Beyond the Pearl River Delta

The contest begins

By Edith Terry

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Abbreviations and Acronyms

APEC  Asia Pacific Economic Cooperation
CEPA  Closer Economic Partnership
GPRD  Greater Pearl River Delta
GPRDBC Greater Pearl River Delta Business Council
OBM  Original Brand Manufacturing
OEM  Original Equipment Manufacturing
ODM  Original Design Manufacturing
PPRD  Pan Pearl River Delta
IVS  Individual Visitor Scheme
PRD  Pearl River Delta
SAR  Special Administrative Region
SARS  Severe Acute Respiratory Syndrome
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Source: CB Richard Ellis
Foreword

Hong Kong today seems perpetually on the fast track. This was not always so. Hong Kong before World War II was a distant if convivial outpost of the British Empire, overshadowed by the metropolitan glamour of Shanghai and the bustle of Guangzhou. The postwar period saw Hong Kong emerge as a low-wage manufacturing center, energized by the tens of millions of refugees who poured across the border after the establishment of the People’s Republic in 1949.

In the late 1970s, at a time when China was nearly as shuttered as North Korea is now, a series of events led to a paradigmatic shift so dramatic that few would recognize the Hong Kong of thirty years ago in the Hong Kong of today. High-rise industrial tenements remain, but the teeming factories within, making textiles, molded plastic wares, shoes, and all manner of light consumer products, have long since migrated across the border.

The developments that triggered this exodus were half-hidden – a new joint venture law in China that created so many hurdles that foreign investors and Chinese state enterprises alike were baffled by the complexities; rising costs in Hong Kong; the beginnings of financial liberalization in the United States that would ultimately supply a new core industry for Hong Kong, once the factories had become empty shells. In Beijing, Vice Premier Deng Xiaoping, his star in the ascendant, gave the go-ahead for economic reforms that would set the pattern for the next few decades, in which patchwork change was the central motif.

“Feeling the stones as you cross the river,” and “it makes no difference if a cat is black or white, as long as it catches mice” were the slogans behind an eclectic, cautiously experimental approach to industrial restructuring, in which reforms were tested first in carefully isolated economic zones before being introduced to the broader economy. Three of the first four economic zones that were set up in 1979-80 were in Guangdong Province, the fourth in Fujian Province. Among the first of the economic experiments was to encourage a type of foreign investment that, importantly, would not face the restrictions involved with foreign investment. This was called export processing. Theoretically, goods were simply processed in China for export. In practice, export processing required massive transfer of equipment and know-how. The first entrepreneurs to grasp the significance of the loophole were in nearby Hong Kong. And within a few short years, the factories had emptied out and the industrial transformation of the region of Guangdong closest to Hong Kong – the “Pearl River Delta” – had begun.

The speed and depth of these changes was unexpected, and it was many years before commentators began to write about the Pearl River Delta as one of the world’s great engines of economic growth, based on a winning combination of cheap land and labor and a durable economic partnership between Hong Kong and Guangdong entrepreneurs. If the full scope of change had been anticipated, it might have led to a frenzy of hand wringing and anxiety about Hong Kong’s future. But the changes, though rapid, were invisible enough, and the emerging paradigm so exciting, that Hong Kong barely stopped to ask questions.

Hong Kong and Guangdong are entering a new period of change that, like the late 1970s, is overtaking the region in ways that mindsets have not had the time to catch up. Guangdong, again, is driving change. A ring of cities is emerging in the Pearl River Delta that challenge Hong Kong’s supremacy in core service industries and is beginning to confront Hong Kong’s leadership in the soft, “creative” attributes that lend a city verve and identity – the attractions of a vibrant civic society, arts, and entertainment. Hong Kong’s nearest post-colonial counterpart, once-sleepy Macau, has emerged suddenly as the gambling capital of the region and perhaps the world, by virtue of the breakup of its gambling monopoly in 2003. Hong Kong, for its part, has jumped into
the top tier of global financial markets as a result of a cavalcade of Chinese initial public offerings (IPOs) and secondary market transactions, helped by the chilling of the US market after the passage of the restrictive Sarbanes-Oxley Act in 2002, which vastly increased the cost of accessing US capital markets.

Guangdong’s urban transformation is being helped along by the central and provincial governments – just as was its industrial revolution thirty years ago. The role of market forces in 2008, of course, is much greater than in the centrally planned Chinese economy of 1978. But the Chinese government continues to pursue its own unique version of industrial policy, and in its eleventh Five-Year Plan (2006-2010) it first expressed its first industrial policy designed explicitly for Hong Kong. Not surprisingly, the policy was a subset of policy for Guangdong.

The State Council clearly viewed Hong Kong, Guangdong and Macau as the interwoven strands of a regional economy, in which Hong Kong would serve as a hub for finance while logistics moved to Guangdong and Macau dominated tourism. The plan, or “program” as it was called, seemed to undermine Hong Kong’s role as a multi-dimensional urban conglomerate, the fire-breathing head of the Pearl River Delta’s dragon. But it also elevated Hong Kong’s neighbors, particularly Guangzhou, Shenzhen and Macau.

I first became intrigued by a revision of the post-1978 Pearl River Delta relationships in September 2006, when Victor Fung, group chairman of the Li & Fung group of companies, spoke to members of the Hong Kong Forum, which he also chairs, about the plan and “Hong Kong’s positioning.”

Li & Fung, a venerable Hong Kong company, founded in Guangzhou in 1906, has morphed over the past century from trade brokering for local Guangdong manufacturers to global supply chain management, and monitors pricing and other manufacturing trends closely. Mr. Fung argued that national efforts to boost technological innovation, services and infrastructure investment would have wide-ranging consequences and opportunities for Hong Kong, particularly for companies and businesses focused on the domestic Chinese consumer market.

This was one of many formal and informal, official and unofficial discussions that took place around the same time, focusing on the first of China’s five-year plans to include specific goals for Hong Kong. Socialist planning seems uniquely inappropriate the city. Hong Kong’s economic success has long been tied to the market system, with its free port, strong rule of law, and low tax rate. More striking than Hong Kong’s targets, though, were those for Guangdong, China’s pioneer province since the early days of the reforms.

The nation’s central planners were determined to lift Guangdong into the leagues of the East Asian tigers and dragons. They seemed to be setting their sights first on an economic strategy reminiscent of Thailand and Malaysia in the 1980s, segueing into South Korea in the 1990s. They would use fiscal policy to build heavy industry and export policy to attract high-technology investment, following the Malaysian model. In the auto sector, they would follow the Thai model, inviting foreign multinationals to use the province as a platform for exports. Simultaneously, they would support businesses with the potential to become international brands, the Korean model of the 1990s.

The plan for Guangdong was based on market assumptions, particularly that rising labor and production costs would put more and more pressure on manufacturers to add value through brand and technology, and that the counterpart of rising labor and production costs – consumer spending power – would create new markets for services. But planners were also not averse to using industrial

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1 “China’s Eleventh Five-Year Program – Implications for Doing Business in China (Li & Fung Research Centre, China Distribution and Trading Issue 28, October 2005)
policy to tilt the playing field, so that the same favors once extended to export processing would now be reserved for high-technology investors and exporters. Meanwhile, they would use regulatory levers to force low value-added light industry into the province’s remaining low-wage enclaves, mostly in semi-rural areas well beyond the waterways and established infrastructure of the Delta.

These policies effectively mean the end of an era for Hong Kong-owned and operated export processing in Guangdong. In a province that has 70,000 of China’s 90,000 export processing enterprises, Hong Kong accounts for 45,000, or nearly two-thirds of the total number of export processing enterprises. Some as yet unknown number of businesses will have to migrate or close shop. By mid-January 2008, in advance of the lunar Chinese New Year, according to some estimates as many as two-thirds of Hong Kong entrepreneurs would make the decision to leave.

Said Peter Chai Kwong-wah, president of the Hong Kong Small and Medium Enterprises General Association (www.hksmega.org), in an interview with the South China Morning Post, “Only 30%, those with liquid funds or high technology, can survive and upgrade their business in the delta.” 2 Simon Shi Kai-biu, Chai’s counterpart at the Hong Kong Small and Medium Business Association (www.hksme.org), told the same newspaper that by early February, “hundreds” of his association’s members were in talks to sell industrial properties to Hong Kong developers. “I won’t be surprised to see 10,000 factories in Guangdong fold around the Lunar New Year,” Mr. Shi said, blaming a combination of rising costs and the province’s efforts to build a more sustainable and service-oriented economy. 3

In 2008, China’s eleventh five-year plan has more than halfway run its course. The cities of the Pearl River Delta and Macau are graduating from their status of industrial ghettos and sleepy weekend getaways to become competitors to Hong Kong. This new competition, in theory, is good for Hong Kong, but it exposes many of the city’s weaknesses – its lack of economic integration with the mainland, for one, down to train lines that stop at the border and a 2,800 hectare swathe of territory along the border with Guangdong, that will remain restricted to both populations as well as to development until 2010. 4 The “restricted zone” remains a testament to the psychological divide between Hong Kong and its neighbors more than a decade after its return to China.

Change in the Pearl River Delta comes at a time when Hong Kong is in a palpable malaise, at the beginning of the second decade of its separate administrative status as a Chinese territory. The end of colonialism has been accompanied by a breakdown in a system accustomed to a large dose of dirigisme in addition to free market theology. Instead of the confident, Westminster-backed British colonial government, Hong Kong’s administrators have fallen into a pattern of government by consultation, with no apparent ability to implement fast-track measures to support specific sectors.

The endless debate over Hong Kong’s air pollution is just one example of the problem. Despite wide consensus over both the causes of Hong Kong’s smog and measures needed to address it, one consultation after another has been conducted on even the most anodyne of issues, such as the one over a statutory ban for idling engines, launched in the wake of an ineffective voluntary initiative.

Among the leading sources of Hong Kong’s air pollution are the industries next door in the industrial zones of Guangdong, many with their origins in Hong Kong. These industries have contributed to Hong Kong’s wealth, but Hong Kong is unwilling to pay to clean up the environmental mess they

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2 He Huifeng, “Drastic changes have HK firms fighting to survive,” South China Morning Post, January 15, 2008
3 Denise Tsang, “End of an era for Pearl River Delta,” South China Morning Post, February 9, 2008
4 Olga Wong, “2,400 hectares of border zone to open up in 2010,” South China Morning Post, January 12, 2008
have left behind. The Hong Kong government has no inventory of enterprises across the border, and has made no effort to exercise a “name and shame” policy towards polluters or even polluting industries with strong Hong Kong connections.

Thus, the government’s main response to Guangdong’s new policies on export processing has been effectively to dither. In January 2008, responding to business complaints about the difficulties of surviving in the Pearl River Delta, it announced a program offering companies voluntary access to the resources of the Hong Kong Productivity Council to analyze their production methods. The grant of HK$93 million to the Council enables companies to apply to participate in assessments and pilot projects on cleaner production methods, on a matching grant basis. The fund, which was approved by the Legislative Council on January 12, 2008, seems doomed to fail, since the average matching grant is only HK$15,000, and covers only the consulting work of the Council, not the clean up itself. On ethical grounds alone, Hong Kong should be mobilizing all its resources to conduct a clean-up program for the Delta – not a rescue plan for failing businesses, but an imaginative program that would pave the way for Guangdong’s new century as well as investment in property and services.

Hopefully, the lack of integration and the malaise are temporary. The rise of competition from Hong Kong’s former hinterland does not need to be a zero-sum game. We can look forward to a regional system of competitive interdependence. What was one-way will now be multi-directional. If Guangdong can again serve as the leading edge of change in China, what will be next for Hong Kong? We can at least ask the question, if not answer it.

Edith Terry
February 2008

5 Winnie Chong, “$93m lure for companies to help clear the air,” The Standard, December 18, 2007
1 Executive Summary

Challenge and Response

Hong Kong faces a new challenge in the Pearl River Delta. For the first time in China’s modern era, its urban neighbors compete in areas of Hong Kong’s strengths. The geographical advantages that lay behind the emergence of the industrial zones along the deep estuary as the “world’s factory” are now to some extent working against Hong Kong, as it begins to compete on a level playing field with Shenzhen, Guangzhou, and Macau – the rising new cities of the Delta. How Hong Kong manages this challenge is a key test that will define its future – whether as an Asian Zurich or a vibrant metropolis akin to New York, London or Tokyo. Despite remaining differences in political and legal systems, wealth and investment gaps are narrowing. Competition is not a zero-sum game, however. The emerging paradigm is one of competitive interdependence, in which the urban clusters on one level fuse to form a mega-city, on the other remain fiercely independent.

The rules of the game are that the cities of Guangdong Province and the two adjacent special administrative regions (SARs) must each define their competitive advantage and get better at it. Hong Kong’s adjustment may be the hardest, since up until now it has been the clear leader in the regional economy in terms of depth of capital and human resources.

What is the appropriate response to the new paradigm? Government, business, and civil society need to work hard to strengthen Hong Kong’s competitive edge by improving its quality of life, diversifying its financial sector beyond its current focus on China, and rethinking barriers to immigration and competition. These are not areas in which Hong Kong shines, and much more work remains to be done. Meanwhile, Guangdong’s effort to add depth and quality to its manufacturing economy is creating enormous opportunities, while once sleepy Macau is well on the way to becoming Asia’s leisure and entertainment capital.

Hong Kong may find itself on the margins of a new explosion of growth in the region, rather than at its center. This is the risk faced by the Delta’s “glittering Pearl,” at a stage when neither the central government nor the provincial government in Guangdong is focused on creating opportunities for it.

1.1 Politics: Key points

The key political backdrop is a changing of the guard: In October 2007, the 17th Congress of China’s Communist Party Central Committee, held once every five years, set the stage for new leadership in Guangdong and the Pearl River Delta.

- In Beijing, Zhang Dejiang, Guangdong Party Secretary from 2002 to 2007, and architect of the Greater Pearl River Delta and Pan-Pearl River Delta regional alliances, was elevated to the State Council, in charge of transport and industry. Xi Jinping, former governor of Fujian and party secretary of Zhejiang Province and Shanghai, joined the Politburo Standing Committee after the 17th National Party Congress in October 2007 as President Hu Jintao’s heir apparent. He has taken over the Hong Kong and Macau Affairs portfolio assumed by Vice Premier Zeng Qinghong in 2003 in the
wake of Hong Kong’s democracy marches and frightening encounter with SARS, or severe acute respiratory syndrome, a runaway virus that was covered up in Guangdong before border hopping to Hong Kong and the world. Xi will head events celebrating the 30th anniversary of China’s economic reforms, and is also in charge of strategy for economic reform over the next five years. 6 Wang Qishan, mayor of Beijing and former party secretary of Hainan, has assumed an expanded portfolio of financial affairs, foreign trade and investment, becoming the principal official dealing with Washington and issues of economic integration between Hong Kong and the mainland

- **In Guangdong**, Suzhou native and graduate of the Central Party School Wang Yang has assumed the post of Party secretary-general, after two years as Party secretary in Chongqing
- **In Hong Kong**, Chief Executive Donald Tsang began his second and last five-year term in office on the back of a booming economy, huge budget surplus, and a record-breaking stock market
- **Macau** Chief Executive Edmund Ho is presiding over the biggest bonanza in tiny Macau’s history, as the world’s largest casino operators transform the Cotai Strip into China’s gambling mecca and a leisure, entertainment and convention hub rivaling Las Vegas

1.2 The regional economy: Key points

The key economic backdrop is **the provincial economy catches up with Hong Kong**: After three decades of industrial partnership, Guangdong has priced itself beyond the reach of labor-intensive industry, marking the end of the Pearl River Delta’s era of rapid industrialization based largely on light industry and manufacturing investment from Hong Kong.

**Guangdong’s new industrial model** is based on heavy industry, services and domestic demand, accompanied by attempts to develop proprietary technology in the core electronics industry, hitherto dominated by made-to-order work for multinationals
- **A new transport network** will link the major urban centers of the Pearl River Delta and a high-speed national rail and road network, leaving Hong Kong and Macau as cul-de-sacs; ports and logistics business moves north
- **Shenzhen and Guangzhou** are building brand-new central business districts, in a determined push to attract multinational headquarters and a quality workforce. Residential property prices have soared as developers follow rising incomes as well as a rising tide of Hong Kong migrants
- **A booming domestic stock market** reduced dependence on bank credit as well as Hong Kong capital markets; as global financial markets entered a downturn in late 2007 and 2008, Beijing pulled back on using Hong Kong to experiment with opening of China’s closed capital account
- **Scandals over toxic toys** and other tainted products from factories with Hong Kong connections mark a turning point in national policy towards product safety – and a psychological turning point against the export processing model introduced by Hong Kong companies in the late 1970s

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6 Ting Shi, “Rising star to organize 30th anniversary gala,” South China Morning Post, January 26, 2008

1.3 The future: Key points

The regional story is entering a new phase. An erstwhile broad convergence of interests between Hong Kong and adjacent parts of Guangdong has weakened as the province matures into a middle-income economy, leaving room for Hong Kong companies that can exploit the growing domestic market or move up the value-added ladder in exports, but not the traditional light industrial export processing sector.

Arbitrage was the way to make money yesterday, as Hong Kong exploited the wide gap between its legal and financial institutions and China’s poorly developed service sector, weak legal enforcement and corruption. Over the next decade, it will be about building asset value, in real estate, logistics, financial products and consumables. Hong Kong will continue to exercise a comparative advantage in services, and as long as it makes no major mistakes it can continue to thrive as a service supplier to the mainland economy. But the historical role, with Hong Kong occupying a critical niche of the industrial supply chain, is ending, with implications for specific value-adding strategies.

**Hong Kong as China’s Zurich:** The challenges for Hong Kong are multiple, and the flush economy should enable its policy makers to take more risks than in the first decade of the Special Administrative Region. With 40 years left in its special status under the “One Country, Two Systems” principle, Hong Kong may be able to entrench its role as an offshore financial center for China with strong legal protections for asset owners combined with a domestic system based on weak anti-trust rules and the benefits of free competition. But the way will not be easy. The chances are diminishing that it can become a London, New York or Tokyo – a vibrant multi-dimensional city based on tourism, a high-end lifestyle, and a special niche in finance. Zurich has only one of these things, a financial center, and does it well. In order to preserve its chances of something greater, Hong Kong would need to be able to take drastic measures, and this does not seem likely in the current environment.

- **No more preferential treatment:** Under the new team in Beijing and Guangdong, the flow of favors to Hong Kong is likely to slow down. The Special Administrative Region has demonstrably weathered threats to its political and financial stability. From Beijing’s perspective, Hong Kong’s prosperity if anything reinforces fears that growing income inequality presents a long-term threat to Communist Party rule. While Beijing’s leaders are far too smart to stand in the way of China’s wealthy enclaves, it may become politically untenable to offer the types of preferences Hong Kong received in the wake of SARS in 2003.

- **Managing the domestic economy takes precedence:** The saga of the “through-train” by which mainland investors were supposed to be able to invest in Hong Kong stocks illustrates the perils of relying on central government favors. The purpose behind the policy, announced in August 2007, was to relieve pressure on the Renminbi generated by China’s fast-rising foreign exchange surplus. But despite causing a sharp run-up on the Hong Kong stock market, the “through-train” has been indefinitely postponed due to management issues. Throughout 2007, Chinese regulators have focused on encouraging growth of the domestic A-share market, at the expense of new mainland initial public offerings or IPOs in Hong Kong. The secondary market in Hong Kong, however, has remained healthy while China’s stock market has a long way to go in terms of depth and liquidity. By opening the market for Hong Kong equities to domestic investors too early, mainland regulators risk undermining growth in the domestic equities market. Managing the gradual liberalization of the capital account is one of the most important and fraught balancing acts facing China’s leadership today. The flip side of the conundrum for Hong Kong is that the opening of China’s capital account will put enormous pressure on the Hong Kong dollar. The sooner it happens, the sooner Hong Kong
loses an independent monetary policy – or at least the right to choose the currency on which its monetary system is based.

• **Wealth or growth:** A one-dimensional Swiss model for Hong Kong, though, is unlikely to be able to sustain its welfare economy at the present levels unless Hong Kong is able to gain market access to China for its service industries. Market access for services under CEPA, the Closer Economic Partnership Agreement, has been limited. If Hong Kong cannot export services, its service professionals will ultimately be forced to migrate across the border to follow the jobs, with consequent impact on property prices, the other linchpin of Hong Kong’s wealth. Hong Kong may lose economic dynamism if it sinks into the Swiss model and relinquishes greater ambitions.

• **Hard choices to make for a “normal” Hong Kong:** If it pursues dynamic growth, one of the trade-offs will be the certainty and low risk of the post-colonial economic model, in which the domestic or internal sector has been effectively protected from competition, while the international or external sector has been ultra-liberal. If China provided national treatment to Hong Kong goods and services, Hong Kong could become a “normal” Chinese city, playing its corner in competition with domestic and international rivals. These rivals are also great cities, and all are fighting for the same things – creative and financial capital, jobs, and quality of life. Questions for Hong Kong will include when and how to enlarge the tax base; the timing and scope of a new competition law; the introduction of serious measures against pollution, as well as energy-efficiency laws with teeth; and how it addresses reforms in the property sector, including fiscal dependence on revenues from land auctions and mismanagement of public housing subsidies.

• **The end of Hong Kong’s export processing enclave in the mainland:** In July and August 2007, the central government alarmed Hong Kong by threatening prohibitions against export processing of low value-added products, jeopardizing the profitability of some 45,000 Hong Kong-funded enterprises in the Pearl River Delta – the majority of an estimated total of about 57,500 enterprises with Hong Kong ties. The Chinese Ministry of Commerce delayed enforcing the rule, which would have required a cash deposit of up to 100% on imports of 1,853 types of environmentally unfriendly industrial materials, in response to lobbying by the Hong Kong government and trade associations.8 In December 2007, the Ministry of Commerce added 590 more products to the list, and in January 2008, there were reports that another 1,000 types of products would soon follow. According to the Federation of Hong Kong Industries, by early 2008, 1,000 shoe manufacturers and 1,000 toy producers had already left the Pearl River Delta because of the new restrictions, coupled with rising costs of production, new taxes, the new labor law, and tighter pollution controls. According to Simon Shi Kai-biu, president of the Hong Kong Small and Medium Business Association, more than 10,000 Hong Kong-owned processing exporters were on the verge of collapse in the weeks before the Chinese New Year holiday in February 2008.9

• **No way to avoid elections:** Hong Kong needs democratic elections to prove to the world that its constitutional protections are meaningful. Without a credible rule of law neither the Swiss model, nor Hong Kong as a “normal” Chinese city will work, let alone as a city along the lines of a London, New York or Tokyo.

**Macau** is the world’s new Las Vegas, offering a convenient gambling-shopping-entertainment experience to a country enthralled with gambling and in which Macau, so far, is the only city in which it is legal.

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8 Denise Tsang, “Beijing delays fee rule penalizing exporters,” South China Morning Post, August 31, 2007

9 Denise Tsang, “Delta factories face more curbs on production,” South China Morning Post, January 30, 2008
A one-dimensional growth model: Macau’s proximity to China by bridge, air and ferry, the individual visa scheme launched in the mainland in 2003, and the scale of investments make it likely that Macau will succeed in its one-dimensional economic strategy. Nonetheless, the absence of fallbacks means that the Special Administrative Region will be uniquely vulnerable to outbreaks of disease, natural disasters, and other events that stem the flow of mainland tourism.

Which is also socially unsustainable: While the casinos act as an employment sponge, social tensions are rising as Macau becomes a resort economy, leading to spiraling property prices and pressure on its aging population.

Guangdong overtakes Taiwan: For investors, Guangdong is the US$400 billion question and is all that matters. In 2006, its US$328.8 billion economy, measured by Gross Domestic Product or GDP, was larger than that of Thailand (US$206 billion) although still behind Indonesia (US$365 billion) and Taiwan at US$361.3 billion. Its per capita GDP was US$3,500 in 2006, above the World Bank’s median of US$2,640 for a middle-income country.

Huang Huahua, the governor of Guangdong, said in November 2007 that the provincial economy would overtake that of Taiwan. With a 14.7% growth rate between January and October 2007, GDP was likely to reach US$390 billion by the end of 2007.10 But while such statistics reflect the relentless growth trajectory of China’s wealthiest province, a more important question is whether the province will successfully move up the value-added ladder to enter the leagues of the East Asian tigers.

The closest parallel to Guangdong’s current economic strategy is Malaysia in the mid-1980s, which similarly anchored its move to higher value-added manufacturing in the auto sector. In the 1990s, however, Malaysia lags far behind East Asian economies such as South Korea and Singapore on a number of technology indicators. 11Thailand, which similarly attempted to build a high-technology sector based on auto manufacturing, remains encumbered by high levels of income inequality and skills mismatch in the 2000s – according to the World Bank’s Knowledge Economy Index, it actually fell from 48 in 1995 to 56 (out of 137 countries) in 2007.12 Interestingly, according to a recent survey, in Guangdong Province, the percentage of those identifying themselves as “middle class” decreased from 42.7% in 1997 to 38.7% in 2007, in part due to rising standards of the meaning of “middle class” as well as a growing income gap. 13

Dumping light industry: Chinese statistics, especially at the provincial level, are slightly dubious, and so, to some degree, is the growth model. From the early 2000s, Guangdong has been hard at work copying the Thai and Malaysian development strategies of the mid-1980s, selectively promoting the auto industry and supporting parts industries, together with specialty steel and petrochemicals, while upgrading the electronics sector and discarding the light industries that carried the province in the first phase of industrialization. This ambitious strategy, however, remains

10 “Chinese Governor sees Guangdong Province passing GDP of Taiwan,” Dow Jones International News, November 15, 2007
13 Wen Antong, “Survey shows that despite rising incomes, higher income and middle high income groups have risen faster” (Diaocha xiangben de nian shouru jun you zengji, dan sheui shangzeng, zhongshangzeng zengban geng da,” Xinkuai Bao, November 13, 2007
a question mark; relative to its national peers in the urban clusters of the Yangtze Delta River region and the Bohai Gulf, Guangdong lacks strong human resources for technological innovation as well as the quality of life to attract urban professionals. It remains to be seen whether it can create these from scratch, as it is trying to do.

- **Inviting Japan’s help:** In the auto industry, Guangdong has invited Japanese automakers to jump start its auto sector, in sharp contrast to the pattern of the national industry, which has been to promote flagship companies. Although Guangdong is a late starter in this sector, it has been the first to export autos from China and its auto industry is seen as a key building block in the restructuring of the provincial economy.

- **Improving quality of life:** In order to move up technologically, the province has also invested in education. Meanwhile, perhaps because of the warm climate, it is developing a resort infrastructure despite the legacy of 30 years of pell-mell industrialization, which has devastated the province’s air, water and natural environment. The provincial environment agency has improved its monitoring of pollution, but more effective are new national land and tax policies that penalize polluting industries.

- **Moral hazard raises its ugly head:** The overall growth strategy as well as the reliance on industrial policy raises questions of asset misallocation, over-investment, and conflicting objectives.

- **Today Malaysia, tomorrow Korea:** Guangdong is aiming at a much higher level of industrial sophistication and modeling itself on Thailand and Malaysia in the 1980s and South Korea in the early 1990s. It is launching global brands and developing a vibrant consumer culture, based on a diversified industrial and service economy led by China’s domestic demand, not exports. The difference between Guangdong’s development trajectory and that of Malaysia or South Korea, however, is that it can rely on the immense hinterland of China, both as a market and a source of cheap manufacturing for its increasingly sophisticated industries.

**Flight to quality: Leading indicators**

<table>
<thead>
<tr>
<th>Flight to Quality: Leading Indicators</th>
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<tr>
<td>Morgan Stanley leases 10 floors in the 118-story International Commercial Centre at MTR’s West Kowloon Station, double the space it is leaving in Central, at one-third the price (August 2007)</td>
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<td>McDonald’s raises pay for 40,000 mainland employees by an average of 30%, after investigative reporters for a Guangzhou newspaper claimed it was underpaying part-time workers in the city (August 2007)</td>
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<td>Central government introduces restrictions on 1,853 types of polluting and inefficient export processing business, in a list that will be expanded to 5,000 (July 2007)</td>
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<td>Shenzhen labor bureau releases new rules on social benefits for part-time workers, including occupational safety insurance and overtime (July 2007)</td>
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<tr>
<td>Hong Kong ports fall to third place after Singapore and Shanghai (April 2007)</td>
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<td>New minimum prices for industrial land introduced (January 2007)</td>
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<td>Shenzhen companies, led by China Merchants Bank chief Ma Weihua, set up the Chinese Federation for Corporate Social Responsibility (October 2006)</td>
</tr>
<tr>
<td>Shenzhen gets the highest minimum wage in the nation, at RMB 810 (July 2006)</td>
</tr>
<tr>
<td>Shenzhen Stock Exchange publishes three-page Instructions for Listed Companies on Social Responsibility (Draft for Comments) (June 2006)</td>
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2 Winners and losers

Guangdong’s eleventh Five-Year Plan (2006-2010) has already had an impact on Hong Kong’s manufacturing assets in the Pearl River Delta. Going forward, it will affect investment opportunities more broadly, establishing a new set of winners and losers as the regional pattern of development adjusts. These issues are separate from Hong Kong’s national and international roles, but have enormous implications for its role in the region. Geography may not determine Hong Kong’s future, but it has been the major source of Hong Kong’s wealth over the past three decades. Thus, Guangdong’s new direction, reflected in both industrial policy and the market, will inevitably change Hong Kong.

The industrial policy outlined in the Five-Year Plan, as well as earlier provincial planning documents point to large-scale industrial restructuring. The province has backed these up with plans to spend RMB 11 trillion (US$1.4 trillion) on projects ranging from transport (RMB 432 billion) to industrial modernization (RMB 248 billion), energy security (RMB 233 billion), cultural development (RMB 72 billion) and innovation (RMB 53 billion). The “six great” development principles behind this program include innovation; accelerated institutional change; internationalization and systemic innovation; administrative coordination among cities, villages and the region; the “greening” of Guangdong, and a “harmonious society.”

One of the most prominent objectives of the planners has been to move up the value chain in manufacturing and services, with direct implications for the typical mix of Hong Kong enterprises, which make up roughly half of total enterprises in Guangdong and historically have been based on light industry. The planners’ new model for Guangdong is based on heavy industry and high technology. Meanwhile, major urban centers in Guangdong are to compete in sectors including finance and logistics that have been dominated by Hong Kong up until now.

Investors are likely to be skeptical of the aims and objectives of state planning. At the national level, leaders were careful to describe the current Five-Year Plan, introduced in March 2006, as a “program” rather than a plan. In Guangdong’s case, the plan outlines an enormous fiscal spending project as well as regulatory indicators. It also conforms to market forces that are driving up the cost of production, land and labor.

Because of China’s top-down system, Guangdong officials have the ability to execute. They face serious questions, however, of quality of execution, timing, market demand, and the continuing drain of corruption and the inefficient banking system – in short, the myriad flaws of central planning. The real miracle of Chinese central planning is that it has managed to interrupt market forces so little, and Guangdong’s planning in many ways represents efforts by the government to fine-tune a process that is already happening, by picking winners and losers among a crowded field of market participants.

2.1 Industrial policy and Hong Kong

As the third decade of China’s economic reforms came to a close, Guangdong’s Five-Year Plan acknowledged the inevitable. The growth of the provincial economy was beginning to slow
from the rocketing growth of the previous 30 years as it matured, a process that demanded structural change and an end to policies that placed manufacturing growth first at the expense of quality of life and the environment.

Winners will be the companies and industries that, to some extent, are already emerging as high fliers, building on Guangdong’s virtual monopoly of manufacturing for the information technology industry, its increasing dominance of ports and logistics for south China, and property, where a combination of urban planning, the rising attractions of the region for multinationals, and speculation are helping to drive an asset boom.

Losers will be many of the same companies and industries as the ones that helped to create Guangdong’s manufacturing miracle but which are now being forced out by policy as well as market pressures. This is not to say that all Hong Kong manufacturers will have to leave the high-growth Pearl River Delta region for the interior of Guangdong or more remote locations. Some, like Esquel or Johnson Electric, have long since made the transition to large-scale manufacturing and adopted sustainable practices. But thousands of small and medium enterprises are facing enormous pressure to relocate or close shop.

The experience of Peter Chai Kwong-wah, the Hong Kong owner of a toy factory in Longgang, Shenzhen, is typical of this latter group. His account to a reporter for the *South China Morning Post* reflects the depth and rapidity of the changes facing out-of-favor industries.

“When I first came to invest in Longgang in 1993, farmland surrounded my plants. Labor and raw materials were cheap and government officials from all levels were happy to help Hong Kong-invested factories. Now everything costs more – except the US importers want to pay less than before.”

Both market forces and Guangdong’s current Five Year Plan present significant challenges for Hong Kong. The plan itself is a blueprint for industrial policy reminiscent of the development strategies of the Asian tigers, particularly Thailand and Malaysia, both of which subsidized a shift to heavy industry in the belief that it would provide a platform to move up the value chain away from light industry and export processing.

It assumes that Guangdong and its cities can replace Hong Kong – or at least, Hong Kong as it is today. The most obvious example is that Guangdong plans to take back the role Hong Kong has played for the Delta since the early 1980s, as front office and showroom for its factories. Guangdong wants to have the showroom, the factory, the shop, and all the associated services – ports, airports, logistics, and finance – whatever it takes to get products to the customer’s door.

In wages, there were signs of convergence, with wages in the urban districts of Guangdong moving up sharply while wages at the bottom end of the ladder in Hong Kong declined. This may be an early sign of factor price equalization bringing the two labor markets into alignment.

