entitled “Rethinking Our Public Housing Policy, Striving to Build Up a Land Bank” by Professor Richard Wong and William Tsang and will not be further discussed here.

6.13 Scenario 3: 5,000, 10,000 or 15,000 Additional Immigrants

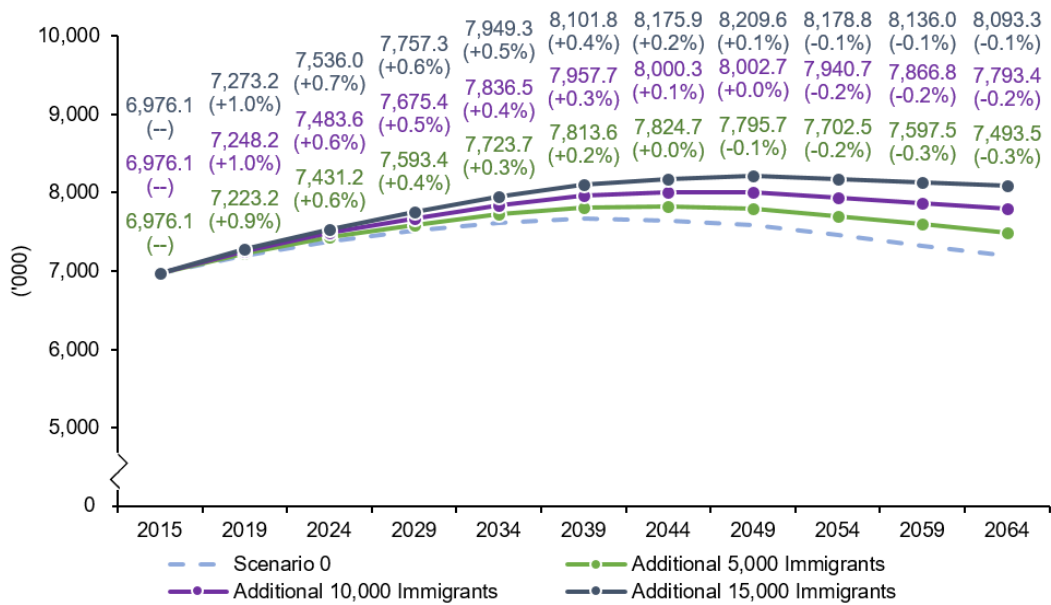
On the assumption that the additional 5,000, 10,000 or 15,000 migrants are young (say 10% age 1-19, 60% age 20-34, 20% age 35-49 and 10% age 50-59) and evenly distributed in gender, we simulate the population, labour force, age composition and overall dependency ratio in **Figures 103 to 108** of Scenario 3. Under this simulation if the number of additional immigrants is 15,000, there will be a modest growth in population over the period which stabilizes at 8.1 million, and the labour force will stabilize at around 3.6 million. If the additional number of immigrants is 5,000 or 10,000, a shrinkage in the population and the labour force cannot be averted.

The percentage of the elderly will stabilize at around 34-35% of the population, a slight improvement from 35.7% of the baseline projection of the Census and Statistics Department (Scenario 0). The total dependency ratio will be 771-803 (depending on the additional number) by 2064, again an improvement over 822 of the baseline projection, but still worse than the 2015 ratio of 387. Ageing of the population and the increasing dependency ratio can only be alleviated but cannot be reversed unless there is a continuous massive influx of young immigrants. Nevertheless, maintaining the size of the population and the labour force are important as they have positive impact on sustaining economic growth.

The numbers of additional immigrants and their simulated demographic effects in Scenario 3 are for illustrative purposes. Government should decide on an appropriate number, taking into consideration capacity constraints in housing and infrastructure.

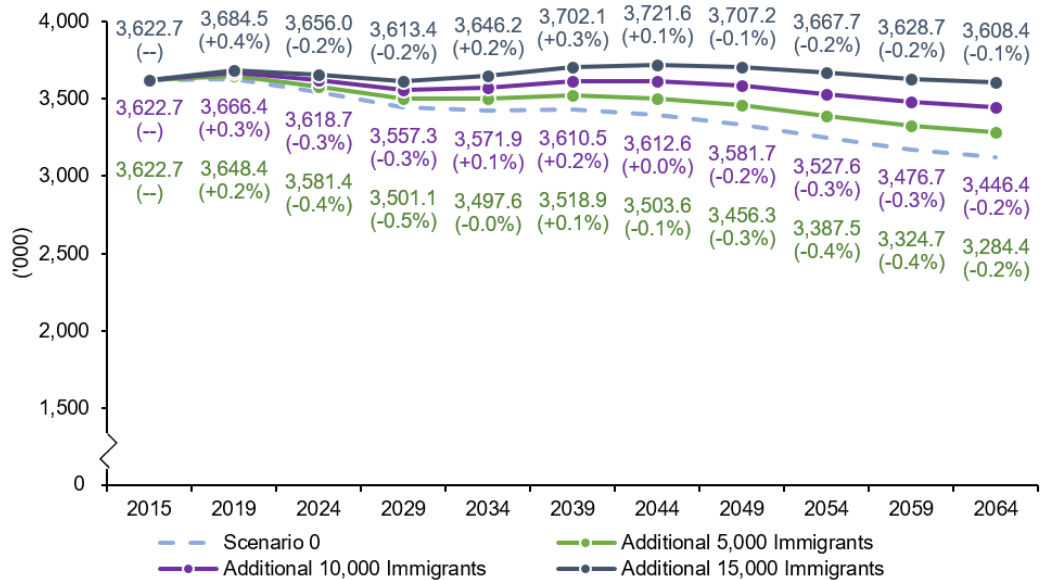
Figure 103: Projected Total Population (Excluding Foreign Domestic Helpers) Under

Scenario 3, 2015 – 2064



Note: Figures in brackets refer to the annualised growth rate since the previous time point.
Sources: Census and Statistics Department, Our Hong Kong Foundation

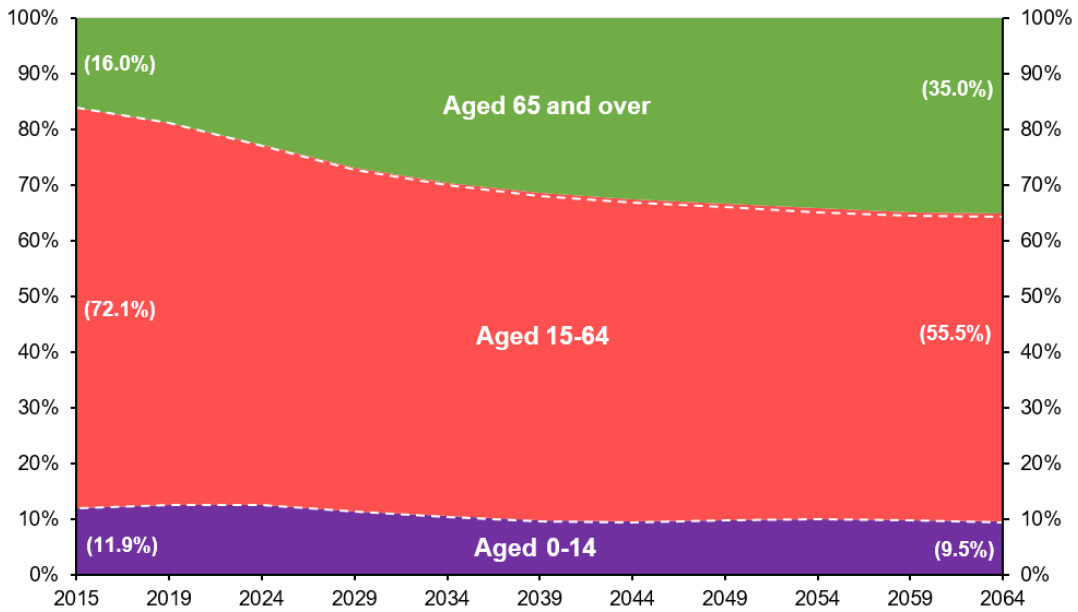
Figure 104: Projected Labour Force (Excluding Foreign Domestic Helpers) Under Scenario 3, 2015 – 2064



