

Chapter III. The Hong Kong Economy on the eve of Return

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Chapter III

The Hong Kong Economy on the Eve of Return

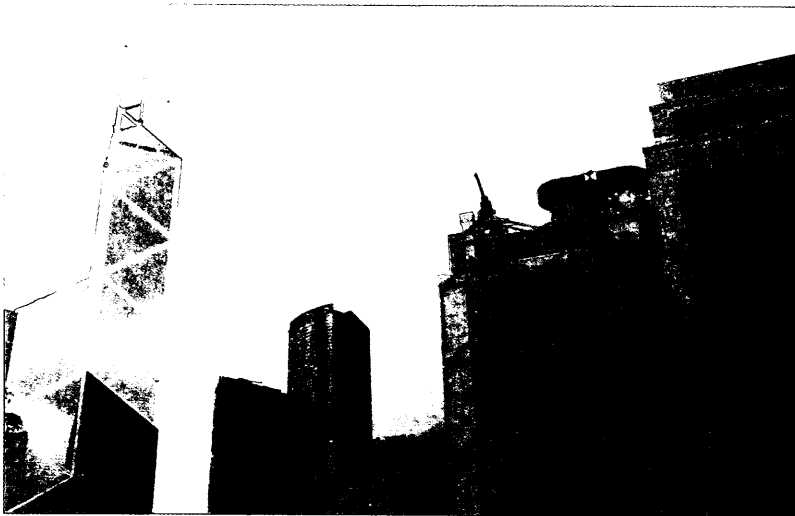
Introduction

It is now less than a year until July 1, 1997 for the return of Hong Kong to mainland China. There have consequently been a spate of discussions as to whether the enclave will be able to maintain its current level of prosperity after the transition of sovereignty. The debate over the future of post-return Hong Kong focuses on the problems accompanying the transition from a British to Chinese system. A more measured look at recent trends in the Hong Kong economy, however, show that be-

cast shadows over the ability of Hong Kong to function as a base for doing business with the PRC.

Accordingly, when examining the future of Hong Kong following its return, although one's attention inevitably tends to be drawn to the change in systems, the problems facing the Hong Kong economy in the transitional period will stem rather from inside the enclave itself. This article will therefore first clarify the state of the Hong Kong economy a year before transition of sovereignty and the state of the close economic relations between China and Hong Kong. Next, it will show how

the ability of Hong Kong to act as a base for doing business with China, a role which has sustained its economic development in the past, is beginning to ebb. Finally, it will discuss the problems which will have to be overcome to enable prosperity in Hong Kong following its return and measures to deal with them.



**Central district:
A business center of Hong Kong and Asian economies**

fore any concern emerged over governability accompanying the transition of systems, the main factors which have sustained the Hong Kong economy to date have already been shaken by changes in the economic environment inside and outside the enclave. Specifically, while Hong Kong grew in its position as the gateway to China or through integration with the Chinese economy after Beijing launched its reforms and opened its doors to the outside world, the recent economic growth of the mainland, the rethinking of its foreign investment policies and the growth of the Hong Kong economy to the level of a developed country have

Downturn in the Hong Kong Economy

The political standoff between China and the U.K. which arose after Governor Patten's proposals for political reform only worsened with Hong Kong's election of the Legislative Council in September 1995, China's announcement of the members of the Preparatory Committee of the Hong Kong Special Administrative Region at the end of 1995 and the establishment of the Provisional Legislative Council. As a result, with each passing day as Hong Kong nears its return, uncertainties are mounting over the political future of the enclave. As if in response to this, the U.S. business journal "Fortune" downgraded Hong Kong from first (1994) to sixth place in its 1995 ranking of business cities around the world. The reason being that even if its role as a window for business with China remains unchanged, there are growing political uncertainties as 1997 approaches.

“Fortune” is not alone. For a while, the prevalent opinion even in Hong Kong was that the murky political outlook was having a detrimental effect on the economy. Hong Kong had maintained a high level of economic growth beginning in 1991 due to the accelerated pace of reforms in China, but in 1995 saw its real growth rate drop to 4.3 percent – falling below the 5 percent line for the first time in five years. In particular, there was a clear drop seen from the second half of 1995. Growth fell to 4.2 percent in the third quarter of 1995, to 3.2 percent in the fourth quarter, and to 3.1 percent in the first quarter of 1996.

In so far as the macroeconomic indicators of Table 1 are considered, the direct reason for the slump in business was the sharp nosedive in private consumption expenditure. Until that point, private consumption had outpaced the GDP in growth, but in 1995 it suddenly dropped back to 1.3 percent. This was the lowest rate of growth in 20 years since 1974 when minus 2.1 percent growth was recorded. In particular, auto sales plummeted a substantial 30 percent from the previous year, while sales of durable consumer goods dropped across the board as well. Empty tables have also become visible recently at fancy restaurants – which had been packed and had turned away guests without confirmed reservations as recently as two years ago. The rumor is spreading that the Hong Kong people are cutting down on spending and building nest eggs in preparation for return.

A more studied analysis of Hong Kong macroeconomic statistics, however, reveals that the politi-

cal uncertainties are not really having a detrimental impact on the Hong Kong economy. The nominal rate of growth of private consumption expenditure surpassed the GDP growth rate even in 1995, and the ratio of private consumption expenditure to the nominal GDP, in fact, increased. If people were building up their bank accounts due to their concerns over the future of the enclave, the rate of growth of consumption expenditure should at least have been less than the nominal rate of increase of income revenue. Accordingly, the cause for the slump in private consumption expenditure must be sought in purely economic factors.