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14 He Huifei, “Boom times are over as rising costs hit industry,” *South China Morning Post*, September 6, 2007

15 In April 2007, the Hong Kong Confederation of Trade Unions released survey data that it said was based on the government’s December 2006 quarterly report on wages that underlined the extent of declining pay in 20 occupations since 1997. While top wage earners had regained the level of 1997 of HK$27,000 per month, this affected only 173,900 workers or five % of the workforce. Meanwhile, some 334,600 unskilled workers earned a median income of HK$5,000 a month, down 16.7% from 1997. The average salary for fast-food shop workers, cleaners and security guards was about HK$5,500 per month, down 10% from 1997, while wages for clerks and shopkeepers also declined by seven % to 10%.
minimum wage in Guangdong and a toughening of labor standards are likely to exacerbate the trend. A new labor law implemented on January 1, 2008, required employers to include welfare benefits such as annual leave and health insurance. Eddie Lam Kwong-tak, the CEO of Onlen Fairlyand (HK), a shoe manufacturer with factories in Fujian, Guangdong and Shanghai, told the South China Morning Post in February 2008 that the impact would be “like a tsunami.” According to Mr. Lam, the new labor law would add RMB 10 to the cost of each pair of shoes.16

While Hong Kong’s liberal form of government remains an obvious exception, the mainland is beginning to close the gap in terms of its legal and regulatory framework. In 2007, China legislated competition, labor, property and tax laws that began to level the playing field by limiting discretionary and administrative powers of the state and instituting a transparent legal framework based on principles of fairness if not democracy. Enforcement remained a glaring weakness of the mainland’s legal system, but the deepening of the regulatory framework will make a huge difference over time.

Guangdong’s economic strategy also challenges whether there is, ever was, or will in the future be a meaningful economic entity defined by the cities along the Pearl River estuary including the two special administrative regions, Hong Kong and Macau. This geographic region has been called “the Greater Pearl River Delta” for more than a decade and has been the subject of books, conferences, and official acclaim. But is it more than political rhetoric?

Despite efforts by Hong Kong’s leaders to “learn” from Guangdong’s plan and adapt to it, the plan in many ways underlines Hong Kong’s isolation from Guangdong and the vulnerability of its industrial hinterland in the province. Macau, by contrast, through a single decision to liberalize its gaming sector, has become the world’s leading gambling destination. Macau is successfully using Chinese market demand for its very specialized assets to lock down a role in the global economy. Hong Kong seems unable to do the same.

The reverse is also true. Guangdong may be the most freewheeling of China’s provinces but its continuing reliance on central planning undermines its potential to find synergies, as opposed to rivalries, with Hong Kong. The border is becoming more porous but the most significant developments have come at the behest of the central government, such as the Individual Visitor Scheme (IVS) that allows mainlanders to visit Hong Kong and Macau on individual, rather than group visas. Guangdong tends to view Hong Kong as a privileged, foreign enclave that deserves to be taken down a peg, an attitude that reflects a lack of confidence and handicaps the province’s efforts to move up in services and urban style.

On the surface, Hong Kong remains a vibrant, dynamic economy, the world’s 11th largest trading economy, with a per capita income in 2006 comparable to Spain and ahead of most of its Asian peers. Its 2006 Gross National Product of HK$1.5 trillion (US$193 billion), and GNP per capita of HK$218,996 (US$28,161) at current market prices, placed it solidly in the category of higher income economies. Its Gross Domestic Product per capita in 2005 was almost nine times that of Guangdong, in US dollar terms. Its role as a trade, logistics and financial center for China has lifted it from the doldrums of the Asian financial crisis in 1997-98 to growth rates of 8.6%, 7.5%, and 6.9% in 2004, 2005, and 2006 – after China, among the highest in Asia.

However, Hong Kong’s prosperity is belied by the rising wage gap and persistent structural distortions in the economy, including the government’s fiscal dependence on revenues from land transactions. And while its role as a trade entrepot is responsible for recent high growth rates, domestic exports of goods have nearly collapsed in the last two years, after the end of the Multi-

16 Denise Tsang, “End of an era for Pearl River Delta,” South China Morning Post, February 9, 2008
Fiber Agreement in 2005, which artificially preserved Hong Kong’s textile industry long beyond its natural lifespan.

2.2 Competitive interdependence

For a quarter century, the expanding ring of cities around the Pearl River Delta has been a laboratory for social and economic change, at the forefront of China’s globalization experiment. Hong Kong was the silent partner in this transformation, its role anchored in the superiority of its legal and financial system as well as its infrastructure and capital resources. Now such differences are dwindling, as the region begins to leverage its wealth and dynamism to compete in areas of Hong Kong’s strengths.

Hong Kong’s relationship to Guangdong is no longer exclusively one of city to hinterland but as part of an urbanized society and diversified economy. In the new model, Hong Kong will compete with its neighboring cities in the Pearl River Delta, in a relationship that potentially strengthens the region as a whole.

Cheng Jiansan of the Guangdong Academy of Sciences observes that Hong Kong investment in the Pearl River Delta shifted in the last decade from manufacturing to real estate and commerce. Hong Kong supplied 80% of manufacturing investment in the region in the mid-1990s. By the mid-2000s, however, it represented half or less of the provincial total, according to Cheng. In the next phase, according to Prof. Feng Xiaoyun, a specialist on East Asian business at Guangzhou’s Jinan University, the “win-win” scenario between Hong Kong and the Pearl River Delta is one in which Hong Kong will apply the same creative and capital inputs to developing Guangdong’s service sector that it once applied to manufacturing.

According to Prof. Feng, “This is not a zero-sum game. We can create a win-win situation. In the past, the relationship between Hong Kong and Guangdong was one of shop front to back shop. Hong Kong, as an international economic center, had advantages of human resources and capital as well as experience in international business. These were all benefits for Guangdong, which had advantages in industry.”

“In the next phase, the question is how to improve the service sector in Guangdong so as to leverage Hong Kong’s role as an economic center. This is where both Hong Kong and Guangdong should be focusing – how to use Hong Kong’s service sector to build capacity in Guangdong.”

Prof. Feng argues that Guangdong has achieved parity in its “hardware” with Hong Kong but not its software, and that this is where the opportunity lies. “This is about Hong Kong’s soft power,” she said. “Hong Kong’s greatest advantage is not the physical things – the harbor, the airport, even finance – but its institutions and human resources. These two things are very important and can be of great power. Guangdong now can be said to be satisfied with its GDP level. It can say that it’s at the top among Chinese provinces. But it still looks to Hong Kong in the service sector, and it has a long way to go. Hong Kongers have no reason to be pessimistic.”

In terms of a SWOT analysis – analyzing the strengths, weaknesses, opportunities and threats to the region – history and community are among the “strengths” – essentially the economic reforms and pioneering role of Hong Kong and the Pearl River Delta – even though the legacy of the reforms includes problems ranging from indescribable environmental degradation to the diminished relevance of Hong Kong to the regional economy.

17 Interview, September 20, 2007, Hong Kong
Among the “weaknesses” is Hong Kong’s quandary as it considers how to transit from a key role in Guangdong’s manufacturing economy to a marginal role in manufacturing and potentially a key role in services and the domestic sector of the provincial economy. Since services are based on the free flow of people and ideas, Hong Kong will need to look at its infrastructure and institutional ties with Guangdong and Macau in a new way. In this context, the “new” Guangdong and Macau present huge areas of opportunity. However, if a sparkling new conurbation is to emerge, it will confront huge strains in terms of the negative externalities of growth, particularly environmental pollution, and must manage them successfully.

To the extent that Guangdong’s economic plan is supported by the market and is a success, it will force Hong Kong into a dramatic restructuring of its own. This restructuring must grapple with the reality of economic convergence. Increasingly, Hong Kong and its neighbors in the Pearl River Delta are part of an economic continuum with fewer and fewer institutions that set them apart.

*Pearl River Delta: SWOT Analysis*

(*Strengths, Weaknesses, Opportunities, Threats*)

<table>
<thead>
<tr>
<th></th>
<th>Hong Kong</th>
<th>Macau</th>
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| **Strengths**        | • Rule of law  
                          • Efficient civil service  
                          • Service sector  
                          • Business-friendly environment including low tax rate  
                          • Active and engaged civil society  
                          • Free press  
                          • Efficient communications and transport infrastructure  
                          • Lively retail and entertainment sector  
                          • Chek Lap Kok International Airport | • Liberalized gaming sector  
                          • Sustainability as a principle in urban planning  
                          • Strong record in heritage conservation |
| **Weaknesses**       | • Government’s lack of accountability  
                          • Political gridlock  
                          • Legacy preferences for vested interests  
                          • Legacy barriers to mainland visitors, students, workers and professionals  
                          • Fiscal dependence on property revenues  
                          • Disjointed urban planning  
                          • Poor protection for air and water  
                          • Poor record on heritage conservation  
                          • Decaying infrastructure  
                          • Weak transport connections with the mainland  
                          • Declining ports | • Overdependence on gaming sector as a source of tax revenues and employment  
                          • Weak infrastructure connections with the mainland  
                          • Lingering problems with crime and corruption |
| **Opportunities**    | • The “greening” of Guangdong  
                          • Dominant position of Hong Kong logistics suppliers in Guangdong  
                          • Supply chain management for new industries | • Entertainment capital of China |
<table>
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<tr>
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<th>Macau</th>
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<tbody>
<tr>
<td>• Drive to property values in Guangdong</td>
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<tr>
<td>• Supplier of creative finance to mainland and global markets</td>
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<tr>
<td>• Creative industries</td>
<td></td>
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<tr>
<td><strong>Threats</strong></td>
<td><strong>Threats</strong></td>
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<tr>
<td>• Continued paralysis over political reform</td>
<td>• Runaway inflation</td>
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<td>• Pollution</td>
<td>• Income inequality</td>
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<tr>
<td>• Opposition to change by vested interests</td>
<td>• Labor strife</td>
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<tr>
<td>• Structural unemployment as major industries decline</td>
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<tr>
<td>• Continued maintenance of border barriers to Shenzhen</td>
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</tbody>
</table>
Winners and losers

Winners

- Low tax areas will be winners – Hong Kong scores
- Low cost areas will be winners – the Delta scores
- People with language proficiency in English and Putonghua will be winners – Hong Kong’s “mother tongue” policy promoting Cantonese loses
- On software, including open communications, a free press, rule of law and transparency in all aspects of government and policy are necessary to compete in the global economy – Hong Kong scores
- On hardware and costs, the Delta scores
- Renminbi appreciation – fundamentally changes the ground rules for industry in the Delta. Value-added strategy is a positive result of thinking on this issue – a net advantage for the Delta
- The weak Hong Kong dollar – an advantage for Hong Kong
- Delta cities score – Guangzhou and Shenzhen make the jump from Third World squalor to sophisticated, vibrant cities based on intermediating international trade and services for South China
Winners

- Macau scores, as the new entertainment and retail destination of choice for China’s nouveau riches.
- Delta retail, real estate, tourism, and utility plays
- In both Hong Kong and the Delta, companies that focus on the domestic Chinese market and “life style” assets including high-quality branded consumer goods.
- High technology exports, taking advantage of Guangdong’s favorable policy environment.
- Guangdong ports and Baiyun International Airport, as they achieve a commanding lead over Hong Kong in terms of container and air cargo volume – the real competitor will be Shanghai, not Singapore or Hong Kong.
- Guangdong’s logistics sector
- Guangdong’s property sector, as it goes through massive renovation and conversion of low-grade factory, commercial and residential infrastructure. We predict the major cities will leapfrog the current low level of infrastructure to high-grade residential and commercial buildings competitive with those of Hong Kong and other advanced service economies.
- Hong Kong’s service sector, especially finance, as China’s gateway to international capital markets, and life style or creative industries.
- Former industrial and port districts of Hong Kong, which will unleash massive value once they are rezoned and released for commercial and residential development.
- Air and water across the region: These will improve as the transition from labor-intensive to capital-intensive industry continues.
- As a result of improved air and water, improved health and quality of life for 100 million people in Guangdong, Hong Kong and Macau.
- Companies that play to the value added theme in the domestic sector, such as Hutchison and the combined MTR and KCRC in logistics and Cheung Kong and Kerry in property.
- Hong Kong’s property developers have been building their land banks in China for more than a decade, but with these two exceptions have bypassed nearby Guangzhou and Shenzhen in favor of Shanghai and Beijing. Growth in the logistics industry will present major opportunities for developers that can offer sophisticated warehouse facilities as the industry migrates from Hong Kong to the Pearl River Delta.
- Companies that move up the value added chain in their industries from labor-intensive to capital-intensive production, such as Esquel. There is a relatively short list of Hong Kong companies that will make the grade, and there will be increasing pressure to bring intellectual property to the table, whether in the form of technology licensing or proprietary brands.
- Hong Kong’s classic trading companies, such as Li & Fung and Noble Group, now recast as supply chain management specialists, will succeed to the extent that they develop global sources and are not locked into low-end manufacturing in the Pearl River Delta.

Losers

- Basic manufacturers that don’t add value
- Basic foodstuffs, toys, cheap apparel, Original Equipment Manufacturing (OEM)
- Hong Kong’s small and medium enterprise sector, which has had a lease on life due to the anomalies of mainland policy on processing industry, now ended.
- Pure Hong Kong logistics plays and local real estate
- Chek Lap Kok International Airport, which will lose ground to Baiyun as an international air cargo hub.
- Hong Kong property, which will gradually face the effects of factor price equalization as the border with the mainland becomes more porous. The current bell curve of the property market – with astronomical prices in Central commercial and Peak residential locations and much lower prices outside – will continue. Over time, the price level of Hong Kong will converge on prices in prime urban areas in Guangdong, particularly Shenzhen and Guangzhou.
Losers

- Support services for trade and logistics, which will move north as Hong Kong ceases to become a factor in the physical movement of goods. They will thrive in a new form, becoming major employers across the border.
- The Hong Kong-Macau-Zhuhai bridge – which will either not be built, or built too late to affect Hong Kong’s role in the regional economy, since the Guangdong and Shenzhen municipal governments oppose it.
3 The new paradigm

The historical relationships that created convergence of interest between the very separate parts of the Pearl River Delta – Hong Kong, Macau and Guangdong – are now breaking the old paradigm apart. The new paradigm is one of intra-regional competition as the rapid growth of Guangdong’s cities together with Macau begins to level the playing field with Hong Kong.

The strategic equation is not limited to financial opportunities but includes considerable scope for social and creative growth. Politics is the one area that looks unlikely to see rapid change, because of the inherent conservatism of the central government even when its communist ideology has changed beyond recognition.

3.1 Strategic perspective

The new paradigm will be good for:

• **Technology:** China’s new tax code provides high technology companies with the tax breaks associated for the last three decades with export processing. President Hu Jintao’s report to the 17th National Congress of the Chinese Communist Party on October 24, 2007 emphasized “scientific development” as the new Party mantra and outlined development themes including innovation, energy savings, and the environment. 18 On a national basis, these will benefit high-tech plays in sectors ranging from telecommunications equipment, shipbuilding, machinery and software under the innovation heading; to alternative energy and building technologies under the heading of energy savings; to water plays, desulphurization equipment, and paper and forestry companies under the environment. 19

• **Guangdong telecommunications sector:** Guangdong is the national leader in telecommunications equipment, with Shenzhen-based ZTE Corp. leading the development of China’s indigenous third-generation mobile telephony. Most of Guangdong’s telcom companies, however, remain original equipment manufacturers, such as Taiwan-owned Foxconn and Huawei Technologies, also based in Shenzhen. Hong Kong companies have little on offer in high technology generally and although Hong Kong’s telecommunications sector is competitive on the operations side, it has not been an innovator in terms of technology or equipment. The new tax incentives may see Hong Kong companies moving into this sector, as niche suppliers and subcontractors to the headline players. Technology is evolving so quickly in the sector that a Hong Kong OEM supplier such as VTech Holdings may be able to segue into high-tech from cordless handsets and educational games. In 2007, VTech spent US $45.2 million on research and development and is trying to move up the value chain in that sector by developing more sophisticated broadband telephony products; in December 2007 it signed an agreement with Funkwerk Enterprise Co. to develop new products for Integrated Access Devices.

• **Property:** This is one area where Hong Kong developers are likely to shine, even though they face stiff local resistance, because they can capitalize on Hong Kong cash flows and finance as

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19 Jun Ma, China’s policy and market outlook after party congress, Deutsche Bank AG, Hong Kong Branch, October 2007
they straddle the border with Guangdong. Efforts by the central government to cool down the overheated domestic property sector work to the advantage of Hong Kong and multinational firms, since they have access to credit from outside China and as they face less competition from the domestic property sector. From an investor perspective, the demand for quality commercial and residential assets is so great that it’s impossible to go wrong in this sector. The smart money is going into industrial facilities following a Silicon Valley motif; Guangdong’s own Huawei Technologies Limited pioneered the upscale high-tech campus for Guangdong that is now being followed by many others.

- **Logistics**: Hong Kong’s logistics industry is shrinking in percentage terms and migrating across the border together with huge infrastructure investments in ports, air cargo facilities, roads and rail in the Pearl River Delta and beyond. Although DHL Worldwide Express, one of the earliest freight forwarders into China, has a multi-hub approach, it announced in November 2007 that it would build a new, US$125 million distribution center at Shanghai’s Pudong Airport in the second half of 2010. Other freight forwarders have moved entirely to China. FedEx has decided to move its regional Asia-Pacific hub from Subic Bay in the Philippines to Guangzhou’s Baiyun Airport, with facilities to be completed by December 2008. UPS became the first express carrier at Baiyun to provide non-stop flights to the US in April 2006, and is also basing its new Asia hub in Guangzhou. As the industry serving Chinese manufacturing becomes more firmly based near the factory gate, the role played by Hong Kong companies will increasingly be one of supply chain management, pioneered by such Hong Kong-based firms as Li & Fung and Noble Group, connecting logistics providers in China with international buyers and transport.

- **Cleanup**: Much like Japan in the 1970s, rising expectations and the legacy of uncontrolled industrial growth are creating a political and market base for the environmental equipment industry. Nuclear energy, renewable energy, coal scrubbing equipment for power stations, waste water treatment, energy efficiency technology for buildings and bio-fuels are rising sectors of opportunity in Guangdong.

- **Consumers**: As China’s wealthiest province, Guangdong has for many years been a proving ground for Hong Kong-based retail operators in China such as Esprit and Giordano. The challenge now may be for Hong Kong manufacturers to retool for the domestic market, and here a Hong Kong company such as Ports Design may provide a role model. Ports Design, which has been operating in China since the early 1990s, has more than 350 directly managed stores throughout the country, with in-country production facilities that give it a cost advantage over multinationals that have to pay import duties. New production facilities due to open in 2008 will double production capacity and improve efficiency. The company, like Esprit and Giordano, has focused on raising product quality and brand value, necessary to keep pace with rising expectations among Chinese consumers. Yet continuing market entry barriers to professional services – now the core of the Hong Kong economy – mean that Hong Kong business is handicapped in testing the full potential of the Chinese consumer market.

### 3.2 Tipping point?

How and why is the Pearl River Delta paradigm changing?

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20 Chris Buckley, “FedEx to move Asia center to China,” *International Herald Tribune*, July 14, 2005

Together, the Pearl River Delta and its two “special administrative regions” of Hong Kong and Macau have been a huge success for the last twenty years. The reasons why are not hard to find. Manufacturers in the Delta could take advantage of good infrastructure, cheap land and labor and low taxes – Hong Kong manufacturers in the Delta paid little for land and nothing in taxes during a time when mainland policy was to use them to sop up labor and jump start the economy through exports.

Today, the region is at a tipping point. Each city in the Delta has its own party secretary, mayor and plan. They are not ruled by any other government in China than their own and haven’t been for 3,000 years. Guangdong has an ambitious set of planners, but neither they nor their municipal counterparts can do more than add fiscal stimulus here or there, or hurl a threat at those who stand in their way. The change agent is the market, and an economy where labor shortages are beginning to bid up prices and Renminbi appreciation is forcing exporters away from low value-added products. As wages increase, so do people’s hopes for a higher quality of life. The fact that migrant labor is turning away from the Pearl River Delta is a sign that opportunities are expanding elsewhere in the country. In early 2008, employers in Guangdong faced a shortfall of about 2 million workers, 10% of the migrant work force. According to Xu Songyuan, a manager in a Dongguan factory, rates for an assembly worker had doubled over the previous two years, from RMB 800 a month to RMB 1,600.

The level and number of competitors is increasing, while in the Pearl River Delta and China generally costs of skilled labor are rising while Renminbi appreciation is squeezing margins. The question for Guangdong is the same as for China as a whole. How will China compete within a weaker global economy as costs rise?

The Pearl River Delta that we know today is changing, and along with it the means of creating value will change. The winners of the last twenty years will not necessarily be winners over the next two decades. In financial services, Beijing with its new financial district and Shanghai with its giant A-share listings are mounting a serious challenge to Hong Kong, as is Singapore for its open invitations to international talent and multinationals.

So the question is, what next? And, how to get there.

3.3 China and Guangdong “move up” the value-added ladder

Meanwhile, China’s “fourth generation” leadership has adopted a new economic model based on value-added manufacturing, services, and domestic demand, responding in part to competition from emerging economies such as India and Vietnam. India’s ample stock of science and engineering graduates has given it an edge in high-value added software development and services. Vietnam, Bangladesh and a host of other low-income countries have become increasingly attractive for labor-intensive manufacturing, against the rising cost of production in the high-growth coastal areas of China.

Guangdong, always an economic pioneer, has embarked on its own ambitious plan to re-invent the provincial economy, in order to be globally competitive in the face of Renminbi appreciation and rising costs. As one example, it has leapfrogged its domestic rivals in the automotive industry by

22 Fiona Tam, “Cheap labour dries up, workers get picky,” South China Morning Post, January 24, 2008
inviting economic partnerships with Japan’s big three automakers, Toyota, Honda and Nissan. It is attempting to use its dominance in consumer electronics to develop domestic flagship companies and proprietary technology.

And it is re-inventing its flagship cities, Guangzhou and Shenzhen, with ambitious rebuilding programs in their Central Business Districts as well as investments in urban light transit. In one sign of Guangdong’s new emphasis on quality of life and sustainability, as well as its problems, in July 2007, the mayor of Shenzhen, Xu Zongheng, begged residents to stop buying cars, which cause 70% of the city’s air pollution. At the current rate, the mayor said, the number of cars in the city of 10 million would increase by 200,000 in 2007.23

Guangdong is now expected to play a central part in the national move up the value-added chain, challenging one of the principal sources of Hong Kong’s dynamism over the last quarter century, since China’s reforms began – its role as the gateway to the Pearl River Delta.

3.4 Hong Kong at a crossroads

With the tenth anniversary of its return to Chinese control now behind it, Hong Kong is at a crossroads. Its leaders are absorbed with establishing political legitimacy against the context of an increasingly restive lower and middle class. Population growth has come to a standstill. Income inequality is among the highest in the world for a developed economy – a sign to some observers that Hong Kong has become as high-priced as such global cities as London and New York, to others that it has failed to develop such basic protections for the bottom income tier as a minimum wage. While Hong Kong offers enviable levels of social benefits, including government health insurance, public housing for nearly half the population, and welfare subsidies, the economy is demonstrably failing to provide more jobs or a rising standard of living for its poor.

Hong Kong is fast becoming a city with a bipolar personality, split between the super-rich and the subsidized. Some 47% of the population lived in public housing and 80% paid no taxes, creating downward pressure on wages for unskilled and clerical workers while putting the dreams of the middle class ever further out of reach.

**Hong Kong’s GDP at current prices, 1961 to 2006**

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP at Current Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>1961</td>
<td></td>
</tr>
<tr>
<td>1971</td>
<td></td>
</tr>
<tr>
<td>1981</td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td></td>
</tr>
</tbody>
</table>

GDP at Current Price

Source: Census and Statistics Department, Hong Kong
Hong Kong’s GDP per capita, at current prices, 1961 to 2006

GDP Per Capita at Current Price

Source: Census and Statistics Department, Hong Kong
3.5 Hong Kong’s competitive disadvantages

Ironically, among Hong Kong’s principal disadvantages is the absence of the leadership required to expand its service economy into the mainland, starting with the nearby Pearl River Delta. Serious barriers remain to trade in services between Hong Kong and its neighbor. But even in areas that are not impeded by specific obstacles, Hong Kong’s leaders have dithered when they should have pushed their advantage. Nowhere is this more evident than in the long-running saga of a bridge to connect the three cities at the tip of the Pearl River Delta – Hong Kong, Macau and Zuhai.

Gordon Wu, a Princeton-trained engineer and the first Hong Kong tycoon to invest in road links with Guangdong, began lobbying for a bridge in the mid-1990s. The concept was simple. A bridge linking Hong Kong with the western shore of the Delta would set off the same economic development train that had transformed the eastern shores, from Guangzhou to Shenzhen and Dongguan, by making it easy for goods to reach Hong Kong’s deepwater port.

By the early 2000s, the bridge project was also on the agenda of the Hong Kong government. But the opposition of some of the territory’s most powerful vested interests weakened the government’s resolve behind the scenes. As a result, negotiations foundered over Hong Kong’s unwillingness to pay for the bridge and Guangdong’s reluctance to allow Hong Kong to undermine Shenzhen’s growth.

Today, the logic of the bridge as a conduit for exports is less persuasive than the need of an expanding service economy for infrastructure to move people. Either way, delays in the Hong Kong-Zhuhai-Macau bridge project have penalized Hong Kong in an emerging transport network that leaves Hong Kong at the bottom of one leg of an inverted V, with Guangzhou as the apex and Zuhai and Macau at the other end. According to Zheng Tianxiang, a professor at the Pearl River Delta Research Center at Zhongshan University in Guangzhou, and one of the province’s leading transport experts, although the central government is still considering the Hong Kong-Zhuhai-Macau bridge, from a provincial perspective the project is all but dead. Not only has the project quadrupled from its original HK$15 billion price tag to HK$60 billion, but the road-based plan would also add to the Delta’s burden in terms of air pollution. “The whole process has been full of conflicts of interest either within Hong Kong or between Hong Kong and the Guangdong government,” he said in a 2007 interview. 24

Hong Kong’s major port interests, led by Li Ka-shing’s Hutchison Whampoa Ltd., opposed the bridge because of its potential impact on their logistics business in Hong Kong and the PRD; Guangdong opposed the bridge not only because it will cause more air pollution, but because Hong Kong restricts entry of mainland cars and trucks, creating a peculiar fairness issue – Guangdong would be burdened by additional airborne emissions from Hong Kong vehicles but unable to contribute its own pollutants to bridge traffic. According to Prof. Zheng, provincial planners now favor a rail-based plan for the bridge, that Macau also likes, but the double deck construction will raise costs yet further.

If and when agreement is reached on the Hong Kong-Zhuhai-Macau bridge project, it may well be too late to affect transport patterns in a meaningful way. A new cross-delta bridge linking Dongguan and Zhongshan, to be completed by 2010, will create an A-shaped flow down the Delta. Macau, with its own international airport and road and tunnel links with the mainland, will have little need for the bridge, and Zuhai is developing its own deepwater port at Gaolan. Together with the heavy-industry port in development at Nansha, the economics of a direct Hong Kong-western shore bridge have already been deeply compromised.

24 Interview, September 19, 2007, Guangzhou
3.6 Two and three solitudes

Two Solitudes was a 1945 novel by Canadian writer Hugh MacLennan about the tensions between English and French Canadians, who shared a country but little else in terms of dialogue or communication. The phrase is an apt description of relations between Guangdong on the one hand and Hong Kong and Macau on the other.

The two sides barely talk to each other. On Guangdong’s side of the border, officials must apply for permission to the central government even to visit Hong Kong. An annual meeting between the chief executive of Hong Kong and the governor of Guangdong is the main formal venue for negotiating agreements on infrastructure and other issues. This is slowly changing; since 2003, thirteen government working groups have been formed to steer the economic relationship reporting to the heads of government. In 2007, inter-governmental task forces were set up on two projects, the so-called Shenzhen Loop, or “Hetao Development Management Authority,” and a 17-minute express rail connection between the Shenzhen and Hong Kong airports.

Such gains are incremental in nature, and don’t begin to address the complexity of the cross-border issues facing the three solitudes of Hong Kong, Guangdong and Macau. These range from managing air and water pollution to transport, infrastructure, human capital development, and the more advanced types of cooperation that Guangdong would like to see as it strives for economic maturity. It took the SARS outbreak and democracy marches in 2003 to convince the central government that it needed to innovate around the “One Country, Two Systems” principle and encourage formal liaison between Guangdong and Hong Kong on administrative issues. Even so, lack of communication has worked against Hong Kong on a number of levels, starting with planning for transport.

Hong Kong’s Airport Authority recently conceded that a 30 kilometer rail link between Chek Lap Kok International Airport and Shenzhen’s Bao’an Airport might be an alternative to building a third runway at Chek Lap Kok. Rather than competing for capacity, the Airport Authority has been executing a “two-pronged” strategy as investor and management consultant to China’s airports. Hong Kong has taken equity stakes in the Zhuhai and Hangzhou airports, and as of December 2007 was negotiating with Shenzhen for a stake as well. 27Victor Fung Kwok-king, chairman of the Airport Authority, said talks were underway with the Macau airport as well. “If we [Hong Kong] are able to become an integral part of China, we will bring the entire mainland network to the international arena,” he said. “It will enhance Hong Kong’s overall competitiveness.”

If the regional service economy is to expand, efficient cross-border passenger transport connections are crucial. But land and water connections for people, as opposed to goods, remain primitive.

The border crossing remains a rude awakening on the Guangdong side of the border. Only one boundary control point has “co-location” facilities for immigration, the Shenzhen Bay Control Point in Shekou, which became operational in 2007, as opposed to conducting immigration at separate checkpoints, between which passengers must walk or take shuttle buses. Beginning in 2004, an

25 Creating a World-class Metropolis – Building the Gangshen Metropolis, power point presentation in Chinese (“Dazao shiji duhui – Jiangou Gangshen Duhui”), Bauhinia Foundation Research Centre, August 9, 2007, p. 33
26 Denise Tsang, “Airport Authority urges closer ties between PRD airports”, South China Morning Post, December 4, 2007
27 Joanne Chiu, “HK airport in talks to buy Shenzhen stake,” Reuters, Hong Kong, December 3, 2007
automated passenger clearance system, using 243 “e-Channels” for passengers and 40 vehicular e-channels eased congestion from Hong Kong to Shenzhen and Macau -- but only worked at one set of border checkpoints, those for Hong Kong.

Restrictions on cross-border vehicular traffic, while positive in terms of reducing air pollution, are an impediment to people working, living or studying across the border. It also does little to limit air pollution, since Hong Kong-based truck fleets with dual plates regularly fill up on cheap, high-sulphur diesel fuel on their runs across the border. Hong Kong prohibits mainland vehicles from entry. Applying for a secondary license plate remains an expensive, time-consuming and one-way process, only in part because Hong Kong has right-hand drive vehicles while the mainland uses left-hand drive. A more significant reason is revenues to the Guangdong government from licensing fees.

Until Macau’s casino boom, the fact that it was similarly stranded was of little relevance.

Today, with billions being poured into the Cotai Strip and downtown Macau, its cozy little monopolies have suddenly begun to pose major inconvenience, such as the blatant efforts by Stanley Ho, who controls the major helicopter, jetfoil and ferry services to Hong Kong, to block Cotaijet, a rival express water ferry by casino operator Sheldon Adelson.28

In December 2007, Mr. Ho vociferously defended a court order blocking the CotaiJet service less than 10 days after it began, complaining that the government’s tendering process for the ferry license had been unfair and supporting the plaintiff in the case, an obscure operator called North West Express, that had petitioned for a license to run a ferry between Macau and Tuen Mun, an industrial town in Hong Kong’s New Territories. Meanwhile, the overloaded ferry system has meant that passengers to and from Hong Kong have to book tickets as much as a week in advance during peak periods, and standby passengers returning home at night routinely wait into the early morning hours for a seat.

28 Danny Mok, “Setback for Sands as Macau court suspends 10-day-old ferry service,” South China Morning Post, December 11, 2007
3.6.1. Case Study: The Lok Ma Chau Crossing

Planning on a macro-economic scale remains sketchy, as reflected in the story behind the opening of the newest rail crossing point at Lok Ma Chau, less than 800 meters away from the major road checkpoint at Huanggang (the poetically named, “Imperial Harbor”).

Imperial Harbor or Huanggang is where Gordon Wu built his Guangshen Highway connecting Hong Kong with Shenzhen and Guangzhou in the early 1980s. A visionary project for its time, it remains the major transit point for truck, bus and auto traffic across the border.

The planning for the new Lok Ma Chau rail crossing, as well as the new Western Corridor link, began in the early 2000s, when transport projections indicated that the two existing road and rail checkpoints, at Lo Wu and Huanggang, and vehicular crossings at Sha Tau Kok and Man Kam To, would reach saturation. However, negotiations on the new checkpoints were conducted solely between the Hong Kong and central governments, leaving out local transport departments, according to a senior executive with KCRC, the Hong Kong rail operator for the two links.

According to Zheng Tianxiang, a transport export with the Pearl River Delta Institute of Zhongshan University in Guangzhou, local planning authorities in Shenzhen regarded the new Lok Ma Chau link, as well as the 5.5 km. Western Corridor link, as benefiting Hong Kong only, and as a result have given little support to the two projects. Both were timed to open during the July 2007 anniversary of Hong Kong’s return to China, but Lok Ma Chau only formally inaugurated passenger traffic on August 15, 2007.

From a Guangdong and Shenzhen perspective, the case against Lok Ma Chau is particularly clear-cut. Lok Ma Chau was designed exclusively as a light rail connecting point, with passengers exiting onto a bridge across the Shenzhen River. Although the gleaming new station is far more passenger-friendly than the aging terminus at nearby Huanggang, it was designed as a light rail connecting point only – and in fact connecting two pieces of rail owned and operated by Hong Kong companies. The HK$18 billion spur line from East Rail’s Sheung Shui Station, owned by KCRC, links to Shenzhen’s Metro Line 4, which is 100% owned and operated by Hong Kong’s other major rail operator, MTR, which merged with KCRC on December 2, 2007.