Note: Figures in brackets refer to the annualised growth rate since the previous time point.
Sources: Census and Statistics Department, Our Hong Kong Foundation

Figure 105: Projected Age Distribution (Excluding Foreign Domestic Helpers) Under

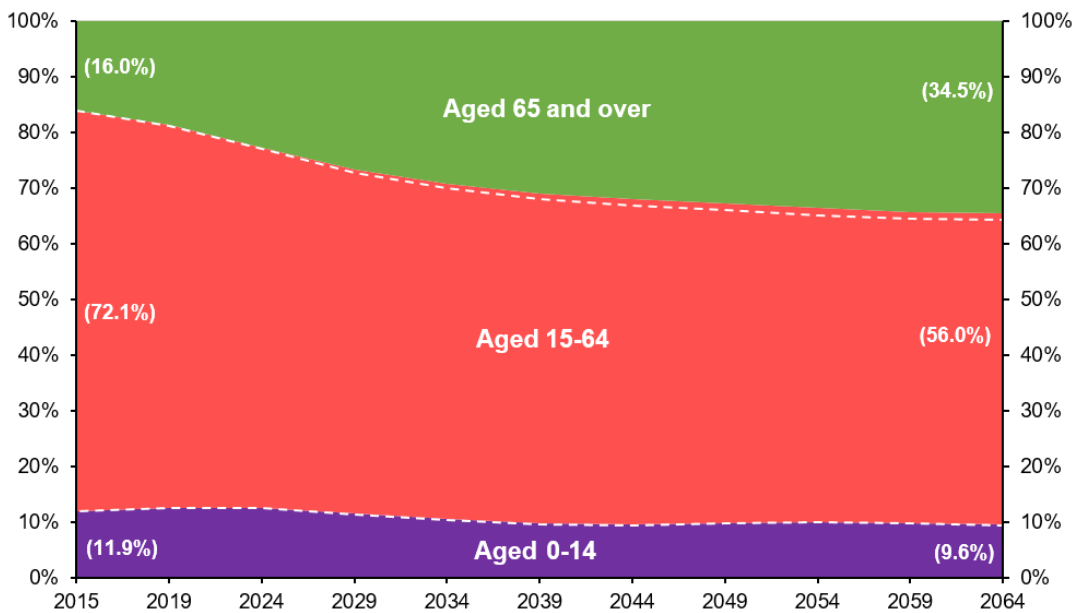
Scenario 3 (Additional 5,000 immigrants), 2015 – 2064



Note: Dash lines refer to the baseline situation under Scenario 0.

Sources: Census and Statistics Department, Our Hong Kong Foundation

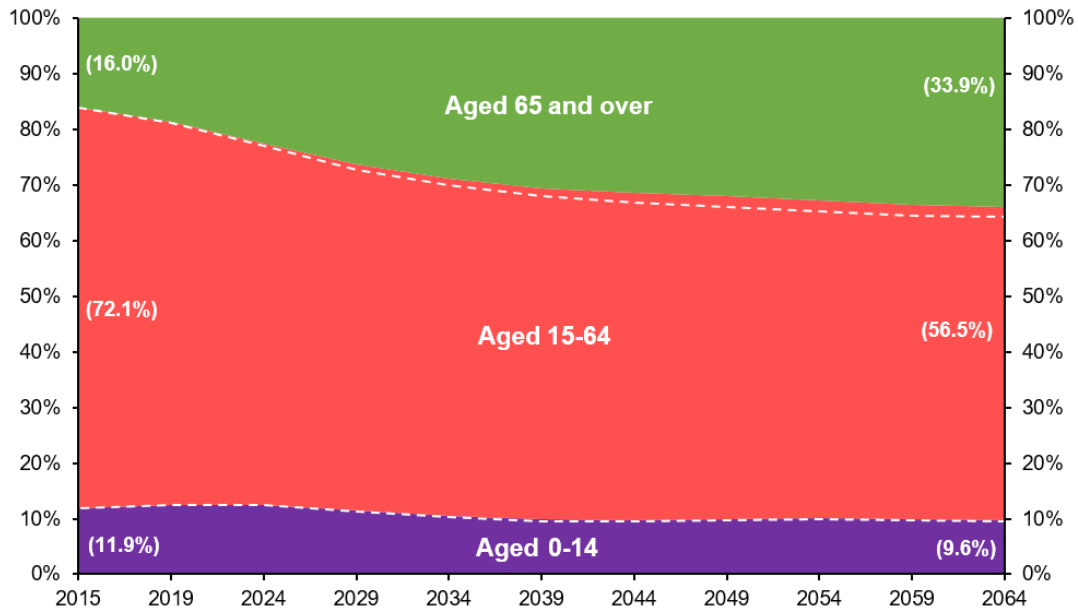
Figure 106: Projected Age Distribution (Excluding Foreign Domestic Helpers) Under Scenario 3 (Additional 10,000 immigrants), 2015 – 2064



Note: Dash lines refer to the baseline situation under Scenario 0.