The primary cause of the first slump in consumption in 20 years was the 1995 plunge in real estate and stock prices, which had risen steadily since 1991, that is, the reverse asset effect. Figure 1 compares private consumption expenditure and asset prices, illustrating housing prices and the Hang Seng Index, and expresses trends over time. The figure shows that stock prices began falling in the fourth quarter of 1994 and that housing prices began dropping in 1995 and thereby sparking the decline in private consumption expenditure. Record highs in real estate and stock prices were behind the high level of growth sustained by the Hong Kong economy beginning in late 1991, the year when Beijing accelerated the pace of its reforms. At the end of 1994, however, stock and real estate prices both tumbled and caused the “economic bubble” to burst, thereby inviting the slump in private consumption expenditure.¹

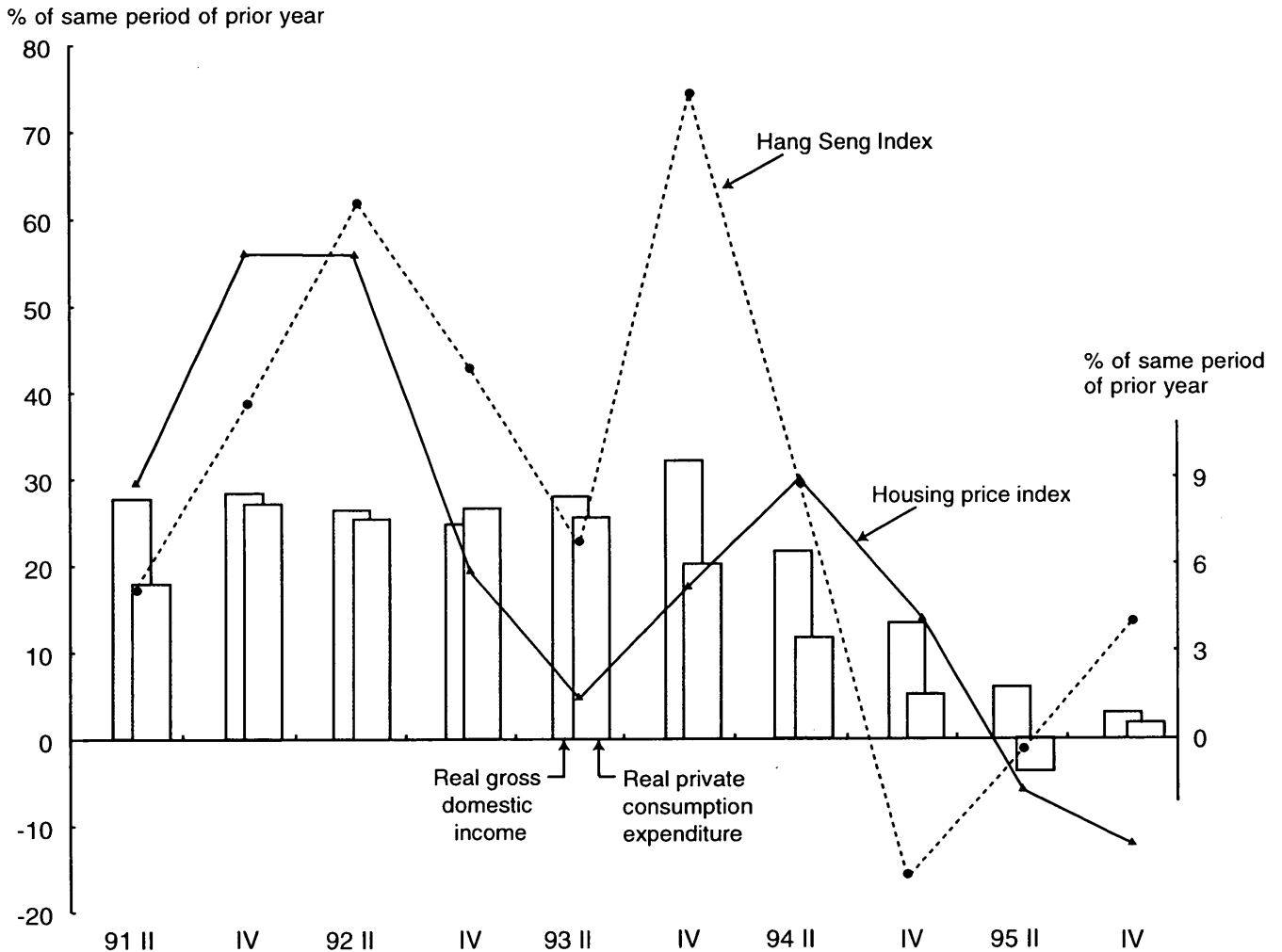
Table 1. Trends in Hong Kong Macroeconomic Indicators: 1990 to 1995

	1990	1991	1992	1993	1994	1995
Private consumption expenditure	5.7	8.6	8.5	7.5	6.3	1.3
Public consumption expenditure	5.5	7.7	7.2	2.2	3.5	4.3
Investment	8.1	9.3	9.2	3.7	14.0	6.4
Exports	9.6	17.3	19.8	13.5	10.4	11.9
Imports	11.4	19.0	22.2	12.7	14.0	13.7
Gross domestic product (GDP)	3.4	5.1	6.3	6.1	5.4	4.6
Gross domestic income (GDI)	3.8	6.4	7.8	7.5	3.6	0.5

Note: For method of calculation of gross domestic income, see notes of Fig. 1.