Line 4 won’t be finished until 2009, and although it connects into the station on the Shenzhen side, subway trains run only every 10 minutes. KCRC was required to build bus connections on the Hong Kong side, but only four bus routes operated from a small bus interchange on the Shenzhen side as of the August 15 opening. “This is a problem for Hong Kong, but not for Shenzhen,” said Zheng, the transport expert. “The road is still very convenient. For Shenzhen, there’s not much to be concerned with. The Line 4 project was invested, built and managed by MTR. It’s Hong Kong’s business.”

Over time, the Lok Ma Chau crossing is likely to be integrated successfully into an expanded network of cross-border transportation, but it is telling that even 10 years after the handover, new border checkpoints are designed in the spirit of “build it and they will come.” The delays in the launch came at a cost to KCRC of as much as HK$500,000 a day.1 Passenger numbers have remained considerably below the 200,000 per day planned capacity, ranging between 30,000 to 40,000 in September 2007, compared to an average of 250,000 daily at Lo Wu and 134,000 at Huanggang (based on 2006 traffic).

According to Zheng, the basic planning flaw was on the Hong Kong side; he argued that the new Northern Link should have been built first, to channel passenger traffic from the west side of Hong Kong’s New Territories, rather than using the existing passenger catchment zone of KCR East (now part of the MTRC system). Once the recently approved Northern Link is finished in 2013, together with the completed Shenzhen Metro Line 4 linking Hong Kong to the new Pearl River Delta light transit system, Lok Ma Chau will most likely reach capacity and prove the wisdom of the original concept.
3.7 Macau strikes it rich

Macau’s aspirations are far simpler than those of Guangdong. It hopes to become the world’s leading casino center, in the Las Vegas style with sporting events and family entertainment attached. Macau’s economy, dependent for roughly 60% of Gross Domestic Product from its gaming monopoly, remained static until 2001, when the sector was liberalized. Stanley Ho, whose Sociedade de Jogos de Macau, or SJM, held the franchise uncontested from 1962 to 2001, remains one of the licensed operators.

SJM now competes with Las Vegas heavyweights Wynn Resorts and Galaxy Casino Company, a venture controlled by the Venetian Resort in Las Vegas and owned by Las Vegas Sands Inc., as well as Australian-Hong Kong joint venture Melco-PBL Entertainment. The big openings in 2007 and 2008 were the $1.1 billion MGM Grand Macau, a partnership between two of Ho’s daughters and MGM Mirage Inc., Ponte 16, a joint venture between SJM and Hong Kong-based Macau Success, and the US$2.3 billion Venetian Resort on the Cotai Strip. Since 2002, when the first three licenses were awarded, 11 casinos have grown to 25, with many more on the way.

Sands owner Sheldon Adelson describes Macau as “Disneyland for adults.” In an interview in 2002, he estimated a market of more than 400 million people – 92 million from Guangdong, 60 million people within a two-hour drive of Guangdong, 150 million from China’s urban eastern seaboard, 24 million Taiwanese, 5 million from Hong Kong, 125 million Japanese and 60 million South Koreans. Adelman said Macau would become “the only destination resort in all of Asia that has all of these features – conventions, exhibitions, entertainment and gaming. We don’t want to be known just as a gambling resort, but as the Asian Las Vegas, with all the features and bells and whistles that Las Vegas offers as a Disneyland for adults.”

Since the first Sands casino opened in Macau in 2004, Macau’s tiny economy has skyrocketed. Between 2002 and 2006, Macau’s GDP nearly doubled, from 63.5 billion patacas to 114.3 billion patacas. By the first quarter of 2007, Macau’s Gross Domestic Product per capita exceeded Hong Kong at 227,508 patacas (US$29,506) per person to Hong Kong’s HK$214,710 (US$27,485). In 2006, gaming revenues were up by 22% to US$7.1 billion, outpacing the famed Las Vegas Strip, which reported US$6.6 billion in 2006 revenues. By 2008, Jefferies & Co. estimates the take will be up to US$12.8 billion.

Before liberalization, ethnic Chinese high rollers, mainly from Hong Kong, contributed one-third of baccarat revenues during the winter holiday months in Las Vegas. Now they play closer to home. According to CLSA Asia-Pacific Markets, the average gaming table in Macau earned three times its counterpart in Las Vegas. Tourism and construction have also soared, boosting GDP by 25.6% in the first three months of 2007.

Macau is looking to take its success a step further by becoming the region’s biggest center for entertainment and retail, with US$16 billion worth of projects underway to build some of the

29 “Making Macau “a Disneyland for Adults”; Impresario Sheldon Adelson is set to bring Las Vegas-style glitz – and money – to China’s less-than-glamorous gambling mecca,” BusinessWeek Online, October 3, 2002
31 “Macao bets on an end to gambling monopoly,” Financial Times, February 7, 2002
32 Ng Kang-chung, “Macau beats HK in GDP growth,” South China Morning Post, April 1, 2007
world’s largest hotel, shopping mall and gaming complexes. Hong Kong property developers, including Galaxy Entertainment and Macau Success, are participating in the bonanza.

Traditionally, international visitors have arrived in Macau by way of Hong Kong, adding Macau to a Hong Kong and China itinerary as an afterthought. The length of the runway at Macau’s International Airport has been a structural obstacle restricting a larger flow. That will change as the airport begins a HK$4 billion expansion undergoing expansion to increase runway capacity by 50% and double the size of the passenger terminal.33 For the first time Hong Kong may find that it has to work hard to convince travelers to make a side trip by water ferry from Macau, rather than the other way around.

**Boom Times in Macau**

<table>
<thead>
<tr>
<th>Boom Times in Macau – GDP, Gambling, Tourism &amp; Construction Fuel the New Economy</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Domestic Product (million patacas)</td>
<td>63,566</td>
<td>82,966</td>
<td>92,951</td>
<td>114,364</td>
</tr>
<tr>
<td>Nominal growth rate</td>
<td>16</td>
<td>30.5</td>
<td>12</td>
<td>23</td>
</tr>
<tr>
<td>Real growth rate</td>
<td>14.2</td>
<td>28.4</td>
<td>6.9</td>
<td>16.6</td>
</tr>
<tr>
<td>GDP per capita (thousand patacas)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gaming receipts (million patacas)</td>
<td>29,476</td>
<td>42,306</td>
<td>45,800</td>
<td>55,884</td>
</tr>
<tr>
<td>Year on year change (%)</td>
<td>29</td>
<td>43.5</td>
<td>8.3</td>
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<tr>
<td>Revenues from gaming tax</td>
<td>10,579</td>
<td>152,366</td>
<td>17,318.6</td>
<td>20,747.16</td>
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<tr>
<td>Visitor arrivals (thousands)</td>
<td>11,887.9</td>
<td>16,672.6</td>
<td>18,711.2</td>
<td>21,998.1</td>
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<tr>
<td>Construction</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Expenditure on public works (million patacas)</td>
<td>1,901.3</td>
<td>2,814.2</td>
<td>3,652.1</td>
<td>3,682.5</td>
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<tr>
<td>Private sector construction (1,000 sq.m.)</td>
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<td></td>
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</tr>
<tr>
<td>Building started</td>
<td>533</td>
<td>715</td>
<td>2,133</td>
<td>1,054</td>
</tr>
<tr>
<td>Building completed</td>
<td>243</td>
<td>215</td>
<td>391</td>
<td>1,276</td>
</tr>
</tbody>
</table>

1,000 Macau patacas = US$127.4 (6/21/07)

*Source: Monetary Authority of Macao*

33 Charlotte So, “HK$4b upgrade aims to boost Macau airport capacity,” *South China Morning Post*, February 2, 2007
Macau: Quarterly GDP Growth Rate, 2001 to 2007

Main Components of the Gross Domestic Product (at Constant (2002) Prices) by the Expenditure Approach

Source: Monetary Authority of Macao
## Major Casino and Leisure Projects in Macau, 2006

<table>
<thead>
<tr>
<th>Major Projects</th>
<th>Casino Table No.</th>
<th>Room No.</th>
<th>Room Rate (US$)</th>
<th>Cost (US$ bn)</th>
<th>Star No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>SJM</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grand Lisboa</td>
<td>300</td>
<td>650</td>
<td>N/A</td>
<td>0.35</td>
<td>5</td>
</tr>
<tr>
<td>Ponte 16</td>
<td>174</td>
<td>423</td>
<td>128</td>
<td>0.31</td>
<td>5</td>
</tr>
<tr>
<td>MGM</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MGM Grand</td>
<td>300</td>
<td>600</td>
<td>180-184</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>Galaxy</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Galaxy Star World</td>
<td>290</td>
<td>500</td>
<td>244</td>
<td>0.3</td>
<td>4</td>
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<tr>
<td>Galaxy Cotai Mega Resort</td>
<td>600</td>
<td>1,500</td>
<td>128</td>
<td>0.6</td>
<td>5</td>
</tr>
<tr>
<td>LVS</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Sands (expansion)</td>
<td>250</td>
<td>740</td>
<td>N/A</td>
<td>0.53</td>
<td>5</td>
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<tr>
<td>Venetian</td>
<td>700</td>
<td>3,000</td>
<td>170-178</td>
<td>2.3</td>
<td>6</td>
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<tr>
<td>Cotai Alliance (LVS)</td>
<td>1,100</td>
<td>17,000</td>
<td>N/A</td>
<td>8</td>
<td>4-6</td>
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<tr>
<td>Wynn</td>
<td></td>
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<tr>
<td>Wynn resort (1 &amp; 2 phases)</td>
<td>350</td>
<td>600</td>
<td>177</td>
<td>1.2</td>
<td>6</td>
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<tr>
<td>Melso – PBL</td>
<td></td>
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<tr>
<td>City of Dreams (Hard Rock &amp; Hyatt)</td>
<td>450</td>
<td>2,000</td>
<td>N/A</td>
<td>1.5</td>
<td>4-6</td>
</tr>
<tr>
<td>Crown Macau</td>
<td>200</td>
<td>227</td>
<td>231</td>
<td>0.26</td>
<td>6</td>
</tr>
</tbody>
</table>
4 Hong Kong’s dilemma

Two charts below illustrate Hong Kong’s dilemma. The first shows Guangdong’s vision for a new division of labor among the three major cities of the Greater Pearl River Delta – Hong Kong,

Role Playing: Hong Kong, Guangzhou and Shenzhen

<table>
<thead>
<tr>
<th>Role Playing: Hong Kong, Guangzhou and Shenzhen</th>
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<tbody>
<tr>
<td><strong>Hong Kong</strong></td>
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<td><strong>Guangzhou</strong></td>
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<td><strong>Shenzhen</strong></td>
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</tbody>
</table>

Guangzhou and Shenzhen.

The second shows Hong Kong’s rapidly vanishing role as a central player in export processing, even before the recent prohibitions by Guangdong. In the last two years, while Hong Kong has continued to thrive as a throughway for sub-assemblies and raw materials from other countries bound for China’s processing trade, Hong Kong’s direct input has nearly vanished.
Hong Kong’s Vanishing Role in Export Processing for the Mainland

<table>
<thead>
<tr>
<th>Hong Kong's Vanishing Role in Export Processing for the Mainland, 1Q, 2007</th>
<th>1Q 2007</th>
<th>% Change Over 1Q 2006</th>
<th>% of Total Involving EP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total value of trade with China (HK$ millions)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total exports</td>
<td>281,129</td>
<td>13.3</td>
<td></td>
</tr>
<tr>
<td>Domestic exports</td>
<td>8,264</td>
<td>-8.7</td>
<td></td>
</tr>
<tr>
<td>Re-exports</td>
<td>272,865</td>
<td>14.1</td>
<td></td>
</tr>
<tr>
<td>Imports from China</td>
<td>282,375</td>
<td>10.3</td>
<td></td>
</tr>
<tr>
<td>Goods imported from China to Hong Kong for export</td>
<td>234,610</td>
<td>6.7</td>
<td></td>
</tr>
<tr>
<td><strong>Value of export processing trade with China</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total EP exports</td>
<td>103,319</td>
<td>21</td>
<td>36.8</td>
</tr>
<tr>
<td>Domestic exports</td>
<td>3,670</td>
<td>-20.9</td>
<td>44.4</td>
</tr>
<tr>
<td>Re-exports</td>
<td>99,649</td>
<td>23.4</td>
<td>36.5</td>
</tr>
<tr>
<td>Imports from China</td>
<td>180,438</td>
<td>6.8</td>
<td>63.9</td>
</tr>
<tr>
<td>Imports from China to Hong Kong for export</td>
<td>180,738</td>
<td>4.1</td>
<td>77</td>
</tr>
</tbody>
</table>

*Source: Census and Statistics Department, Hong Kong*

This is not necessarily a bad thing, since re-exports through Hong Kong, mostly to China, have been rising steadily and have exceeded domestic exports since mid-2001. The problem is the exposure of re-exports to export processing. The entire base of Hong Kong’s export processing trade with China, nearly 40% of total exports to China and more than 60% of imports in the first quarter of 2007, is now in jeopardy due to policy changes that cover not only Guangdong but the rest of China as well. Based on the first quarter 2007 numbers, Hong Kong’s China trade without re-exports was about HK$56 billion—HK$8 billion in exports and HK$48 billion in imports. Hong Kong’s trade economy suddenly starts to scale down to its own middle-income economy and population of six million.

In export processing, the trader supplies raw materials to a China-based factory, sews, processes or assembles a product, and ships it back to the Hong Kong-based trader in exchange for processing fees. Customs duties and China’s value-added tax, have been waived for this type of business. Textiles was the major industry in which Hong Kong continued to have a role into the 1990s and 2000s. Hong Kong manufacturing retained an afterlife, particularly in the quota-protected textile, garments and footwear businesses, until 2005, when the end of the Multi-Fiber Agreement removed the last props protecting Hong Kong manufacturing (with some hiccups, as both the United States and European Union negotiated temporary continuation of quotas).

As Guangdong’s composition of trade shifts from light to heavy industrial products, Hong Kong is likely to lose not only the flow of domestic exports but also re-exports, especially those based on surface transport. Hong Kong’s port facilities are not equipped to deal with heavy industry,
chemicals or raw materials. Hong Kong’s status as a trading center, one of the linchpins of Hong Kong employment, is becoming ever more dependent on the competitiveness of its ports and airport relative to their mainland counterparts.

The writing is on the wall for both. As the world’s second busiest air cargo hub after Memphis, Tennessee, Hong Kong’s position remains dominant in air cargo – as recently as 2005 Hong Kong’s Chek Lap Kok International Airport handled air cargo more than all of the mainland’s airports combined. But by 2006, at 3.6 million tonnes, Chek Lap Kok was beginning to lag behind the combined 4 million tonnes in air cargo volume of Shanghai, Beijing and Guangzhou. 35 Shanghai’s Pudong International Airport, with 2.1 million tonnes, had moved into the sixth largest air cargo spot and grew by 16.3% in 2006, compared to 5.1% growth in Hong Kong. Beijing, with 1 million tonnes in cargo traffic, grew by a sizzling 31.1%.

Compared to Hong Kong, Shanghai and Beijing, Guangzhou’s Baiyun International Airport is still a regional player but is preparing to move into the big leagues. In 2006, it had air cargo traffic of just 824,906 tonnes, ranking 25th globally. Its neighbor Shenzhen ranked 34th with air cargo traffic of 559,293 tonnes. But Baiyun is positioning itself to serve as a transport hub for interior Chinese cities including Chengdu, Nanning, Changsha and Guiyang, and will complete its second phase in 2008.

At that point, Baiyun will be able to handle 40 million passengers and 2 million tons of cargo annually, still well behind the 45 million passengers and 3.6 million tons per year capacity of Hong Kong’s Chek Lap Kok International Airport, but with room to grow. Fedex will move its Asia-Pacific transport center to an 82,000 square meter facility at Baiyun in 2008, adding another 600,000 tons annually, based on an agreement signed in July 2005.

Hong Kong’s container port, meanwhile, is losing ground to international competitors. It lost its status as the world’s busiest container port to Singapore in 2005, and became number three in the first quarter of 2007, when it was overtaken by Shanghai. It is expected to fall to fourth place after Shenzhen in 2008. 36 Throughput in the Hong Kong port is stagnant and would likely collapse were it not for the efficiency of its Customs regime relative to the mainland. 37 Port expansion programs at Shekou and Chiwan on the east bank of the Pearl River Delta and construction of a huge new port at Da Chan Bay will give Shenzhen ports spare capacity to pursue international trans-shipment business. In April 2007, Shenzhen Deputy Mayor Zhang Sipang announced a “one-off” concession of as much as RMB 5 million to shipping lines and freight forwarders to increase their presence in the city, in an effort to fill up three brand new berths. 38 Meanwhile, Hong Kong’s trucking regulations add as much as US$100 to the cost of a 40-foot container, by forcing trucking companies to use higher-cost Hong Kong-based drivers and the same truck on both legs of trips.

35 “Asia’s top 35 air cargo airports in 2006,” Air Cargo World, July 1, 2007
36 Charlotte So, “Shanghai port knocks Hong Kong off No 2 sport,” South China Morning Post, April 19, 2007
37 Robert Wright, “Hong Kong’s efficiency helps to keep its port afloat,” Financial Times, April 17, 2007
38 Charlotte So, “Shenzhen dangles port subsidies,” South China Morning Post, April 10, 2007
Such factors have led the central government to pressure Hong Kong to leave the expansion of container terminals to neighboring cities in Guangdong. In June, in an interview with the South China Morning Post, Zhang Xiaochang, a deputy chairman of the National Development and Reform Commission, said Hong Kong should embrace a “regional perspective” in building any new terminals, instead concentrating on the high-end logistics industry.39

Will Hong Kong survive? Of course. Will it have to adapt? Naturally. Will the role that government plays in the market increase as a result? Hopefully not. Hong Kong’s greatest resource in dealing with the effects of Chinese central planning, for better or for worse, is its strong market institutions and policies that support the free flow of goods and ideas.

4.1 Hong Kong: No more hinterland

Hong Kong’s two neighbors, Guangdong and Macau, have raised a challenge to Hong Kong, but it is by no means one that Hong Kong cannot meet.

For Hong Kong’s manufacturers, Guangdong’s industrial policy imposes tough conditions on polluting industries and traditional light industry, but favors companies that move up the value-added ladder, and are oriented to the domestic market. The uniform tax code that came into effect in 2008 will increase pressure to exercise control from Hong Kong, and will favor wholly-owned foreign enterprises over export processing enterprises, which are more likely to be taxed at higher domestic tax rates (25% versus 17.5% in Hong Kong).40

Competition from mainland ports, logistics, supply-chain management and other services will intensify. Hong Kong will need to move higher up the value chain in services as well as manufacturing, and learn to view its hinterland from new perspectives, as a market, service supplier, and source of human capital – increasingly expensive and skilled human capital at that.

In finance and property, two industries in which Hong Kong has a commanding lead, it will have to work harder to keep its advantage, as mainland competition grows in these areas as well.

In the leisure and travel sector, success will be linked to improvements in the quality of living and the environment, which have deteriorated and need to be addressed through bold regulatory measures. Hong Kong has plenty of opportunity, but its policy makers and business leaders must learn a new landscape – and work with it, rather than against it.

4.2 An optimist’s scenario

In the summer of 2007, as Guangdong threatened action against dirty and inefficient export processing industries in the Delta, Hong Kong trade associations begged for time and Secretary for Commerce and Economic Development Frederick Ma Si-hang promised help. 41

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39 Kristine Kwok and Dennis Eng, “HK urged to rethink role as shipping hub,” South China Morning Post, June 22, 2007
41 Denise Tsang, “Cross-border taskforce to help factories hit by new export rule,” South China Morning Post, August 3, 2007
A government taskforce, comprising 21 chambers of commerce, business groups and government departments, had its first meeting on August 3, 2007, headed by Yvonne Choi Yin-pik, permanent secretary for Commerce. Ms. Choi recommended that Hong Kong factory owners give careful consideration to an invitation from Hunan provincial authorities to relocate to Guangdong’s northern neighbor. The Hong Kong Association of Banks made soothing noises about finding “ways to support” local companies. 42

The frantic cries of Hong Kong small and medium-sized enterprises notwithstanding, the Hong Kong government is unlikely to intervene in any more meaningful way than its January 2008 grant to the Hong Kong Productivity Council, aimed at helping companies assess production methods. One reason is that there is too much money to be made from the next phase of Pearl River Delta growth.

Hong Kong’s Delta entrepreneurs have had nearly thirty years to get rich. Now a new set of entrepreneurs is likely to rise up behind them, seizing opportunities under Guangdong’s new policy framework and leveraging the advantages, as before, of family and language ties as well as access to international markets.

Hong Kong business, finance and entrepreneurs have both more to lose and more to gain from the Pearl River Delta than their global counterparts, but the fundamental question is the same – how to leverage existing assets to “move up” to an economy based on vertically integrated manufacturing and high technology with an efficient transport network and rising quality of life? In other words, how to get from A to Z, or even B?

4.3 A decade that could make or break Hong Kong

The immediate threat for Hong Kong is coping with upheaval among its export processing enterprises in the Pearl River Delta. Longer term, it must also reckon with loss of other key industries, including ports and logistics. In the short term, Hong Kong faces enormous disruption and temptations to slow the process down. The faster Hong Kong gets on with moving to a new industrial structure, the better, even though this means rethinking its role in the regional economy as well as dismantling legacy protection and anti-competitive rules in its domestic economy.

A generation ago, in the late 1970s, something amazing happened to Hong Kong. Through an administrative slight of hand, it gained what economists and urban geographers call a “hinterland.”

The circumstances were completely unpredictable. An aging Long March veteran, Deng Xiaoping, authorized reforms that made it possible for factories in Guangdong Province, neighboring Hong Kong, to manufacture products on order from abroad.

As long as the customer supplied raw materials and equipment, and guaranteed purchase of the output, the factory and its customers could skip the nightmare bureaucracy of China’s import and export corporations, with its licensing and tariff structure. This was called “processing trade,” and by 2006, it accounted for 47.2% of China’s total foreign trade, or US$831.9 billion. Guangdong was always at the forefront of this trade, because as was intended, Hong Kong entrepreneurs instantly took advantage of it. In 2005, more than 80% of Guangdong’s trade was based on some form of processing, representing almost 60% of China’s total for processing trade. By 2006, out of 90,000

42 Ng Kang-chung, “Banks offer to help HK factory owners,” South China Morning Post, August 24, 2007
enterprises engaged in processing trade in China, 70,000 were in Guangdong, and of those, approximately 47,000 represented Hong Kong capital.44

This entire system is now being unwound, as China’s central government begins forceful interventions to move to a new level of industrialization. Guangdong, with its wealth and success, is again a test case. Its level of environmental degradation has become a national embarrassment, and despite achieving numerous milestones in terms of economic development, it has become a byword for sweatshops and labor abuse even among some 36.7 million migrant workers45, mostly from neighboring provinces. Over the last few years, Guangdong has been losing employment to the Yangtze River Delta, where wages and quality of life are higher, and the processing industry is held responsible.

The reasons are simple. Processing industry has supported the development of mutually reinforcing industrial clusters of small and medium-sized enterprises, extraordinarily flexible in meeting the needs of the global supply chain but also capable of creating vicious cycles and negative externalities for the environment and for technological learning. By the early 2000s, some 34,000 Hong Kong enterprises were engaged in a massive toy manufacturing “cluster” in Guangdong that provided over 60% of the world’s supply. 46 The Pearl River Delta also served as a platform for industrial clusters in the footwear, electrical and electronics industries, producing 88.2% of China’s exports of electrical fans, for example. Deconstructed, theses industries have provided foreign exchange earnings for China at the cost of environmental pollution and the emergence of higher value-added industries. Migrant workers send most of their earnings to families back home, as much as RMB 30 billion a year, according to a 2005 estimate.47

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4.4 Hong Kong’s export processing “shock”

Nonetheless, it came as a shock on July 25, 2007 when the Chinese Ministry of Commerce and China Customs Bureau jointly released Notice Number 44, announcing a list of 1,853 products, covering 15% of the Chinese Customs code, that would no longer enjoy export tax rebates – one of the main devices used by Guangdong to create a virtual Customs-free zone for export processing since the 1970s. Export rebates were removed or reduced for a range of labor-intensive industries including plastic raw materials and products; yarn; textile, and furniture.48

On July 26 and July 27, the South China Morning Post ran the story and the Hong Kong government’s reaction on the front page of its business section, as Simon Shi Kai-biu, president of the Hong Kong Small and Medium Business Association predicted that 2,000 to 3,000 Hong Kong enterprises would fail within the year. 49 The Greater Pearl River Delta Business Council had said that some 14,500 Hong Kong enterprises “would be seriously affected.” 50 The next day’s newspaper carried news that the Hong Kong government would set up an ad hoc group to “ease communication with mainland authorities” and a fund to help companies install environmental protection equipment.

Commerce and Economic Development Secretary Frederick Ma Si-hang was quoted saying: “Hong Kong enterprises in the Pearl River Delta will certainly be hit hard with the policy. Since this is a nation-wide policy, what the Hong Kong government can do is work on details of the policy including lining up some mainland banks to provide financing arrangements for manufacturers.” Clement Chen, chairman of the Hong Kong Federation of Industries, called for a grace period of six months, including “incentives and reasonable measures for the transition.”51

It was left to acerbic columnist Shirley Yam, also writing for the South China Morning Post, to observe that the policy had been announced in May and June, largely ignored until signs that the central government was serious.52 In fact the order that came out in July, with effect from August 23,53 seems to have been reduced in scope from a previous announcement in June covering 2,831 types of products and 37% of the Customs code.54 According to a report in China Daily, the levies would add RMB 8 billion to costs of exporters, half of whom were backed by Hong Kong-based companies. 55 After enormous uproar, in late August 2007, Beijing announced a delay in

49 Denise Tsang, “HK firms hit as more cheap exports cut,” South China Morning Post, July 26, 2007, op. cit., p. 58
50 Hong Kong Trade Development Council Research Department
51 Denise Tsang, “HK government offers a fund for jittery firms,” South China Morning Post, July 27, 2007
52 Shirley Yam, “Fate of processing plants provides a timely reminder,” South China Morning Post, July 28, 2007
54 Carol Chen and Kandy Wong, “Beijing cuts tax rebates on exports,” South China Morning Post, June 20, 2007
implementation of the new rules – and apparently as of the end of 2007 manufacturers had not yet paid the threatened cash deposits on imported raw materials.56

Goods under the prohibited and restricted categories for processing are not banned from trade. The new policy simply makes them liable for payment of Customs duties, including payment of a deposit equal to half the value when goods are imported for processing. The policy also introduces a new list of preferential products, including products using high technology and advanced applications technology; products that “can help upgrade product range”; products that are energy efficient and “raw materials efficient”; products made with renewable and “integrated” resources; and branded products or ones incorporating intellectual property rights.57

The Hong Kong reaction may seem excessive, given its robust economy and the deep pockets of its flagship enterprises. But, as Ms. Yam noted in her weekly column on July 28, the combination of “inertia plus prosperity” was a bad sign, whether it was Hong Kong’s reaction to the end of its dominance of low-end processing on the mainland or its response to the priority that the central government has placed on development of domestic listings.

Hong Kong has faced the change in processing trade policy and the erosion of its lead in mainland listings with the same disturbing lack of urgency and calls for delay. It will be for reasons like this if Hong Kong is to fade in the way that some other major port cities have for reasons of history – the decline of Trieste with the fall of the Austro-Hungarian Empire and its annexation to Italy; or Shanghai’s hibernation during the era of Mao Zedong. This study foresees a much better fate for Hong Kong, but only if its business and financial community show the same kind of speed and decisiveness as they did when they re-discovered South China in the first stage of China’s economic reforms.

4.5 “Hong Kong’s economy must adjust”

Feng Xiaoyun is an economist at Jinan University’s Institute of Economic Research on the Special Administrative Regions of Hong Kong and Macau, and author, with the Taiwanese scholar Liu Renjie, of a 1996 analysis of Japanese, Taiwan, and Hong Kong investment in China, The Dragon of Asia.

In November 2006, the academic was blunt in her comments at a conference in Hong Kong on the Pearl River Delta: “Hong Kong’s economy must adjust. If you rely only on exports, there will be adverse implications in the long run.” Hong Kong, she said, would see its “best opportunities” in supporting development of the relatively backwards west bank of the Delta and in exploiting the domestic market.58 A year later, in an interview in September 2007, she was more sympathetic to the plight of Guangdong’s export processing industry, but still inclined to pessimism with regard to Hong Kong. “Hong Kong enterprises don’t have this upgrading tradition or culture, and have found

56 Denise Tsang, “Beijing delays rule penalizing exporters,” South China Morning Post, August 31, 2007
57 Hong Kong Trade Development Council, op.cit., p. 31
58 Feng Xiaoyun, Economic Research Institute, Jinan University, at Seminar on Guangdong’s Economic Restructuring and Development of Western Pearl River Delta – Opportunities and Challenges for Hong Kong, Hong Kong, November 13, 2006
it harder to upgrade,” she said. “Hong Kong enterprises have to upgrade, and if not, they will have to leave. This is a market choice and survival of the fittest.”

From a Chinese perspective, the success of industrial policy is not a foregone conclusion. The new restrictions against export processing put enormous pressure on provincial revenues. According to Prof. Feng, Guangdong accounts for about one-third of China’s exports and of this, export processing represents 70% of the total. Thus, the ability of the industry as a whole to succeed in the new environment is of critical importance to the province. Many of the same favors that were once extended to light industry will now go to firms engaged in some aspect of high technology. The question for Hong Kong business is whether it can manage this transition. According to Feng, it may not.

In July 2007, as an adviser to the Dongguan municipal government, Feng conducted a survey of Guangdong’s export processing industry to measure the impact of the policy changes. Her findings in the unpublished report included a sharp difference in reaction between Hong Kong and Taiwan-funded enterprises in the sector.

Taiwan companies, clustered in electronics, had for the most part moved beyond simple subcontracting or Original Equipment Manufacture (OEM) to components design and brand designs, known by the acronyms ODM (original design manufacture) and OBM (original brand manufacture).

The Hong Kong companies in Feng’s survey, on the other hand, were concentrated in OEM in labor-intensive industries, and thus more affected by rising labor costs in the province than by the new emphasis on energy efficiency, environmental sustainability and resource conservation in the post-2006 industrial policy. She found that Hong Kong companies were solving their short-term problems by adapting their product structure to the new rules, and abandoning the prohibited categories. But in the longer run, they had a much more intractable problem in the lack of human capital needed for product innovation and development.

Feng found little enthusiasm for one of the more questionable aspects of Guangdong’s industrial policy – moving less desirable industries to remote locations in the province. Despite establishing “20 plus” industrial parks in the less developed eastern and northern parts of the province, she said, “the outcome has not been satisfactory.” Infrastructure support was lacking and transport costs became a major issue. Companies’ “first choice is to stay or to move to other parts of the country – especially the Yangtze River Delta or Dalian – rather than to the industrial parks. Their last choice would be to move out of the country altogether,” she said.

Cheng Jiansan, deputy director of the Institute of Economics at the Guangdong Academy of Sciences, describes himself as “cautiously optimistic” about the fate of Hong Kong manufacturers in part because of his faith in the resilience of Hong Kong business. “Hong Kong enterprises are world class,” he said in an interview in September 2007. “They are very willing to adapt to policy requirements and rising costs, and they have a unique advantage as an information center linking manufacturers in the Pearl River Delta with the world market.”

Cheng estimated that of the roughly 60,000 Hong Kong enterprises in the PRD, 70-80% would survive as long as they were able to adapt, but to do so they would need move up the ladder technologically while taking advantage of the labor cost differential and the advantages they have in terms of information and the world market. According to a China Academy of Social Sciences study

59 Interview, September 20, 2007, Hong Kong
60 Interview, September 19, 2007, Guangzhou
cited by Feng, out of 90,000 Hong Kong enterprises across the whole country, 4,000 to 6,000 would be forced to leave not only Guangdong but also China.

4.6 Case Studies

4.6 Case studies – Adapting to the new reality

Delays in implementation of the central government’s new restrictions on export processing firms have given Hong Kong firms breathing room. But many firms also understand that it is only a matter of time before the combination of rising land and labor costs, together with the new rules, force changes. Taking the long view, some Hong Kong companies have planned ahead, looking for ways to move up the value chain or introduce sustainable strategies to their manufacturing ventures in the Pearl River Delta.

4.6.1 Dunwell Group

Daniel Cheng, managing director of Dunwell Group, moved out of a business manufacturing metal components when he saw profit margins being squeezed, and into running the largest waste oil treatment facility in Asia, based in Yuen Long. “As an environmentalist, I try to look ahead,” he said in a 2006 interview. “Ten to 20 years from now, Hong Kong has to somehow merge with the PRD and be in harmony. Meanwhile, we will still be one step ahead. If they make the factories, we’ll make the design.”

Dunwell has been developing high-end technologies for waste-water treatment, including robots for cleaning reservoirs and advanced membrane treatment technologies for waste water. He also spearheaded the Hong Kong Federation of Industries’ “1-1-1” program to encourage Hong Kong-owned and operated companies in the Pearl River Delta to adopt sound environmental practices. “1-1-1” stands for “one factory, one year, one program.”

Launched in March 2005, the program offered to help factories identify processes that could be used to increase efficiency as well as reduce pollution. In one example, an electroplating production line was able to reduce toxic gas emissions by installing new equipment. The entire project was conducted between April and August 2005 and reduced the pH level of fumes from 5.6, a level that causes acid rain, to 6.8. Although the numbers of companies signing on to the program have been disappointingly small, it has launched a Hang Seng Pearl River Delta Environmental Award, staged numerous educational seminars, and been recognized by former US Vice President and Nobel prize winner Al Gore.

4.6.2 Esquel Group

From the perspective of Guangdong’s policy reforms, Hong Kong-based textile giant Esquel Group is in the wrong industry. It is one of the world’s largest manufacturers of cotton shirts and high-quality cotton fiber; a single woven fabric mill in Gaoming makes more woven fabric than Italy. Like Dunwell Group, Esquel is unlisted and its owner, Marjorie Yang, has a personal commitment to conservation and the natural environment.

