

Antony Leung's economic vision: another important milestone in HK's strategic re-positioning

Executive summary

- Most east Asian economies suffered badly after the Asian crisis. Restructuring and strategic re-positioning are important themes for every economy.
- In Hong Kong, it was not clear to many people why the Special Administrative Region (SAR) did not prosper in the past few years when China developed fast, in sharp contrast to what happened during the 1980s and 1990s. Some people just take it for granted that HK's future is doomed now that China needs HK a lot less than HK needs China. Some people just blamed the currency peg. Some businessmen and some officials also ventured out in different directions (reviving industrial base? technology/IT? Chinese medicine? ...) in a desperate attempt to look for a new future.
- In the past two years or so, HK is gradually coming to grasp with what the key problems of the SAR are. Antony Leung's economic vision for Hong Kong outlined in his Budget address is distilled from the collective wisdom of many people who debated at length over the past few years where Hong Kong's future lies.
- **HK must promote a more smooth flow of people, goods, capital, information and services between HK and the Mainland. To achieve this, the border between the SAR and the Mainland must be made more porous, and this means that more liberalization from the Mainland is called for.** The "gortex" border (allowing flows in one direction much more than in the opposite direction) has been a main problem for HK in recent years.
- The HK government has already been working on a number of fronts in this direction. Some of these efforts are beginning to bear fruit, eg. quotas on group tourists from the Mainland to HK have been eliminated, the validity of business visas for Mainlanders coming to HK has been extended to 3 years, and HK's proposals of channeling money from the Mainland to invest in stocks listed in HK (what is called the QDII scheme) and for the setting up of a Closer Economic Partnership Arrangement have been given a very favourable response from Beijing.
- Recently, the Central Government has become a lot more proactive in working with HK to deal with the obstacles that impede economic integration.

Antony Leung's economic vision for Hong Kong

In his Budget delivered on March 8, 2002, Antony Leung laid down his economic vision for the HKSAR. This vision is not just his ingenious ideas coming out of nowhere. It epitomizes the results of a long soul-searching process by the elite in HK. This vision represents in my view another important milestone in HK's strategic re-positioning.

The first major milestone in HK's re-positioning was the decision to launch a new logo featuring a flying dragon (instead of the old Chinese junk) and to position the territory as "Asia's World City" in 1999/2000. That re-branding exercise was also the result of much discussion/debate about HK's future. Developments in the last few years have enriched this vision, and Leung's version has therefore a lot more detail.

Strategic ideas may sound like meaningless slogans to some people. But in the aftermath of the Asian crisis and in the face of rapid global change, the long-term prospects of many Asian economies have been questioned. Finding a new niche and developing a new strategy for the economy have been an urgent and important job for the elite of many economies in the region. Some economists came up with ideas that Asia could no longer rely on export-led growth and must grow its consumer demand. Singapore, for instance, came up with the vision of lifting the island republic out of its geography and go global. In the case of HK, the debate on such a strategic re-positioning also evolved in the past few years.

Leung's economic vision for Hong Kong could be summarized into a few key ideas:

Moving up the value chain

- There is no way HK could compete with its neighbours by cutting costs alone. To justify its significantly higher level of costs, HK must keep on improving value added
- Technology and IT are not the only way to improve value added (this is in sharp contrast to the weight given by the government a few years ago to technology/IT, Cyberport, GEM, etc.)
- Value added in HK's context often comes from improving **quality**, **speed** or/and **innovation** in whatever the territory does well

Fostering economic flows between HK and its hinterland

- As a regional financial and commercial centre, HK must maintain a smooth flow in both directions of economic activity with its neighbouring areas, in particular the Mainland
- HK's interaction with other economies generally proceeds smoothly. With the Mainland, however, the flows, in particular those of people, goods, capital, information and services, still need improvement.
- To address this issue, the "gortex" border between HK and the Mainland (allowing flows in one way but not the other) must be made more porous.