Sources: Census and Statistics Department, Our Hong Kong Foundation

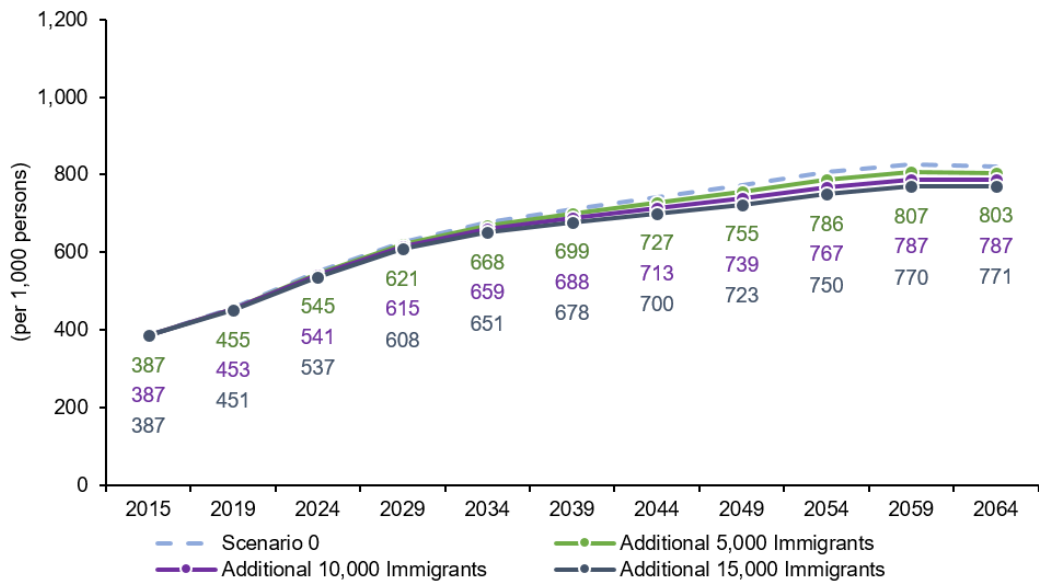
Figure 107: Projected Age Distribution (Excluding Foreign Domestic Helpers) Under Scenario 3 (Additional 15,000 immigrants), 2015 – 2064



Note: Dash lines refer to the baseline situation under Scenario 0.

Sources: Census and Statistics Department, Our Hong Kong Foundation

Figure 108: Projected Overall Dependency Ratio (Excluding Foreign Domestic Helpers) Under Scenario 3, 2015 – 2064

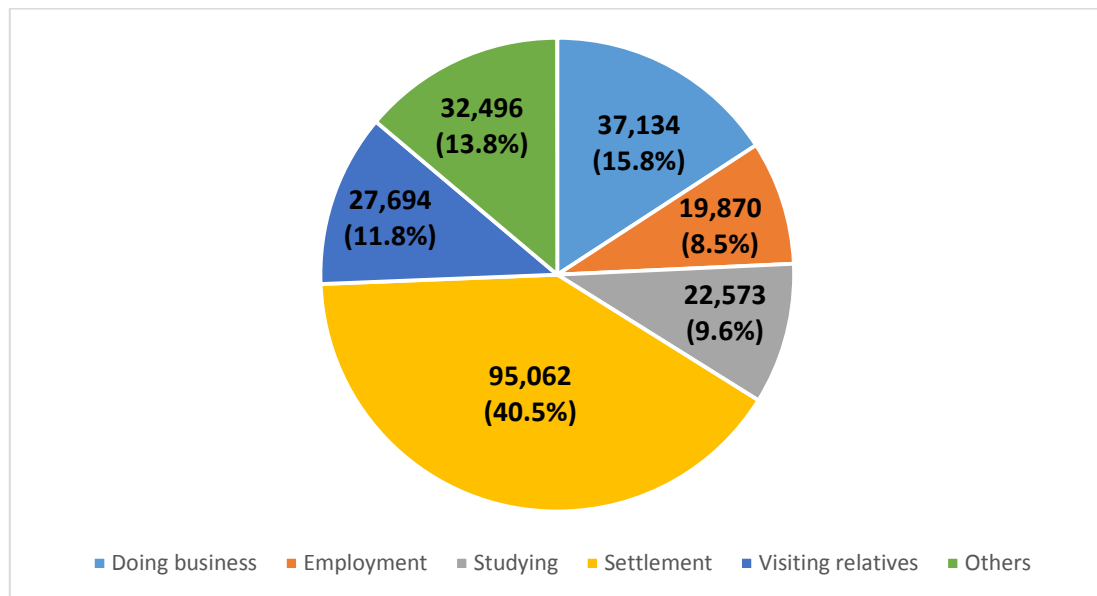


Sources: Census and Statistics Department, Our Hong Kong Foundation

6.14 A Two-Way Flow of People

A study of the people flow between Hong Kong and the Mainland will not be complete without a review of the flow of Hong Kong residents into the Mainland. According to the 2010 population census of the Mainland, about 234,800 Hong Kong residents were in the Mainland at the time of the census. Classifying by the purpose of their going to the Mainland, the largest number (about 95,100) returned to the Mainland to settle, constituting 40.5% of the total. The second largest percentage were business visitors (15.8%), followed by those who visited relatives (11.8%). (see **Figure 109**)

Figure 109: Hong Kong people residing in the Mainland by the purpose of visiting the Mainland, 2010

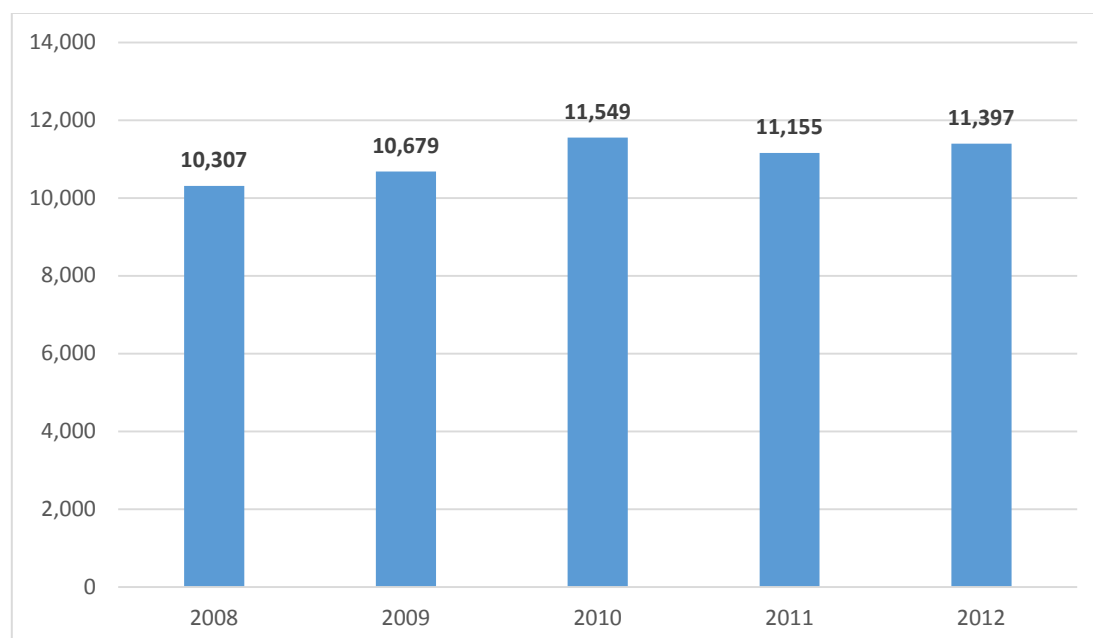


Source: National Bureau of Statistics of China

It is noteworthy that in 2010 as many as 22,600 Hong Kong residents were in the Mainland for different lengths of study. The Ministry of Education of the People's Republic of China has more detailed statistics of Hong Kong residents studying in Mainland universities and graduate schools. **Figure 110** shows that the number was about 11,400 in 2012. Taking into consideration the vast difference in the scale of the two education systems, the number of Hong Kong residents leaving Hong Kong to study in the Mainland is relatively large. As a comparison, it is pertinent to note that the number of Mainland students coming to study in Hong Kong universities with student visas was only 16,400 in 2012. Mainland universities are gradually becoming

a viable and attractive alternative to local universities for Hong Kong secondary school graduates.