Source: Census and Statistics Department, “*Estimates of Gross Domestic Product 1961-1995*,” March 1996, Hong Kong.

Fig. 1. Fluctuating Correlation between Real Private Consumption Expenditure, and Asset Prices and Real Gross Domestic Income



Note: Real gross domestic income calculated as follows.

$$RGDI = GDP + \left(\frac{Xg}{Pgm} - \frac{Xg}{Pgx} \right) + \left(\frac{Xs}{Psm} - \frac{Xs}{Psx} \right)$$

- RGDI: Real gross domestic income
- GDP: Real gross domestic product
- Xg: Exports of goods
- Xs: Exports of services
- Pgm: Price deflator for import goods
- Pgx: Price deflator for export goods
- Psm: Price deflator for imported services
- Psx: Price deflator for exported services

Sources: 1. Census and Statistics Department, "Estimates of Gross Domestic Product 1961-1995," March 1996, Hong Kong.
 2. Census and Statistics Department, "Hong Kong Monthly Digest of Statistics," April 1996, Hong Kong.

The fall in real income was another cause. Consumption is income minus savings, so any fluctuation in income naturally has a decisive impact on consumption expenditure. Further, the current business recession is being accompanied by increased unemployment – a rare phenomenon in the enclave. The unemployment rate reached the 3 percent level in 1995 and had climbed to 3.5 percent by the end of 1995. Hong Kong relies on imports for the majority of its durable consumer goods, and forbearance in purchasing manufactured goods therefore should not lead directly to increased unemployment. Accordingly, the simultaneous slump in consumption and rise in the jobless rate can only be explained by the sluggish growth in real income.

Until now, the only macroeconomic indicator available in Hong Kong corresponding to income has been the GDP. In a free economy with as large a scale of overseas transactions as Hong Kong, the GNP, which includes overseas net element income, is best suited as an income indicator. In addition, the real income effect caused by changes in trade terms, namely, the ratio of the export price index to the import price index, is also significant.² Statistics on the GNP, however, are difficult to obtain. Hong Kong champions a free economic system, and has therefore been slow to compile statistics on capital transactions. Figures for the nominal GNP for 1993 were only announced at the end of 1995. Statistics on the GNP are essential for an accurate analysis of the Hong Kong economy, but are not available. The authorities recognize the need for information on the real income effect caused by the changes in terms of trade and conducted test calculations in the “Estimates of Gross Domestic Product 1961 to 1995” published in March 1996.³ Table 1 and Fig. 1 calculate real gross domestic income (after adjustment) as affected by fluctuations in income accompanying changes in terms of trade for not only goods, but services as well. The growth rate over the previous year (same period) for each quarter is shown.

A look at the adjusted real gross income reveals that real gross income growth surpassed that of the GDP from 1991 to 1993, when China was aggressively pressing forward with its reforms, but slowed in 1994 and dropped to zero growth in 1995. Real gross income is a leading indicator of private consumption expenditure as well and has a large impact on trends in private consumption expenditure (see Fig. 1).

A look at recent trends in the Hong Kong economy reveals that while political uncertainties cannot be said to have been absolutely inconsequential, the boom in business with China calmed considerably in 1993, and it was the repercussions of this that surfaced all at once in 1995. Why then did the bubble burst, terms of trade deteriorate and real income plunge? Behind this were, first, the effects of the protracted economic austerity program adopted by China in late 1993 and, second, the destabilization of the role of Hong Kong as a base for business with China due to the speed in which China is catching up, rising costs in Hong Kong and intensifying competition with neighboring countries.

Close Economic Relations between China and Hong Kong

It is necessary to explain the economic integration of Hong Kong and China when considering the impact of China on the Hong Kong economy. Hong Kong has been pursuing economic integration with the mainland since the start of reform and open door policy and has enjoyed striking economic growth as Beijing accelerated its reforms.

When China decided to reform its economy and open up to the outside world, Hong Kong was the first to start up trade with China on a large scale. Trade between Hong Kong and China boomed after a 30-year dormancy both in terms of direct trade between the two partners and the more traditional Hong Kong entrepot trade. Foreign goods were being re-exported to China through Hong Kong, and Chinese goods were being re-exported to the world through Hong Kong. At the same time as it changed its policy toward foreign investment, China embarked on trade more aggressively. Further, its port facilities were terribly inadequate due to 30 years of economic isolationism. This resulted in a sharp surge in entrepot trade through Hong Kong.

Another factor in addition to entrepot trade was behind the jump in trade figures. The manufacturers which had sustained the Hong Kong economy up until the late 1970s increased their consignment processing production in Guangdong and elsewhere after China launched its reforms and open door policy. This led to steadily climbing trade with the mainland as well. The active consignment

processing trade, in which Hong Kong manufacturers exported materials and parts required for consignment processing production to branch factories in neighboring Guangdong, brought the finished products back to Hong Kong and then re-exported them, had a large impact as well.