Roughly half of Esquel’s worldwide capacity is in its factory at Gaoming in Foshan, which has regularly topped the charts as Guangdong’s most polluted city. In 1999, long before Guangdong began to crack down on textile dyeing operations, however, Esquel installed its first US$3.6 million wastewater treatment plant in Gaoming.

61 Interview, December 7, 2006, Hong Kong
establishing an in-house sustainable development team the same year. In 2002, it began building a low emission power plant, which met its power needs in Gaoming as well as providing steam as a by-product from electricity generation for dyeing and finishing processes. The power plant, completed in 2004, had an efficiency rate of 50% compared to 30-40% for conventional plants, and although based on coal, collected 99.5% of static dust to prevent air pollution and recycled 100% of dust and residues.

With labor costs rising in the PRD and pressure on imported inputs from Renminbi appreciation, Cliff Chan, director of Esquel’s sales management office in Hong Kong, describes it as a simply a good management decision to be “forward looking” in the company’s operations in the PRD. Gains in productivity will be key to maintaining profits as these trends continue, Chan said, and he expects to achieve these at least in part by making the company an attractive place to work, as well as by controlling its power bills. Labor represents 50% of the cost of making garments, while electricity is the highest cost in fabric making, after depreciation.

The company is also focusing on value-added. “If we go on positioning China as a low-cost base, we’re creating trouble for ourselves,” Chan said in the January 2007 interview. In addition to positioning Esquel as a premium quality manufacturer – it has established its own brand, Pye, and is working with customers to reduce inventory through supply chain management (SCM), Esquel gets no separate revenues for SCM, but extracts benefits by offering a better bargain on price, according to Chan. Esquel’s new fabric mill in Gaoming, opened in October 2006, is dedicated to high-end products.

Esquel also began growing organic cotton in 2000 at a farm near Kashgar in Xinjiang, and had its farm and ginning mill certified by OCIA (Organic Crop Improvement Association International). It became involved as well with Organic Exchange, an industry group committed to creating fair, transparent and sustainable supply chains for organic cotton. “As a manufacturer, we try to make everything we do green,” said Chan, but this is also good marketing sense with the increasing sensitivity of global consumers to corporate social responsibility and environmental standards.

### 4.6.3 DHL

DHL, another unlisted company, is not a Hong Kong native – currently it is 100% owned by the German post office – and has been in China since 1980, through a joint venture with Sinotrans that it still maintains. It opened its Central Asia hub operation in Hong Kong in 2000 and committed to double its capacity in 2005, from 18,200 sq.m. to 35,000 sq.m., at a cost of US$110 million. The Central Asia Super-Hub is now the largest air express facility in Asia. Although in November 2007, DHL signed an agreement with the Shanghai Airport Authority for a North Asia Hub, to open in 2010, Hong Kong remains a critical piece of its multi-hub strategy.

DHL has just “Hong Kong is still an ideal hub for the PRD,” said Alan Wong, director of marketing for DHL Express Hong Kong, in a January 2007 interview.

According to Wong, Hong Kong’s advantages as a hub included a flexible joint venture arrangement with Cathay Pacific that made it easy to work with Cathay’s partner airlines, relative to the time it would take to negotiate air rights in China. Chek Lap Kok’s lead in terms of international routes remains substantial over Guangzhou’s Baoyun. Hong’s real advantage, though, is its role as a finance center.

“It depends on the terms of trade,” said Wong. “If the transport cost is born by the US buyer, you have direct payment. But a lot of foreign charges are born by shippers, and they may have the choice of paying in Hong Kong or Thailand. They may have multiple manufacturing locations, each with their own invoice. From Hong Kong, we’re able to bill once a month, and break down the invoices as the customer wishes, without currency

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64 Interview, January 8, 2007, Hong Kong
65 “Esquel Group: Transforming into a vertically integrated, service-oriented, leading manufacturer of quality cotton apparel,” Case GS-48, Revision date 11/30/06, Stanford Graduate School of Business, Global Supply Chain Management Forum
66 Interview, January 15, 2007, Hong Kong
fluctuation risk. Our little plan at DHL reflects on a micro level the role of Hong Kong. It’s really the finance and control center for a lot of international businesses.”

**Hong Kong Enterprises on the Move from the Pearl River Delta**

<table>
<thead>
<tr>
<th>That Moving Feeling – Hong Kong Manufacturing Enterprises Planning to Leave the PRD, 2007-2010</th>
<th>% of Enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relocating all production activities elsewhere</td>
<td>5.9</td>
</tr>
<tr>
<td>Relocating some production elsewhere</td>
<td>31.4</td>
</tr>
<tr>
<td>No plans/idea</td>
<td>62.7</td>
</tr>
</tbody>
</table>

...and Where They Will Go

<table>
<thead>
<tr>
<th>% of Enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other parts of Guangdong ex-PRD</td>
</tr>
<tr>
<td>Pan-PRD ex-Guangdong</td>
</tr>
<tr>
<td>Yangtze River Delta</td>
</tr>
<tr>
<td>Other parts of the mainland</td>
</tr>
<tr>
<td>Away from the mainland</td>
</tr>
</tbody>
</table>

*Source: Hong Kong Trade Development Council Survey, “Implications of Mainland Processing Trade Policy on Hong Kong, June 2007*

**Impact of New Policy on Export Processing on Hong Kong Enterprises in the Pearl River Delta**

<table>
<thead>
<tr>
<th>Top 15 Enterprises Hit by Export Processing Policy</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shoes</td>
<td>34.7</td>
</tr>
<tr>
<td>Clocks and watches</td>
<td>32.6</td>
</tr>
<tr>
<td>Printing/packaging materials</td>
<td>29.7</td>
</tr>
<tr>
<td>Computer/telecommunication products</td>
<td>29.6</td>
</tr>
<tr>
<td>Hardware</td>
<td>27.3</td>
</tr>
<tr>
<td>Machinery</td>
<td>27.0</td>
</tr>
<tr>
<td>Plastic articles</td>
<td>26.4</td>
</tr>
<tr>
<td>Gifts/premiums</td>
<td>25.4</td>
</tr>
<tr>
<td>Housewares (non-electrical)</td>
<td>25.2</td>
</tr>
<tr>
<td>Garments</td>
<td>25.0</td>
</tr>
<tr>
<td>Electrical appliances</td>
<td>25.0</td>
</tr>
<tr>
<td>Toys</td>
<td>24.7</td>
</tr>
<tr>
<td>Textiles</td>
<td>24.4</td>
</tr>
</tbody>
</table>
Decorations and handicrafts 23.6
Electronic parts and components 22.9

<table>
<thead>
<tr>
<th>Top 15 Enterprises Hit by Reductions in Export Tax Rebates</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Printing/packaging materials</td>
<td>26.1</td>
</tr>
<tr>
<td>Housewares (non-electrical)</td>
<td>23.8</td>
</tr>
<tr>
<td>Machinery</td>
<td>21.6</td>
</tr>
<tr>
<td>Shoes</td>
<td>20.4</td>
</tr>
<tr>
<td>Clocks and watches</td>
<td>20.0</td>
</tr>
<tr>
<td>Plastic articles</td>
<td>19.8</td>
</tr>
<tr>
<td>Gifts/premiums</td>
<td>19.0</td>
</tr>
<tr>
<td>Textiles</td>
<td>18.9</td>
</tr>
<tr>
<td>Stationery and office supplies</td>
<td>18.8</td>
</tr>
<tr>
<td>Raw materials and metals</td>
<td>18.8</td>
</tr>
<tr>
<td>Toys</td>
<td>18.7</td>
</tr>
<tr>
<td>Computers/telecommunications products</td>
<td>18.5</td>
</tr>
<tr>
<td>Chemicals</td>
<td>18.5</td>
</tr>
<tr>
<td>Hardware</td>
<td>18.2</td>
</tr>
<tr>
<td>Electrical appliances</td>
<td>17.5</td>
</tr>
</tbody>
</table>


**Minimum Wage Hikes in Guangdong, 2002-2006**

<table>
<thead>
<tr>
<th>Guangdong’s Minimum Wage Hikes, 2002-2006</th>
<th>(RMB per Month)</th>
</tr>
</thead>
<tbody>
<tr>
<td>City</td>
<td>1/11/02</td>
</tr>
<tr>
<td>Guangzhou</td>
<td></td>
</tr>
<tr>
<td>Zhuhai, Foshan, Dongguan, Zhongshan</td>
<td>450</td>
</tr>
<tr>
<td>Shantou, Huizhou, Jiangmen</td>
<td>400</td>
</tr>
<tr>
<td>Shaoguan, Heyuan, Meizhou, Shanwei, Yangjiang, Zhanjiang, Maoming, Zhaoqing, Qingyuan, Chaozhou, Jieyang, Yunfu</td>
<td>360</td>
</tr>
</tbody>
</table>

Shenzhen Special Economic Zone (1/5/02; 1/7/05; 1/7/06)

Source: Labor and Social Security Office of Guangdong, in “Implications of Mainland Processing Trade Policy on Hong Kong”
## Minimum Wage in Guangdong – Breakdown by District, 500/month to 810/month

### Minimum Wages in the Pearl River Delta

<table>
<thead>
<tr>
<th>City</th>
<th>Country/Suburb/District</th>
<th>Minimum Wage (RMB)</th>
<th>Starting Date</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>500-810/month</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Guangzhou</td>
<td>Urban areas</td>
<td>780/mo.; 4.66/hr.</td>
<td>Sept. 1, 2006</td>
</tr>
<tr>
<td></td>
<td>Panyu</td>
<td>690/mo.; 4.12/hr.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Huadu District</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Zengchang City</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Conghua City</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td>Shenzhen</td>
<td>Urban areas</td>
<td>810/mo.; 4.66/hr.</td>
<td>Jul. 1, 2006</td>
</tr>
<tr>
<td></td>
<td>Baoan District</td>
<td>700/mo.; 4.02/hr.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Longgang</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td>Zhuhai</td>
<td>All district and counties</td>
<td>690/mo.; 4.12/hr.</td>
<td>Sept. 1, 2006</td>
</tr>
<tr>
<td>Foshan</td>
<td>All districts and counties</td>
<td>690/mo.; 4.12/hr.</td>
<td>Oct. 20, 2006</td>
</tr>
<tr>
<td>Jiangmen</td>
<td>All districts and counties</td>
<td>600/mo.; 3.59/hr.</td>
<td>Sept. 1, 2006</td>
</tr>
<tr>
<td>Dongwan</td>
<td>All districts and counties</td>
<td>690/mo.; 4.86/hr.</td>
<td>Sept. 1, 2006</td>
</tr>
<tr>
<td>Zhongshan</td>
<td>All districts and counties</td>
<td>690/mo.; 4.12/hr.</td>
<td>Sept. 1, 2006</td>
</tr>
<tr>
<td>Huizhou</td>
<td>Huicheng District</td>
<td>690/mo.; 3.59/hr.</td>
<td>Sept. 1, 2006</td>
</tr>
<tr>
<td></td>
<td>Huiyang District</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Daya Bay Economic Zone</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Huidong County</td>
<td>500/mo.; 2.99/hr.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Boluo County</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Longmen County</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td>Shantou</td>
<td>Urban areas</td>
<td>600/mo.; 3.59/hr.</td>
<td>Sept. 1, 2006</td>
</tr>
<tr>
<td></td>
<td>Nan’ao County</td>
<td>500/mo.; 2.99/hr.</td>
<td></td>
</tr>
<tr>
<td><strong>500/month and below</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Qingyuan</td>
<td>Urban areas</td>
<td>500/mo.; 2.99/hr.</td>
<td>Sept. 1, 2006</td>
</tr>
<tr>
<td></td>
<td>Qingcheng District</td>
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<td></td>
</tr>
<tr>
<td></td>
<td>Other areas</td>
<td>450/mo.; 2.69/hr.</td>
<td></td>
</tr>
<tr>
<td>Heyuan</td>
<td>Urban</td>
<td>500/mo.; 2.99/hr.</td>
<td>Sept. 1, 2006</td>
</tr>
<tr>
<td></td>
<td>Other areas</td>
<td>450/mo.; 2.69/hr.</td>
<td></td>
</tr>
<tr>
<td>Shaoguan</td>
<td>Wujiang District</td>
<td>500/mo.; 2.99/hr.</td>
<td>Sept. 1, 2006</td>
</tr>
<tr>
<td></td>
<td>Zhenjiang District</td>
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<td></td>
</tr>
<tr>
<td></td>
<td>Qujiang District</td>
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<td></td>
</tr>
<tr>
<td></td>
<td>Other areas</td>
<td>450/mo.; 2.69/hr.</td>
<td></td>
</tr>
<tr>
<td>Meizhou</td>
<td>Urban areas</td>
<td>500/mo.; 2.99/hr.</td>
<td>Sept. 1, 2006</td>
</tr>
<tr>
<td></td>
<td>Meizhou District</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td>City</td>
<td>Country/Suburth/District</td>
<td>Minimum Wage (RMB)</td>
<td>Starting Date</td>
</tr>
<tr>
<td>--------------</td>
<td>---------------------------------------</td>
<td>--------------------</td>
<td>---------------</td>
</tr>
<tr>
<td>Mei County</td>
<td>Same</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td>Xingning City</td>
<td>Same</td>
<td>450/mo.; 2.69/hr.</td>
<td></td>
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<tr>
<td>Pingyuan County</td>
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<td>Same</td>
<td></td>
</tr>
<tr>
<td>Jiaoling County</td>
<td>Same</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td>Dapu County</td>
<td>Same</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td>Fengshun County</td>
<td>Same</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td>Wuhua County</td>
<td>Same</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td>Shanwei</td>
<td>Urban Areas</td>
<td>500/mo.; 2.99/hr.</td>
<td>Sept. 1, 2006</td>
</tr>
<tr>
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<td>Same</td>
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</tr>
<tr>
<td>Luhe County</td>
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<td>Sept. 1, 2006</td>
</tr>
<tr>
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<td>450/mo.; 2.69/hr.</td>
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<td></td>
</tr>
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<td>500/mo.; 2.99/hr.</td>
<td>Sept. 1, 2006</td>
</tr>
<tr>
<td>Maoming</td>
<td>All districts and counties</td>
<td>500/mo.; 2.99/hr.</td>
<td>Sept. 1, 2006</td>
</tr>
<tr>
<td>Chaozhou</td>
<td>Urban areas</td>
<td>500/mo.; 2.99/hr.</td>
<td>Sept. 1, 2006</td>
</tr>
<tr>
<td>Xiangqiao District</td>
<td>Same</td>
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<tr>
<td>Fengzi District</td>
<td>Same</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td>Chaoan County</td>
<td>Same</td>
<td>450/mo.; 2.69/hr.</td>
<td></td>
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<tr>
<td>Raoping County</td>
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<td></td>
</tr>
<tr>
<td>Jieyang</td>
<td>Urban areas</td>
<td>500/mo.; 2.99/hr.</td>
<td>Sept. 1, 2006</td>
</tr>
<tr>
<td>Puning City</td>
<td>Same</td>
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<tr>
<td>Jiedong County</td>
<td>Same</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td>Huilai County</td>
<td>Same</td>
<td>450/mo.; 2.69/hr.</td>
<td></td>
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<tr>
<td>Jiexi County</td>
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<td>Same</td>
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</tr>
<tr>
<td>Pupiao County</td>
<td>Same</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td>Da’nanshanzhiao District</td>
<td>Same</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td>Yunfu</td>
<td>All districts and counties</td>
<td>500/mo.; 2.99/hr.</td>
<td>Sept. 1, 2006</td>
</tr>
</tbody>
</table>

Source: Chenyan Liu and Jacky Wu, “Minimum Wages in the Yangtze & Pearl River Delta,” CSR Asia, Vol.3, Week 11, 14/03/07, p.4
Hong Kong’s Guangdong Ties Keep Getting Stronger

Hong Kong’s Investment in Guangdong is still growing...

<table>
<thead>
<tr>
<th>Foreign Direct Investment to Guangdong Province</th>
<th>1979-2005</th>
<th>2000</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>No. of Agreement</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hong Kong</td>
<td>87,274</td>
<td>2,474</td>
<td>5,122</td>
<td>5,208</td>
</tr>
<tr>
<td>Taiwan</td>
<td>8,774</td>
<td>482</td>
<td>589</td>
<td>531</td>
</tr>
<tr>
<td>Macau</td>
<td>6,238</td>
<td>304</td>
<td>418</td>
<td>448</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Utilized Foreign Capital (US$ million)</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong</td>
<td>168,241.6</td>
<td>4,122.2</td>
<td>9,520.0</td>
<td>12,208.6</td>
</tr>
<tr>
<td>Taiwan</td>
<td>94,217.2</td>
<td>483.5</td>
<td>631.0</td>
<td>602.3</td>
</tr>
<tr>
<td>Macau</td>
<td>76,096.2</td>
<td>128.6</td>
<td>609.9</td>
<td>799.3</td>
</tr>
</tbody>
</table>

*Source: Guangdong Provincial Bureau of Statistics, Guangdong Statistical Yearbook 2006*

While Hong Kong manufacturing employment & domestic exports decline

<table>
<thead>
<tr>
<th>Manufacturing Employment (%) change</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>No. of Workers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apparel</td>
<td>-9.0</td>
<td>-10.3</td>
<td>-3.0</td>
<td>-2.0</td>
<td>-2.5</td>
<td>159,300</td>
</tr>
<tr>
<td>Textiles</td>
<td>-19.3</td>
<td>-11.6</td>
<td>-0.8</td>
<td>-4.7</td>
<td>-10.5</td>
<td>17,700</td>
</tr>
<tr>
<td>Electronics</td>
<td>-1.1</td>
<td>-16.8</td>
<td>-11.1</td>
<td>0.5</td>
<td>-4.4</td>
<td>18,800</td>
</tr>
<tr>
<td>Plastics</td>
<td>-13.1</td>
<td>-18.9</td>
<td>-2.3</td>
<td>-4.7</td>
<td>-12.9</td>
<td>12,000</td>
</tr>
<tr>
<td>Metal Fabrication</td>
<td>-17.0</td>
<td>-19.1</td>
<td>-16.8</td>
<td>-1.3</td>
<td>-8.8</td>
<td>2,700</td>
</tr>
<tr>
<td></td>
<td>-14.6</td>
<td>-20.7</td>
<td>-4.9</td>
<td>-9.7</td>
<td>-2.3</td>
<td>5,500</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Exports</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Exports (HK$ million)</td>
<td>1,562,121</td>
<td>1,749,089</td>
<td>2,027,031</td>
<td>2,251,744</td>
<td>2,467,357</td>
<td></td>
</tr>
<tr>
<td>Domestic Exports</td>
<td>131,079</td>
<td>122,126</td>
<td>126,386</td>
<td>136,324</td>
<td>138,759</td>
<td></td>
</tr>
<tr>
<td>Re-exports</td>
<td>1,431,041</td>
<td>1,626,964</td>
<td>1,900,645</td>
<td>2,115,419</td>
<td>2,328,598</td>
<td></td>
</tr>
</tbody>
</table>

*Source: Analysis Division, Financial Secretary’s Office, Government of Hong Kong, First Quarter Economic Report 2007, May 18, 2007*
### Ports of the Pearl River Delta

<table>
<thead>
<tr>
<th>PORT</th>
<th>Operators</th>
<th>Location</th>
<th>Terminal Space</th>
<th>Berths</th>
<th>Annual Capacity</th>
<th>Future Development</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong</td>
<td>Modern Terminals; Hong Kong International Terminals; Cosco Information &amp; Technology; Dubai Port; Asia Container Terminals</td>
<td>Hong Kong</td>
<td>2.7 sq.km.</td>
<td>24</td>
<td>18 million TEU</td>
<td>Four new sites identified to expand to 30 million TEU by 2020</td>
</tr>
<tr>
<td>Chiwan International Container Terminal (CCT)</td>
<td>Chiwan Wharf; Kerry Holding; Hidoney Development</td>
<td>30 km. west of Central Shenzhen</td>
<td>510,000 sq.m.</td>
<td>7</td>
<td>4.1 million TEU</td>
<td></td>
</tr>
<tr>
<td>Shekou International Container Terminal (SCT)</td>
<td>China Merchant; Swire Pacific; P&amp;O; Modern Terminals</td>
<td>28 km. east of Central Shenzhen</td>
<td>1.16 million sq.m.</td>
<td>7</td>
<td>4.5 million TEU</td>
<td></td>
</tr>
<tr>
<td>Yantian International Container Terminal</td>
<td>Hutchison Port; Yantian Port; Maersk- Sealand</td>
<td>25 km. east of Central Shenzhen</td>
<td>118 hectares</td>
<td>5.0 million TEU</td>
<td>Phase III berths adding 90 hectares to be completed in 2010</td>
<td></td>
</tr>
</tbody>
</table>

*Source: US Commercial Service, 2006*
Shenzhen and China’s Top Ten Container Ports, First Half of 2007

**Shenzhen Ports Container Throughput**

深圳港口集装箱吞吐量
Jan - June 2007  2007年1至6月

<table>
<thead>
<tr>
<th>Port</th>
<th>TEUs</th>
<th>Over same period last year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yantian Terminal</td>
<td>4,164,935</td>
<td>(+11.9%)</td>
</tr>
<tr>
<td>Shekou Terminals</td>
<td>2,181,414</td>
<td>(+11.1%)</td>
</tr>
<tr>
<td>Chiwan Terminals</td>
<td>2,790,649</td>
<td>(+16.9%)</td>
</tr>
<tr>
<td>Total</td>
<td>9,499,393</td>
<td>(+13.7%)</td>
</tr>
</tbody>
</table>

**China Top Ten Container Ports**

中國十大集装箱港
Jan-May 2007  2007年1-5月

<table>
<thead>
<tr>
<th>Port</th>
<th>'000 TEUs</th>
<th>Over same period last year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shanghai</td>
<td>10,267</td>
<td>(+26.5%)</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>7,515</td>
<td>(+9.7%)</td>
</tr>
<tr>
<td>Qingdao</td>
<td>3,785</td>
<td>(+26.5%)</td>
</tr>
<tr>
<td>Ningbo-Zhoushan</td>
<td>3,664</td>
<td>(+39.5%)</td>
</tr>
<tr>
<td>Guangzhou</td>
<td>3,571</td>
<td>(+41.1%)</td>
</tr>
<tr>
<td>Tianjin</td>
<td>2,740</td>
<td>(+21.6%)</td>
</tr>
<tr>
<td>Xiamen</td>
<td>1,786</td>
<td>(+17.2%)</td>
</tr>
<tr>
<td>Dalian</td>
<td>1,389</td>
<td>(+18.0%)</td>
</tr>
<tr>
<td>Lianyungang</td>
<td>691</td>
<td>(+37.2%)</td>
</tr>
<tr>
<td>Yingkou</td>
<td>578</td>
<td>(+37.3%)</td>
</tr>
</tbody>
</table>

## Hong Kong’s Air Cargo Throughput, Jan. 2007

<table>
<thead>
<tr>
<th></th>
<th>Tonnes</th>
<th>Over same period last year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loaded  裝貨</td>
<td>880,000</td>
<td>(+0.6%)</td>
</tr>
<tr>
<td>Unloaded 卸貨</td>
<td>517,000</td>
<td>(-0.1%)</td>
</tr>
<tr>
<td>Total 總貨</td>
<td>1,397,000</td>
<td>(+0.3%)</td>
</tr>
</tbody>
</table>

### Hong Kong Container Throughput

**Hong Kong Container Throughput**

香港貨櫃碼頭吞吐量

Jan. - June 2007 2007年第1至6月

<table>
<thead>
<tr>
<th></th>
<th>'000 TEUs 千個貨櫃單位</th>
<th>Over same period last year 與去年同期比較</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kwai Tsing Container Terminals</td>
<td>8,324</td>
<td>(+12.2%)</td>
</tr>
<tr>
<td>其他葵青碼頭以外</td>
<td>5,224</td>
<td>(-16.4%)</td>
</tr>
<tr>
<td>Total</td>
<td>13,548</td>
<td>(+2.5%)</td>
</tr>
</tbody>
</table>

Source: 吳樂華幼稚 - Hong Kong Port Development Council 香港港口發展局

### Drewry Hong Kong-Los Angeles Container Rate Benchmark

Drewry香港-羅省貨櫃運費指標

In US$ per full 40 ft. container load, excluding terminal handling charge at origin port.

美元/四十呎貨櫃

(not including origin port handling charges)

<table>
<thead>
<tr>
<th>Week</th>
<th>Month/Year</th>
<th>Rate per 40-foot box US$</th>
<th>Change (%) by week</th>
<th>Change (%) from a year earlier</th>
</tr>
</thead>
<tbody>
<tr>
<td>Week 1</td>
<td>1-07</td>
<td>$1,731</td>
<td>0.0%</td>
<td>-3.3%</td>
</tr>
<tr>
<td>Week 2</td>
<td>1-07</td>
<td>$1,734</td>
<td>0.2%</td>
<td>-10.3%</td>
</tr>
<tr>
<td>Week 3</td>
<td>1-07</td>
<td>$1,734</td>
<td>0.0%</td>
<td>-11.2%</td>
</tr>
<tr>
<td>Week 4</td>
<td>1-07</td>
<td>$1,730</td>
<td>-0.2%</td>
<td>-13.8%</td>
</tr>
<tr>
<td>Week 5</td>
<td>1-07</td>
<td>$1,733</td>
<td>0.2%</td>
<td>-11.1%</td>
</tr>
<tr>
<td>Week 6</td>
<td>1-07</td>
<td>$1,730</td>
<td>0.0%</td>
<td>-13.1%</td>
</tr>
<tr>
<td>Week 7</td>
<td>2-07</td>
<td>$1,741</td>
<td>0.4%</td>
<td>-13.0%</td>
</tr>
<tr>
<td>Week 8</td>
<td>(Chinese New Year)</td>
<td>$1,730</td>
<td>-0.1%</td>
<td>-12.0%</td>
</tr>
<tr>
<td>Week 9</td>
<td>2-07</td>
<td>$1,700</td>
<td>-2.3%</td>
<td>-9.7%</td>
</tr>
<tr>
<td>Week 10</td>
<td>3-07</td>
<td>$1,700</td>
<td>0.0%</td>
<td>-8.3%</td>
</tr>
<tr>
<td>Week 11</td>
<td>3-07</td>
<td>$1,693</td>
<td>-0.4%</td>
<td>-8.7%</td>
</tr>
<tr>
<td>Week 12</td>
<td>3-07</td>
<td>$1,801</td>
<td>-0.7%</td>
<td>-9.3%</td>
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<tr>
<td>Week 13</td>
<td>3-07</td>
<td>$1,861</td>
<td>0.0%</td>
<td>-8.6%</td>
</tr>
<tr>
<td>Week 14</td>
<td>4-07</td>
<td>$1,688</td>
<td>0.5%</td>
<td>-8.2%</td>
</tr>
<tr>
<td>Week 15</td>
<td>4-07</td>
<td>$1,688</td>
<td>0.5%</td>
<td>-8.2%</td>
</tr>
<tr>
<td>Week 16</td>
<td>4-07</td>
<td>$1,688</td>
<td>0.0%</td>
<td>-9.8%</td>
</tr>
<tr>
<td>Week 17</td>
<td>4-07</td>
<td>$1,689</td>
<td>0.0%</td>
<td>-8.1%</td>
</tr>
<tr>
<td>Week 18</td>
<td>5-07</td>
<td>$1,689</td>
<td>0.0%</td>
<td>-9.4%</td>
</tr>
<tr>
<td>Week 19</td>
<td>5-07</td>
<td>$1,689</td>
<td>0.0%</td>
<td>-10.3%</td>
</tr>
<tr>
<td>Week 20</td>
<td>5-07</td>
<td>$1,672</td>
<td>-1.0%</td>
<td>-14.6%</td>
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<tr>
<td>Week 21</td>
<td>5-07</td>
<td>$1,666</td>
<td>0.9%</td>
<td>-15.6%</td>
</tr>
<tr>
<td>Week 22</td>
<td>5-07</td>
<td>$1,662</td>
<td>0.3%</td>
<td>-15.6%</td>
</tr>
<tr>
<td>Week 23</td>
<td>6-07</td>
<td>$1,710</td>
<td>1.0%</td>
<td>-9.2%</td>
</tr>
<tr>
<td>Week 24</td>
<td>6-07</td>
<td>$1,724</td>
<td>0.0%</td>
<td>-5.0%</td>
</tr>
<tr>
<td>Week 25</td>
<td>6-07</td>
<td>$1,705</td>
<td>0.6%</td>
<td>-5.1%</td>
</tr>
<tr>
<td>Week 26</td>
<td>6-07</td>
<td>$1,705</td>
<td>0.0%</td>
<td>-5.2%</td>
</tr>
<tr>
<td>Week 27</td>
<td>7-07</td>
<td>$1,754</td>
<td>1.1%</td>
<td>-4.2%</td>
</tr>
<tr>
<td>Week 28</td>
<td>7-07</td>
<td>$1,737</td>
<td>-0.9%</td>
<td>-1.7%</td>
</tr>
</tbody>
</table>

Source: Drewry Shipping Consultants. Derived from Hong Kong and vessels' operating common carriers.

Information Correct as of July 15, 2007

SUBJECT TO CHANGE WITHOUT NOTICE 請有更改，若不另行通知

5 The making of a miracle

In 1978, Hong Kong was a free port with a labor economy based on a generation of refugees from mainland China. As a British colony, it was able to take advantage of Commonwealth trade preferences and institutional networks, including a liberal government. China’s economic reforms, however, gave it access to an industrial hinterland of formidable proportions. The central government created its first special economic zones in Guangdong, aimed at attracting investment from Hong Kong and Taiwan. It succeeded brilliantly in Shenzhen, due to its access to Hong Kong’s ports and the absence of political complications, particularly after 1984 and the Sino-British declaration on Hong Kong’s eventual return to the mainland. The deep pockets of Hong Kong investors created an economic miracle in the Pearl River Delta, and established Hong Kong as the “gateway” of China, with a thriving service sector based on ports and logistics and finance. Hong Kong was thus anchored in one of the world’s fastest growing regional economies in the Pearl River Delta, far beyond the capacity of its indigenous labor pool.

For most of the three decades, the region around the Pearl River estuary has been as much policy experiment as a community. The only city integrated with the international economy was Hong Kong, which served as the showroom for tens of thousands of factories, their major international port, and financing center.

In 1978, Hong Kong business was given a magic wand to bypass the clumsy state trading system, through the granting of export processing contracts in which Hong Kong companies maintained possession of inputs and finished products, paying processing fees to factories in China. A year later, the State Council endorsed the first special economic zones (SEZs) in Shenzhen and Zhuhai, which offered an array of tax incentives and duty waivers for foreign enterprises. These were gradually extended in whole or in part to the rest of the province, making it a laboratory for rapid industrialization based on the classic inputs of land, labor and capital.

Workers were recruited from all over the country to the factories of Shenzhen, Dongguan, Foshan, Huizhou and Guangzhou, the epicenters of Guangdong’s industrial explosion. According to one estimate, in 2004 migrant workers made up 80% of the population of Shenzhen. Between 1992 and 2004, monthly wages for those workers rose by just RMB 68, and in Foshan, one of the most heavily industrialized townships in the world, wages in 2004 were RMB 600 to 700, unchanged for a decade.

Three of the four original SEZs established in 1979 were in Guangdong Province – Shenzhen, Zhuhai and Shantou – with a fourth just up the coastline in Xiamen, in Fujian Province. Central government planners intended that the new SEZs would take advantage of the proximity of Hong Kong and Taiwan. In 1978, Hong Kong exported more than all of China, and Guangdong, with only one-seventh of China’s export revenues, was a “second-tier player” in China’s foreign trade. 69

Of the four original SEZs, only Shenzhen has been an unqualified success. Indeed, Shenzhen and its surrounding counties and townships flourished to an astonishing degree, driven by proximity to

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68 Alexandra Harney, “Migrant workers shun long hours and low pay,” Financial Times, November 2, 2004
Hong Kong and eager entrepreneurs in Guangdong’s government. The others, including Zhuhai, separated from Hong Kong by the muddy Pearl River estuary, lagged considerably behind.

5.1 The birth of the “Pearl River Economic Zone”

The success of Shenzhen, radiating out to Dongguan, Huizhou, Guangzhou and Foshan, quickly led to recognition of an emerging regional economy. As early as 1987, planners began using the concept of a “big PRD region,” and in 1994, Guangdong formally initiated the Pearl River Economic Zone, as a high-growth area within Guangdong Province subject to favorable tax and policy incentives. By the end of 2005, exactly 25 years after the launch of Guangdong’s economic miracle, the Gross Domestic Product of the 14 cities and counties included in the Pearl River Delta Economic Zone was US$223.8 billion, placing it in size between Thailand and Indonesia, the largest Southeast Asian economy.

2005 is the most recent year for which comparable data are available for the rest of the world as well as Hong Kong, Macau and Guangdong. In 2005, the Delta grew three times as fast as the ten-nation Association of Southeast Asian Nations (ASEAN), 15.8% compared to 5.5%. If the GDPs of Hong Kong and Macau were included, in 2005 the Pearl River Delta Economic Zone would have measured nearly half the size of the ASEAN economy, amazing considering that the Greater Pearl River Delta has less than one-fifth the population and 4% of the land mass of ASEAN.

In terms of the Greater Pearl River Delta’s attractions to foreign investors, it also stacks up as a mini-ASEAN. Foreign direct investment in individual cities in Guangdong exceeded that of most ASEAN members. In 2004, the latest year for which comparable data are available, inflows of foreign direct investment to the PRD were US$11.1 billion into the PRD, not including Hong Kong and Macau, compared to US$25.6 billion for ASEAN. Then again, adding FDI to Hong Kong and Macau of US$34.8 billion in 2004, the Greater PRD advantage seems almost unfair, with the Greater PRD claiming US$45.9 billion in foreign investment that year.