Figure 110: Number of Hong Kong Residents Studying in Universities and Graduate Schools in Mainland China, 2008 – 2012



Source: Educational Statistics Yearbook of China

In 2010 about 19,900 Hong Kong residents went to the Mainland to be employed. What would be the future trend? The Hong Kong SAR government has in many occasions encouraged Hong Kong young people to go north to seize the opportunities opened up under CEPA. A recent survey of the attitude of Hong Kong young people towards employment in the Mainland commissioned by Bauhinia Foundation Research Centre could be informative.⁸⁹ The survey was conducted from August to September 2014 (a month before the Occupy Central Movement) among young people, age 18-29, who had no Mainland employment experience, yielding a successful sample of 1,001. The survey finds that 33% of the respondents are very willing or willing to be employed in the Mainland, as opposed to 65% who are very unwilling or unwilling. Among those who are willing (including very willing), the main considerations are Mainland's economic prospect, followed by Mainland's quality of life and personal ability. Their assessments of Mainland's economic

⁸⁹Hong Kong Institute of Asia-Pacific Studies at CUHK (2015), “香港青年往內地就業態度意見調查” .

environment include better economic prospect and employment opportunities, a shift of the economic centre of gravity to the Mainland, and attractive remuneration and welfare. Among those who are unwilling (including very unwilling) to be employed in the Mainland, their main considerations are quality of life followed by Mainland's political prospect and personal family factor. They lack confidence in the rule of law in the Mainland. They are not used to life in the Mainland and hold negative views on the quality of life and the community.

The view of the full sample of young people on the economic and political prospects of Hong Kong and the Mainland is rather revealing. Only slightly over half (50.3%) of the young people are optimistic or very optimistic about Hong Kong's economic prospect, but as many as 76.1% are optimistic about the Mainland. When it comes to the political prospect, a high percentage (86.5%) are not optimistic about Hong Kong, higher than the 71.2% concerning the Mainland. In all, Hong Kong young people are more optimistic about Mainland's economic prospect than Hong Kong's. When it comes to the political prospect they are more pessimistic about Hong Kong than the Mainland. Given this difference in assessment in the economic and political prospect of the two places, the factor that may weigh on the decision to be employed in the Mainland could be the difference in the quality of life and family consideration. If the quality and the standard of living in major Chinese cities improve and the differential with respect to Hong Kong narrows, Hong Kong people's perception may change and there could be a greater inducement for Hong Kong people to move to the Mainland for employment.

To summarise, when the difference in the standard of living between Hong Kong and the Mainland gets smaller, it is expected that there will be an increasing two-way flow of people for the purpose of study, work and business.

6.15 Concluding Remarks on Immigration, Population and People Flow

The several scenarios in population growth and composition demonstrate the demographic force of low fertility and high life expectancy and how important it is to have immigration. The different number of additional immigrants a year is just one proposal. We can vary the number, phase in the increase and simulate different scenarios to attain different desirable demographic outcomes. For many potential

Mainland immigrants, Hong Kong is still an attractive place to come for study, work and living. We should seize the opportunities and select the desired additional immigrants while we can. As the Mainland grows and improves in quality and standard of living, we may see an increased flow of Hong Kong residents in the other direction to study, work and live in the Mainland.

Increased immigration is a sensitive issue these days in many countries, including the U.S., U.K. and the European Union, especially when it is uncontrolled. One should bear in mind the community's receptivity to the size of the increased inflow. By carefully managing the size of the inflow and weighing the pros of a younger population against the cons of having an aged society and a shrinking labour force, hopefully we can allay the concern that some people have concerning admitting more Mainland immigrants.

The community should bear in mind that Mainland immigrants, especially their second generation, have over the years assimilated reasonably well into the Hong Kong community. The proposed additional immigrants are expected to be young, well-educated and economically active. They are expected to assimilate even better than their predecessors from the Mainland. They should integrate well into the labour market and cause minimal burden on social welfare and public housing. In this connection, we are fortunate to have the Mainland hinterland as a source from which we can select the additional immigrants we desire. Plagued by an uncontrollable influx of immigrants and refugees of different cultural, religious and linguistic background, European countries are not as fortunate.

The presence of a larger pool of human capital and skills will enable the development of new economic activities and complementary jobs. As the population continues to grow with immigration, there will be an increase in the demand for more transport infrastructure, hospitals and housing but the increase is much more manageable than previously as the projected rate of future population growth is much lower.

7. Concluding Remarks

Like other successful small economies, Hong Kong attains a high GDP per capita by capitalising on the external demand for its goods and services to make up for the deficiency in the domestic demand of a small economy. This is achieved by being completely open to international trade and investment. Hong Kong has long adopted a free port policy. In an era before WTO when the international trade regime was dominated by export quotas and tariffs, Hong Kong unilaterally opened itself to free trade with zero tariff on imports. The flow of capital has always been free.

As a small open economy, Hong Kong must cultivate a friendly and win-win economic relationship with its neighbours and trading partners. Despite its smallness in size, Hong Kong has been deft and skillful in intense trade negotiations with the European countries and the U.S., then our largest trading partner, on issues like textile quotas and country of origin restrictions. Hong Kong has always been able to maintain an amiable relationship with its trading partners.

The reform and the opening up of China in 1978 changed the fortune of Hong Kong. Instead of leaning towards Europe and the U.S. in trade and investment and competing with other low-cost manufacturers in the region, Hong Kong found itself a new role as the driving engine of China's development and modernisation. The re-location of Hong Kong's manufacturing into the Pearl River Delta for processing and re-exports was a great success, so much so that at the peak in the early 1990's, the one city of Hong Kong alone accounted for nearly 50% of the whole country's merchandise trade. Hong Kong also brought foreign direct investments and management expertise to the developing economy of the Mainland. Today over 70% of the foreign direct investment flows into China are from Hong Kong.

In playing the role of a driving engine, Hong Kong has seized the opportunities that arise from the opening up of China ahead of everybody else, and in the process reaps much economic benefits from the rapid economic development of China. The process also brings Hong Kong and Mainland China closer together economically. The economic relation between Hong Kong and the Mainland is much closer than that ever existed between Hong Kong and the U.S..