China's share in Hong Kong's trade rose sharply, and the overall value of Hong Kong's trade, primarily re-exports, also shot up. Hong Kong trade statistics are divided into domestic exports (added value of 25% or more), re-exports and imports. In 1995, domestic exports had risen to 5.7 times the level in 1978, before the reforms and open door policy, re-exports 84.3 times and imports 23.6 times. China's share in Hong Kong's trade, further, grew to 28 percent for local exports, 92 percent for re-exports and 36 percent for imports.

Trade relations between Hong Kong and China did not end there. Hong Kong established itself as a base for doing business with China. Active triangular trade continued to link China with third countries without going through Hong Kong customs. That is, deals were concluded between Chinese export and import companies based on Hong Kong and Japanese and Western trading companies, while the actual cargo was exported directly from Chinese ports to Japan and the West or vice versa. A survey by the Hong Kong Trade Development Council estimated that this triangular trade alone reached HK\$192.0 billion in 1991. This corresponded to 82 percent of domestic exports.⁴

Trade relations between Hong Kong and China are diverse in nature with these trade relations and the function of Hong Kong in entrepot trade being extremely complicated. This is illustrated in a more readily understandable fashion in Fig. 2. The flow of trade is shown by the arrows. The darkened portion in the center represents the Hong Kong region. Trade, other than domestic exports and retained imports, passing through this region constitutes re-exports. Triangular trade not passing through Hong Kong customs is illustrated by the dotted lines at the right of the figure. Before China's reforms and open door policy, trade with China had been of little importance. The situation is tremendously different today with Hong Kong forging close relations with China in trade, as can be understood from the figure. Further, as mentioned earlier, consignment processing trade accounts for a large share of the trade between Hong Kong and China. Entrepot trade is primarily governed by domestic

trends in China, while Hong Kong companies hold the initiative in consignment processing trade. Consignment processing trade is important in the close trade relations between Hong Kong and China in that it functions to protect the economic independence of Hong Kong.

Economic relations between Hong Kong and China in terms of investment have also picked up in recent years. Most of the investments made by Hong Kong in China in the 1980s were small-scale and aimed at consignment processing production, but with the accelerated pace of reforms in China in 1992, Hong Kong began investing in China in earnest, and investment from China to Hong Kong surged as well. In particular, Chinese enterprises made stunning investments in Hong Kong from 1992 to 1994. If operation ended today, it would be a blow to the Hong Kong economy. Direct investment by China in Hong Kong reportedly surpassed the US\$20 billion mark at the end of 1992. Chairman Shen Jueren of the Association of Chinese Enterprises in Hong Kong stated in March 1996 that this direct investment had risen to US\$42.5 billion by the end of 1994 (1,756 companies).⁵ This is far more than the combined investments by Japan and the U.S., and places China at the top of investors in Hong Kong.

Consequently, the impact of Chinese enterprises on Hong Kong is substantial. Chairman Shen indicated that Hong Kong-based Chinese companies account for 22 percent of the enclave's total trade, 55 percent of its re-exports to China, 23 percent of its bank deposits, 21 percent of its insurance premium revenues, 22 percent of its freight shipments, 50 percent of travel business to China, 12 percent of construction projects and 5 percent of the total value of investment in the stock market. A look at the financial statements of Chinese companies for the first half of 1995 reveals that performance had slumped across the board due to the economic retrenchment policy in China. Reflecting this, Chinese-related shares, in particular "H shares" (shares of Chinese companies listed on the Hong Kong markets), tumbled. Hong Kong is now very vulnerable to not only political, but also economic trends in China.

Economic integration with China appears in the fluctuations of Chinese business and the growing number of people employed in Chinese businesses. Consequently, the industrial structure of Hong Kong has also changed tremendously. A look

Fig. 2. Trade among Hong Kong, China, and Third Countries (1995)

(Unit: HK\$ billion)

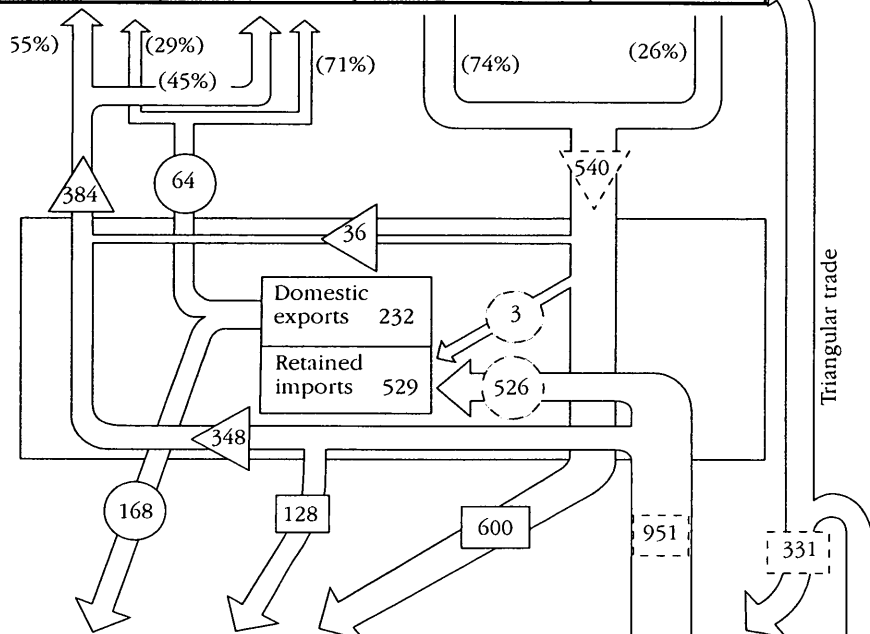
China

(China's balance of trade with Hong Kong:
 $540 - (384 + 64) = 92$)