As a trading entity, in 2005, the Greater Pearl River Delta would have ranked as the world’s fifth largest trading power after Japan. Indeed, if the numbers dazzle, in China, one set of improbable

70 Made in PRD: The Changing Face of HK Manufacturers (Hong Kong, Federation of Hong Kong Manufacturers, 2003)
71 Guangzhou, Shenzhen, Zhuhai, Foshan, Jiangmen, Dongguan, Zhongshan, the urban district of Huizhou, Huiyang County, Huidong County, Buluo County, the urban district of Zhaoqing, Gaoyao and Sihui.
72 There are considerable problems with statistical data from Chinese provincial sources, which tend to overestimate growth. Comparisons between the Pearl River Delta, Greater Pearl River Delta (including Hong Kong and Macau) are thus for indicative purposes only. Sources for data on GDP include the ASEAN Statistical Pocketbook 2006 (Jakarta, ASEAN Secretariat, 2006); Guangdong Statistical Yearbook 2006 (Beijing, China Statistics Press, July 2006); Yangtze River Delta & Pearl River Delta and Hong Kong & Macao SAR Statistical Yearbook 2005 (Beijing, China Statistics Press, December 2005). In US dollar terms at constant prices, the Gross Domestic Product of the ASEAN economy was $876.1 billion; the Pearl River Delta economy was $223.8 billion; Hong Kong was $200.9 billion, and Macau was $11.2 billion. The ASEAN growth rate for 2005 was 5.9% while the PRD growth rate was 15.8%; Hong Kong was 7.3%; and Macau was 6.7%.
numbers always seems to be trumped by another. In the case of the Greater Pearl River Delta, the
great rival is the Yangtze River Delta, anchored by Shanghai, a city of 17 million. The Hong Kong
Centre for Economic Research figures that in 2005, the Yangtze River Delta region had exports of
US$206 billion and retained imports of US$257.8 billion, putting the region – the provinces of
Jiangsu and Zhejiang together with Shanghai Municipality – ahead as a trading entity within China.

The Yangtze River Delta has been growing far more rapidly than the Greater Pearl River Delta since
2001. In 2001-2005, the average annual growth rate of exports of foreign invested enterprises in the
Yangtze River Delta was 40%, compared to 25.6% for the Greater Pearl River Delta. Whether the
regional comparison is appropriate is another story. The population of the Yangtze River Delta
region was 141 million in 2005, 40% more than the Pearl River Delta’s 99 million. The two regions
serve very different domestic supply chains and markets, even if they compete internationally.
Greater PRD and Yangtze River Delta Regions, GDP Comparison, 2005


Pearl River Delta and Yangtze River Delta, Merchandise Trade, 2005

Greater Pearl River Delta and ASEAN, GDP Comparison, 2005

Greater Pearl River Delta and ASEAN, GDP 2005

<table>
<thead>
<tr>
<th>US$</th>
<th>450</th>
<th>400</th>
<th>350</th>
<th>300</th>
<th>250</th>
<th>200</th>
<th>150</th>
<th>100</th>
<th>50</th>
<th>0</th>
</tr>
</thead>
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<tr>
<td>Yangtze River Delta</td>
<td>421.408.3</td>
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<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Greater PRD</td>
<td>158%</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<td>-</td>
<td>-</td>
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<tr>
<td>Indonesia</td>
<td>135%</td>
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<td>-</td>
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</tr>
<tr>
<td>PRD</td>
<td>9.9%</td>
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<td>-</td>
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<td>-</td>
<td>-</td>
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<tr>
<td>Thailand</td>
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<tr>
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<td>-</td>
<td>-</td>
<td>-</td>
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</tr>
<tr>
<td>Singapore</td>
<td>4.5%</td>
<td>-</td>
<td>-</td>
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<td>-</td>
<td>-</td>
<td>-</td>
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</tr>
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<td>-</td>
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<tr>
<td>Vietnam</td>
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<td>-</td>
<td>-</td>
<td>-</td>
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</tr>
<tr>
<td>Brunei</td>
<td>3.0%</td>
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<td>-</td>
<td>-</td>
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<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<tr>
<td>Malaysia</td>
<td>3.0%</td>
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<td>-</td>
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<td>-</td>
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<tr>
<td>Philippines</td>
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<td>Vietnam</td>
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<td>Myanmar</td>
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<td>-</td>
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</tr>
<tr>
<td>Cambodia</td>
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<td>-</td>
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</tr>
<tr>
<td>Lao PDR</td>
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<td>-</td>
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<td>-</td>
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</tr>
</tbody>
</table>

Source: ASEAN, National Bureau of Statistics

Pearl River Delta and ASEAN, Global Trade Ranking, 2005

Pearl River Delta and ASEAN, Global Trade Ranking, 2005

<table>
<thead>
<tr>
<th>Top Exporters</th>
<th>$ bn</th>
<th>%</th>
<th>Top Importers</th>
<th>$ bn</th>
<th>%</th>
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<tbody>
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<td>Exporters</td>
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<td>Rank</td>
<td>Importers</td>
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<td>9.3</td>
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<td>US</td>
</tr>
<tr>
<td>2</td>
<td>US</td>
<td>904.4</td>
<td>8.7</td>
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<tr>
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<td>625.9</td>
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<td>Canada</td>
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<td>11</td>
<td>Hong Kong</td>
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<td>2.8</td>
<td>11</td>
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12 South Korea 284.4 2.7 12 Spain 278.8 2.6
13 Russia 243.6 2.3 13 South Korea 261.2 2.4
14 Singapore 229.6 2.2 14 Mexico 231.7 2.1
   PRD 227.0 2.1 15 Singapore 200.0 1.9
   Mexico 213.7 2.0 15 PRD 183.6 1.7
   World 10,431.0 100 15 World 10,783.0 100
   Europe 4,372.0 43.0 14 Europe 4,543.0 43.2
   EU 4,001.1 38.3 14 EU 4,135.4 38.3
   Asia 2,779.0 27.4 13 Asia 2,599 24.7


Comparing FDI to PRD, Greater PRD, and ASEAN, 2004

FDI to PRD, 2004

<table>
<thead>
<tr>
<th>City</th>
<th>FDI (US$ mn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong</td>
<td>691</td>
</tr>
<tr>
<td>Guangzhou</td>
<td>512</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>63</td>
</tr>
<tr>
<td>Dongguan</td>
<td>804</td>
</tr>
<tr>
<td>Foshan</td>
<td>2,401</td>
</tr>
<tr>
<td>Jiangmen</td>
<td>2,350</td>
</tr>
<tr>
<td>Zhuhai</td>
<td>2,139</td>
</tr>
<tr>
<td>Zhongshan</td>
<td>510</td>
</tr>
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<td>Heyuan</td>
<td>510</td>
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<tr>
<td>Zhaoqing</td>
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<td>Zhuhai</td>
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<tr>
<td>Guangyo</td>
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<td>Beilo</td>
<td>76</td>
</tr>
<tr>
<td>Huibong</td>
<td>73</td>
</tr>
<tr>
<td>Shui</td>
<td>63</td>
</tr>
</tbody>
</table>

FDI to Greater PRD, 2004

<table>
<thead>
<tr>
<th>City</th>
<th>FDI (US$ mn)</th>
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</thead>
<tbody>
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<td>Hong Kong</td>
<td>34,090</td>
</tr>
<tr>
<td>PRD</td>
<td>10,153</td>
</tr>
<tr>
<td>Macau</td>
<td>804</td>
</tr>
</tbody>
</table>
FDI to ASEAN, 2004

Source: National Bureau of Statistics, Census and Statistics Department, Hong Kong, Monetary Authority of Macau, ASEAN
5.2 Tracking Hong Kong business in the delta

Hong Kong investors and managers followed the flow of funds, especially into assembly and processing of a wide range of light industrial products, from ceramics to toys and textiles. According to official Guangdong statistics, by 2005, “units funded by entrepreneurs from Hong Kong, Macao and Taiwan” employed 6 million out of a provincial workforce of 50 million. There were 33,204 legal entities and 345,672 industrial enterprises under the same category. 73

The official numbers understate Hong Kong investment and employment, largely due to the range of contractual forms available to Hong Kong investors through family and informal connections. The first wave of Hong Kong investment in the 1980s largely skipped the bureaucracy and tangled approval issues associated with direct investment and joint ventures. Shenzhen and Zhuhai, the first special economic zones, quickly followed by the rest of the province, made it easy and attractive to process materials for export. Export processing could be conducted by domestic enterprises without foreign equity although most needed substantial inputs in terms of manufacturing know-how, raw materials, and order books.

From 1980 to the millennium year, virtually all Hong Kong’s manufacturing sector moved across the border to the north. According to economist Francis Cheung of Standard Chartered Bank, manufacturing grew “out of Hong Kong’s boundary.” Between 1980 and 2005, Hong Kong’s manufacturing sector shrank from 22.8% of Gross Domestic Product to 3.4%, and employed ten times more workers in the mainland than it had employed workers in Hong Kong during the peak period of the mid-1980s.74

Export processing later became a sophisticated business model in the hands of companies such as Li & Fung and Noble Group, which transformed it into supply chain management. In the early days, Hong Kong business, much of it family-owned, was ready to invest in export processing as long as their Guangdong-based business partners could supply them with goods for their global customers. Thus, a very large percentage of Hong Kong business was conducted under the mantle of “other contractual forms,” by domestic enterprises, even if these included substantial investment in terms of machinery, raw materials, and sub-assemblies or components. Hong Kong companies handled supply, distribution and logistics in export processing, a type of business still almost unique to Guangdong in China.

Despite a quarter century of deepening networks and integration, the precise scale of Hong Kong’s exposure to the Pearl River Delta remains elusive. Official Chinese data aggregate information for Hong Kong, Macau and Taiwan investment, as in the enterprise and employment figures cited above.

Three sets of data illustrate the difficulty. While the Guangdong Provincial Bureau of Statistics in 2005 cites a total of 35,672 enterprises in 2005 employing 6 million, under the category of Hong Kong, Taiwan and Macau, the same series gives a figure of 11,292 industrial enterprises “above a designated size” employing 4.9 million. The National Bureau of Statistics, in a related series, gives a

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74 Francis Cheung, “Made in Asia: where is the country of origin?” Asia Focus, Standard Chartered Bank, April 2007
number of 13,965 industrial enterprises in the Pearl River Delta in 2005, although without a number for employment.

Without more information on the reporting criteria used by the national and provincial statistical bureaus, or a separate breakdown for Hong Kong enterprises, it is difficult to reconcile the obvious inconsistencies, especially in the employment statistics.

The third data set, by the Hong Kong Centre for Economic Research (HKCER), provides a set of metrics based on statistical sampling rather than government registrations. Sponsored by the Federation of Hong Kong Industries (FHKI), HKCER conducted surveys in 2003 and 2005-06. Published in 2003, the first survey found a total of 21,300 factories in Guangdong classified as foreign funded enterprises, with another 32,000 factories providing processing operations for Hong Kong-based companies. These 53,300 enterprises represented 84% of Hong Kong’s manufacturing investments in the whole of China, and employed an estimated 10 million workers. 75

By the time of the second FHKI survey, published in April 2007, the total number of enterprises had gone up to 55,200 and the number of factories to 57,500, employing 9.6 million workers. In the second survey, there were 22,900 Hong Kong-funded manufacturing enterprises with 23,700 factories. Another 32,300 enterprises and 33,800 factories fell under the category of “other contractual forms,” many of which are registered as domestic Chinese enterprises. 76

**Federation of Hong Kong Industries: Hong Kong-funded Enterprises in the PRD including Other Contractual Forms (OCF)**

<table>
<thead>
<tr>
<th>Hong Kong-funded Enterprises in the PRD including Other Contractual Forms (OCFs), 2006</th>
<th>HK-funded enterprises</th>
<th>HK-funded OCFs</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guangzhou</td>
<td>2,700</td>
<td>6,600</td>
<td>9,300</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>4,900</td>
<td>6,600</td>
<td>11,500</td>
</tr>
<tr>
<td>Zhuhai</td>
<td>1,200</td>
<td>1,000</td>
<td>2,200</td>
</tr>
<tr>
<td>Foshan</td>
<td>1,200</td>
<td>4,500</td>
<td>5,700</td>
</tr>
<tr>
<td>Jiangmen</td>
<td>900</td>
<td>1,600</td>
<td>2,500</td>
</tr>
<tr>
<td>Dongguan</td>
<td>8,200</td>
<td>6,100</td>
<td>14,300</td>
</tr>
<tr>
<td>Zhongshan</td>
<td>1,300</td>
<td>3,800</td>
<td>5,100</td>
</tr>
<tr>
<td>Huizhou</td>
<td>2,200</td>
<td>1,200</td>
<td>3,400</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>22,600</strong></td>
<td><strong>31,400</strong></td>
<td><strong>54,000</strong></td>
</tr>
</tbody>
</table>

Source: Federation of Hong Kong Industries and Hong Kong Centre for Economic Research

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75 *Made in PRD: The Changing Face of HK Manufacturers* (Hong Kong, Federation of Hong Kong Manufacturers, 2003), p. 21

76 *The Hong Kong Centre for Economic Research, Made in PRD: Challenges and Opportunities for HK Industry* (Hong Kong, Federation of Hong Kong Industries, 2007), p. 47
**Guangdong Provincial Bureau of Statistics: Registered Hong Kong, Macau and Taiwan-funded Enterprises and Employment in Guangdong, 2005**

<table>
<thead>
<tr>
<th>Number of Corporate Units and Industrial Establishments, Guangdong 2004-2005</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Guangdong</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate Units</td>
<td>434,988</td>
<td>480,005</td>
</tr>
<tr>
<td>Industrial Establishments</td>
<td>551,542</td>
<td>594,006</td>
</tr>
<tr>
<td>Employment (millions)</td>
<td>46.8</td>
<td>50.2</td>
</tr>
<tr>
<td><strong>Enterprises with Funds from Hong Kong, Macao and Taiwan</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Corporate Units</td>
<td>30,644</td>
<td>33,204</td>
</tr>
<tr>
<td>Total Industrial Establishments</td>
<td>33,473</td>
<td>35,672</td>
</tr>
<tr>
<td>Employment (millions)</td>
<td>4.9</td>
<td>6.0</td>
</tr>
<tr>
<td><strong>Of which:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Joint ventures (units)</td>
<td>4,829</td>
<td>5,133</td>
</tr>
<tr>
<td>Joint ventures (establishments)</td>
<td>5,574</td>
<td>5,818</td>
</tr>
<tr>
<td>Cooperative enterprises (units)</td>
<td>3,261</td>
<td>3,474</td>
</tr>
<tr>
<td>(Cooperative enterprises (establishments)</td>
<td>3,593</td>
<td>3,795</td>
</tr>
<tr>
<td>Sole investment enterprises (units)</td>
<td>22,257</td>
<td>24,280</td>
</tr>
<tr>
<td>Sole investment enterprises (establishments)</td>
<td>23,623</td>
<td>25,395</td>
</tr>
<tr>
<td>Shareholding companies (units)</td>
<td>297</td>
<td>317</td>
</tr>
<tr>
<td>Shareholding companies (establishments)</td>
<td>683</td>
<td>684</td>
</tr>
</tbody>
</table>

*Source: Guangdong Provincial Bureau of Statistics, Guangdong Statistical Yearbook 2006*
**Guangdong Provincial Bureau of Statistics: Registered Hong Kong, Macau and Taiwan-funded Industrial Enterprises in Guangdong, 2005**

<table>
<thead>
<tr>
<th>Registered Hong Kong, Macau and Taiwan-funded Industrial Enterprises in Guangdong, 2005*</th>
<th>RMB billions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of enterprises</td>
<td>11,292.0</td>
</tr>
<tr>
<td>GIÖ</td>
<td>1,116.7</td>
</tr>
<tr>
<td>Total assets</td>
<td>908.1</td>
</tr>
<tr>
<td>Revenues</td>
<td>1,111.0</td>
</tr>
<tr>
<td>Taxes</td>
<td>3.8</td>
</tr>
<tr>
<td>Profits</td>
<td>60.5</td>
</tr>
<tr>
<td>Employees (million)</td>
<td>4.9</td>
</tr>
</tbody>
</table>

* "Hong Kong, Macau and Taiwan funded enterprises above designated size" (Source: Guangdong Provincial Bureau of Statistics)

**National Bureau of Statistics: Registered Hong Kong, Macau and Taiwan-funded Enterprises in the Pearl River Delta, 2005**

<table>
<thead>
<tr>
<th>Registered Hong Kong, Macau and Taiwan-funded Industrial Enterprises in the Pearl River Delta</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Enterprises</td>
<td>RMB million</td>
</tr>
<tr>
<td></td>
<td>2000</td>
</tr>
<tr>
<td>Guangzhou</td>
<td>1,810</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>1,450</td>
</tr>
<tr>
<td>Zhuhai</td>
<td>528</td>
</tr>
<tr>
<td>Foshan</td>
<td>675</td>
</tr>
<tr>
<td>Jiangmen</td>
<td>480</td>
</tr>
<tr>
<td>Dongguan</td>
<td>1,320</td>
</tr>
<tr>
<td>Zhongshan</td>
<td>547</td>
</tr>
<tr>
<td>Huizhou</td>
<td>220</td>
</tr>
<tr>
<td>Huiyang</td>
<td>102</td>
</tr>
<tr>
<td>Huidong</td>
<td>21</td>
</tr>
<tr>
<td>Boluo</td>
<td>108</td>
</tr>
<tr>
<td>Zhaoqing</td>
<td>81</td>
</tr>
<tr>
<td>Gaoyao</td>
<td>70</td>
</tr>
<tr>
<td>Sihui</td>
<td>39</td>
</tr>
<tr>
<td>Total</td>
<td>7,451</td>
</tr>
</tbody>
</table>

5.3 The delta money mill

All three sets of data are consistent in one detail – a steady increase in the number of Hong Kong enterprises in Guangdong, despite pressures to scale back export processing and scale up heavy industry and technology. Whether that will change with the recent prohibitions on export processing remains to be seen. Such numbers parallel the steady decline of Hong Kong manufacturing employment and domestic exports since the end of the textile Multi-Fiber Arrangement in 2005, which kept an artificial platform under Hong Kong manufacturing through its system of international quotas. The increase in number of enterprises also tracks numbers for foreign direct investment, in which separate series are published for Hong Kong, Macau and Taiwan.

Hong Kong’s re-exports, 48% of which went to China in 2006, are the most visible measure of its link to Guangdong. In 2006, re-exports grew by 10% to US$294.3 billion (HK$2.3 trillion) out of total exports of US$307.1 billion (HK$2.4 trillion) mirroring China’s larger than expected 10.7% increase in Gross Domestic Product for the year. Meanwhile, Hong Kong’s domestic exports, a measure of its links to everywhere else, grew by 1.7% in 2006 by to US$17.8 billion (HK$138.7 billion). Hong Kong’s re-exports made it the world’s 12th largest exporter in 2005 after South Korea, according to the World Trade Organization.77

Market forces, cultural affinity, and a favorable policy environment drove the migration of Hong Kong manufacturing into the Delta. The success of Guangdong was not as a factory for the world, however, but as a factory for Hong Kong, with the latter serving as manager of the value chain. Geographic proximity to Hong Kong played a large and distorting role in regional development. Nonetheless, the economic miracle was real and sustained over a quarter century, longer than the high-growth peaks of any other high-performing Asian economy.

Hong Kong has been the beneficiary of this miracle as much as its immediate neighbors in Guangdong. In 2006, Hong Kong was the world’s second-largest financial center after London in terms of funds raised, with US$64.7 billion (HK$506 billion) a result of a steady stream of new public listings by mainland companies.78 On the sidelines of the National People’s Congress in March 2007, officials began to make a new distinction between Hong Kong as China’s international funding center and Shanghai as its domestic funding center, implying a division of labor in which Hong Kong would continue to play a major role in global fundraising for China’s listed companies. 79 By the end of the first quarter of 2007, there were 370 mainland enterprises listed on HKEx, including 141 H-share companies, 90 “red chips” and 139 private enterprises, with a market capitalization of HK$6.7 trillion, about half the total market cap of listed companies.

Starting in early 2007, mainland authorities began to encourage high quality Chinese firms listed abroad to support the mainland exchanges by initiating “dual listings”. The shift in policy has been reflected in a slowdown of mainland listings in Hong Kong, which was expected to accelerate through the end of the year. Through the end of April 2007, Hong Kong Exchanges and Clearing (HKEx) reported that new H-share initial public offerings (IPOs) amounted to HK$44.7 billion, compared to HK$303.8 billion in H-share IPOs for the entire year of 2006. 80

78 Research and Planning Department, “The Profile of Company New Listings in Hong Kong” (Hong Kong Exchanges and Clearing, Inc., January 19, 2007)
79 Cary Huang, “Fillip for HK international finance role,” South China Morning Post, March 13, 2007
Nonetheless, the two largest IPOs in the first half of 2007 have been mainland listings, with China CITIC Bank raising HK$32.8 billion and Country Garden Holdings raising HK$14.7 billion in April. In May, the China Banking Regulatory Commission (CBRC) re-energized the market by announcing that it would extend the “qualified domestic institutional investor” (QDII) scheme to allow mainland banks and insurers to invest in foreign equities as well as fixed-income securities. Initially, Hong Kong was to be the only approved market for QDII equity transactions, by virtue of a memorandum of understanding signed with CBRC.

5.4 Question: What if Hong Kong’s factories had moved elsewhere?

Through most of the 1980s, Hong Kong investors had a clear-cut choice between investing in Southeast Asia and investing in Guangdong. Early in the decade, the major Southeast Asian economies introduced export and investment incentives competitive with those of southern China. Hong Kong investors chose Guangdong. What if they had chosen Southeast Asia? Hong Kong’s fortunes after its return to China in 1997 might have been very different.

It is unlikely that Hong Kong would have emerged as a central government favorite relative to Shanghai, which has long sought preeminence as China’s financial and commercial hub. Nor might Hong Kong have weathered quite so well either the Asian financial crisis of 1997-98 or the economic downturn associated with the outbreak of Severe Acute Respiratory Syndrome in 2003.

The wealth generated by business with the mainland, whether in manufacturing or tourism, is evident today in the revival of Hong Kong’s property prices, the robust retail sector, and a widening wealth gap. As in the mainland itself, in Hong Kong the rich are getting richer and the poor, poorer, as a plentiful labor supply and under-valued Renminbi continue to exert negative pressure on wages for unskilled workers in both Hong Kong and the mainland. The question remains relevant today as Hong Kong factories in the Pearl River Delta consider whether to stay or move out of China to countries and region that can provide cheaper land and labor than the increasingly expensive Delta.

5.5 From dependence to convergence

Cheap labor and Hong Kong investment were the twin drivers of industrial growth in the Greater Pearl River Delta in the first phase, knit together by central government policy aimed at fencing off large parts of the Pearl River Delta as export processing zones. The next phase, however, promises to be based on convergence among the economies of Guangdong, Hong Kong and Macau, as opposed to the policy-driven cooperation of the first phase. Convergence implies a vigorous competition between the urban poles of the regional economy for human and capital resources. And competition will lead to higher levels of economic activity as well as cooperation, as Hong Kong, Shenzhen, Guangzhou and Macau work to make it easier for human and financial capital to flow freely in search of the highest returns.

Signs of convergence began to emerge in the early 2000s, characterized by developments in Guangdong including a sharp increase in wages, improvements in lifestyle, and a dramatic change in industrial structure. These signs became more sharply etched after the SARS outbreak in 2003, transmitted to Hong Kong from Guangdong by way of a sick doctor in a Kowloon hotel.

When the Hong Kong economy contracted sharply in its aftermath, Beijing took measures to stimulate the economy, through free trade agreements under the rubric of Closer Economic
Partnership (CEPA) schemes with the special administrative regions in Hong Kong and Macau. These measures for the first time legitimized and expanded the service sector exports of Hong Kong and Macau to the mainland, including tourism, financial and professional services, and also gave both special administrative regions a modest head start on market liberalization under China’s 2001 accession to the World Trade Organization.

The language was adopted to avoid the appearance that the two CEPAs were free trade agreements between countries, but the impact was one of leveling the playing field to encourage common rules and ultimately a common market. One CEPA-related policy in particular, the introduction of an Individual Visitor Scheme for mainland tourists, did more than anything else to kick-start the emergence of a cross-border urban culture, as mainland tourists began to pour into Macau and Hong Kong.

At the same time, the central government gave quiet encouragement to mainland companies to raise capital through listings on the Hong Kong Stock Exchange. By 2006, mainland listings had elevated Hong Kong to the world’s second ranking bourse after London in terms of funds raised for initial public offerings. The individual visitor scheme radically changed Macau’s gaming industry, from one of backroom high rollers to mass market gambling, with lower per-table revenues than before but many, many more gamblers. It also revitalized Hong Kong’s retail and restaurant sectors, which had been come close to collapse during SARS.

By the first quarter of 2007, the individual visitor scheme covered 49 mainland cities and Guangdong Province, and accounted for nearly 60% of mainland visitors. In 2006, mainland visitors accounted for more than half the total, 13.5 million out of 25.5 million, and showed a tendency to spike during holiday periods. During the 10 days of the major “Golden Week” holiday in May 2007, there were 540,285 mainland visitors to Hong Kong, more than 60% of all visitors. In 2006, same-day visitors from the mainland spent HK$1,537, up 23% from 2005, while mainland visitors on longer stays were spending HK$4,705 each, more than visitors from South and Southeast Asia if less than visitors from North America, Europe, Australia, New Zealand or Taiwan. 81

The changing demographics have given a boost to luxury-brand retail as well as to commercial property owners and developers. The pre-2003 mainland tourist was content to be bused around the city in package tours to merchandisers specializing in brand-name knockoffs. The new Chinese tourist wants only the best, whether in brand-name goods, property, or restaurants.

5.6 Alphabet Soup: CEPA, the Greater Pearl River Delta, and the Pan-Pearl River Delta

I
Ronically, the beginnings of economic convergence between Hong Kong, Guangdong and Macau have coincided with a series of misfortunes, beginning with a collapse in property prices after the handover in 1997 and reaching a trough in 2003, with the outbreak of Severe Acute Respiratory Syndrome (SARS).

That same year, the central government decided to move ahead with a proposal to accelerate market liberalization under terms of China’s accession agreement with the World Trade Organization (WTO). The original focus on WTO was lost when Hong Kong’s GDP growth went

81 “Record visitor spending in 2006 exceeds forecast,” Hong Kong Tourism Board, March 30, 2007
negative in the aftermath of SARS. But the idea of a Closer Economic Partnership Arrangement, or CEPA, took hold as a means of shoring up Hong Kong confidence.

In June 2003, the central government approved not only the idea of advancing the WTO timetable to benefit Hong Kong companies, but also knocked away the ban on individual travel by mainlanders to Hong Kong from selected Chinese cities and ended the quota system for Hong Kong listings by mainland companies. These two measures had important economic as well as symbolic impacts.82

CEPA formally began in January 2004 and has gone through four rounds of revision through 2007, although with the end of WTO phase-ins in 2006, WTO-related “advantages” for Hong Kong business are no longer meaningful. Hong Kong Chief Executive Donald Tsang reported in June 2006 that in its first two years CEPA had created 29,000 jobs, generated HK$5.4 billion in service revenues and HK$5.5 billion in capital investment. He added that 380 mainland enterprises had applied for approval to set up operations in Hong Kong, with “over US$2.2 billion” in investment.83 Considering that Hong Kong had net service exports of HK$281 billion in 2006, and is a net creditor economy, with net external assets of HK$4.1 trillion at the end of 2006, including HK$5.9 trillion of direct investment, the impact of CEPA has been more symbolic than substantive.

5.6.1 CEPA: Substance and symbol

Government departments, led by the Commerce, Industry and Technology Bureau, have reported twice on the economic effects of the agreement, in April 2005 and June 2007, with findings summarized by the Legislative Council Panel on Commerce and Industry. The June 2007 report said that CEPA had created 35,000 jobs between 2004 and 2006 and would create another 3,642 jobs in Hong Kong in 2007, together with HK$239 million in capital investment. The report attributed HK$103 million in new capital investment in 2005 and HK$202 million in 2006, considerably below Mr. Tsang’s figures.84

Even if the impact is marginal, however, the symbolism has been powerful. “CEPA” has become a general heading for a range of policies that go well beyond trade and investment. The most important effects have come from unilateral decisions by the central government to ease tourism restrictions to Hong Kong and Macau, encourage mainland IPOs in Hong Kong, and allow mainland investment in global equity markets by way of Hong Kong-registered funds.

By the end of 2006, 17.1 million mainland visitors had entered Hong Kong under the individual visit scheme since it was initiated in July 2003, and every month the number of arrivals was growing by 20% or more.85 In the financial markets, although the actual number of new mainland listings fell from 74 in 2002 to 30 in 2005, the amount of funds raised soared, from HK$111 billion in 2002 (for all new listings) to HK$506 billion in 2006.86 The included the world’s largest public listing in 2006, the US$22 billion debut of the Industrial and Commercial Bank of China on October 28.

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82 Edith Terry, “CEPA and beyond...,” CLSA Asia-Pacific Markets, May 10, 2005
83 “CE speaks at opening of Mainland, HK and Macao Trade and Economic Cooperation Forum,” Hong Kong government press release, June 29, 2006
84 Danny Mok, “Cepa creating jobs, say trade bosses,” South China Morning Post, June 7, 2007
CEPA also became a means to justify a wider array of cross-border institutions engaging the business community as well as government. Up until 2003, contact with Guangdong was limited to an annual official meeting between the Hong Kong and Guangdong governments. Traffic between the two entities was routed through the Hong Kong and Macau Affairs Office, reporting directly to the State Council. Together with SARS, the democracy demonstrations in July 2003 convinced the central government that its hands-off regime was no longer viable. From 2003 onwards, Hong Kong’s business elite was under new pressure to develop informal linkages beyond their own business networks.

5.6.2 The PRD becomes the “Greater” Pearl River Delta

On August 5, 2003, at the sixth annual meeting of the Hong Kong/Guangdong Cooperation Joint Committee, the Hong Kong government announced the formation of the Greater Pearl River Delta Business Council (GPRDBC) and appointed Victor Fung, chairman of the eponymous family company, Li & Fung, as its head (the Li family has long since ceased to be part of management). The new council’s mission was to “come up with new business ideas on how to facilitate value-added operations and sustainable development across the boundary.” 87

The council, with 31 members, set up six sub-groups on cross-boundary passenger and cargo flow; services implementation of CEPA; sustainable development; joint investment and trade; technology, education and human resources; and tourism, culture and sports.88 Mr. Fung organized the council along the lines of a similar elite panel he was familiar with from the Asia Pacific Economic Cooperation forum (APEC), in which members seconded their own staff to serve secretarial functions. Like APEC’s Business Advisory Council, the GPRDC busied itself with recommendations and studies, in theory serving as a counterpart to the Guangdong branch of the China Council for the Promotion of International Trade.

In June 2004, with the backing of Zhang Dejiang, secretary of the Guangdong provincial Communist Party Committee, Hong Kong was included in the “9 + 2” Framework Agreement on Regional Cooperation in the Pan-Pearl River Delta, which included nine provinces and the two special administrative regions, Hong Kong and Macau.89 The members agreed to establish a “joint meeting mechanism” for provincial governors and chief executives to push regional integration, focusing on 10 sectors ranging from energy and infrastructure to a Pan-PRD Economic Cooperation Zone in Hengqin, the largest of Zhuhai’s 146 islands and three times the size of Macau. The Hengqin idea was later abandoned in favor of Guangdong/Macau cooperation for development of the island, which is adjacent to the island of Coloane in Macau. 90

In the post-SARS years, the “PRD” and Greater PRD, including Hong Kong and Macau, became the subject of numerous research publications and government pronouncements. Together with “CEPA,” these served as a mantra for the struggling administration of Tung Chee-hwa, by demonstrating the central government’s preferential treatment and support of Hong Kong. When Donald Tsang took over as chief executive in April 2005 after Tung’s resignation, CEPA, PRD

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87 “HK govt appoints Greater Pearl River Delta Business Council chairman,” Xinhua News Agency, February 26, 2004
89 The nine provinces and autonomous regions are Fujian, Jiangxi, Hunan, Guangdong, Guangxi, Hainan, Sichuan, Guizhou and Yunnan.
cooperation, and pan-PRD cooperation grew in importance as Tsang, a career civil servant, felt pressure to prove his credentials with Beijing.

5.6.3 Hong Kong dallies with central planning

In March 2006, for the first time, China’s eleventh Five Year Plan (2006-2010) included Hong Kong in its national “division of labor” – but only as an international hub in finance, trade, shipping and information services, which would receive central government support. The list left out logistics and tourism, roles that went to Guangdong and Macau. Hong Kong’s inclusion in the Five Year Plan led to wide comment even though the plan itself represented a large step away from central planning for the government – it included few specific targets. In Chinese, it was called a guihua (program) rather than a jihua (plan). But for the Hong Kong government, it precipitated a new effort to promote economic convergence with the mainland.

In 2006, chief executive Donald Tsang tasked a senior advisory body, the Commission on Strategic Development, to come up with ideas about Hong Kong’s role in the mainland economy. Its efforts were folded into an economic summit on September 11, 2006, at which Mr. Tsang formed a task force of 33 elite business people, academics and professionals to come up with more recommendations. On January 15, 2007, four subcommittees reported 50 strategies and 207 recommendations in an “action agenda” entitled “Our Way Forward”. A parallel effort by the Greater Pearl River Delta Business Council looked specifically at how Hong Kong might fit into Guangdong’s eleventh Five-Year Plan.

If Hong Kong’s leaders had more experience with the role of symbolism in Chinese politics, or the art of lobbying within the central government structure, or the history of regional organizations in China, they might have spared themselves some pain. Zhang Dejiang, who moved to Guangdong in 2002 as party secretary, was far more concerned with competition from the Yangtze River Delta region and Bohai Gulf than with the future of Hong Kong and Macau. CEPA, and subsequently the 9 + 2 framework, presented new ways to package economic output and raised the region’s profile in the competition for central government fiscal allocations.