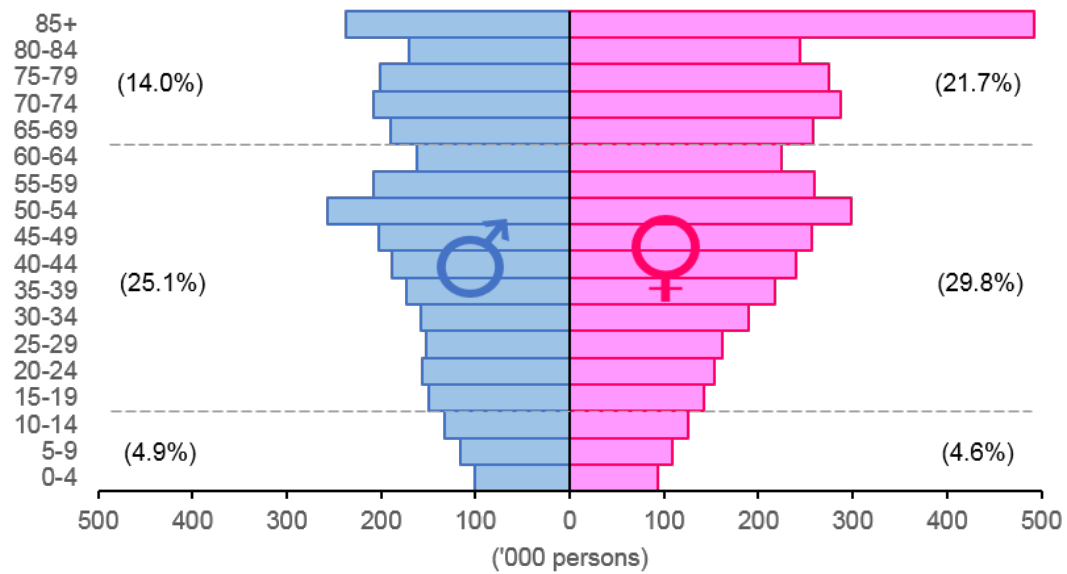
The relation between Hong Kong and Mainland China entered a new era in 1997. The “One Country Two Systems” defines the constitutional relation between the two places and underpins the economic relation. As Hong Kong settles down to its new position in the nation, the meteoric rise of China takes everybody by surprise. Since its accession to WTO in 2001, Mainland China’s external trade grows by leaps and bounds. China has signed numerous free trade agreements with different countries and regional blocs. Hong Kong is no longer its largest trading partner. As its container ports bloom up and down its coast, the Mainland does not have to rely on Hong Kong for re-exporting and freighting. Besides being an importer of foreign capital much needed for its development, Mainland China begins to export capital. In no time it becomes the second largest exporter of capital through its outward direct investment. As China rises to become the second largest economy in the world, the relative importance of Hong Kong to China diminishes. In terms of GDP, it is less than 3% of the Mainland. Hong Kong people must recognise that times are changing. We have to adapt and forge ahead in this new era, as we have done before.

China is now entering a “New Normal” phase of growth with economic re-balancing and re-structuring, emphasising internal demand and further opening up of its capital account and internationalising its currency. In this new phase Hong Kong must re-position itself as a major service provider for the Mainland and a gateway for the two-way flow of capital, with Mainland on one side and the rest of the world on the other. While Hong Kong is still an attractive place for Mainland’s skilled professionals to work and to live, Hong Kong must be effective in bringing in more skilled Mainland immigrants to add to its human capital stock to stimulate growth, and to alleviate its ageing problem.

As old windows of opportunities in manufacturing and re-export trade close, new windows of opportunities open. Hong Kong must look out for these new opportunities and ride with the tide of China’s rise to become, in the not too distant future, the largest economy in the world. In the process Hong Kong must play a critical role and be an indispensable partner of Mainland in some, if not all, aspects of its economic development. Only then will the Hong Kong-Mainland productive economic relationship be sustainable.

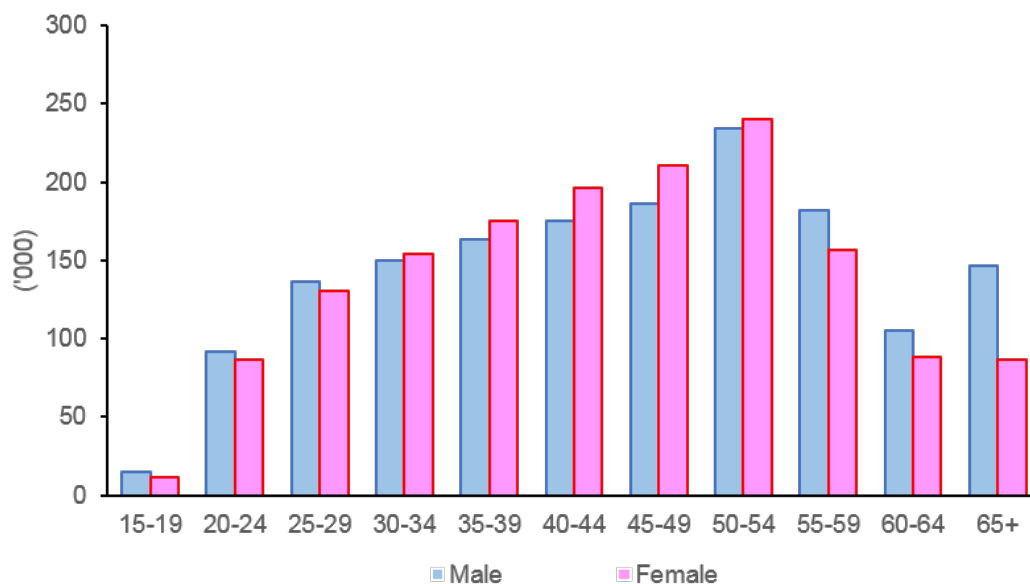
Appendix: Projected demographic structure under various scenarios

Figure A1: Projected Population Pyramid (Excluding Foreign Domestic Helpers) Under Scenario 0, 2064



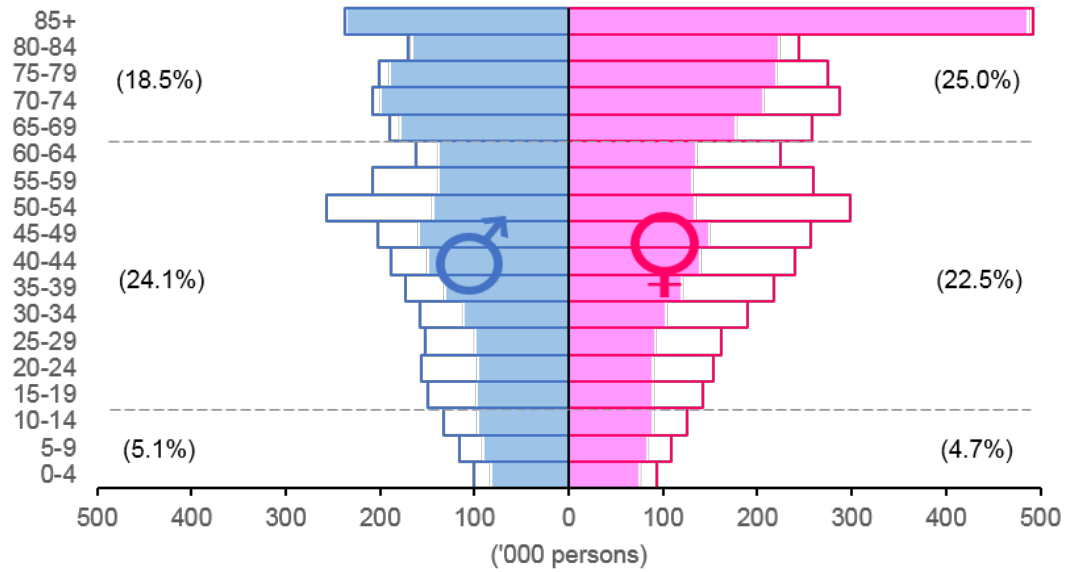
Source: Census and Statistics Department, Our Hong Kong Foundation