This is an extremely important point. HK prospered in the past as China grew and modernized. But in recent years, it was not clear why HK seems to be suffering as the Mainland appears to have become more competitive than complementary. Many people just take it for granted that HK's good old days are gone. But such a phenomenon is counter-intuitive. Yet it took a long time for the elite in HK to understand that the "gortex" border is the problem, and that the restrictions on the interflow of economic relations (particularly those imposed by the authorities in the Mainland) must be addressed in the next stage of China's development. A lot more efforts were then put into this direction in the past two years, and some of them are beginning to bear fruit. Unfortunately, the importance of this conceptual point is not yet fully understood by many people, including some senior government officials. More on this point below.

Four major strategic sectors to focus on

- Financial services
- Tourism
- Logistics
- Professional and business services

The debate about HK's future in the past few years has taken many twists and turns. There was a time when some people argued forcefully that HK should rebuild its manufacturing industries in order to create employment for the large numbers of people who could not upgrade themselves. There was also a time when some wanted HK to make itself the center for a long list of activities, including a major trading hub for flowers and for red wine. Over time, however, the consensus that has evolved is that HK should focus on a few strategic niches. Note again that technology/IT is not specifically on the list, nor are concepts such as Chinese medicine, entertainment, or creative arts. Not that these activities should not be supported, but that they are not the core strategic issues HK should be focusing its attention.

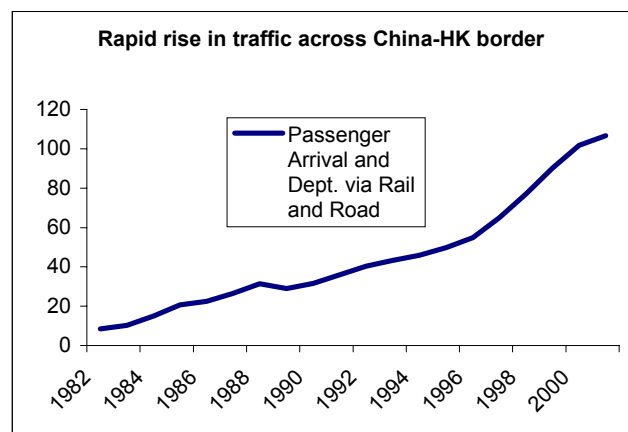
The “gortex” border problem and what has been done

China is changing fast and HK's old mode of cooperation with the Mainland is challenged

- HK was instrumental in China's opening up and modernization in the 1980s and 1990s, and benefited in turn in the process. But things are changing fast.
- China's industrialization has got to the point where the industries China needs more are playing into the strengths of the multinationals in the US, Europe or Japan, rather than investors from HK.
- MNCs are going into China direct without using HK as much as in the past.
- China's domestic market has grown to such an extent that more and more investors are focusing on China as a market – HK's middleman role is decreasing in relative importance
- China is no longer as dependent as in the past on HK as a source of foreign capital or foreign currency earnings.
- China is also becoming less dependent on HK as a trading hub. Indeed, the rapid emergence of Shenzhen's ports is threatening the growth in HK's port status.
- After the relocation of manufacturing into the Mainland, more and more services activities in HK are also relocating into China in recent years.
- Consumers in HK are also taking advantage of the low costs in southern China, going into the Mainland increasingly for their holidays and for their shopping.

As China grows, there are actually a lot more business opportunities for HK. However, the border between HK and the Mainland has been like a “gortex” – allowing flows from HK into the Mainland much more than in the other direction. To capture new business opportunities, HK needs to work with the authorities in the Mainland to unblock the obstacles.