In terms of Zhang’s own career, the pan- Pearl River Delta agreement was astute since it combined two of the central government’s favorite themes, reducing income gaps between rich and poor provinces, and encouraging a closer relationship with Hong Kong and Macau. But in terms of substance, such agreements meant little. In the first three decades after the establishment of the new Communist government in 1949, six large administrative regions, which later became “economic cooperation regions”, provided a framework for implementation of central government policy. With the beginning of economic reforms, decentralization became a central motif of economic growth. From the early 1980s onwards, hundreds of economic cooperation organizations sprang up essentially as lobbying organizations with the central government. These came and went as the political environment changed.

91 “Hong Kong must take NPC economic chances,” The Standard, March 1, 2006
92 Carrie Chan, “Beijing’s focus on Macau stuns SAR delegates,” The Standard, March 9, 2006
What these relationships and agreements have done for Hong Kong is unclear, however. A lack of realism with regard to regional cooperation – and the difference between regional cooperation and regional regulation – has contributed to Hong Kong’s lethargic development of policy in the post-SARS years. Instead of taking SARS as an urgent signal of a need to adopt tough cross-border regulatory policies, Hong Kong’s leaders have been slow to act on issues ranging from air pollution to management of food shipments across the border to enacting a competition law.
6 Guangdong as number one

Over the last few years, the idea of a “Greater Pearl River Delta” has become a mantra in official
and business circles in Hong Kong. The phrase includes Hong Kong, Macau and the fast-
growing cities and industrial areas mainly along the eastern shores of the Pearl River Delta as part of
a single economic entity, ignoring the political fracture lines and even more importantly, perhaps,
the absence of efficient transportation links or large-scale social and cultural interaction.

The idea behind the idea was that the huge exodus of Hong Kong business into the Delta from the
late 1970s onwards was a permanent feature of the economic landscape. Another assumption was
that economic integration between Hong Kong and Guangdong would deepen. Finally, from a
Hong Kong perspective, Hong Kong capital was responsible for creating the economic miracle on
its doorstep, as a generation of Hong Kong entrepreneurs took their machines and know-how into
the fishing villages and market towns and created a factory for the world.

Today, China as a whole is assessing the negative consequences of rapid growth and in many
respects, throwing out the old formula based on light manufacturing and exports. It has engaged in a
large-scale attempt to refashion its economy by moving up the technological scale in manufacturing
and by developing its service industries and consumer demand as the basis for growth. Guangdong,
as one of the wealthiest of China’s provinces and pioneer of economic reforms, is in the vanguard of
the shift. This is exactly the same exercise that China’s East Asian neighbors have undertaken, with
varying degrees of success. The approach acknowledges that increases in productivity are necessary
for long-term growth, and that export-led growth represents a short-term fix.

Guangdong’s Ten Big Projects

<table>
<thead>
<tr>
<th>Guangdong's Ten Big Projects (11th Five-Year Plan, 2006-2010)</th>
<th>RMB billions</th>
</tr>
</thead>
<tbody>
<tr>
<td>(233 programs, with a total investment of RMB 1.1 trillion)</td>
<td></td>
</tr>
<tr>
<td>Comprehensive transport network</td>
<td>432</td>
</tr>
<tr>
<td>Modernized heavy industry</td>
<td>248</td>
</tr>
<tr>
<td>Energy security</td>
<td>233</td>
</tr>
<tr>
<td>Independent innovation</td>
<td>53</td>
</tr>
<tr>
<td>Modern agricultural infrastructure</td>
<td>31</td>
</tr>
<tr>
<td>Modernized service sector</td>
<td>29</td>
</tr>
<tr>
<td>Hydropower construction</td>
<td>38</td>
</tr>
<tr>
<td>Ecosystem preservation</td>
<td>49</td>
</tr>
<tr>
<td>Cultural development</td>
<td>72</td>
</tr>
<tr>
<td>Law and order</td>
<td>10</td>
</tr>
</tbody>
</table>

Source: Jinan University Research Institute of the Economy
## Guangdong’s Economy, 2005

### Macro-economic indicators

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Value</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth rate</td>
<td>13%</td>
<td>(Versus planned growth rate of 9.5%)</td>
</tr>
<tr>
<td>GDP</td>
<td>RMB2.1 trillion</td>
<td></td>
</tr>
<tr>
<td>GDP per capita</td>
<td>RMB23616 (US$2938)</td>
<td></td>
</tr>
</tbody>
</table>

### Qualitative and structural indicators

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Value</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial structure</td>
<td>6.3: 49.5: 44.2</td>
<td></td>
</tr>
<tr>
<td>(Primary, secondary and tertiary industries)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Urbanization rate</td>
<td>57%</td>
<td></td>
</tr>
<tr>
<td>Technological innovation rate</td>
<td>48%</td>
<td>(Versus national rate of 30%)</td>
</tr>
<tr>
<td>Relative weighting of light to heavy industry</td>
<td>44.56</td>
<td>(Versus 65.83:34.17 in 1990; 52.94: 47.06 in 2000)</td>
</tr>
</tbody>
</table>

*Source: Lingnan University Research Institute of the Economy*
6.1 Guangdong’s flight to quality

There are huge social and environmental costs associated with China’s attempt to restructure its economy based on capital and technology intensive manufacturing, logistics and services. Daniel Rosen and Trevor Houser, in a project for China Balance Sheet, have shown persuasively how industrial restructuring at the national level has played a key role in a surge in China’s energy consumption, from an average of 4% annually between 1978 to 2000, to 13% from 2001 onwards.

Energy demand growth was four times faster than predicted, due to a national structural shift away from light industry to heavy industry. Over 80% of China’s electricity is generated from coal – 86% in the first half of 2007, according to the China Electricity Council, and less than 15% of coal power plants are fitted with flu gas desulphurization (FGD) systems. Of 100 FGD systems in operation throughout the country, only ten are in use, according to reports. The environmental consequences are ruinous. In June 2007, the Netherlands Environmental Assessment Agency declared that based on its preliminary estimates, China had become the world’s largest source of carbon dioxide emissions, surpassing the United States by 8%. Such factors are clearly linked to health. In a report whose findings were partially suppressed, the World Bank found that 350,000 to 400,000 people in China die prematurely due to poor air quality; another 60,000 premature deaths were attributed to poor water quality.

Guangdong is a microcosm of the national trend. The province has had serious power shortages for five years, despite construction of new gas-fired capacity and retrofitting existing plants with FGD. Power shortages in Guangdong became so serious in the summer of 2007 that power to factories in Dongguan was cut to two working days per week, according to the Hong Kong and Kowloon Electro-plating Trade Merchants Association. Guangdong issued a “red alert” for electricity consumption after demand grew by more than 13% in the first half of the year, with peak load in excess of 5.8 Gigawatts in the first quarter. Tiny Macau’s electricity demand has jumped as well, and was up 17.6% in the first five months of 2007, on the strength of its casino boom, and faces annual demand of 4.3 Gigawatt hours by 2010, according to Companhia de Electricidade de Macau.

94 Stephen Chan, “Coal power struggles in war on sulfur,” South China Morning Post, June 23, 2007
98 van Zhai, “Guangdong still plagued by power shortages,” South China Morning Post, May 29, 2007
99 He Huifeng, “HK factories hurt by Delta power deficit,” South China Morning Post, July 29, 2007
the monopoly supplier. In Guangzhou, only acid rain fell in the first three months of the year, and pollution in 2006 reached record levels.

But these are problems of transition for the province, as well as for the country. Guangdong is shifting its fuel mix from coal to nuclear power and natural gas. By 2020, it plans to have 24 Gigawatts of installed nuclear capacity, 60% of China’s national total. China Petroleum & Chemical Corp., a unit of Sinopec Group, will begin construction of a second, US$1 billion terminal for Liquefied Natural Gas (LNG) at the Ganlan port in Zhuhai, to be completed by 2010, and together with China National Offshore Oil Corp. (CNOOC) has set up a gas pipeline venture to supply the province, with an estimated demand of 12 billion cubic meter annually by 2010.

On the environmental front, in July some 300 top provincial officials attended the first official conference on the impact of global climate change on the province. In April 2007, officials signed a commitment to stop buying electricity from small, less than 50 Megawatt generating stations burning coal and fuel oil, which supply up to half of Guangdong’s electricity but are also a major source of smog. According to reports, the province will shut down at least 9 Gigawatts of capacity in such stations, which are 30% to 50% more energy intensive than larger stations, and will fit power stations over 125 Megawatts with FGD equipment by 2008.

Since the National People’s Congress in March 2007, in fact, the provincial government has made sweeping commitments to clean up the province’s air, from deploying an RMB 2.3 billion satellite based monitoring system to commissioning an RMB 200 million study of sources of pollution. At the national level, Guangdong will be helped by new prohibitions against export processing, providing disincentives to polluting and energy-intensive manufacturing, and the beginnings of a “green” credit system modeled after the Equator Principles, in which banks take environmental costs into account as a factor in lending.

While the province originally committed just RMB 49 billion to environmental protection under its eleventh Five-Year Plan, concerns over air pollution raised at the National People’s Congress in March 2007 led to an additional RMB 200 million in funding to identify sources of air pollution in the Delta. The province will launch a RMB 2.3 billion, satellite-monitoring center for air pollution, to “single out those consuming the largest amounts of energy,” Guangdong Governor Huang Huahua told reporters in Beijing in March 2007. “We will also disclose the identity of serious polluters.”

Guangdong is also a microcosm of another national trend – a sharp increase in spending on research and development. According to the Organization for Economic Cooperation and

100 Fox Yi Hu, “Power demand from casino boom sapping Macau’s electricity supply,” South China Morning Post, July 16, 2007
101 He Huifeng, “Only acid rain falls on Guangzhou,” South China Morning Post, July 5, 2007
103 Ivan Zhai, “Global warming putting heat on economy,” South China Morning Post, July 14, 2007
104 Reuters, “China’s Guangdong tackles small power stations,” April 2, 2007
105 Ivan Zhai and Olga Wong, “Joint study will track down Delta air polluters,” March 13, 2007
Development (OECD), in 2006, China became the second largest spender on research and development after the United States and ahead of Japan, spending US$136 billion compared to US$130 billion for Japan, although still far behind the US$330 billion spent by the US. The 20% jump in China’s R&D spending in 2006, led Dirk Pilat, head of the OECD’s science and technology division, to describe it as “stunning”.

Relative to Beijing and Shanghai, Guangdong is disadvantaged in terms of its ability to groom scientists and technicians. None of its universities come close to the prestige of Tsinghua or Peking University in Beijing or Fudan in Shanghai. But it is working to fix the problem by creating the local equivalents of the academic concentrations of Beijing and Shanghai. In Guangzhou, the province designated the small island of Xiaoguwei as “Guangzhou University City,” and ramped up construction of an RMB 30 billion complex of ten universities, with a targeted student population of 200,000, in 19 months. The Guangdong Department of Education hired Intel Corp. to develop a “mega-tech, unwired campus” with a “wireless ecosystem” and Wi-Fi enabled laptops and teaching methods. According to Intel, 15% of the student population had “gone wireless” by the end of 2006.

Shenzhen is trying something similar, with its own University Town completed in 2003, with 2,000 graduate students enrolled in extension campuses of Peking University, Tsinghua University, and the Harbin Institute of Technology. In Nansha, on the west coast of the Delta, Hong Kong University of Science and Technology will open a graduate school extension in September 2008, as part of the Nansha Information Technology Park, funded by the late Henry Fok Ying-tung and shepherded by Otto Lin, former president of the Industrial Technology Research Institute in Taiwan.

The cities of the Pearl River Delta are among the wealthiest and most experimental in China. This has enormous implications for the future. Private enterprises made up over half of corporations (224,236 out of 434,254) and 43% of industrial enterprises (238,141 out of 544,078) in Guangdong in 2005, according to the provincial bureau of statistics. Guangdong’s flagship companies are, far more than is true of companies headquartered in Shanghai or Beijing, operations that came up by their bootstraps, and have few of the hidden skeletons of state enterprises. Collectively, they represent a stable of brand names on the verge of going global, much like South Korea’s technology giants, who moved up the technology value chain as original equipment manufacturers (OEMs) before breaking into world markets with their own brand names in the late 1980s.

China’s largest telecommunications equipment manufacturer, Huawei Technologies, an unlisted US$11 billion giant with 62,000 employees, started shop in Shenzhen in 1988 as a distributor of imported private branch exchange (PBX) products and today ranks second worldwide in the optical network hardware and broadband access markets. ZTE, China’s second largest telecommunications equipment maker after Huawei, and TCL, the world’s largest manufacturer of television sets, are also Pearl River Delta success stories.

Ping An Insurance Group, a financial services conglomerate that is China’s second largest life insurer and wants to be the country’s first financial “supermarket”, got its start in Shenzhen in the same year as China’s first joint stock insurance company. Today it has 32 million life insurance and 7.9 million property and casualty insurance customers, with a fee turnover of RMB 84.8 billion in 2006. China Merchants Bank, founded in Shenzhen in 1987, was the first wholly private commercial bank in China and remains one of its most respected.

The employees who jostle into the elevators at Ping An or Huawei are technocrats earning some of China’s highest salaries. Their rising demand for luxury goods is being felt in Hong Kong, where since 2003 a new “individual visitor scheme” authorized by the mainland has made it easier for them to drop by for a day of shopping and entertainment. And they do.

During the ten days of the “Golden Week” holiday from April 27 to May 6, 2007, half a million tourists visited Hong Kong from the mainland, more than 60% of total visitors during the period. McKinsey, the consulting firm, argues that a middle class will emerge in China of 520 million people by 2025, with spending power of RMB 13.3 trillion. Many of these will be in the cities of the Delta, who will by then be dressed as well, going to work in offices, and buying homes and cars as luxurious as their counterparts in Hong Kong today.

Transportation Plan for Hong Kong-Shenzhen-Guangzhou

Source: CB Richard Ellis

New Inter-city Direct Rail Network

Source: CB Richard Ellis
6.2 From central planning to industrial policy

The current five-year plan, China’s eleventh since 1949 and its predecessor covering the 2001-2005 period, have both moved away from the macro-economic strategy of the first quarter-century of reforms. A key objective of the two most recent plans has been industrial restructuring, aimed at moving Guangdong up the value-added ladder, through spending on research and development and investment in heavy industry. Its three pillar industries are to be information technology, petrochemicals and consumer electronics; automobiles, machine making, and steel are the “pioneer” industries; and biotechnology, new materials and alternative energy are to be its new, and “strategic” industries. The plan slated the province’s “three great traditional industries” – textiles, foodstuffs and building materials – for restructuring and upgrading. 111

The key strength of the eleventh five-year plan is that it builds on Guangdong’s existing dominance in information technology. By 2005, Guangdong factories were turning out RMB 1.1 trillion of information technology products, more than one-third of national output.112 According to the province’s 15-year plan for science and technology, it plans to increase spending on R&D from 1.34% of Gross Domestic Product in 2004 to 2% in 2010 and 2.8% in 2020. By comparison, China’s national target for R&D spending in 2020 is 2.5% of GDP.113 With a national economy growing at double-digit rates, and the province’s own plan calling for an annual growth rate of 9%, this implies huge increases in spending. With a target GDP of RMB 3.35 trillion by 2010, the implied spending for R&D by 2010 is RMB 67 billion per year, or US$8.8 billion.

The plan’s key weakness, however, lies with human capital and the inherent difficulties of transiting from light to heavy industry. Guangdong might want to model itself after South Korea and its industrialization drive, but a more accurate model might be Malaysia. Like Guangdong’s current leadership, former Prime Minister Mahathir Mohammed looked to a combination of consumer electronics, and heavy industry to drive growth. Malaysia had problems including the Asian financial crisis and competition from China, but even so, the effort to create a domestic auto industry was a disaster, and the plan to move up the high-technology ladder in electronics never materialized.

The skills involved in assembly manufacturing are different from those needed for high-technology manufacturing or R&D. Workers with higher skills are attracted by a very different mix of assets than those associated with Guangdong and its major cities today. A drive across the border from Hong Kong to Shenzhen, Dongguan and Guangzhou passes through a wasteland of crumbling, small-scale factory infrastructure, heavily polluted waterways, and hills mined for landfill.

The journey onwards, towards the central and western shores of the Pearl River and its tributaries, is even worse. Foshan, the region’s fourth-largest city after Hong Kong, Guangzhou and Shenzhen, and a traditional center of ceramics manufacturing, also has the Pearl River Delta’s foulest air. The degraded environment, together with a reputation for a low quality of life, is a significant obstacle to Guangdong’s attempted transformation, and the biggest question marks over its future.

111 Feng Xiaoyun, Jinan University Economics Institute, “Guangdong and Hong Kong: Competition and Cooperation in the Next Five Years” (Powerpoint dated June 15, 2006, in Chinese)

112 “Electronic information becomes No. 1 industry of Guangdong,” Xinhua Electronics News, July 31, 2006

6.3 Guangdong’s East Asian models

Guangdong, and the central government, now wants something different. They are taking their cue from half a dozen successful East Asian economies to move up the industrial ladder. Through a series of ambitious policy directives focused on the supply side, the central and provincial governments are attempting to remake Guangdong in the image of South Korea, with a vibrant high-technology sector and a high value-added heavy industry sector, developed in partnership with major multinationals. In place of processing, they want foundation industries. In place of small and medium enterprises, they are hoping for their own brand-name multinationals.

At the same time, unlike some of its East Asian counterparts, China is re-engineering its economy to stimulate domestic demand. A new property law and a unified corporate tax law will increase the attractions of property ownership and reduce the cost of doing business for Chinese companies. Through new regulations setting minimum prices for industrial land, the central government is acting to end the practice of giving land away as part of investment deals. What may be bad for foreign investors will be good for the domestic economy, by ending price distortions in the property market and putting a floor under market policies. Other policies, aimed at ending property speculation, are aimed at taming asset bubbles. Reforms in the stock market have given a huge boost to domestic investors, who are beginning to have access to foreign equity and bond markets as well. The beginnings of a national social insurance program, and vigorous growth of a domestic commercial insurance business, are taking pressure away from individuals to save all their earnings. A 15-year science and technology initiative is focusing its efforts on research and development spending by the private sector.

In Guangdong, after more than a decade of wage suppression, the province began to increase the minimum wage in 2004 and has gone through three major increases since then. It has launched programs to relocate polluting industries in industrial parks with centralized waste treatment programs, and to move low value-added industries to the poor rural areas of the province. In September 2006, it gave notice to processing industries that a large number of restrictions were on the way, including outright bans on polluting and energy-intensive industries and a new Customs regime for industries not on the preferred list.

Guangdong’s New Policy Regime

<table>
<thead>
<tr>
<th>Year</th>
<th>Document Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>Guangdong Province Industrial Restructuring Implementation Plan</td>
</tr>
<tr>
<td>2003</td>
<td>Guangdong competitiveness study of nine major industries</td>
</tr>
<tr>
<td>2004</td>
<td>The Plan for the Coordinated Development of the PRD Township 2004-2020 (7/04)</td>
</tr>
<tr>
<td>2004</td>
<td>Opinion on Expediting Guangdong’s Development of Service Industry</td>
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<td>2005</td>
<td>Guangdong Province Industrial Restructuring Implementation Plan (2/05)</td>
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<td>2005</td>
<td>Recommendations Regarding Accelerating the Development and Reform of the Service Industry in Guangdong Province (Guangdong Province Number 1 Official Document) (4/4/05)</td>
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<td>2005</td>
<td>Guangdong province recommendations on increasing industrial competitiveness (5/05) Medium-to-Long-Term Plan for the Development of Science and Technology (1/06)</td>
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<td>2006</td>
<td>11th Five-year Plan (2006-2010) (2/06)</td>
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<td>Synopsis Extract of the 11th 5-Year Plan for Domestic Economic Development in Guangdong Province (2/06)</td>
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<td>2006</td>
<td>PRD Coordinate Development Plan</td>
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<td>2006</td>
<td>Development Plan of Guangdong’s Petrochemical Industry, 2006-2010</td>
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<td>2006</td>
<td>Development Plan of Guangdong’s Electronic Information Industry, 2006-2010</td>
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<tr>
<td>2006</td>
<td>Development Plan of Guangdong’s Automotive Industry, 2006-2010</td>
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<td>2006</td>
<td>Guangdong Provincial Environmental Protection Initiative (4/06)</td>
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<td>2006</td>
<td>Suggestions for Further Strengthening the Environmental Protection and Management of Construction Projects</td>
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<td>2006</td>
<td>Suggestions for the Implementation of Centralized Planning and Centralized Distribution for Electroplating Industry in Guangdong</td>
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<tr>
<td>2006</td>
<td>Suggestions for the Implementation of Centralized Planning and Centralized Distribution for Chemical and Paper Pulp Industries in Guangdong</td>
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<td>2006</td>
<td>Decision on Strengthening the Comprehensive Harnessing of the Pearl River Circular of the State Council on Relevant Issues Concerning Strengthening Land Control (9/06)</td>
</tr>
<tr>
<td>2006</td>
<td>Circular Number 1391 [on adjustments to export tax rebates and expansion of the prohibited category], by Ministry of Finance, National Development and Reform Commission, Ministry of Commerce, General Administration of Customs, and State Administration of Taxation (14/09/06)</td>
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<td>2006</td>
<td>Circular Number 145 [supplementary on adjustments to export tax rebates] (29/09/06)</td>
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<td>2006</td>
<td>Circular of Issuance and Implementation Standards for Minimum Granting Price for Industrial Land, by Ministry of Land and Resources (12/06)</td>
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<td>2006</td>
<td>Uniform Tax Code, approved by National People’s Congress, 2/07</td>
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<tr>
<td>2007</td>
<td>Circular Number 17 [on new expanded list of 1,140 prohibited products as of 26/04/07], by Ministry of Commerce, General Administration of Customs, and State Environmental Protection Administration</td>
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<td>2007</td>
<td>Circular on Issues Concerning the Management of Processing Trade, by Ministry of Commerce (04/07)</td>
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<tr>
<td>2007</td>
<td>Labor Contract Law, third draft [sets ceilings on severance pay]</td>
</tr>
<tr>
<td>2007</td>
<td>Water Consumption Quotas for Guangdong (Trial Implementation), by Guangdong Provincial Development and Reform Commission, Guangdong Provincial Economic and Trade Commission, and Guangdong Provincial Water Conservancy Department (two years, from 1/03/07)</td>
</tr>
</tbody>
</table>
6.4 Guangdong Restructures

Guangdong’s plans for industrial restructuring were set out in 2001, at the beginning of China’s tenth national Five Year Plan. The plans called for technological upgrading, the identification of flagship companies, and a migration of labor-intensive industries to regions far from the Pearl River Delta. It included a new industrial plan dividing nine key industries into categories for encouragement, upgrading and prohibition.

The provincial government followed up with a competitiveness study of the nine major industries in 2003, and in May 2005, announced a target of achieving the competitiveness level of middle-income countries in these nine industries, including information technology, petrochemicals and the automotive industry. At the same time, a series of central government directives have reinforced Guangdong’s restructuring by implementing restrictions on export processing, a minimum price threshold for industrial land, a new labor law and uniform tax regime, and restrictions on manufacturing of products based on energy-intensive or polluting processes.

The province achieved its targets during the tenth Five Year Plan (2001-05), including the reduction of the share of light industry in total output and increasing the rate of technological innovation. Its industrial policy is now firmly based on heavy industry, high technology and services. It has been grooming Shenzhen to replace Hong Kong in key sectors, especially logistics. It wants Guangzhou to replace Hong Kong as a headquarters city for multinationals focused on South China. Zhuhai’s deepwater port is to compete with Hong Kong, as new highways and bridges are built to cut land transport times from the eastern side of the Delta. Nansha, adjacent to Hong Kong, is fast becoming a center for heavy industry – steel, petrochemicals, and autos.

It has also followed through on plans to move light industry and “traditional” manufacturing sectors away from the urban centers of the Pearl River Delta, to the relatively poor western and mountainous regions of the province or outside the province altogether. Within the Pearl River Delta itself, a “spatial” component of the plan is to focus industrial restructuring and upgrading in the eastern region of the Delta, in an axis running from Shenzhen to Guangzhou, while the western region acquires second-tier industries as they relocate from the increasingly expensive, high-tech eastern zone.

This is not intended as a straight trade-off between east and west – instead, some high-tech, logistics and heavy industry will go to the west, especially to Zhuhai, which is planned as the center of a new “high-tech, new-tech” area and a logistics hub anchored by the Zhuhai airport and the port of Gaolan, one of two “harbourfront infrastructure industry cluster areas” with development of petrochemicals, iron and steel smelting, and paper making. 115

6.4.1 Guangdong’s infrastructure mega-projects

A key element in Guangdong’s industrialization strategy is a new network of roads and rail linking the major cities of the Delta in an inverted V with Guangzhou as the hub. Even accounting for political hyperbole, the numbers are vast. The province has allocated RMB 1.1

114 The Greater Pearl River Delta Business Council, Industrial Restructuring in Guangdong Group, op. cit., p. 9-11
115 Greater Pearl River Business Council Task Group on Western Pearl River Delta Development, “The Development of Western Pearl River Delta Region and its Prospects for Collaboration with Hong Kong,” (Hong Kong, Greater Pearl River Delta Business Council, August 2006), p. 17
trillion (US$142 billion) to infrastructure and other projects, including RMB 432 billion for transport, RMB 248 billion for heavy industry, and RMB 233 billion for energy security.

Among the most remarkable transformations may come from the simple bricks and mortar exercise of creating a network of roads and rails, which, surprisingly, has been fragmentary up until now. The three poles of the mega-city, Hong Kong, Shenzhen and Guangzhou, are fast building high-speed infrastructure to link their tens of thousands of factories, offices and residential areas.116

These include an intercity express rail network, with major axes to be completed by 2010, from Shenzhen to Humen, Dongguan, Shibi, Xiaolan and Zhuhai. The network is to extend to Hong Kong from Shenzhen by 2013. These will connect to a national high-speed network, with a first phase, from Guangzhou to Wuhan, to be completed by 2009. A second high-speed rail line will extend from Shenzhen to Hangzhou by way of Xiamen and Fuzhou, with the Shenzhen-Xiamen section to be finished by 2010.

6.4.2 Bridge to nowhere?

The idea of a bridge linking Hong Kong with the west bank of the Delta has been around since at least the early 1990s, and negotiations have been slow due to rivalry between Hong Kong and Shenzhen. Hong Kong wants the bridge to bypass Shenzhen, and to be limited to road traffic, aiding the powerful Hong Kong trucking lobby. Shenzhen resists the bridge because it would lose its stranglehold over traffic to Hong Kong, including lucrative revenue from the limited quota of cross-border vehicular licenses. Guangzhou doesn’t like the idea because it would erode its position as the transportation and communications hub for the region. Even environmentalists don’t like it, arguing that without rail access, the bridge will exacerbate the region’s severe air pollution.

Years before the bridge is built, if it is, connecting infrastructure between Hong Kong, Shenzhen and Guangzhou will see radical improvements, together with roads and rail leading to the western shores of the Pearl River Delta from Shenzhen and Guangzhou. The route from Guangzhou to Shenzhen will have an express highway, to be completed by 2008. The Hong Kong-Shenzhen Western Corridor road, bridge, and border checkpoint opened on July 1, 2007, while the Lok Ma Chau light rail spur line and its border checkpoint opened a month later. Gradually the PRD’s emerging transport pattern is becoming A-shaped, anchored by a new bridge linking Zhongshan to the west and Shenzhen and Dongguan to the east.

All of these should ease congestion and improve ease of transit across the Hong Kong-Guangdong border, which, in 2005, saw 72 million people crossing by rail alone. In July 2007, after years of negotiation, the Hong Kong and Guangdong governments finally agreed to build an express rail line on a dedicated track that will link West Kowloon with Shenzhen and Guangzhou, cutting transit time from the current 110 minutes to 48.117

116 I am indebted to Andrew Ness, executive director of CBRE Research, for the concept of a “tri-nodal” city, from his presentation to the American Chamber of Commerce in Hong Kong on March 22, 2007, in Hong Kong, “Pearl River Delta Integration and The Hong Kong Office Property Market”

6.5 Tools of industrial policy

Guangdong has used a variety of policy tools to enforce its new regime, from implementing a new minimum price threshold for industrial land to the introduction of a minimum wage to the repeal of its export tax rebate policy to environmental enforcement.

6.5.1 Export processing restrictions

Policies to reduce export tax rebates for polluting and energy-intensive industries are playing a major role in provincial efforts to move up the value chain. China adopted the policy of offering rebates of the value-added tax on exports in 1994, when a series of reforms led to the opening of the current account. Since the late 1990s, largely for revenue reasons, the government began to close this loophole.

From mid-2007, however, the policy gained new momentum, as part of a strategy to reduce trade friction with the United States and turn the economy away from export dependence. In June 2007, China’s Finance Ministry announced that value-added tax rebates would be cut on 553 types of goods that used large amounts of energy and resources, or were polluting, and on 2,268 types of low-value added exports, including toys, steel products, textiles and paper. The new rules were to come into effect on July 1, 2007. 118 On July 25, 2007, the Ministry of Commerce announced that it would expand the list of goods subject to export limits, including toys, clothing and other low-value added products, in order to curb pollution and reduce China’s trade surplus. This announcement followed one on July 23 requiring exporters to pay as a deposit half of the import value of a list of 1,853 raw materials including metals, plastics and textiles. 119

The government will also place all processing trade under new scrutiny, according to the Hong Kong Trade Development Council. “As China’s current level of development stands, the practice of promoting trade without taking cost and access threshold into account is outdated,” its 2007 report notes. 120 Under terms of a Ministry of Commerce directive issued in April 2007, commerce departments “at all levels” are to assess processing enterprises “based on hard facts” including their performance across a range of criteria, including environmental protection, energy consumption, level of technology, and labor practices including compliance with minimum wage standards and payment of social insurance. Offending enterprises will not be allowed to engage in processing trade, according to the notice.

According to the Hong Kong Trade Development Council, the new rules reflect a bias against processing industry across the board, and will force enterprises to register as foreign-owned enterprises or joint ventures – which entail difficulties that will force most out of business, since it takes an average of six to nine months to disentangle themselves from the Customs bonding system. 121 The new system provides favorable terms to enterprises that can demonstrate that they involve high technology, but is massively biased against exactly the type of industries in which Hong Kong has been prominent for the last 25 years.

Toys, textiles, shoes, furniture, porcelain, appliances, the plastic flowers that legendarily gave Hong Kong tycoon Li Ka-Shing his start – all are under pressure to move up the value chain or move to remote parts of the province beyond the magic three-hour circumference from Hong Kong by car.

The province is not driving “traditional” processing industries out of the Pearl River Delta altogether. To some extent, the new prohibitions will be balanced by the “spatial” dimension of Guangdong’s current Five-Year Plan, which envisions industrial migration to western shores of the Pearl River Delta as part of industrial

118 Carol Chan and Kandy Wong, “Beijing cuts tax rebates on exports,” South China Morning Post, June 20, 2007
119 Denise Tsang, “HK Firms hit as more cheap exports cut,” South China Morning Post, July 26, 2007
120 Hong Kong Trade Development Council, op. cit., p. 32
121 Hong Kong Trade Development Council, op. cit., p. 64
restructuring in the east. But even this represents a different approach than the early days of the economic reforms, when “Guangdong needed a speedy urbanization and industrialization process to build up its industry bases in the city,” according to an August 2006 report by the Greater Pearl River Delta Business Council.

Instead, the industrial policy for cities such as Zhuhai, Zhongshan and Zhuhai will be on integrated development. The plan calls for three major “processing manufacturing clustering areas” including construction materials in the central Pearl River Delta, electronics and electrical equipment in the east, and appliances, hardware and textiles in the strip along state highway 325, linking Foshan, Shunde, Jiangmen and Zhongshan. In 2006, Cheng Jiansan, with the Guangdong Academy of Social Sciences, predicted that only 20% of Hong Kong companies in the Delta would be able to survive by upgrading, and that the rest would move out within three to five years. A year later, in an interview, his view had not changed, although he preferred to put the emphasis on the positive, stating that 70-80% would survive if they made the needed changes. In industries such as textiles, especially upstream dyeing, electroplating, chemicals, pulp and paper, and other polluting industries, “environmental demands will be higher and higher, and it will be hard to maintain them.” Labor-intensive industries would face increasing pressures due to rising land and labor costs, and “will not be able to survive.”

A 2007 study by the Hong Kong Trade Development Council reported that nearly one-third of Hong Kong-invested enterprises in the Delta had already felt the impact of the new policy on daily operations, while just under 20% said that the reduced level of export tax rebates had “seriously” affected daily operations. According to the report, some 14,500 Hong Kong enterprises would be seriously affected by the new policy.

### 6.5.2 Minimum wage standards

For nearly a quarter century, wage suppression was an effective instrument of Guangdong’s economic policy. Wages remained stagnant during the 1990s, despite the province’s double-digit growth rates. China’s supply of cheap labor seemed bottomless, and the factories of Guangzhou, Shenzhen, Foshan and Dongguan could draw on migrant workers from poor rural areas from around the country.

Wage policy began to change in 2004, when the province raised the minimum wage for the first time in a decade. In Shenzhen, the monthly wage went from RMB 595 in 2002 to RMB 690 in 2004 and RMB 810 in September 2006, giving it the highest minimum wage in China.

The increases coincided with rising concerns of labor shortages and competition for workers with other parts of the country, especially Shanghai and the Yangtze River Delta region, where wages are higher and the quality of life is seen as superior to the ravaged, polluted industrial districts of Guangdong. In 2006, Guangdong labor authorities reported that only 4.8 million of 7.3 million job vacancies had been filled. In 2007, the province expected demand for technically skilled workers would rise by 20% and for unskilled workers by 10%, exacerbating the shortage. In June 2007, the Development Research Center of the State Council found that in 74% of villages surveyed there were no workers left who could leave for jobs in cities. A companion study by the Chinese Academy of Social Sciences predicted that China would face a national shortage of labor by 2009.