Figure A2: Projected Labour Force (Excluding Foreign Domestic Helpers) by Age and Gender Under Scenario 0, 2064



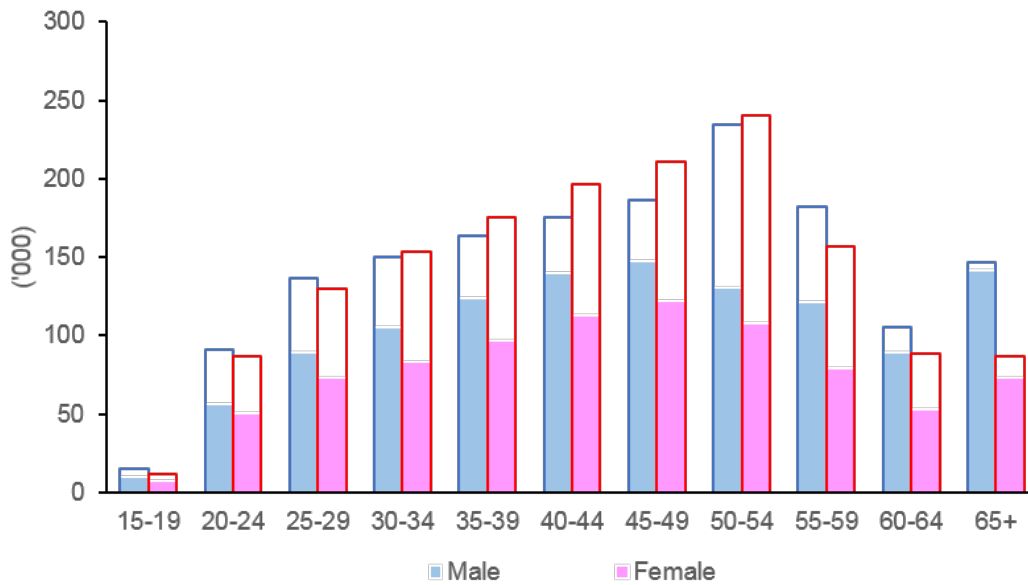
Source: Census and Statistics Department, Our Hong Kong Foundation

Figure A3: Projected Population Pyramid (Excluding Foreign Domestic Helpers) Under Scenario 1, 2064



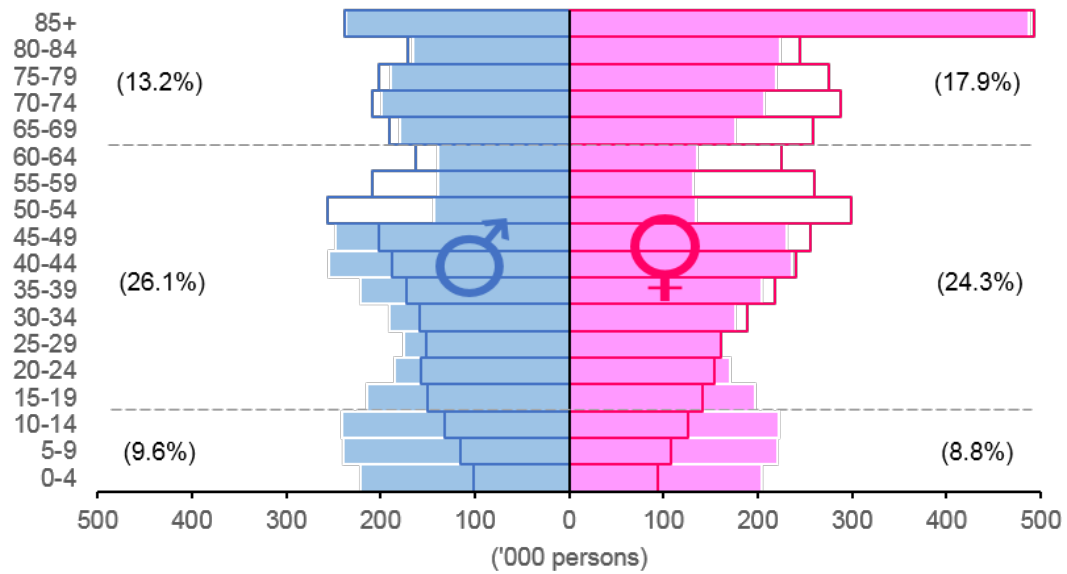
Note: Bar borders refer to the baseline situation under Scenario 0.
 Source: Census and Statistics Department, Our Hong Kong Foundation

Figure A4: Projected Labour Force (Excluding Foreign Domestic Helpers) by Age and Gender Under Scenario 1, 2064



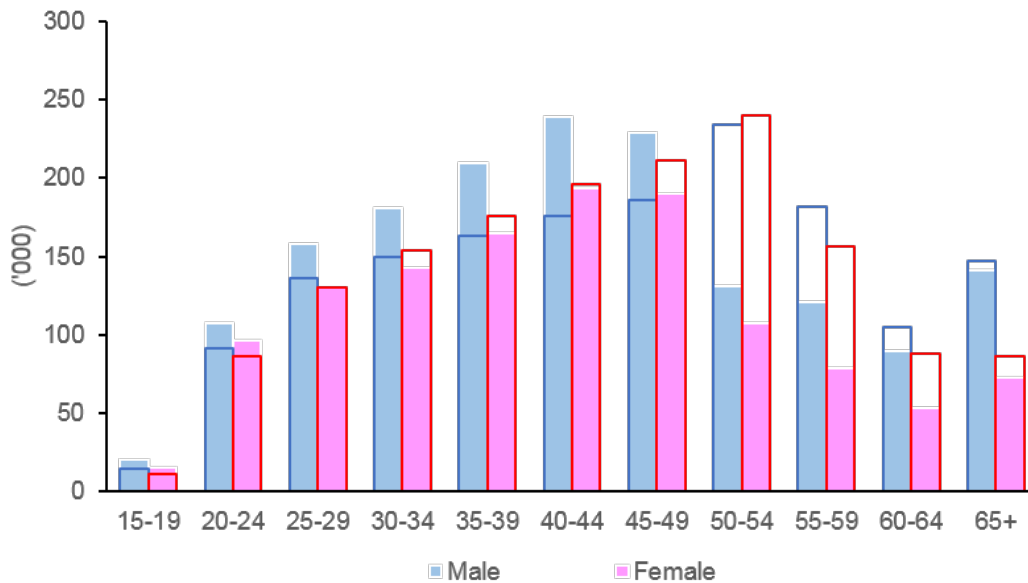
Note: Bar borders refer to the baseline situation under Scenario 0.
 Source: Census and Statistics Department, Our Hong Kong Foundation