- As people in the Mainland become more affluent, the demand for tourist travel to HK has grown rapidly. However, for a long time, people in the Mainland have to go through various approval and bureaucratic procedures in order to travel, and these procedures are often expensive and time consuming. In the past few years, the government and the tourist operators in HK have been working with their counterparts in the Mainland to facilitate more tourists coming to HK. The latest significant



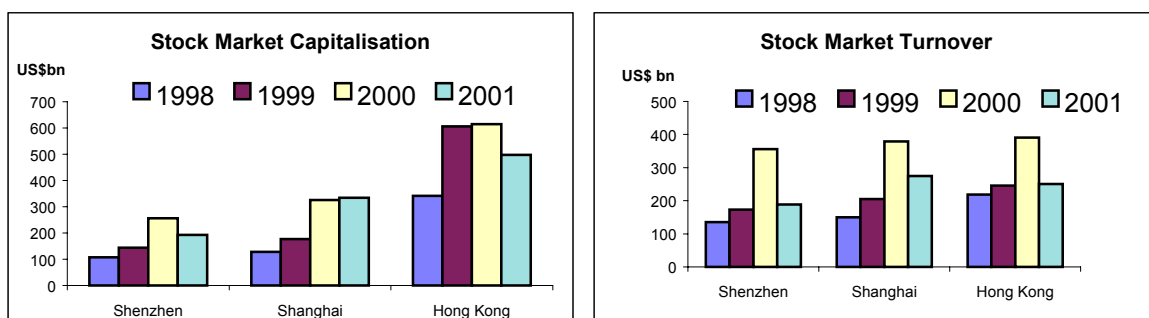
breakthrough is the abolition of quotas on group tourist travel to HK. Tourists from the Mainland are now the largest source of tourists for HK and are growing rapidly in the past decade. In 2001, some 4 mn Mainlanders visited HK, and they are on average the biggest spenders amongst visitors from various sources.

- As China grows, more and more businessmen in the Mainland want to come to HK to do business with the outside world. Indeed, to make HK a vibrant business center for China, businessmen and professionals from various parts of China must be able to travel to HK easily. Unfortunately, business travel to HK was subject to various restrictions and approval procedures. For a long time, it was easier and quicker to get approval for a businessman to go to Thailand than to come to HK. Again, the authorities in HK have been working with their counterpart in the Mainland to iron out as far as possible the restrictions on business travel. The latest breakthrough is the agreement by the Mainland authorities to issue business visa to business travelers to HK, which are valid for 3 years.
- For a long time, China needed foreign exchange earnings and capital inflows, and HK served as a source and as a conduit for such foreign capital. Today, however, China has a lot of foreign currency reserves and also a large pool of domestic savings. China's main problem is no longer how to attract more capital, but how to deploy its capital more efficiently. To the financial markets in HK, there are much more opportunity arising from how to help China allocate its capital efficiently than to channel more capital into China. However, foreign exchange control and capital flow restrictions in China are preventing the financial markets in HK to play such a function. HK has put forward various ideas to the central government to enable more cooperation between HK and the Mainland in this direction. These ideas include (a) managing more of China's foreign exchange reserves in HK, (b) managing more of the Chinese banks' foreign currency assets in HK, (c) allowing people in the Mainland to invest in stocks in HK through close-end funds (or what is often referred to as a QDII arrangement), (d) allowing firms from HK with investments in the Mainland to issue Chinese Depository Receipts in China's stock markets. Some of these ideas are now taken forward positively. Recently, Governor Dai of the PBOC indicated that the central bank has no problem with the QDII idea. He also put forward the idea earlier that banks in HK may be allowed to offer deposits in RMB.
- As China grows, opportunities in many services sector play into the strength of HK's investors. However, the pace of liberalization in many services sector has been much slower than desired. Opening up business opportunities for the services sector in HK has been one of the key initiatives of the HK government. In the area of legal services, for example, a lot of progress has been made by Ms Elsie Leung in opening doors in the Mainland for HK's legal professionals.
- To enable further economic integration between HK and southern China, a lot of work has been put into enhancing the efficiency of border controls, both on the flow of people and the flow of goods. Various infrastructure works are in train – the more important ones include a new passenger border crossing via the Lok Ma Chau Railway Spur Line, and the new Shenzhen West Corridor highway (which will have twice the capacity of all the existing land crossings combined), both of which should be commissioned within the next 5 years. The idea of building a high-speed train between HK and Guangzhou is now actively pursued.
- HK raised the idea with Beijing that a free trade area be set up between HK and China in their capacity as WTO members. The idea has got the blessing at the most senior level in Beijing and has evolved into a discussion about setting up a Closer Economic Partnership Agreement (CEPA).