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122 Greater Pearl River Business Council Task Group on Western Pearl River Delta Development, op.cit., p. 15
123 Greater Pearl River Delta Business Council Task Group on Western Pearl River Delta Development, op.cit., p. 16
124 Kevin Huang, “Minimum wages rise in labour shortage,” South China Morning Post, September 5, 2006
125 Interview on September 19, 2007, Guangzhou
126 Hong Kong Trade Development Council, op. cit., p. 58
127 Xinhua, June 16, 2007
China Labor Watch, a US non-governmental organization, reports that despite increases in the minimum wage, employers have made cuts in other benefits, and that the provincial government discriminates against migrant workers in terms of social services and schools for their children. The impact is felt especially around Chinese New Year, when many workers fail to return to their jobs. A survey by the Guangdong Labor and Social Security Bureau found that 60% of Guangdong employers had forced employees to sign guarantees that they would return after the annual vacation.128

Some employers view the minimum wage rules as a ceiling, not a floor, and violations are frequent even among multinationals. In March 2007, an investigative report in Guangzhou’s New Express Daily (Xinkuai Bao) accused McDonald’s and KFC of violations of the labor law including underpaying part-time workers and failing to provide them with social insurance. 129 Rising expectations among workers, however, mean that even companies that pay well above the minimum wage are facing increasing pressure to improve working conditions.

In 2005, the London Financial Times reported the case of an Italian-owned sofa factory in Shenzhen that was the site of a scuffle between workers and the factory’s Italian manager, followed by a two-day strike. The factory paid its workers RMB 2,000 per month, well above the RMB 580 level of the minimum wage in Shenzhen at the time, and also covered medical expenses. A social compliance audit firm that was called in found 30 areas of concern, ranging from underpaid overtime, working longer hours than the legal maximum, frequent delays in payment of salary, and inadequate social insurance coverage. 130

Wage increases have been ineffective in addressing structural shortages, however. The province faces acute shortages of skilled workers and those willing to do dirty and dangerous jobs, according to Lu Zhiguo, a labor economist. In 2007, the Delta will have 3.2 job vacancies for every skilled technician, he estimates. Gary Lo, chairman of the Federation of International Small and Medium Enterprises in Hong Kong, told the South China Morning Post factories were 30 to 40 % understaffed in the textile industry, where conditions were particularly bad. 131

In Guangzhou, the province’s main educational center, there are 79,000 students in technical schools with 20,000 graduates annually, but the number is far short of demand. In February 2007, the Guangzhou labor bureau launched a two-year program to train 20,000 former soldiers in 93 vocational schools around the province, but labor bureau director Cui Renquan admitted that his target date for solving the problem was 2010. 132

### 6.5.3 New restrictions on industrial land use

Among the most far-reaching changes affecting the Chinese economy and consumers is a new property law, which will come into effect in October 2007. Passed after years of debate at the National People’s Congress in March 2007, it gives equal protection to state and private property, and will provide greater clarity to ownership rights, land-use rights, the regulatory framework for mortgages, and land registration. Many details are as yet unclear, particularly surrounding the renewal of land-use rights, but it represents a major step towards a more transparent property market and reduced risks for owners and developers. 133 On these grounds alone the policy should provide greater stability to the market and help in a shift to quality.

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128 He Huifeng, “Guangdong losing on labor front,” South China Morning Post, February 26, 2007
130 Alexandra Harney, “Unease in the Pearl River Delta,” December 6, 2005
131 Chow Chung-yen, “Factories struggle to keep skilled workers,” South China Morning Post, February 12, 2007
132 Ivan Zhai, “Shortage of skilled workers may jeopardize Guangzhou’s industry,” South China Morning Post, March 28, 2007
133 Ashley Howlett, “Only implementation will reveal full impact of new property law,” Financial Times, August 1, 2007
For industrial land, the central government has introduced a more direct set of measures to encourage upgrading of industrial land by setting minimum prices for land-use and introducing public auctions for land sales. The new rules increase transparency and will build confidence on the part of buyers and developers, by removing a source of corruption on the part of local officials and ending the practice of competing for investment by offering land at below-market prices.

According to Andrew Ness, executive director of CBRE Research Asia, two new sets of rules are biased towards high-end manufacturing and will be used to force low-end manufacturing and export processing away from prime urban areas. In September 2006, China’s State Council issued a directive on “Relevant Issues Concerning Strengthening Land Control,” which included harsher penalties for illegal land transactions by local officials as well as a provision to include revenue from local land sales in local budgets, where it could be scrutinized.

In December 2006, the Ministry of Land and Resources issued a second policy directive in its “Circular on Issuance and Implementation Standards for Minimum Granting Price for National Industrial Land”. This established new minimum price standards on industrial land with effect from January 2007, as well as requiring local officials to conduct land sales through bidding, auction or a listing process. It bans discounts based on development level, thus limiting the practice of offering land at below market value to attract investment. Bidding criteria, according to Mr. Ness, will reflect the new bias towards high-end manufacturing, and will be enforced by local inspection offices in twelve provinces.

China’s New Minimum Grant Prices for Industrial Land

| Land class (based on 15 grades of industrial land) | 1 | 2 | 3 | 4 | 5 |
| Minimum grant price (RMB) | 840 | 720 | 600 | 480 | 384 |

| Land class (continued) | 6 | 7 | 8 | 9 | 10 |
| Minimum grant price (cont’d) | 336 | 288 | 252 | 204 | 168 |

| Land class (cont’d) | 11 | 12 | 13 | 14 | 15 |
| Minimum grant price (cont’d) | 144 | 120 | 96 | 84 | 60 |

*Source: CBRE Research*

134 I am again indebted to Andrew Ness, executive director of CBRE Research Asia, for his presentation, “China Moves up Manufacturing Value-added Chain: Implications of the new minimum industrial land price regulations,” to the British Chamber of Commerce in Hong Kong on July 13, 2007.

135 “China Moves up the Manufacturing Value-Added Chain: Implications of the New Minimum Industrial Land Price Regulations,” CBRE Research April 2007 (Hong Kong, CB Richard Ellis, 2007)
6.5.4 China’s new uniform corporate tax

For decades, Hong Kong enterprises in the Pearl River Delta and beyond were able to avoid taxes altogether or take advantage of tax holidays and other incentives if they were incorporated as wholly foreign owned enterprises or joint ventures. Foreign-owned ventures were taxed at preferential rates as low as 5%, while domestic companies paid tax officially at a 33% rate but often much higher.

Export processing arrangements were not in themselves legal entities and since Hong Kong does not tax outside its borders, the owners could escape tax liabilities, which it seems that most of them did. According to the Hong Kong Trade Development Council, some 32,300 Hong Kong-invested enterprises in the Pearl River Delta in 2006 were not operating in the form of a foreign invested enterprise, and thus are without legal status, which means they do not pay taxes but also cannot apply for bank loans, among other things.136

From 2008, China will apply a uniform tax code of 25% to all domestic and foreign enterprises, ending three decades of favorable tax treatment for foreign enterprises, with a five-year transition period for foreign enterprises that are currently entitled to tax benefits. The law puts pressure on Hong Kong companies to clarify any ambiguities about their businesses in the mainland in order to claim Hong Kong’s lower tax rate. Under the new tax code, a company’s “place of effective management” determines tax liability. For Hong Kong companies to escape mainland taxes they will need to establish significant operations in Hong Kong.

The rules will also introduce complications for investors based in tax havens that have not signed double taxation agreements with China. This aspect of the law was aimed at ending the practice of round tripping, in which one Chinese enterprise exports capital to an entity established outside China and the non-Chinese entity re-invests the capital in China. 137 They will have to pay a 20% corporate withholding tax or rebase themselves in jurisdictions that do have double tax agreements with the mainland.138

The National People’s Congress passed the new uniform tax law in March 2007, at the same time as the new property law, and like it was the subject of many years of debate. In addition to the uniform corporate tax rate of 25%, it applies a corporate withholding tax of 20%, eliminates most tax incentives in the current law, contains the new tax-residence concept, and applies tax preferences for investments in technological development, environmental protection, energy conservation, production safety, and venture capital, at a likely rate of 15%. Tax benefits are retained for agriculture, animal husbandry, fisheries, and infrastructure development, although the tax rate and other details will not be clear until the publication of implementing regulations. These were due to be released in October 2007 but may be delayed.139

Existing tax benefits for high-tech enterprises in special economic zones are likely to continue, as are incentives for investing in China’s Far West. Otherwise, the entire regime of tax incentives in the special economic zones will come to an end. The law ends the long-standing five-year tax holiday for foreign-invested manufacturing enterprises, which consisted of a two-year exemption and a three-year 50% reduction of the tax rate, together with a 50% tax reduction for enterprises exporting more than 70% of output.

The zones themselves will focus on high-tech and advanced manufacturing, pushing out labor-intensive industries and encouraging vertical “clustering.” According to Liu Peiqiang, the chairman of the China Association of Development Zones, development zones will gain a new life as clusters. “Development zones have realized that they can no longer fall back on unlimited land expansion and favorable government policies,” he told the China Business Weekly. “So industry clustering and strengthening industrial chains should be the focus.”140

6.5.5 Environmental enforcement

136 Hong Kong Trade Development Council, op.cit., p. 62
Environmental enforcement has typically taken second place to economic growth and profits in Guangdong, but is gradually getting more attention. In 2006, according to the Guangdong Environmental Protection Bureau, the government inspected 150,000 polluting factories and closed down 2,100. In March, Li Qing, the director-general of the Guangdong Environmental Protection Bureau said that the province had vetoed 26 polluting projects in the first half of 2006, 10% of those seeking approval, and would set limits on the practice of polluting industries moving to mountainous areas to escape the increasing crackdown in the Pearl River Delta. 141

In February 2007, seven city delegations to the Guangdong People’s Congress tabled proposals defining legal responsibilities for governments to set up air pollution monitoring systems, as well as emission caps for enterprises and limits on the level of motor exhausts in cities. 142 Governor Huang Huahua announced on the sidelines of the National People’s Congress in Beijing that the province would build an RMB 2.3 billion satellite monitoring center to spot polluters, 143 which was shortly followed by news that the Ministry of Science and Technology would contribute RMB 100 million to a RMB 200 million project with the Guangdong government to establish an air quality monitoring network. This is to be the first such effort on the mainland although it builds on a small-scale cross border air quality monitoring project with Hong Kong that began publishing data in 2006. 144

Typical of the recent mood was the announcement in February 2007, by the mayor of Dongguan, Li Yuquan, giving 1,252 Hong Kong-invested factories one year to install pollution control equipment or have their operating licenses revoked. The total reprimand was actually more like two years, since the factories first came under scrutiny in late 2005 and the decision had already been made not to renew their licenses. “We set a cushion for them,” said Li, who described all of Dongguan’s rivers as “black”. 145

Dongguan’s neighbor, Shenzhen, has committed RMB 100 billion on a “green” campaign running through 2020, or the equivalent of 3% of economic output annually. It aims to reduce the amount of acid rain-causing sulfur dioxide emissions by 20% by 2010, as well as treat 80% of its wastewater and recycle 20% for re-use. The campaign, outlined in the municipal government’s first public circular for the year, warned industrial polluters that they would face stricter regulations and fines, and that local administrations would not grant land or loans to factories that did not meet standards. High-polluting industries were to be shut down and moved out of Shenzhen. 146

Administrative discretion in the new laws on export processing and industrial land use will give Guangdong authorities considerable range in shutting down polluters, although only time will tell if they use it. Although environmental authorities are clearly gaining more clout, a new program announced in July by the State Environmental Protection Administration and China Banking Regulatory Commission to restrict lending to polluting firms has gained little traction. The green credit mechanism requires environmental authorities to submit lists of good and bad performers on the environment to banks, but the lists themselves originate with local governments, opening the likelihood if not certainty of abuse. 147

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141 Ivan Zhai, “Brakes put on polluters,” South China Morning Post, March 24, 2007
142 Kevin Huang, “Seven Delta cities seek new air pollution laws,” South China Morning Post, February 8, 2007
144 Ivan Zhai and Olga Wong, “Joint study will track down Delta air polluters,” South China Morning Post, March 13, 2007
145 Ivan Zhai, “Dongguan mayor gives HK factories a year to clean up,” South China Morning Post, February 7, 2007
146 Chow Chung-yan, “Shenzhen pledges 100b yuan by 2020 for ambitious green campaign,” South China Morning Post, January 5, 2007
147 Stephen Chan, “Top creditors still in the dark about green regulations,” South China Morning Post, July 31, 2007
7 Investor’s guide to Guangdong

If we run a scenario for 2020 based on the relative strengths of the major Delta cities and their hinterlands, we like what we see. Guangzhou, Shenzhen and Dongguan become the urban playgrounds of a Silicon Valley-style concentration of high technology and consumer electronics innovation, taking advantage of existing strengths in terms of production networks while adding a new dimension in terms of R&D support.

The central and western cities of the Pearl River Delta – Foshan, Jiangmen and Shunde – provide the raw industrial muscle, as centers for petrochemicals and heavy industry, anchored by the new port at Gaolan in Zhuhai. A brand-new road and rail network, together with efficient ports and airports, link the province to the global economy.

Zhuhai gets the spillover from cramped Macau in terms of the resort business, while Macau becomes the Pearl River Delta’s entertainment hub. A trimmer, wealthier Hong Kong loses its ports and support industries, but thrives as a financial center and a magnet for creative industries.

Brands might not be born in Hong Kong, but Hong Kong provides the spin. Property values boom across the region as a combination of urban renewal, improved air and water quality, and the exodus of polluting industries take effect.

In the optimist’s scenario, Guangdong succeeds in its high-tech ambitions. By 2020, the province plans to increase R&D to 2.8% of GDP, roughly equivalent to that of the United States today. It also has to perform the hat trick of advancing from the commodity end of consumer electronics manufacturing to the more desirable product innovation end. It helps that Guangdong is already the world’s dominant producer at the commodity end of consumer electronics, although its products are marketed almost entirely under the brand names of foreign multinationals. Guangdong makes half of China’s television sets and one-third of its mobile phones. Dongguan, a vast industrial sprawl covering three counties and 25 townships, accounts for 30% of the world’s personal computer drives, 20% of its scanners and 16% of its keyboards.

Guangdong’s dominance of the global market for consumer electronics is as indisputable as it is invisible. It accounts for 40% of China’s technology exports, which increased by 25% in 2006 to US$300 billion and could amount to US$390 billion in 2007. As a yardstick, Asia’s total exports of electronics in 2005 were US$700 billion, according to the World Trade Organization. At an international sourcing fair for electronics and components in Hong Kong in April 2007, Guangdong suppliers took up more than half the fair’s 2,000 booths.

Moving up the value-added ladder to capture the leading edge of product cycles will not be easy, but it can be done. South Korea’s electronics manufacturers faced the same kinds of hurdles in the late 1980s, when manufacturers such as Samsung, LG, Hyundai and Daewoo began experimenting with the use of their own brand names. Guangdong’s new industrial policy will help, since it will

149 “Industrial Clusters in Pearl River Delta (PRD),” Li & Fung Research Centre, May 2006, Issue No. 2
preserve the tax incentives, export tax rebates, import duty relief, privileged access to industrial land, and other sweeteners that are being phased out for inefficient, polluting industries.

The technology sector presents offers limited opportunities to Hong Kong manufacturers, unless they have deep pockets. Manufacturers in the so-called traditional industries, such as textiles, may follow the model of the unlisted Esquel, and introduce high-speed, automated production lines that can be operated by relatively few workers. Others may attempt to switch to contract manufacturing for high-tech customers, but without intellectual property of their own, the future may be limited. The primary goal of China’s 15-year technology plan is to lead China through a transition from importing technology to creating its own – reducing or eliminating the current dependence of its high-tech exports on imported high-tech parts.151

China’s most recent articulation of its technology policy, the February 2007 Development Guide for Current High-Tech Industrialization Policy Areas, leaves little doubt what the central government means by high-technology promotion – systems equipment for TD-SCDMA and other 3G telecommunications; biotechnology; advanced aviation systems; new materials; renewable energy technology, and so on. 152

From a Hong Kong perspective, the list reflects a simple truth. No Hong Kong manufacturers play in this arena, at least not on a large scale, and they will be among the losers in this sector. Hong Kong’s flagship companies are not its manufacturers but service providers, most often in protected Hong Kong industries such as property and utilities but also in finance and shipping. A company such as Johnson Electric Holdings, a maker of car parts and power tools, with 2006 revenues of US$2.08 billion, illustrates the problem.

Despite attempts to diversify into trading and venture capital, in recent years its profit margins have been squeezed by rising material and wage costs. Johnson Electric, originally a toy maker, is among Hong Kong’s largest employers in the Delta, with about 30,000 people at its main factory in Shenzhen, dubbed “Johnson City”. The rising cost of copper and plastic, higher wages in its mainland factories, yuan appreciation and finance costs have cut deeply into profits. The company has tried to buy its way into proprietary technology, with the purchase of Saia-Burgess Electronics Holding, a Swiss motor supplier, and Parlex Corp., a Nasdaq-listed maker of electronic components, but while revenues were up by 37% to US$2.08 billion for the year through March 31, 2007, earnings were less than half market guidance, at 16.7%.153

The contrast between Johnson Electric and Foxconn, or Hon Hai Precision Industry Co. Ltd., is stark. Foxconn, a Taiwan company with 2005 revenues of US$28.3 billion, designs products for customers including Apple Computer, Intel, Dell, Hewlett Packard, and Microsoft. Unlike Johnson Electric and other Hong Kong companies with stakes in the high-tech sector, Foxconn has behind it the resources of Taiwan’s high-tech drive. Foxconn’s chief executive officer, Terry Guo, recently purchased a US$30 million castle in the Czech Republic. Patrick Wang Shui-chang, chairman of Johnson Electric, ranked number 365 on the Forbes list of the world’s richest people in 2006, with a net worth of US$2.1 billion. Mr. Guo ranked 147 with a net worth of US$4.3 billion.

153 Denise Tsang, “Johnson Electric warns of flat year amid higher costs,” South China Morning Post, June 9, 2007
Some contract manufacturing may make the transition successfully. Simon Shi Kai-biu, president of the Hong Kong Small and Medium Business Association, and owner of Dongguan-based Sun Motor International, a maker of motor systems for toys with annual revenues of HK$600 million, told the *South China Morning Post* that he would simply tighten his belt and start making motors for automobiles and printers. Although he will have to fire people in order to meet the new requirement to pay Customs duties on raw materials imports, his profit margin on motors for toys is only five % while that for cars and printers is as high as 18%.154

Another such example is a partnership between Wah Shing Toys, one of the world’s largest contract toy makers and a division of South China Industries, and Horizon Fuel Cell Technologies, a Shanghai-based developer of fuel-cell products that has produced a fuel-cell powered toy vehicle, the H-racer, as well as a fuel cell conversion kit for race hobbyists. The deal, if concluded, would establish an “eco-friendly” toy industry and also branch into reusable chargers for toys. Wah Shing would provide manufacturing from its factories in Shenzhen, Dongguan and the neighboring province of Guangxi.155

Value seekers should look at the technology, logistics and property sectors in the Pearl River Delta because these will be the most affected by Guangdong’s policy drive. Within these sectors, they should look for companies and industries that are moving up the value-added chain – even if it is only in small steps, like Sun Motor International figuring out that it can make motors for products other than toys.

### 7.1 Sectors: Technology

#### 7.1.1 Consumer electronics

China has already become the world’s dominant manufacturer of consumer electronics, and Guangdong is the major platform for the sector. In 2005, Guangdong produced 36% of the national output, according to official statistics – RMB 986 billion out of the national total of RMB 2.7 trillion, or 36%. Value-added output in the two sectors, according to provincial statistics, was RMB 205.9 billion in 2005 and increased by 31.1% over 2004.156 These figures, are impressive but in the next phase, as China eliminates preferences for low-tech, the numbers are likely to swell. Guangdong is following the classic East Asian model of jump-starting its high-tech industry through joint ventures with blue chip multinationals, starting with the auto industry, in which Honda, Nissan and Toyota each have made substantial investments.

Hong Kong’s manufacturers are squeezed out of this industry segment both through lack of scale as well as the absence of proprietary technology. But Shenzhen and nearby cities have produced a bumper crop – TCL Corp., the world’s largest maker of television sets, in Huizhou; Huawei Technologies, an unlisted manufacturer of switching systems and modems that puts 10% of its revenues into R&D; and ZTE, the handset maker. Each of these represents deep pockets and companies that can benefit from national policy favoring technology. Huawei is private; TCL and ZTE are listed.

154 Denise Tsang, “Factories struggle as export curbs bite,” *South China Morning Post*, August 6, 2007
155 “To infinity and beyond,” *South China Morning Post*, July 15, 2007
7.1.2 Auto parts

The automotive industry also provides substantial opportunities for local production of auto parts and electronics. Guangzhou, which is China’s second largest producer of autos and is likely to become the largest producer within the next five years, with a planning target of 1.6 million cars per year, up from 400,000 in 2005. 157 Growth of the industry is likely to favor licensees and subcontractors of Japan’s big three automakers, Honda, Nissan and Toyota. These are building some of their latest models, including hybrids, in Guangdong, and Honda has begun exports to Europe from its gleaming plant near Guangzhou. Like consumer electronics more broadly, Hong Kong’s small-scale, contract manufacturers are unlikely to be competitive or thrive in the industry.

7.1.3 Renewable energy

If project finance and cost issues have blocked the pollution control industry, renewable energy is another story. Following introduction of a renewable energy law in 2005, China will begin requiring that power companies take all available supplies of renewable energy as of September 1, 2007, as part of an overall program to have 16% of energy from renewable sources by 2010. The investment cost associated with the program is US$198 billion.158

Renewable energy companies are creating enormous market interest. Shares of China High Speed Transmission Equipment, China’s largest wind power transmission gear manufacturer, doubled their initial offering price of HK$7.08 in their first day of trading on July 4, raising HK$2.1 billion for its H Shares. 159 Dragon Power, a Beijing-based biofuel company, will try to raise as much as US$2 billion from an initial public offering in Hong Kong in 2008, using as a draw its 50-50 joint venture with Shenzhen State Power Scietech Development, a subsidiary of the State Grid Corp., to open 100 biofuel power stations by 2010. China Agri-Industries Holdings, another biofuel play, raised HK$3.4 billion in its Hong Kong listing in March 2007.

In Hong Kong, only CLP Holdings has been active in the China renewable energy sector, with its 25% holding in the first two generation units at the Daya Bay nuclear reactor and participation in 100 Megawatt and 400 Megawatt wind power farms with China Datang Corp. in Jilin Province.160 As a group, it has set a 5% target for power generation through alternative energy sources, and has invested in projects in India as well as China. 161

CLP is also conducting a feasibility study for a 200 Megawatt wind power farm in the offshore waters of Sai Kung in the New Territories, together with Wind Prospect, a British wind and solar energy development company. The Sai Kung wind farm would cost about US$300 million and involve 67 wind turbines, making it Asia’s largest offshore commercial wind farm. Alex Tancock, Wind Prospect’s Hong Kong representative, has been trying without success, however, to persuade

157 Dr. Yok-shiu Lee, School of Geography, University of Hong Kong, lecture, “Rapid Motorization in the Pearl River Delta Region,” Centre of Urban Planning and Environmental Management, University of Hong Kong, April 4, 2007
158 Tim LeeMaster and Nevin Nie, “Dragon Power plans IPO to raise US$2 billion for biofuel plants,” South China Morning Post, August 7, 2007
159 “China High Speed claims best IPO performer crown,” Reuters, July 4, 2007
160 Denise Tsang, “Datang, Roaring 40s to start Jilin project,” South China Morning Post, February 27, 2007
161 Denise Tsang, “CLP taps wind power in India,” South China Morning Post, August 7, 2007
Pearl River Delta manufacturers to invest in a cluster of 100 wind turbines, modeled after the company’s Wind Direct joint venture in Britain, in which it takes over management of turbines. 162

7.1.4 Environmental technology

Renewable energy and environmental technology are also on the government’s wish list for indigenous development. Foreign suppliers have dominated the market for environmental protection equipment; a check of the web site of the China Environmental Protection Industry Association shows only two Guangdong-based members, both foreign licensees—Guangzhou Shunhe Environmental Equipment Company and Shenzhen Runchuan Industrial Company.

Government controls over pricing of electricity and water have slowed down the pollution control industry, although some suppliers have been able to cope with obstacles to project finance. 163 Veolia Water, one of the largest international water management companies with revenues of Euro 10.1 billion in 2006, signed its first deal in China in 1997 with the Tianjin government, and in 2003 signed 50-year deals with both Shanghai Pudong and Shenzhen for managing their water and wastewater supplies.

Howden Power, a British industrial equipment manufacturer with a joint venture in Shandong Province, has been selling desulphurization equipment and heat exchangers to power stations. In 2004, Ken Ramsey, Howden Power’s global marketing director, told the Wall Street Journal that the market emerged only after Beijing had been awarded the 2008 Summer Olympic Games and would grow at least until the Games were done.

One example of the way in which Hong Kong could serve as a platform for creative financing for cleaning up the Pearl River Delta is a program dreamed up by Stewart Ballard, commercial counselor of the US consulate in Hong Kong and a former staffer in the office of the US executive director at the Asian Development Bank in Manila. Starting in the fall of 2007, the ADB will make US$800 million available as bridge financing for pollution abatement and energy saving equipment, with loans to be repaid from energy savings. Nine Hong Kong-based commercial banks and 20 service companies are backing the program, dubbed P2E2 for Pollution Prevention and Energy. Some 20 out of 30 projects are in the Pearl River Delta, according to US Consul General James Cunningham. 164

7.2 Sectors: Logistics

162 Denise Tsang, “Wind power development plan hit by headwinds,” South China Morning Post, February 27, 2007; Interview with Alex Tancock, Wind Prospect, Hong Kong, December 11, 2006


164 Olga Wong, “US$800 million for firms to clean up mainland,” South China Morning Post, May 12, 2007
7.2.1 Goodbye to Hong Kong’s ports

Historically, Hong Kong has been so dominant in logistics in the Pearl River Delta that it is hard to imagine the city without its container ports and giant warehouses. Hong Kong’s economy was built on the maritime trade.

Yet, just as warehouses around the no longer active industrial districts of Hong Kong have emptied out, the same process is slowly happening with Hong Kong’s container ports. In January 2007, a government advisory group chaired by Tung Chee-chen, brother of the former chief executive and chairman of the family shipping company, Orient Overseas International Limited, argued that Hong Kong should not build a planned tenth container terminal or a proposed logistics park in Siu Ho Wan on Lantau Island. 165

Hong Kong as a geographic anchor for ports and the associated logistics industry is losing ground to northern ports for reasons almost too many to number. It cost US$200 more per container to truck goods to Hong Kong from the Delta’s factories than it does to Shenzhen. Hong Kong’s trucking lobby has made sure that only local Hong Kong drivers can be employed, not their cheaper mainland counterparts.

Drivers have to return in the same trucks they drive across the border – also a gift of the trucking lobby. For years the industry has also used the rule as an excuse to tank up on cheap, high-sulfur, low-quality mainland diesel fuel, adding to Hong Kong’s air pollution. Although Hong Kong’s port traffic continues to show apparent growth, according to logistics specialist Russell Barling, in recent years any statistical increase in throughput has been a result of double counting – once when containers come off the delivery vessel and once onto the destination vessel.166

A final blow may come with the shifting composition of the physical flow of goods, from light to heavy industry, as Guangdong moves up the value chain. Hong Kong’s logistics industry has paralleled the development of its manufacturing base in the Pearl River Delta, and with space and other constraints will not easily leap from the logistics of toy and apparel exports to autos and heavy industrial products, although consumer electronics is a middle ground where Hong Kong’s logistics infrastructure may be able to adapt more easily.

7.2.2 Is Chek Lap Kok losing its edge?

With the opening of Chek Lap Kok International Airport in 1997, Hong Kong’s status as the region’s primary air hub seemed assured. Hong Kong’s flexible customs and trade regulations gave it a competitive edge in the fastest growing segment of the cargo business, transshipment or goods relayed through Hong Kong on their way to or from China. These made up 85% of the 3.4 million tons of air cargo shipped through Chek Lap Kok in 2005.

However, outdated regulations impeding transshipment of controlled goods, including medicine and pharmaceuticals, are routinely diverted to other regional airports such as Singapore’s Chang Yi.

165 Anita Lam, “Caution on expanding HK port,” South China Morning Post, January 16, 2007
166 Russell Barling, “Officials silent as logistics business sails across the border,” South China Morning Post, October 20, 2006
A 2006 report by GHK Consultants also pointed to Hong Kong’s transshipment tax, which like the ports’ terminal handling charge adds unnecessary costs. 167

Another indicator of change is where the jobs are going. In Hong Kong’s logistics industry, where once it was difficult to get their staff to accept jobs in southern China, now there is so much opportunity that they “are wanting to get exposure and are interested in the challenge,” according to Markus Muecke, manager director of Panalpina China’s Pearl River Delta operations.168

7.2.3 Northern exodus

For Hong Kong’s port operators, the math has been obvious for years, and Modern Terminals, majority owned by Wharf Holdings, and Hutchison International Terminals, part of the Cheung Kong Group of companies owned by Li Ka-shing, have both pushed deep into the Pearl River Delta and beyond.

The world’s largest ports operator, Hutchison International, has been the most aggressive, beginning with a 50% stake in Shanghai’s container port in 1992, followed by its RMB 5 billion joint venture to own, operate and develop Yantian Port in Shenzhen. It has 11 deep-water berths at Yantian, as well as its own railway and warehousing and container depots. Hutchison is the principal player in Zhuhai’s new Gaolan container terminal on the western shore of the Pearl River Delta.

Near Huizhou, there are handling facilities for bulk cargo, oil and liquefied petroleum gas in nearby Huizhou, as well as warehouses in Jiangmen and Nanhai, and, further up the Guangdong coast, in Shantou. Hutchison has terminals as well in Shanghai at Wusong Port, Waigaoqiao Port, and Pudong, as well as a deepwater container handling facility in Ningbo’s Beilun Port, and the only container-handling facility in Xiamen’s Special Export Zone capable of handling post-Panamax vessels.

Modern Terminals is in partnership with the Suzhou Municipal Government in Suzhou’s Taicang Container Port, as well as the Shenzhen Municipal Government in Phase 1 of the container terminal at Dachan Bay. It has equity in Phase 1 and 2 of Shekou Container Terminals, and 20% of the Chiwan Container Terminal. Its first joint venture was with Phase 1 of Shekou Container Terminals in 1998.

Modern Terminals and Hutchison are models for smaller players, such as Kerry Logistics, which has a stake in Shenzhen’s Chiwan container terminal, and Swire Pacific. They also serve as a model for Hong Kong’s Airport Authority, which is managing the Zhuhai Airport in a 20-year contract beginning in October 2006, making it the mainland’s first foreign-owned airport management company. In January 2005, the airport authority also signed a letter of intent with Hangzhou Xiaoshan International Airport to plan a logistics park, as part of the terms of a strategic alliance, following up with the HK$1.9 billion purchase of a 35% stake the following April.169 Hong Kong’s listed mass transit company, MTR Corp., built Shenzhen’s core east-west subway line, opening 20 stations in December 2004, and the first phase of a second line, to be completed by September 2009. MTR is funding the RMB 6 billion railway project as an investment, including property development rights to 2.9 million sq. m. of municipal land.

167 Russell Barling, “Outdated rules threaten HK’s coveted role as global air cargo hub,” South China Morning Post, September 8, 2006
169 Leu Siew Ying in Zhuhai and Russell Barling, “HK throws lifeline to troubled Zhuhai airport,” South China Morning Post, May 27, 2005
Each of these deals and investments have accomplished two broad strategic goals – planting corporate stakes deep in the rapidly expanding mainland economy, and pushing Hong Kong’s professional standards and values north. The Lowu terminus, built and managed by MTR, is as polished as its counterpart in Hung Hom, but with a much larger shopping mall.

The next logical step is to provide mainland operators comparable stakes in Hong Kong’s ports and airport. This is the model followed by Cathay Pacific, 40% owned by Swire Pacific, which in June 2006 struck a cross-shareholding deal with Beijing-based Air China that has been enormously lucrative for the carrier. In addition to giving it ownership of Hong Kong-based Dragonair, the deal provided Cathay Pacific a 17% stake in Air China with Air China taking a roughly equal stake in Cathay.

The arrangement opens the way for Cathay to provide managerial input to Air China and realize capital gains, which have been substantial. More importantly, however, it gives Air China a stake in the success of Hong Kong’s flagship carrier. Ultimately the Hong Kong Airport Authority may wish to follow suit by offering equity in its operations to the Chinese government – perhaps to the Pudong International Airport or Beijing’s Capitol Airport – as part of a strategy of gaining access to domestic and international routes as China’s global air network expands.

7.2.4 Air cargo – split personality

The continuing dominance of Chek Lap Kok in air cargo has given that industry, however, a split personality. DHL Express, the first international air express company to operate in Hong Kong from the early 1970s, has been owned by Deutsche Post Express International since 2002. It has placed most of its bets on Hong Kong, although its China operations began in 1980 as an agent for Sinotrans.

DHL, which bases its Central Asia Hub at Chek Lap Kok, built a new, HK$780 million, 18,200 sq.m. Express Cargo Terminal in 2004 under a 15-year agreement with the airport. Its rival, FedEx, the world’s largest express freight carrier, is moving its Asia-Pacific hub from Subic Bay in the Philippines to Baiyun International Airport in Guangzhou, at a cost of US$150 million. When it opens there in December 2008, it will have facilities covering 63 hectares. David Cunningham, Jr., president of FedEx Asia-Pacific, told the International Herald Tribune that the hub would make Guangzhou into “one of the leading cargo airports in the world.”

Ultimately, the logistics business will follow manufacturing, as China’s transport infrastructure and trade services improve. The players to watch are the companies that, like Hutchison, Cathay Pacific and FedEx, lock themselves in as first movers in an expanding mainland market. Those that lag behind are likely to be the losers, as they seek to arbitrage an ever-dwindling gap between assets in Hong Kong and the mainland.