Figure A5: Projected Population Pyramid (Excluding Foreign Domestic Helpers) Under Scenario 2, 2064



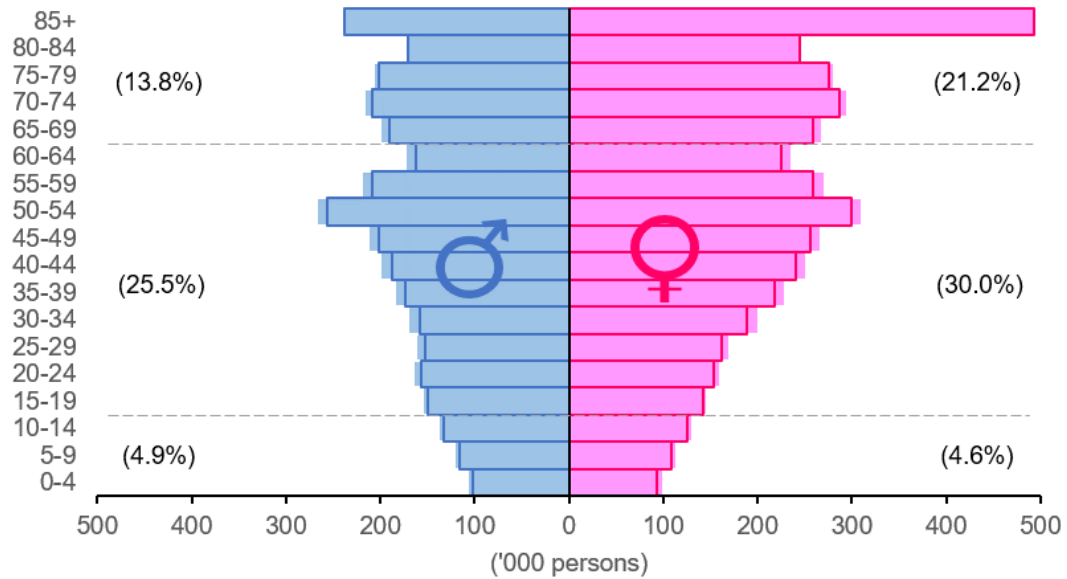
Note: Bar borders refer to the baseline situation under Scenario 0.
 Source: Census and Statistics Department, Our Hong Kong Foundation

Figure A6: Projected Labour Force (Excluding Foreign Domestic Helpers) by Age and Gender Under Scenario 2, 2064



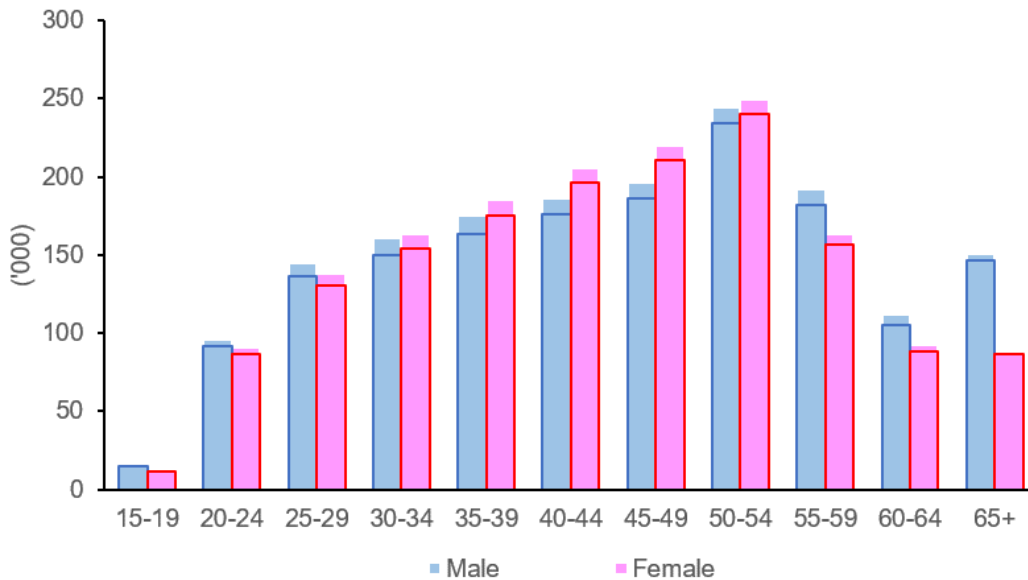
Note: Bar borders refer to the baseline situation under Scenario 0.
 Source: Census and Statistics Department, Our Hong Kong Foundation

Figure A7: Projected Population Pyramid (Excluding Foreign Domestic Helpers) Under Scenario 3 (Additional 5,000 immigrants), 2064



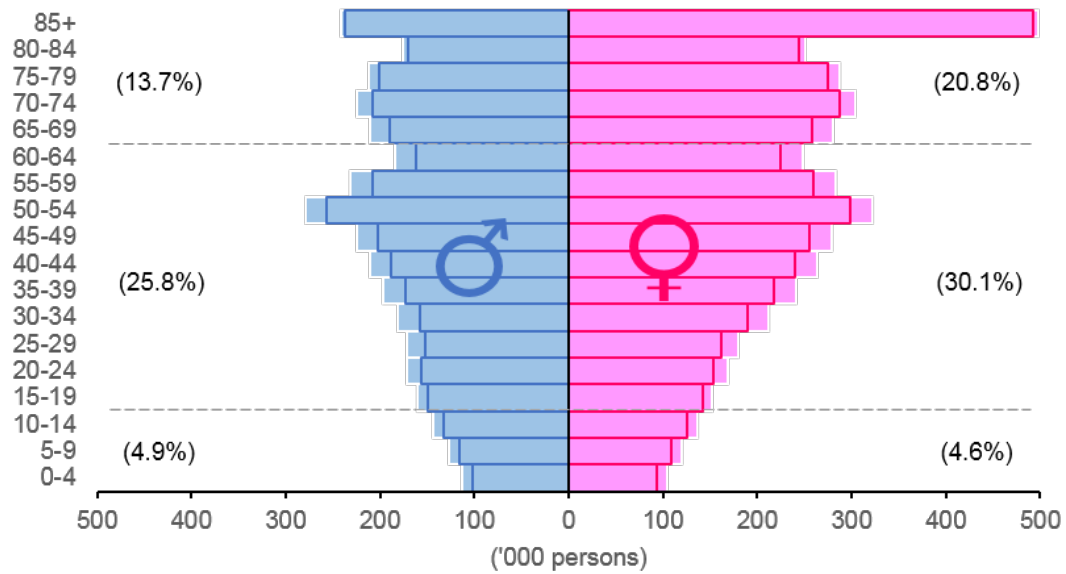
Note: Bar borders refer to the baseline situation under Scenario 0.
 Source: Census and Statistics Department, Our Hong Kong Foundation

Figure A8: Projected Labour Force (Excluding Foreign Domestic Helpers) by Age and Gender Under Scenario 3 (Additional 5,000 immigrants), 2064