- Apart from the movement of goods, capital and services, HK also needs to remove the restrictions on the movement of professionals. HK should be able to attract the best and brightest from all over China to work in HK if it wants to function as the business and financial center of China. Today, HK is open to businessmen and professionals from the rest of the world to come and work in HK. But there are various restrictions, both from the Mainland and from HK, to prevent the professionals from the Mainland to come to HK. There is some sensitivity in this subject, as professional bodies worldwide tend to be rather protectionist. Mr Tung has recently raised the idea of a population policy. It could be expected that HK would gradually move in this direction.

HK's potential as a financial centre

There was a time when the rapid growth in the stock markets in Shanghai and in Shenzhen led many people to question HK's future as a financial center. However, such views have quietly disappeared as major problems in Mainland China's stock markets (false company accounts, lack of transparency, administrative interference, very immature investors with strong casino mentality, etc.) revealed themselves in the past year. Indeed, it is becoming increasingly clear that the Shanghai and Shenzhen stock markets are still very immature and will take a long time before they could function as efficient capital markets.

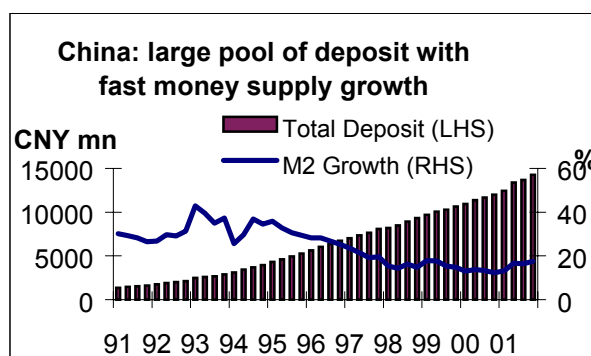


Meanwhile, despite talks about banking reform for the past 2 decades, China's banks have yet to live up to what is expected of them.

There is a huge pool of savings in China that is looking for a home. Money supply growth averaged 20% a year in the past 2 decades. This rapid increase in personal savings threatens to ignite inflation during the early 1990s. In recent years, such rapid growth in savings threatens to produce financial bubbles. The authorities in Beijing are aware of the potential dangers to social stability if financial market risks are not well managed.

There is therefore a lot of potential for the financial markets in HK to help China manage the country's financial resources and risks. But to achieve this, the flow of funds between HK and the Mainland has to be liberalized gradually and managed well.

At the same time, however, HK will probably have to pay a price in terms of having to manage the increased volatility spilled over from the Mainland to HK.



HK's efforts to develop tourism

HK used to be a shoppers' paradise, a gateway to China, and a place where the east meets the west. In comparison with many other economies, the territory did not need to do very much to promote itself, and before 1997, HK used to be one of the top 10 tourist destinations of the world (although HK is just a small city).

But times have changed. Instead of a shoppers' paradise, HK is more known for being an expensive city. Its China gateway function was also gradually undermined when China opens up to the outside world. The sudden downturn in tourist arrivals after the Asian crisis shattered the wishful thinking of many tourist operators. Many people knew that the days when tourists would automatically want to come are gone.

What followed was an intensive debate as to what HK should do to promote itself to the world. There was also a deep self-criticism process highlighting the drawbacks HK must work at. A long list of changes then ensued, some are already bearing fruit and a lot more will be coming on stream in the next few years. These include:

- Efforts to promote a much more tourist-friendly environment – from cleaning up the toilets to various education programme fostering a customer-friendly service mentality; from planting more trees in tourist spots to the promotion of alfresco dining in places like Stanley; from redeveloping Tsimshatsui east into a more tourist-friendly place to a fundamental rethinking about how the water-front promenades along the long stretches of HK island and Kowloon could be better developed; etc.
- Development of tourist attractions: Apart from Disneyland, there are plans for theme parks on Ma Wan Island, the re-development of Aberdeen into a fisherman's wharf type of tourist attraction, a cable car linking Ngong Ping with Tung Chung, etc.
- Events promotion: the Rugby Seven has already become an international event; the Christmas & New Year Lights, and the Chinese New Year Parade and fireworks, have already become popular events; but the Dragon Boat racing could be improved; and the Standard Chartered Marathon has the potential to become at least an Asian event
- Eco-tourism and historic sites: a lot more efforts are being put into the preservation of local history and local ecology, some of these would become good tourist attractions for specific tourist groups
- Efforts were directed at streamlining the restrictions on tourists coming to HK. The latest significant breakthrough is the abolition of quotas on group tourist travel to HK. An iPermit electronic visa for Taiwanese visitors is also introduced.
- Efforts by tourist operators to promote HK together with attractions in the Pearl River Delta region to outside tourists

The importance of tourism to HK should not be underestimated. In 2000, the small city of HK ranked 15th in the world's top tourist destinations. The visitors brought in a total of around US\$7.2 bn (HK\$64.3 bn) in spending, an equivalent of 8.7% of total private consumption expenditure.

Logistics and the distribution chain

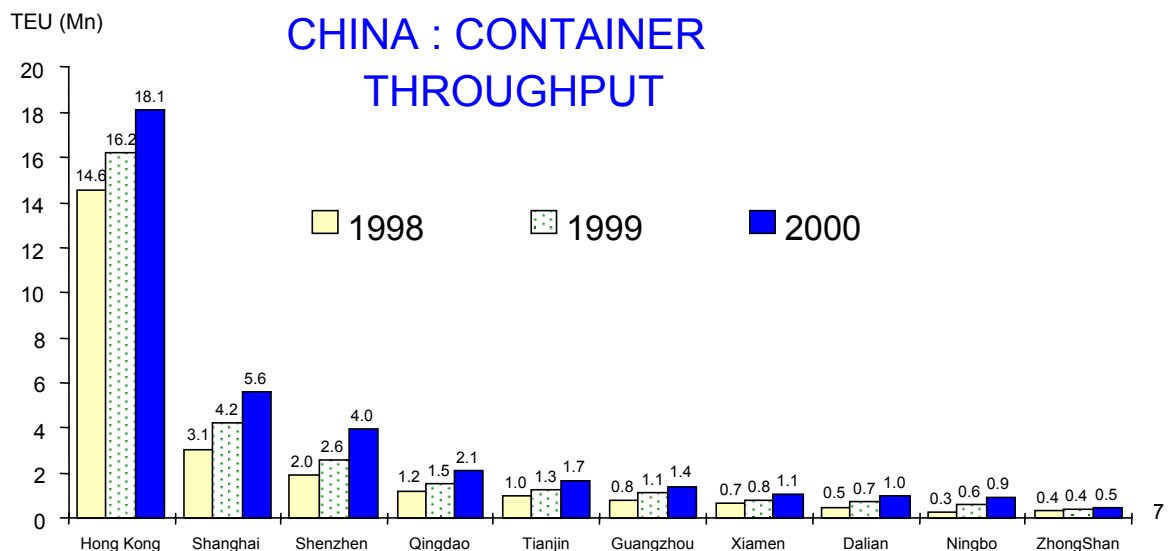
Manufacturing, trading and distribution are increasingly linked up by various distribution chains. Value creation comes from improving the efficiency of such distribution chains. Competition is increasingly no longer a competition between one player versus another player in any particular segment within this distribution chain, but between one distribution chain and another.

Trading and the movement of goods remain a major bread and butter business for HK. While many people argue that HK's port would lose out to much cheaper ports in other parts of China, the fact is quite different.