Total exports (Hong Kong → China)				Total imports (China → Hong Kong)			
448				540			
Others (66)	Guang-dong [163]	Oth-ers (11)	Guangdong (208)	Guangdong (381)	Oth-ers (20)	Guang-dong [92]	Others [47]
Domestic consumption (229)		Consignment processing production (219)		Consignment processing production (401)		Domestic production (139)	

Hong Kong

(Hong Kong's trade balance:
 $1344 - 1491 = -147$)



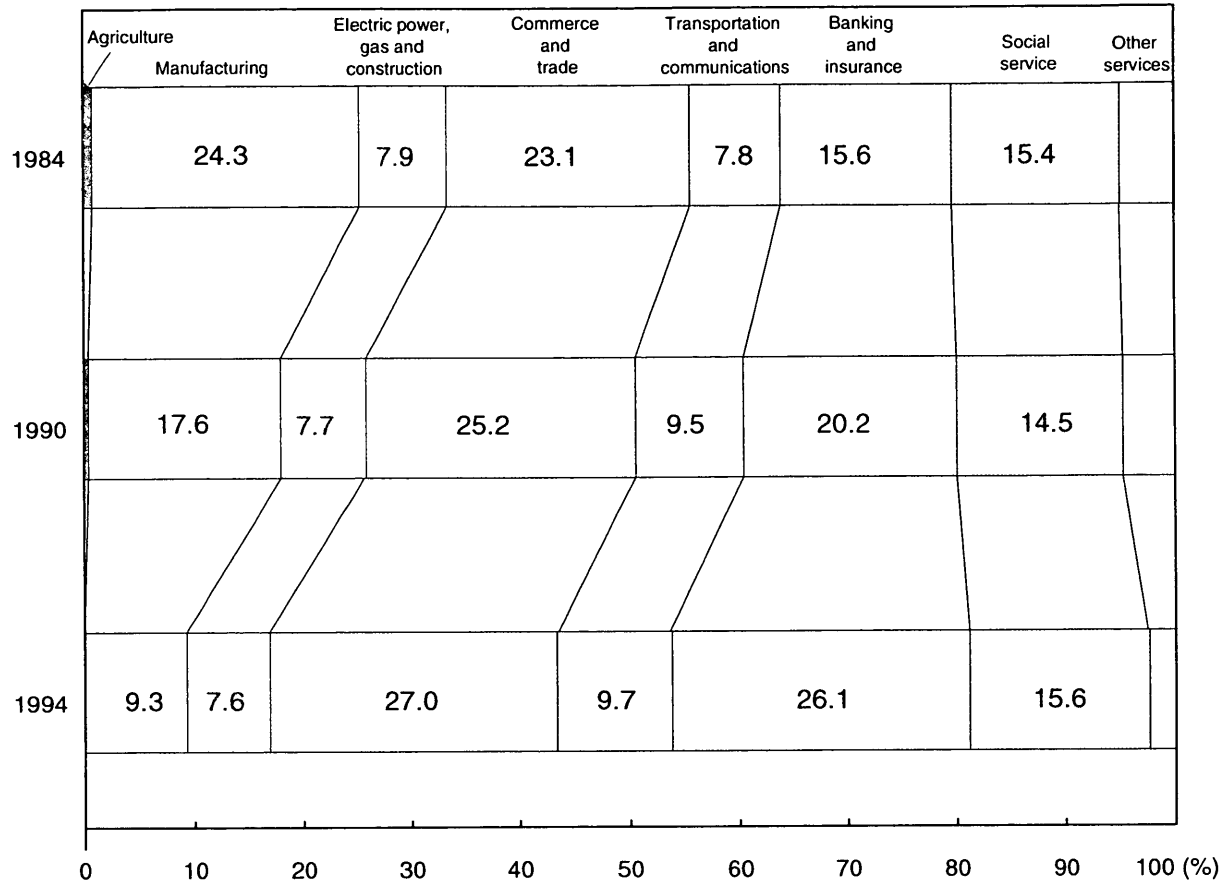
Third countries

(Entire world excluding China)
 (World trade balance with Hong Kong:
 $951 - (168 + 128 + 600) = 55$)

Local exports 168		Re-exports 728		West etc. 338	Asia/Oceania 613
West etc. 115	Asia/Oceania 53	West etc. 498	Asia/Oceania 230		
Total exports 896				Total imports 952	
(Hong Kong → Third countries)				(Third countries → Hong Kong)	

- Notes:
1. Percentages in parentheses () are findings of the field survey by Hong Kong Census and Statistics Department, while figures in parentheses are estimated values thereof.
 2. Figures in brackets [] are estimates using the share of Guangdong in trade of China as a whole with Hong Kong.
 3. Estimates based on the survey of Hong Kong Trade Development Council conducted in 1991.
 4. Based on findings of the survey by Census and Statistics Department (1994), a margin of 18.64 percent was added to re-exports from China through Hong Kong and 11.93 percent to re-exports from third countries through Hong Kong.