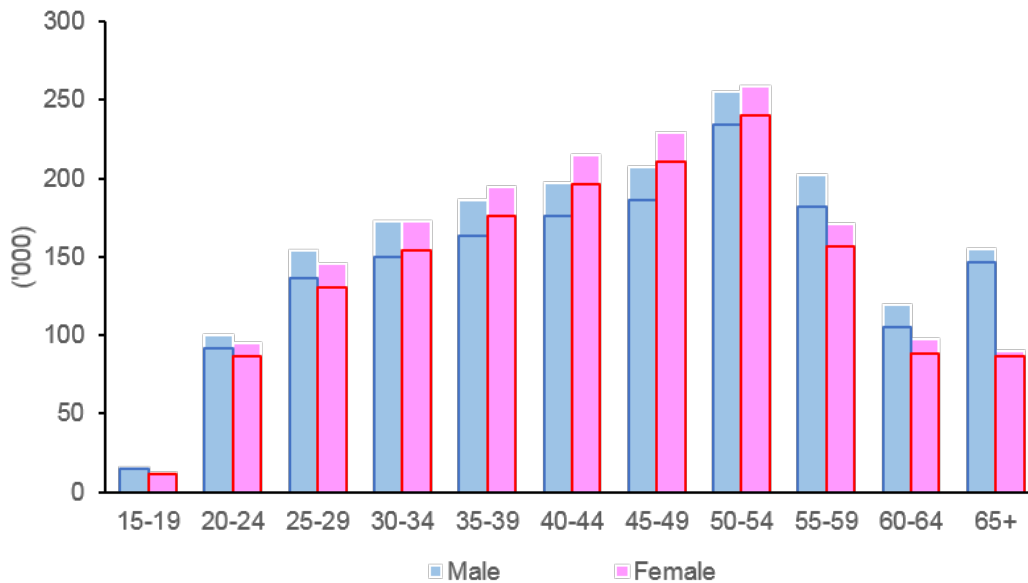
Note: Bar borders refer to the baseline situation under Scenario 0.
 Source: Census and Statistics Department, Our Hong Kong Foundation

Figure A9: Projected Population Pyramid (Excluding Foreign Domestic Helpers) Under Scenario 3 (Additional 10,000 immigrants), 2064



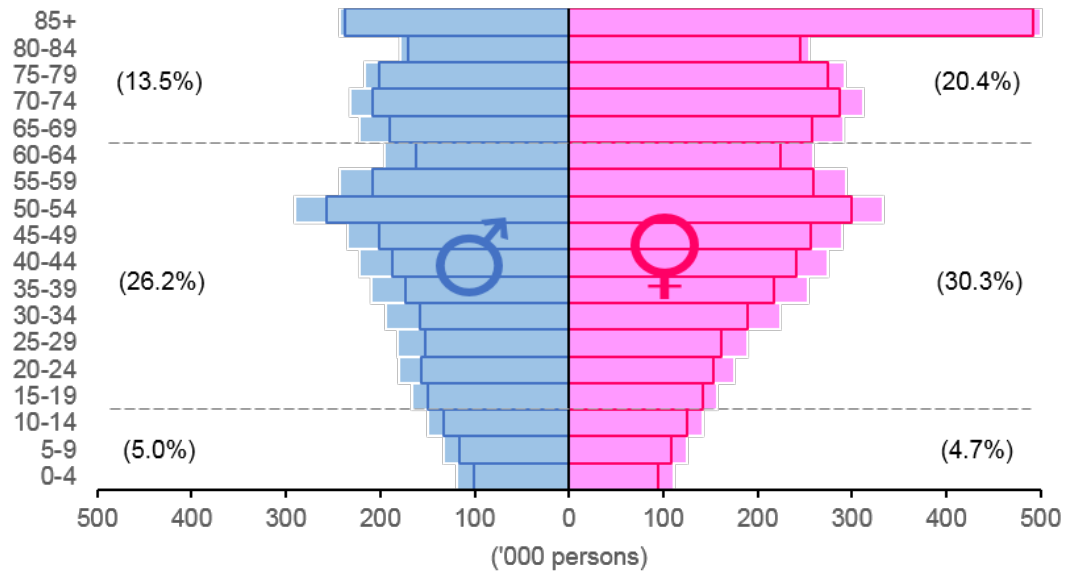
Note: Bar borders refer to the baseline situation under Scenario 0.
 Source: Census and Statistics Department, Our Hong Kong Foundation

Figure A10: Projected Labour Force (Excluding Foreign Domestic Helpers) by Age and Gender Under Scenario 3 (Additional 10,000 immigrants), 2064



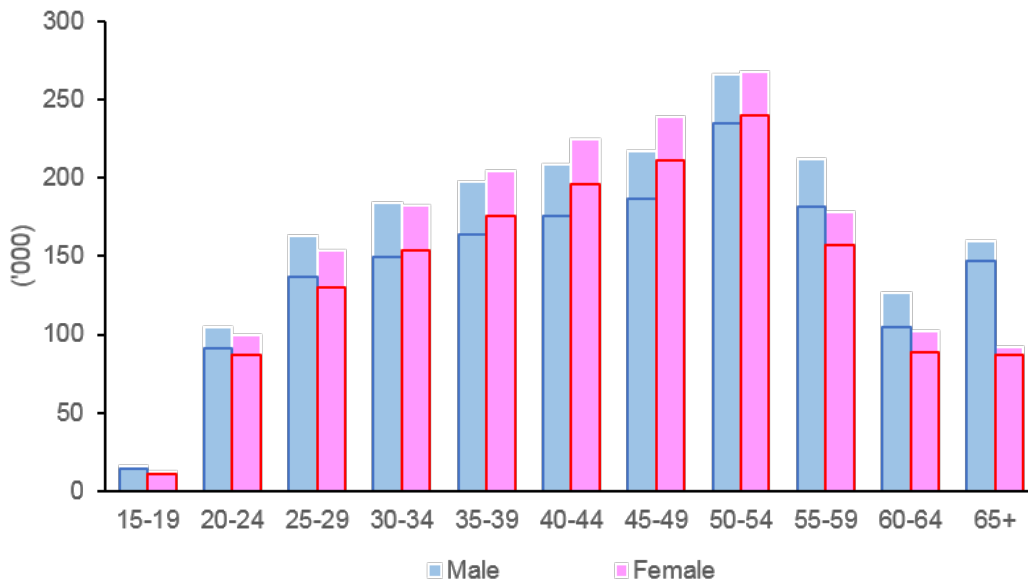
Note: Bar borders refer to the baseline situation under Scenario 0.
 Source: Census and Statistics Department, Our Hong Kong Foundation

Figure A11: Projected Population Pyramid (Excluding Foreign Domestic Helpers) Under Scenario 3 (Additional 15,000 immigrants), 2064



Note: Bar borders refer to the baseline situation under Scenario 0.
 Source: Census and Statistics Department, Our Hong Kong Foundation

Figure A12: Projected Labour Force (Excluding Foreign Domestic Helpers) by Age and Gender Under Scenario 3 (Additional 15,000 immigrants), 2064



Note: Bar borders refer to the baseline situation under Scenario 0.
 Source: Census and Statistics Department, Our Hong Kong Foundation

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