The World's Top 15 Tourist Revenue Generating Economies

<u>2000</u>		<u>Revenue</u> (US\$ Mn)
1	US	74,448
2	Spain	32,913
3	France	31,699
4	Italy	28,357
5	UK	20,972
6	Germany	16,828
7	China	14,098
8	Austria	11,088
9	Canada	10,025
10	Greece	8,765
11	Russia	7,771
12	Australia	7,525
13	Switzerland	7,355
14	Mexico	7,223
15	Hong Kong	7,210

Strategically, HK's position as a deep-water port in southern China is not going to be easily rivaled. HK is the largest port in China and shall remain so for many years to come. The next biggest port, Shanghai, has a container throughput less than 1/3 that of HK. The ports in Shenzhen are more serious competitors with HK. But HK has continued to grow in the past despite the rapid growth in Yantian, the main port in Shenzhen. While Yantian has certainly the potential to continue growing fast in the coming years, HK has a special niche over Yantian in that it is strategically better positioned at the mouth of the Pearl River, which enables HK to capture much of the cargo flowing down the Pearl River. Indeed, river cargo has been one of the fastest growing source of cargo for HK in recent years. But there is a lot to be done by the industry and the authorities concerned in HK to sort out how to maximize the efficiency of the river trade cargo business



Another major strategic initiative HK is working on in the field of logistics is how to leverage on the strength of HK's airport. Increasingly, more and more trade will be carried out by air, particularly for those time-sensitive and expensive items. Today, more than 20% of HK's trade by value is carried out by air. HK's Chek Lap Kok airport has more international flights than all the other airports in China added together. Some preliminary thinking is to link up the airport in HK directly with ports and airports in different parts of China so as to achieve a more efficient distribution network.

Longer term, a better use of railway to link up HK with the interior parts of China will be a possibility. But it is early days.

The whole business of logistics is going to evolve gradually. The Airport Authority has taken up this business actively under the chairmanship of Mr Victor Fung. The government has also set up a Logistics Council to coordinate efforts in this direction.

Professional and business services

This is another major bread and butter business for HK, and shall remain so as HK continues to grow as a business and financial centre. The main challenge right now for many professional services is how to open up the market in the Mainland. A lot of this is also tied to the development of HK's financial markets.

If one takes a long-term view, HK's strength versus the rest of China lies in its rule of law, protection of property rights including intellectual property, its depth of modern business experience, its global network and its "internationalness". When more and more Chinese companies want to become international players, HK will be an important partner to them. However, in terms of timing, most Chinese companies are focusing their efforts in securing their place in the local market at this stage. The potential of HK in this dimension has therefore yet to be fully tapped.

Another important dimension in this subject area is the fact that HK does not have a large talent pool. For a long time, HK relies on the inflow of expatriates from all over the world, but the territory provides an attractive playing field for the services providers. Now that HK has become an expensive city, the ability of HK to create the unique business opportunities for professionals to operate in HK is even more important. The uniqueness of HK lies in its proximity to and its indepth understanding of China. Opening up business opportunities in the Mainland for the services sectors in HK by some government agencies and professional bodies is an ongoing effort. Allowing more professionals from the Mainland to come and work in HK is also inevitable if HK wants to serve as China's premier business centre.

However, professional bodies worldwide tend to be protectionist, and those in HK and in the Mainland are no exception. Mutual professional recognition between HK and the Mainland is a direction to work towards. But one could expect protectionist sentiments in both HK and the Mainland to be major obstacles in the process.

Conclusion

Hong Kong's strategic re-positioning is becoming more and more obvious. This vision is summarized in Antony Leung's Budget. The SAR could put its efforts in the proper direction and HK's economic prospects are much clearer and brighter. But one should not underestimate the difficulties and obstacles that such efforts will encounter in the process.

The good news is that leaders in Beijing are also coming round to understanding the need to take a different attitude towards the relationship between HK and the Mainland. Premier Zhu Rongji said recently that, "no city in the Mainland could overtake HK in the near term", but that "as the global economy evolves, HK's role should be fine-tuned". Zhu also said that "the Central Government is discussing closely with the officials of the HKSAR to see how the Central Government could help and cooperate with the HKSAR" and that "the Central Government will do all it could if these are beneficial to HK".

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