- Sources:
1. Census and Statistics Department, "Hong Kong Annual Digest of Statistics 1995," April 1996, Hong Kong.
 2. Census and Statistics Department, "Estimates of Gross Domestic Product 1961-1995," March 1996, Hong Kong.
 3. Hong Kong Trade Development Council, "Survey on Hong Kong Domestic Exports, Re-exports and Triangular Trade," 1992, Hong Kong.
 4. Zhongguo Tongji Nianjian (China Statistics Yearly) 1995.

Fig. 3. Trends in Industrial Structure: 1984 to 1994

Source: Same as Fig. 1

over the 10 years from 1984 to 1994 reveals that manufacturing has retreated considerably in Hong Kong and has been replaced by trade, banking and insurance (see Fig. 3). In 1984, manufacturing accounted for 24 percent of the nominal GDP, but fell to 18 percent in 1990 and to single-digits, 9 percent, in 1994. The decline in manufacturing is even more evident when the number of workers employed is considered. In 1984, 899,000 workers were employed in manufacturing activities. By 1994, this had dropped to 376,000. In the past 10 years, over half a million workers have in fact left manufacturing for other industries. Conversely, commerce and trade as well as banking and insurance, rose from 23 to 27 percent and from 16 to 26 percent of the GDP between 1984 and 1994, with the number of workers climbing from 574,000 to 1.018 million in commerce and trade and from 170,000 to 378,000 in banking and insurance.⁶

Hong Kong is not waiting for transition of sovereignty in 1997. It is currently changing from an independent economy reliant on manufacturing to a service economy reliant on China.

Shaky Position as Base for China Business

Considering the close economic relations between Hong Kong and China, it is natural that trends on the mainland have a major effect on the economy of the enclave. The recent slump in the Hong Kong economy, however, cannot be explained that simply. While masked by China's economic austerity program, the role of Hong Kong as a base for doing business in China, a role which has sustained the economy to date, is being threatened by China's striking economic growth, recent

changes in its policies regarding foreign investment and the rising costs in the enclave economy – an economy on par with developed countries.

More specifically, the diversification of trade channels in China had resulted in slower growth in entrepot trade. Until the 1980s, direct investment from foreign corporations had been concentrated in the China's southern region adjoining Hong Kong. Further, due to poor ports and other infrastructure in the coastal areas of China, most trade was funneled through Guangdong and Hong Kong. In the 1990s, however, China increased the pace of reform and opening to the outside world and made improvements in its investment environment leading to a dispersion of foreign direct investment and

trade throughout the country. Accordingly, there has been sluggish growth since 1992 in China-related re-exports through Hong Kong, exports of Chinese products through Hong Kong and re-exports from other countries to China through Hong Kong.

Table 2 illustrates the trends in exports obtained by adjusting Hong Kong export statistics, comprised of domestic exports and re-exports, according to actual economic activities. That is, over half of the value of re-exports in Hong Kong statistics is products made by consignment processing by Hong Kong manufacturers in China. This constitutes exports of products contracted out by Hong Kong manufacturers to adjoining Guangdong

Table 2. Trends in Exports and Entrepot Trade by Hong Kong Manufacturers: 1978 to 1995

(Unit: 100HK\$, %)

	Exports of Hong Kong manufacturers (A+B)	Local exports (A)	Exports of consignment processing products (B)	Entrepot trade (C+D)	China-related re-exports (C)	Other re-exports (D)
1978	40,700 <75.5%>	40,700 (100.0%)	0 (0.0%)	13,200 <24.5%>	3,868 (29.3%)	9,332 (70.7%)
1991	411,189 <63.2%>	189,426 (46.1%)	221,763 (53.9%)	239,179 <36.8%>	156,931 (65.6%)	82,248 (34.4%)
1992	488,428 <62.5%>	188,087 (38.5%)	300,341 (61.5%)	292,496 <37.5%>	197,349 (67.5%)	95,147 (32.5%)
1993	541,489 <61.3%>	176,135 (32.5%)	365,354 (67.5%)	342,280 <38.7%>	245,787 (71.8%)	96,493 (28.2%)
1994	603,957 <61.2%>	178,532 (29.6%)	425,425 (70.4%)	382,708 <38.8%>	276,434 (72.2%)	106,274 (27.8%)
1995	679,698 <60.5%>	186,279 (27.4%)	493,419 (72.6%)	444,695 <39.5%>	316,535 (71.2%)	128,160 (28.8%)
(Rate of increase over previous year)						
1978-91	19.5%	12.6%	—	25.0%	33.0%	18.2%
1992	18.8%	-0.7%	35.4%	22.3%	25.8%	15.7%
1993	10.9%	-6.4%	21.6%	17.0%	24.5%	1.4%
1994	11.5%	1.4%	16.4%	11.8%	12.5%	10.1%
1995	12.5%	4.3%	16.0%	16.2%	14.5%	20.6%

- Notes: 1. Re-exports of consignment processing products produced by Hong Kong companies in China included in exports of local manufacturers for adjustment of Hong Kong export statistics. Namely,
(Exports of Hong Kong manufacturers) = (Domestic exports) - (Domestic exports for consignment processing production) + (Re-export of consignment processing production in China)
(Entrepot trade) = (Re-exports) - (Re-exports of consignment processing production in China) - (Re-exports for consignment processing production)
2. Percents in parentheses below export figures represent shares. Figures in triangular brackets < >, however, represent shares of exports of domestic manufacturers and entrepot trade in total exports, while figures in parentheses () represent shares of items in export of Hong Kong manufacturers or entrepot trade.