7.2.5 The traders

Among Hong Kong’s most interesting companies are its traders, who in many ways embody the strength of the south China economy for centuries if not millennia. Through its trading networks, emigrant communities and seafarers, south China’s quintessential asset is arbitrage. Hong Kong’s success as a trade entrepot took advantage of one of history’s unique arbitrage opportunities – between China’s relative isolation and the manufactured goods of the industrial revolution.

170 Chris Buckley, “Fedex to move Asia center to China,” International Herald Tribune, July 14, 2005
Since China’s reforms began, arbitrage remains the basis of its intellectual capital. In the last quarter century, it has thrived by matching demand in global markets with Chinese supply. As that equation changes, however, the traders will also have to recast their strategies and networks.

The basic trading model tends to favor commodities, since arbitrage is price based and relatively straightforward. But China’s emergence as a factor in the global economy created a niche for companies like Li & Fung and Luen Thai to help buyers manage production as well as delivery, while Noble Group has gained traction with China’s runaway demand for industrial and agricultural commodities. These are pure service companies, with risks and vulnerabilities based on their networks.

Luen Thai, with 2006 revenues of US$661 million, is most exposed of the three to Guangdong’s heavy-industry ambitions, since its supply chain, anchored in Dongguan, is focused on the apparel industry. Li & Fung, with a 2006 turnover of HK$68 billion, is much larger and began to diversify its sourcing operations in the 1990s. It has minimized the geographic risk of its China exposure both through forward integration – buying distribution in Europe and the US – and through broadening its product menu. Noble Group, with US$11.7 billion revenues in 2006, has pursued a classic trading strategy by focusing on commodities but has been enormously successful because of China’s growing demand for energy and raw materials.

The supply chain management model is more risky than pure trading against the context of China’s move up the value chain. But these companies tend to be so flexible – since they have no assets – that they are almost always survivors in the long run.

In order to take advantage of opportunities arising from the Pearl River Delta’s shift to heavy industry and high-tech, they need to restructure their supply chains and identify new customers, or follow their suppliers to the Chinese interior cities or to the developing economies of South and Southeast Asia and beyond. Some, like Li & Fung or Luen Thai, have too much intellectual capital invested in specific product lines to make this transition easily, and as a result will be more exposed to rising labor production costs to the degree that they are committed to Chinese sources.

7.3 Sectors: Property

7.3.1 Hong Kong property values – eroding at the edges

For decades, Hong Kong’s property developers have occupied a privileged position in the hierarchy of Hong Kong business. The reason was simple. Fees from land auctions – the “land premium” – went straight into the government’s Capital Works Reserve Fund. The latter serves as an off-balance sheet source for infrastructure projects of all sorts.

Although, in terms of the government’s total revenues, the land premiums supply a relatively modest percentage, the flexibility attached to the fund makes it extremely attractive as a political tool. In the fiscal year for 2005-06, for example, land premiums amounted to HK$29.4 billion, out of total
government revenues of HK$247 billion (including operating revenue). That is roughly equivalent to the government’s annual target for infrastructure spending of HK$29 billion.

The arrangement has introduced a fundamental conflict of interest in the government’s land policy, since it provides a strong motive for keeping land values high by rationing the amount of land available for development. As a result, Hong Kong’s property has not gone through a predictable process of factor price equalization with land values across the border, despite the increasing number of Hong Kong retirees and commuters who have bought land for their own use in nearby communities such as Shenzhen and Zhuhai.

Some parts of the market, such as the financial district in Central or millionaire’s row on the Peak, price behavior is rational based on perennially high demand and scarcity of supply. In other parts of Hong Kong, the gap between Hong Kong prices and top quality urban assets in Guangdong is increasingly unrealistic. Even Central is beginning to lose market support, with the emergence of West Kowloon as a competing financial district.

In August 2007, Morgan Stanley announced that it would move operations from Hong Kong Land’s Exchange Square in Central to Sun Hung Kai’s new 118-story International Commerce Centre in West Kowloon. About the same time, two government land auctions in June and July attracted below market bids, a sign that developers have become more focused on building up their mainland land banks than on development sites in Hong Kong.

The land premium system has given Hong Kong developers another advantage besides the government as an ally – their Hong Kong properties have served as utilities, offering stable cash flow that they have used as leverage to develop property in China and elsewhere. The developers understand that Hong Kong land values will eventually reach parity with the mainland’s top cities, and that Shenzhen, Guangzhou and Macau will be among them. While the most aggressive of Hong Kong’s developers in the mainland – Cheung Kong and Sun Hung Kai, followed by Kerry Properties – have focused on top-tier cities, they are increasingly moving into Guangzhou and Shenzhen, both of which are creating brand new core business districts, Guangzhou at Pearl River New City and Shenzhen in Futian.

### 7.3.2 Shenzhen and Guangzhou get slicker

Shenzhen property prices have been rising faster than any other city in China, and since 2002 the city has also seen the emergence of an upscale retail sector, with the opening of mega-malls.

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171 Census and Statistics Department, Public Accounts, Table 193: Government Revenue (General Revenue Account and Funds)

172 The actual figures on infrastructure spending were HK$28.3 billion in 2002-03; HK$31.4 billion in 2003-04 and 2004-05; HK$22.1 billion in 2006-07; and HK$20.4 billion in 2007-08, according to Legislative Council Paper No. FC70/06-07. Ref: CB1/F/1/2, http://www.legco.gov.hk/yr06-07/english/pc/pc/minutes/pc070301.pdf.

173 Sandy Li, “Morgan Stanley moving to Kowloon,” South China Morning Post, August 8, 2007

174 Sandy Li, “Developers turn to mainland sites,” South China Morning Post, August 9, 2007

175 Andrew Ness, “Pearl River Delta Integration and the Hong Kong Office Property Market,” presentation to American Chamber of Commerce in Hong Kong, March 22, 2007
including Citic City Plaza, King Glory Plaza, and The Micx, a modern integrated shopping complex anchored by a Gucci store, ice rink and cinemas.176

Multinationals have been moving back office operations in the major Delta cities, lured by steep improvements in quality as well as the cost differential between Hong Kong and Guangzhou and Shenzhen. HSBC has moved its data processing and account maintenance operations for Hong Kong and Britain to Guangzhou. Bank of East Asia has moved its data entry, telephone enquiries, computer programming and web page design to Guangzhou. Citigroup’s new call center for China and Hong Kong, as well as its retail banking customers, is in the same city. Standard Chartered Bank is providing back office services to Hong Kong and China from Shenzhen.177

Coca Cola’s largest Asian call center is in Guangzhou, operated by Guangzhou Telecom. FedEx is building its new Asia Pacific air cargo hub at the Baiyun International Airport. IBM will move its global procurement headquarters from New York to Shenzhen. Wal-Mart’s Asian headquarters and global procurement center are in Shenzhen as well.

These developments signal a gradual shift towards a regional strategy on the part of multinationals, according to Andrew Ness, head of research at CB Richard Ellis. He sees front office sales, marketing and headquarters operations remaining in Hong Kong’s Central district, while “decentralized Hong Kong” – the cheaper commercial centers in Quarry Bay and Cyberport on Hong Kong Island, and West Kowloon across Victoria Harbor – provide the platform for operations in which security of information is a priority. Data centers, labor-intensive back-office support and call centers, procurement offices, and R&D, however, will move to the Pearl River Delta.

Meanwhile, their China developments give Hong Kong property companies space for projects they can only dream about in Hong Kong. Swire Properties is building an RMB 4 billion, 4 million sq.ft. complex called Taikoo Hui in the Tianhe district of Guangzhou, with a performing arts center, library, retail, offices and hotels. Kerry Properties has luxury properties in Shenzhen’s Futian business district including Shenzhen Kerry Plaza and Arcadia Court, a residential complex, as well as Shenzhen Kerry Centre and Regency Park in Lowu.

Sun Hung Kai, with a 19.8 million sq.ft. land bank in China, is just beginning to venture into Guangzhou and the Pearl River Delta, where it will find Cheung Kong Properties in retail, residential and leisure developments in Guangzhou, Shenzhen, Dongguan and Zhuhai. Henderson Land has glamorous office and residential projects in Beijing and Shanghai, but has so far left the Pearl River Delta alone, as have Hang Lung and Shui On. Hong Kong Land has invested in Macau, but has no major developments so far in China.

7.3.3 How value-added industry leads to value-added real estate

From a Chinese perspective, Hong Kong developers have all the cards – deep pockets, familiarity with the culture, brand names that are famous at least in China. The Pearl River Delta has become a last frontier within China in part due to the prevalence of other types of Hong Kong investors – the people running factories with cheap migrant labor and inside-the-fence power generation based on the dirtiest and cheapest fuel available. As this segment of the economy is pushed out, Delta real estate is moving up the scale along with industry, opening up new opportunities in retail and logistics as well as commercial and residential property.

177 Andrew Ness, “Pearl River Delta Integration,” op.cit.
China’s high-tech drive, together with the attempt to improve waste management for polluting industries, is also creating demand for industrial parks and tailored high-tech facilities. The introduction of minimum prices for industrial land has boosted industrial prices, most visibly in Shanghai and Beijing. Even with attempts by the Chinese authorities to control property speculation and price bubbles, the potential of the market is huge. Before long, just as the container ports and warehouses of Hong Kong must vanish, so will the quality gap between the industrial infrastructure of Guangdong and Hong Kong.

One of the opportunities for Hong Kong developers, outside the mainland, will be redevelopment of former industrial zones and obsolete housing estates. Let’s hope that the developers and the market support a more sustainable approach to residential and commercial real estate in Hong Kong, so that cramped quarters and the high-rise jungles of the new towns will be a fading memory of Hong Kong’s past.

The problems with “Pearl City”

The extraordinary development of the “Greater” Pearl River Delta, including Hong Kong and Macau, has come at the expense of huge strains on the environment and quality of life. In the next phase, these strains are likely to grow even more severe without radical action on the part of policy makers. As the cities of the Delta converge in terms of economic and social fundamentals, the argument for complementary becomes weaker. While some synergy may exist between Hong Kong and its counterparts, such opportunities will exist in particular niches with increasingly less support from policy makers at the local level.

Nonetheless, a mega city—an assembly of cities in close proximity—is developing along the banks of the Pearl River. Despite political boundaries that will persist for another four decades, in many respects it is already a common market. Over the next ten years, remaining vestiges of difference between Hong Kong and its urban rivals—the famed efficiency of Hong Kong’s ports, advantages of its financial markets due to China’s closed capital account, the superiority of Hong Kong’s legal system and professional sector—may disappear.

Call it Pearl City, or keep the traditional place names. If they keep up their current pace, Guangzhou, Shenzhen, Hong Kong and Macau will be part of a single inverted V of a metropolis connected by a vast new road and light rail network as well as the traditional waterways. It will be China’s undisputed capital of wealth, leisure and sophistication, as well as its gateway to the world, an extended city like an extended family, as comfortable with diversity as it is with its Chinese heritage.

But this mega-city may have mega-problems as large as any of its global peers. Its rivals in China, along the Yangtze River Delta and Bohai Gulf, are growing faster and have developed a superior quality of life. They have not damaged the environment as extensively as Guangdong has done, and their cities are better in terms of culture, education, and civic institutions. While migrant workers tend to settle down in other parts of the country, in Guangdong employers are grateful if they return after the Lunar New Year holiday. Over the next decade, the gap between Guangdong and China’s new high-growth centers may widen. Living conditions could deteriorate sharply as millions more people find themselves in densely packed chaos, with untreated waste piling up, clean water running out, and the wildfire spread of infectious diseases.

Guangzhou, the capital city, is a case study in the imminent risks of over-population. Zheng Zizhen, a population expert from the Guangdong Academy of Social Sciences, believes that Guangzhou will reach its capacity in terms of the number of people it can support in less than a decade, based on a baby boom among migrant workers. 179Millions of these are women in their mid-twenties to mid-thirties, the prime age for childbirth. Since the beginning of economic reforms in 1980, the city’s population has risen from 3 million to 12 million; Guangzhou Party Secretary Zhu Xiaodan says the maximum the city can support is 15 million.

The choices made today could alleviate such problems or make them worse. Pearl City could be crippled by its political and social divides, chaotic infrastructure, and wounded environment, or it could be a megalopolis such as that along the eastern corridor of the United States, anchored by

179 Ivan Zhai, “Guangzhou faces population crisis,” South China Morning Post, April 10, 2007
New York, with a vibrant strand of cities attracting human talent and creativity from around the world.

8.1 Growing pains

Problems are large-scale in Pearl City. These start with social injustice in the form of wide gaps in income, by 20 to one or more. In Hong Kong, the average annual per capita income in 2005 was HK$233,698 (US$29,914). In Macau, the GDP per capita was MOP 194,000 (US$25,184). (In 2006, Maccanese became the Delta’s wealthiest residents with a GDP per capita of 227,508 patacas, or US$29,506, versus Hong Kong’s HK$214,710, or US$27,485). At the other end of the scale, residents of Zhaoqing, on the western shores of the Pearl River but still within the wealthy urban zone, earned an average of RMB 12,315 (US$1,594) per year.

The real income gap is likely to be far greater. China first distinguished between temporary and permanent residents in the 2000 census, but local statistical yearbooks may fail to make the distinction, so that hundreds of thousands if not millions of migrant workers are left out of such wealth calculations. The Shenzhen yearbook for 2001 reported its 2000 population as 1.25 million, while the national census reported a population of 7 million permanent residents (who have lived in the census area longer than six months) and an additional 923,619 temporary residents (who have lived in an area less than six months). 181

Statistical distortion was highlighted again in January 2007, when Guangzhou announced that it had become the first mainland city to reach a “developed country” income threshold of US$10,000 per year – only to retract the number and replace it with US$7,800, including the city’s 3.7 million migrant workers on top of the resident population of 7.5 million. 182

Pearl City – if it was viewed as a single entity today – would be an administrative nightmare. The region falls under three different political jurisdictions, in Guangdong and the two special administrative regions of Hong Kong and Macau, making urban planning a contradiction in terms. It suffers from the social, cultural and psychological isolation of its separate parts, fostered by history as well as political boundaries and poor connecting infrastructure, such that Hong Kong, Macau and Guangdong more co-exist than co-habit. Residents of each have distinct identities and prejudices against each other.

Guangdong’s industrial restructuring will create a whole new set of problems. Business will see a massive winnowing of the industries that have flourished over the last quarter century. Governments will see huge tests of their ability to develop infrastructure, protect the environment, and improve quality of life across the region. New levels of cooperation, not only at the official level, but also among business and civil society will be crucial in managing the transition.

Policy and market opportunity have driven the Delta’s economic miracle so far. But the complementary economic relationship at the policy level has come to an end, as a by-product of Guangdong’s strategy of moving up the value chain in manufacturing and services. In tandem,

180 Ng Kang-chung, “Macau beats HK in GDP growth,” South China Morning Post, April 1, 2007
market forces are putting pressure on wages and costs of production, cutting into the margins of enterprises at the lower end of the value chain, and forcing many of them to migrate elsewhere.

In the years after China’s kai fang or liberalization policy began in 1979, Hong Kong moved its textile, footwear, toys, and plastics industries to Guangdong. Now it is under pressure to give up large chunks of its service sector to the north, starting with ports and logistics but extending to all sorts of professional and marketing services aimed at managing the huge flow of goods into and out of China. Such changes will be wrenching, and face Hong Kong with the challenge of reinventing systems and institutions adapted to an older economy that will soon be obsolete.

8.2 Beyond arbitrage

The model in which Hong Kong could arbitrage its strengths as a source of capital, equipment and technology for the Pearl River Delta was based on weak institutions in Guangdong and strong institutions in Hong Kong. The convergence model is based on strong institutions in both, and lays the basis for an integrated economy.

Guangdong and the central government view the regional economy in terms of a hierarchy, with Hong Kong as the province’s link to global finance. The official breakdown of roles under the eleventh Five-Year Plan has Hong Kong serve as the center of the Delta’s international network and financial “leader,” with Guangzhou as the hub of the regional economy and support center for heavy industry, anchored in its new and thriving automobile sector. Shenzhen is to become a regional finance center, center for high-tech industry, and outsourcing center for Hong Kong in movement of goods and finance. 183 This is a vision of Guangdong, Hong Kong and Macau as part of a single regional or provincial economy in which transport and institutional links are far closer than they are today.

Convergence implies competition for capital, manpower and resources. The time is past when Hong Kong could play a significant role by exporting its manufacturing assets, managers, or capital. Guangdong has these in abundance. It will have need of Hong Kong’s intellectual capital, however, for problem solving and new ideas.

One of Hong Kong’s roles in the Delta could be as consultant and change agent, which of course is already happening. Take two examples. In 2006, Hong Kong-based Bank of East Asia teamed with Hong Kong-listed TCL, the world’s biggest manufacturer of color television sets by unit sales, in a joint venture based in TCL’s headquarters in Huizhou, Guangdong, to help with financial restructuring after the disastrous 2004 acquisition of the television production of Thomson SA and mobile division of Alcatel.

Or GS1 Hong Kong, a non-profit organization, promotes globally accepted supply chain management standards in Hong Kong and the Pearl River Delta. It has launched a program called the EPCglobal initiative to deploy both electronic product coding (EPC) and radio frequency identification (RFID) among manufacturers in the Delta. VTech, a Hong Kong manufacturer of telephone handsets and educational toys, became the first to work with GS1 to tag shipments from

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183 Feng Xiaoyun, Jinan University Economics Institute, “Guangdong and Hong Kong: Competition and Cooperation in the Next Five Years,” Power Point presentation in Chinese, June 15, 2006
its factory in Dongguan to one of its major customers, Wal-Mart, which began implementing RFID systems in 2004. 184

8.3 Planning for a mega-city

The regional economy is entering a period of transition that will require great skill as well as an appetite for risk on the part of Hong Kong business, government and civil society. In 2010, the Pearl River Delta will mark the thirtieth birthday of its economic reforms, and the era of policy-driven functional specialization is likely to be all but dead.

If the dominant trends of the first 30 years were specialization, it is likely that the next few years will see greater competition and higher levels of differentiation among key cities, as convergence becomes a central theme of growth. The Pearl River Delta is becoming part of the “flat” world of globalization dominated by information technology and the free flow of goods and services. Hong Kong’s future success will depend on how well it distinguishes itself and its opportunities from its peers in the Delta, but these differences increasingly will be a matter of degree, not differences in kind or system.

The economies of Hong Kong, Macau and Guangdong are already redefining their relationships with each other as they pursue very different economic objectives, even if the political rhetoric remains unchanged. As early as 2010, it may become meaningless to think in terms of a regional economy, instead of a constellation of urban centers with strong linkages, competing with each other for investment, growth and human resources.

Such competition does not have to be a zero-sum game. The Pearl River Delta may once again rewrite the economic textbooks as its combination of infrastructure, creative capital, and financial strength launch new synergies based on capital and knowledge.

The prospect of a circle of vibrant cities competing with each other for human capital and investment may arouse fears of redundancy and value destruction. It should inspire confidence that the region as a whole will move up the value chain. The more these neighboring cities sparkle, the more the region as a whole will attract domestic and international talent by virtue of the scale of its opportunities for managers and professionals as well as for the “creative class” – Professor Richard Florida’s term for innovators and other “purveyors of creativity”. 185

Because of the quality of its services, its strong legal, educational and health institutions, as well as the vigor of its retail and to some extent, entertainment sector, Hong Kong has had a huge head start as a creative city. Key to moving to the next stage is a focus on quality of life, starting with the cleanup of the atmosphere.

Indeed, air and water pollution have become crucial obstacles both to Guangdong executing its industrial policy and to Hong Kong maintaining its competitive edge. Beyond its ever more porous borders, Hong Kong has a role to play in accelerating convergence through exporting its standards in services, management, and lifestyle. The smart money is already doing so.

184 “Company adopts new technology to comply with Wal-Mart’s requirement,” South China Morning Post, October 11, 2006
8.4 Hong Kong’s creative challenge

It may be the factory of the world, but few Western journalists have spent much time in Guangdong or tried to describe its unique political economy and culture. If any had tried to follow the region consistently, they might well be tempted to throw up their hands in frustration. Few regions on earth have changed so quickly in such a short time.

In 2002, Arthur Kroeber, writing for Wired Magazine, could describe Dongguan in terms of a wild and crazy sweat factory. He was writing about just one corner of a region that includes cities like Shenzhen, Huizhou, Foshan, Zhongshan, and Zhuhai, many of which could be described in similar terms:

“No one really wants to be here, but they come because it’s where the money is. The city lies at the heart of the Pearl River Delta, just inland from Hong Kong — in less than two decades, this part of South China has transformed from a subtropical backwater into a hub of global manufacturing. With a population of 40 million — just 3% of the country’s 1.3 billion - the region generates more than 7% of China’s GDP, one-quarter of its foreign direct investment, and one-third of its exports. The MADE IN CHINA label you see on a toy or appliance in Kmart was likely affixed in a Pearl River Delta factory.”

But this manufacturing powerhouse – Kroeber described Dongguan as manufacturing “everything” more cheaply and efficiently “than anywhere else on earth” – has led to environmental problems on a vast scale, and is now facing rising costs. It is no longer the low cost center of Asia, or China, and this single fact is leading to a sweeping transformation. As products become commoditized, it is less and less profitable to be a contract manufacturer – Dongguan’s lifeblood in Kroeber’s account.

Five years later, James Fallows, writing in the Atlantic Monthly, finds the same chaos, the same energy, and the same ranks of young female employees. Yet something has changed. Nearby Shenzhen is working its way up the hierarchy from production of printed circuit boards and plastic boxes for television sets to sophisticated components, that has Andrew “Bunnie” Huang, a blogger with a Ph.D. from the Massachusetts Institute of Technology all agog:

“Chips that I couldn’t dream of buying in the U.S., reels of rare ceramic capacitors that I only dream about at night!,” Huang wrote. “My senses tingle, my head spins. I can’t suppress a smirk of anticipation as I walk around the next corner, to see shops stacked floor to ceiling with probably a hundred million resistors and capacitors.” Within an hour’s drive north, he noted, were hundreds of factories that could “take any electronics ideas and pump them out by the literal boatload.”

Fallows’ Shenzhen is one based on skilled labor and innovation, with a well-educated workforce – one that is, in fact, better educated than Hong Kong.

The Pearl River Delta was a world in which Hong Kong was so different, and so far ahead, of all its neighbors that it seemed logical that 1997 would unleash a new flood of economic refugees if Hong Kong failed to lock the door. Today, in many respects, the shoe is on the other foot. Chinese companies are less likely to hire Hong Kong managers than a few years previously, according to the Hong Kong Federation of Industries.

It’s not just that Hong Kong professionals demand more pay; they are not as well trained as their mainland counterparts, whether it is language skills in Putonghua or engineering. Hong Kong companies with investments in the Delta have to do more than simply provide employment to prove they are eligible to stay. The Delta is not clamoring to take advantage of Hong Kong capital and Hong Kong ports. They have their own.

And it’s not just about competition for competition’s sake, but about costs and competitiveness. This is what the free market demands, and what it will get.

In August 2007, the Bauhinia Foundation Research Centre tabled a report arguing that Hong Kong and Shenzhen should work towards a new “Gang Shen Metropolis,” in a ten-point program including “rationalizing” the cross-border transport system and allowing the use of smart cards for immigration, already a feature of the Chinese immigration checkpoints along the border. 188

Two of the report’s key recommendations were establishing an express rail link between Hong Kong’s Chek Lap Kok Airport and the Shenzhen Airport, with a Pearl River Delta airport development advisory committee to review problems of air traffic control; and to establish a “Hetao Development Management Authority” under joint management of Hong Kong and Shenzhen, to develop a high-tech zone in a former industrial area called the “Shenzhen Loop” (now renamed Hetao). The latter would establish a “special region within special regions” and a “model area for a Hong Kong-Shenzhen Metropolis,” according to the report.189 By late 2007, government task forces were meeting regularly on both projects.

In terms of immigration, while arguing for a seamless border crossing, the Bauhinia Foundation report proposes unrestricted passage using smart cards for Shenzhen residents – but only those with “formal residence in Shenzhen, with a stable income, and reaching a specific annual income tax threshold.” The latter could apply for smart cards with a limited validity. 190 These are interesting proposals but they do not go far enough, and really add very little. Hong Kong needs to extend the same treatment to mainland nationals as it does to those of other countries. It desperately needs to move beyond the three current areas in which it has a semblance of cross-border communications – immigration, food safety, and the environment – and establish transparency and a level playing field with visitors and immigrants from the mainland. While the most imposing restrictions are maintained by the mainland itself in terms of limitation on individual travel, to Hong Kong as well as to any foreign destination, Hong Kong should not apply higher entry bars for mainland residents than it does for foreign nationals.

Hong Kong must reassess its own strengths and weaknesses not in the light of London, New York and Tokyo but as a regional city on China’s coast facing limited growth other than in financial services. Financial services are at the high end, and provide little employment although huge added value. Hong Kong’s secretary for financial services and the treasury, Chan Ka-keung, noted recently that each individual in the asset management industry added HK$2.26 million in value, based on 2005 data. 191 But as an overall employer, the trend to outsourcing means that Hong Kong will lose many of these jobs to back offices in Shenzhen, Guangzhou, and beyond.

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188 Bauhinia Foundation Research Centre, Building a Hong Kong-Shenzhen Metropolis, Executive Summary (in English), August 2007
189 Bauhinia Foundation, op.cit., p. 14
190 Bauhinia Foundation, op.cit., p. 10
191 Chan Ka-keung, “Let’s sustain our advantage in asset management,” South China Morning Post, August 13, 2007
Moreover, Hong Kong’s current advantages as a financial center are precarious, based on the fact that mainland companies and individuals are comfortable with Hong Kong as an environment to raise funds and invest offshore.

Neither Hong Kong nor the Delta cities are automatic winners in the new economy, but Hong Kong faces the distinct chance of becoming an underdog. The more that policy makers understand this fact and take it seriously, the better its chances for survival. We are at an inflection point where new thinking is critical, and all the cities in the Delta must learn how to align their interests, to attract new investment, new skills and new jobs. The old ways no longer serve.

In late 2007, in some respects the policy logjam that had beset Hong Kong since 1997 seemed to be breaking. New proposals on immigration, the environment, financial services and even democracy reflected a creativity and decisiveness that had been lacking. Decisions were being made on major infrastructure and cultural projects, including the West Kowloon “cultural hub” that reflected lessons learned from the earlier rounds of criticism and public protest. In many ways, it seemed that Hong Kong was beginning to assemble the pieces of a new identity that would take it forward in the newly competitive environment of the Pearl River Delta, energized, as ever, by its openness and connections with the world.

8.5 What next?

A clear view of its strengths and weaknesses will help Hong Kong survive in one of the world’s great urban clusters, comparable to the urban grids of the eastern seaboard in the United States or the Kanto plain in Japan that encompasses Tokyo, Yokohama and the research city of Tsukuba. In this cluster of cities, Hong Kong is likely to remain the most international, most open, and most competitive in terms of its market structures. Among the first steps it needs to take is to open its borders to mainland talent, and remove the last remaining vestiges of Cold War isolation from the mainland.

Despite substantial advantages, at this phase in the region’s development Hong Kong has more to lose than any of its neighbors. It can survive the loss of its industrial hinterland, but will be less involved with the physical production of goods in Guangdong as well as their movement across its border. It will lose part of its service economy as well, with the northward migration of its ports and logistics sector. Employment in the import and export sector, which accounted for more workers than the entire finance industry in the first quarter of 2007, 15% of total employment, may also decline as trade services relocate along with ports and logistics.192

It is true that Hong Kong will play an important financial role for the mainland as long as China’s capital account remains closed. But the barriers to the free flow of capital are being eroded and the end may come as quickly and unexpectedly as the opening of China’s current account in 1994. Hong Kong, to maintain a role, needs to look beyond arbitrage. To put it another way, the better its neighborhood becomes, the faster Hong Kong must run to stay ahead.

Hong Kong’s future is not assured. It will depend on the quality and maintenance of intangible assets – the free flow of finance, human capital and services. Supporting these will become a major priority of public policy for Hong Kong. To thrive, Hong Kong must become not only a free port of goods and services, but a free port of ideas.

192 Census and Statistics Department, Quarterly Report on General Household Survey, January to March 2007, p. 47.
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**Immigration Barriers:** Hong Kong’s institutional barriers to mainland workers are obsolete.

- Hong Kong needs to offer the same treatment to mainland workers as it does to those from other countries, including categories of unskilled labor such as domestic workers.
- Hong Kong should scrap the quota for foreign students at its universities, charging a premium for foreign and mainland students; Guangdong should allow national treatment for Hong Kong secondary and tertiary institutions, and drop barriers to Hong Kong people living and working in the Pearl River Delta.
- The lifting of restrictions should apply to all of China, not just Shenzhen.
- Pressure will be felt in Hong Kong in white collar clerical jobs and jobs in retail, restaurants and tourism, but as factor price equalization takes hold in the cross-border labor market, the wage gap will close as the overall job market expands.

**Border Infrastructure:** Hong Kong and Guangdong need to make cross-border movement of people and goods as efficient as possible.

- Smart cards used by Hong Kong and Guangdong residents should work on both sides of the border. There is no need to create a special category of cards for those with cross-border privileges. In principle, governments on both sides of the border will follow their own policies in issuing cards, which will record any limits to employment such as temporary visa or work permits, but both sets of cards will work at immigration checkpoints.
- Hong Kong should ensure that its border checkpoints operate 24/7 and provide electronic and drive-through facilities.
- The system of cross-border licensing should be scrapped so that vehicle traffic can move freely across the border. The two jurisdictions – potentially to include Macau – should adopt common auto emissions standards and cooperate on penalties and enforcement.

**Transport Planning:** Guangdong’s development priorities mean that it is building out a transportation system designed to improve the access of its factories, ports and airports to the domestic and global markets, not to Hong Kong. Transport planning within its major cities is aimed at building capacity and efficiency for a major shift of China’s population from farms to cities.

- Hong Kong needs to adjust its transport planning to an evolving A-shaped traffic flow down the Delta, in which Hong Kong risks becoming a cul-de-sac if it does not address urgent problems within its own jurisdiction, including express connections to the border.
- Hong Kong’s container ports have limited viability going forward and their ultimate rezoning should serve as a guide for transport planning.
- The Hong Kong Airport Authority should concentrate on passenger traffic, not air cargo, which will gradually move closer to manufacturing centers in the Delta.
- It should consider offering equity in the privatized airport to the Baiyun International Airport and to the Ministry of Transportation and Communications, in order to give its principal regional competitor as well as the central government a stake in its success.
- Macau’s major market will be mainland tourists, who will arrive by bus, further undermining the economic case for a Hong Kong-Macau-Zhuhai bridge. Hong Kong should cede this market to Macau and focus on high-end domestic and international visitors arriving by air.

**Waste Management:** This is a huge issue, like air pollution, in which both Hong Kong and the Pearl River Delta will lose if they do not get it right.

- Authorities should understand that new technology makes available scale solutions to waste management that suggest a closer level of cooperation. Hong Kong could get ahead of the game by employing cutting edge
technology for waste management and serving as a model for other Delta cities.

- Hong Kong has an urgent problem with landfill, and even without cross-border cooperation should be looking for the most effective, even if costly solutions to the problem.

**Air Pollution and the Environment:** Hong Kong should serve as a model for the Pearl River Delta by enacting tough air standards and enforcing them. It will lose its financial industry if it does not.

- Hong Kong should be seeking ways to fund the cleanup of the Pearl River Delta, which will lead to massive value creation in terms of health and property values
- Hong Kong should aim for parity or better than China’s environmental standards, and model itself on international best practice in enforcement
- The government should move ahead with mandatory energy efficiency standards for buildings, bans against idling engines, and road pricing
- HKEx should move ahead with experiments in emission trading

**Energy Planning:** The region needs to cooperate on planning for energy use and infrastructure. A regional energy task force would look at consumption and supply issues on a regional level, serving as an advisory body to governments.

- CLP would be a winner in a regional planning context, although it might have to develop its new LNG terminal in the Sokos Islands on an open-access basis. The Pearl River Delta’s existing LNG terminal and new terminals planned by Sinopec and CLP should be used to support regional conversion from coal and other highly polluting sources to gas.
- Hong Kong Gas, with its experience in building local gas distribution in mainland cities, would be a winner if regional energy planning was instituted.
- Hong Kong Electric, with its narrow focus on the Hong Kong Island market and lack of a development portfolio on the mainland, would be a loser.
- A logical step for regional energy planners would be to move towards open access to the Hong Kong grid, with preferences for renewable energy such as are being implemented on the mainland. This would interrupt the scheme of control and make CLP and Hong Kong Electric temporary losers, but provide support for renewable energy start-ups such as China High-Speed Transmission, a wind power company, and independent power producers like China Power International that are developing high-quality Guangdong assets.

**Regulatory Review:** Hong Kong needs to conduct a bottoms-up review of policies that undermine the competitiveness and efficiency of its service economy, including land policy and anti-monopoly rules.

- Despite Hong Kong’s reputation as one of the world’s most open economies, this applies mainly to its external economy. A web of regulations including explicit authorization of cartels protects the domestic economy, including financial services.
- A competition law with teeth needs to be enacted as soon as possible. The process of consultation has led to watering down of the law that has been under debate since 2005.
- Barriers to entry in the retail sector need to be addressed and eliminated.
- Barriers to practice in the legal and medical professions must be reviewed in order to recruit the best international talent. Lawyers, for example, are required to pass an overseas lawyer qualifying exam that imposes five-year experience standards for non-common law practitioners, ruling out new graduates. The qualifying exam is administered only once annually, making it difficult for foreign or mainland applicants to participate.
- In the power sector, the legacy scheme of control is a non-transparent operating contract between government and utilities. Hong Kong needs a more objective and accountable policy framework in line with international practice, in order to reduce transmission and pricing anomalies and enable wider application of preferences for clean and renewable energy from sources including the mainland.

**HKEx:** The stock exchange needs to become a center of innovation in order to prosper.
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