Source: Prepared from yearly editions of Census and Statistics Department, "Annual Review of Hong Kong External Trade."

plants. It clearly differs in nature from re-export through Hong Kong of products consumed domestically or produced domestically in China, namely, entrepot trade. The re-export of consignment processing products differs in that products are made in Guangdong rather than Hong Kong, but are similar in nature to domestic exports in the sense of being exports by Hong Kong manufacturers. Accordingly, Table 2 adjusts the Hong Kong export statistics, dividing them into exports by local Hong Kong manufacturers and entrepot trade. It further divides the exports by local manufacturers into domestic exports and exports of consignment processing products, and divides entrepot trade into China-related and other trade.

Viewing this table, entrepot trade, in particular China-related re-exports, has slowed in growth since 1994. Having grown by an average annual roughly 20 percent until 1993, China-related re-exports increased by only 12.5 percent in 1994 and 14.5 percent in 1995. Comparing this with the rate of increase in Chinese trade (on a U.S. dollar basis), an average 17.5 percent for 1978 to 1991, 22.0 percent in 1992, 18.2 percent in 1993, 21.0 percent in 1994 and 18.7 percent in 1995, China-related re-exports exceeded overall China trade in terms of the growth rate until 1993, but subsequently dropped considerably below overall trade. Accordingly, the slow pace of growth in entrepot trade since 1994 was not due only to China's economic retrenchment, but was affected by greater competition for Chinese business accompanying diversification of channels for trade with China.

The recent slowing in growth in not only domestic exports, but also consignment processing production by Hong Kong manufacturers in China is more serious for the Hong Kong economy. Hong Kong businesses rapidly increased their consignment processing production in China in the late 1980s to circumvent the higher costs accompanying inflation. As a result, manufacturing activities within Hong Kong itself have been atrophying as discussed in the previous section. Domestic exports also leveled out in 1988. In their place, re-exports of consignment processing products have rapidly risen. The share of exports of consignment processing products in all exports by Hong Kong manufacturers rose as high as 73 percent in 1995. In so far as consignment processing production is considered

from the value of exports, growth began slowing in 1994, which may be understood from Table 2 as well.

The retraction of incentives offered by China to foreign investments and the speed in which Chinese companies are catching up are reasons for this. The change in policy to treat foreign investments the same as domestic enterprises means that incentives provided to date will be successively eliminated. Chinese companies are therefore finding it less and less advantageous to connect with Hong Kong businesses. Accordingly, some of the Chinese enterprises which concluded joint venture agreements with Hong Kong firms in the early 1980s, and are now generating sufficient profits and operating well on their own, have been declining renewal of these agreements upon the expiration of the 10 or 15 year terms of the ventures and have been dumping their Hong Kong partners.⁷ Further, some of the Chinese enterprises which had performed consignment processing for Hong Kong firms have acquired production, management, and sales knowledge in the 10 or more years of their association and have decided to go into business for themselves. Cases are now beginning to appear in which partners of Hong Kong firms refuse to do further consignment processing production, another factor behind the slower growth of consignment processing production.

The fact that consignment processing production, the survival strategy of Hong Kong manufacturers, has reached a turning point is inevitable considering the labor-intensive processing and assembly work involved. This will have a large future impact on the Hong Kong economy, however. First, added value remaining in the Hong Kong region will decline. The consignment processing business is designed to make use of the inexpensive, well-trained Chinese labor force. For this reason alone, Hong Kong's losses will be extremely large. Second, the shift of Hong Kong's trade structure from consignment processing production to entrepot trade makes the Hong Kong economy more vulnerable to the economic weight of China.

Another sign of the endangered position of Hong Kong as a base for doing business with China, in addition to the slower growth of consignment processing trade, is the leveling out of the profit margin obtained from such trade. A survey by the Hong Kong authorities found that the gross profit margin obtained from Chinese re-exports, includ-

ing consignment processing and entrepot trade, rose from the 11.5 percent in 1989 to 26.1 percent in 1993, but edged down to 24.9 percent in 1994. The gross profit margin obtained from re-exports with partners other than China fell from the 10.3 percent of 1989 to 5.7 percent in 1994. Even viewing re-exports as a whole, profit margins had risen since 1989, but began declining in 1994.⁸

Chinese factors, such as inflation, the somewhat firmer Chinese rmb and fiercer competition with neighboring countries may be mentioned as factors behind the decline in the gross profit margins in 1994. The recently soaring personnel costs and real estate rents in Hong Kong have also had a major impact, however. Hong Kong firms are working to cut down on labor costs and have recently started moving not only their production plants, but even their administrative offices elsewhere so as to reduce spending. They are fully occupied simply maintaining sales and profit margins at their current levels.⁹ In addition, there are a substantial number of upward cost factors in the future Hong Kong economy. The Hong Kong economy has already reached the level of developed countries, and there have been corresponding mounting demands for democratization of the political process. How long will Hong Kong be able to maintain its most attractive features, the inexpensive charges for infrastructure and low tax rates, which have supported it to date? This is also a serious issue when considering the future of Hong Kong.

Issues Facing Hong Kong Economy

When considering the Hong Kong economy after its return, attention tends to be drawn to the transition to the Chinese system, but the issues facing Hong Kong reside rather in the enclave's economy itself. It is true that the free economic and trade system and cheap, efficient infrastructure, which have made Hong Kong's prosperity to date possible will be somewhat spoiled by the transition to the Chinese system and that the uniquely Hong Kong "efficiency," "fairness," "openness" and "decisiveness" will be hampered. Before going into this, however, the Hong Kong economy has already begun to lose its footing as it approaches return, and its role as a base for business with China, which provides the underpinnings for the Hong Kong economy, has already been threatened.

Fortunately, Hong Kong still maintains an unshakable position as an international financial center. The Hong Kong government established the "Hong Kong Monetary Authority" in 1993 to reinforce the enclave's functions as an international center of finance. This worked to stabilize the currency, ensure the safety and stability of the banking system, promote a more streamlined and sound banking system and improve Hong Kong's position as an international banking center. Further, since Hong Kong and China will be one country following its return, some people will view Shanghai as a rival, but it will probably take Shanghai at least 10 to 20 years to catch up with Hong Kong. Accordingly, Hong Kong must decide on its future while it still maintains an unshakable position as an international financial center, and devise measures for dealing with the mounting problems it faces.

First, it is necessary to further improve the infrastructure, namely the port, airport and communications system, both in terms of knowledge and hardware. The authorities announced in October 1989 a large-scale project called the "Port and Airport Development Strategy (PADS)" which is currently underway. There was a fight between China and the U.K. over funding at the time of the announcement, but work will hopefully begin as early as possible. Numerous similar infrastructural development projects are underway in the Pearl River delta, however, so competition will become fiercer in the future. Accordingly, more knowledge in areas of improving efficiency and holding costs down will become increasingly important.

The second issue is the development of human resources. A look at the Hong Kong economy as it now stands reveals inappropriateness of labor due to the speed of the structural changes. Hong Kong will not only have to develop human resources for handling the increased emphasis in its economy on services, but will also have to develop high-quality human resources enabling it to be competitive with nearby countries. The authorities have been increasing the number of universities and their student enrollments and have been offering various types of training through the Vocational Training Council and Employment Retraining Council. Many problems, such as how to educate the average daily influx of 150 Chinese nationals and how to deal with the recently declining English language abilities of the population, remain, however.

The third issue is the revitalization of Hong Kong manufacturing activities, including consignment processing. While the manufacturing's share in the Hong Kong GDP and number of workers has fallen, manufacturing, when consignment processing production is included, still plays a major part in the Hong Kong economy, as is clear from Table 2.¹⁰ Accordingly, it is necessary to either encourage more sophisticated manufacturing activities in Hong Kong or aim at becoming a R&D base for Guangdong and the rest of China southern region which is now evolving into a huge manufacturing base in its own right. The Hong Kong authorities are well aware of this situation, having established investment-related organizations for the manufacturing sector and strengthening the role of the Industry and Technology Development Council, the advisory organization for formulation of industrial assistance programs, to deal with the gutting of the manufacturing sector. They are much more aggressive in doing this than in the past, implementing, for example, an "Industrial Support Fund" aimed at technical development through R&D and the training of human resources in 1994. In whichever case, ending the collapse of the manufacturing sector will require measures encompassing Guangdong and the rest of the hinterlands as well.

As previously explained, the Hong Kong economy is facing problems of an unprecedented severity. No place in Asia, however, enjoys advantages in every regard. It would be meaningless for Hong Kong, which has surpassed even the U.K. with a per capita GDP of US\$23,000, to try to compete with Shanghai, Manila or Bangkok in costs. The

issue is whether it can provide a level of services warranting its higher costs. The "quality" of the economy, therefore, will be questioned most.

Notes:

- 1 For more details, see Mariko Watanabe, "Henkan o Hikaete – Saikin no Hong Kong Keizai" (On the Brink of Return – The Recent State of the Hong Kong Economy), *Journal of the Japan-China Association for Economy and Trade*, March 1996.
- 2 For the importance of the effect of changes on trade terms on real gross domestic income, see "The Deterioration in Hong Kong's Terms of Trade and its Impact on Real Income," *Hong Kong Economic Indicators*, August 1995, Standard Chartered Bank.
- 3 Census and Statistics Department, "Estimates of Gross Domestic Product 1961-1995," March 1996, Hong Kong, pp. 86 and 87.
- 4 For more details, see *Xinbao*, April 24, 1996 and Hong Kong Trade Development Council, "Survey on Hong Kong Domestic Exports, Re-exports and Triangular Trade," 1992, Hong Kong.
- 5 *Xinbao*, March 17, 1996.
- 6 For trends in the number of workers in different industrial sectors, see Census and Statistics Department, "Hong Kong Monthly Digest of Statistics."
- 7 *Xinbao*, April 24, 1996.
- 8 *Xinbao*, February 29, 1996. See also pp. 72 and 73 of (Note 3).
- 9 See "Rationalization of the Services Industries," *Hang Seng Economic Monthly*, August 1995, Hang Seng Bank Limited.
- 10 See "An Analysis of Hong Kong – China Trade," *Hong Kong Economic Indicators*, April 1994, Standard Chartered Bank.