Hong Kong’s Competitiveness: A Multidimensional Approach

A project sponsored by the Bauhinia Foundation Research Centre

Phase II: Industry Level Competitiveness

Enright, Scott & Associates Limited

February 2007

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Introduction

The present document is the summary document for the second phase of a four phase project on Hong Kong’s competitiveness sponsored by the Bauhinia Foundation Research Centre and carried out by Enright, Scott & Associates Limited. The first phase compiled and reviewed a wide range of international assessments of Hong Kong’s competitiveness and various forces that influence that competitiveness. The documentation for that phase can be found on the website of the Bauhinia Foundation Research Centre (www.bauhinia.org). The second phase involves assessments of the competitiveness of individual Hong Kong industries. The third will focus on Hong Kong’s competitiveness in different corporate activities. The fourth and final phase will examine issues that cut across Hong Kong’s economy that influence a wide range of industries and activities. The fourth phase will also pull together conclusions from all the phases of the project to provide an overall picture of Hong Kong’s competitiveness and the forces that influence that competitiveness.

Industry Level Competitiveness

Aggregate measures of competitiveness (as described in the first phase of the present project) provide important insights into the performance and potential of an economy, but it is in individual industries that economies succeed or fail against foreign competition or when measured against comparison economies. Each nation or region tends to have its own distinctive pattern of success and failure influenced by underlying comparative advantages. It should be noted that there is no single “right” set of industries that every economy must succeed in for the economy to prosper. Certain types of economies will differ from other types of economies in systematic ways. City economies differ from national economies; developed economies differ from developing economies; and so on. Each economy has its own set of industries that will drive its future and that must be understood if the economy’s overall competitiveness is to be understood and improved.

The goal of this second phase of this project is to understand Hong Kong’s overall competitiveness at the industry level, and to examine what this
competitiveness (or lack of competitiveness) means for Hong Kong’s economic future. In order to carry out this task, we have studied the competitiveness of several leading industries in Hong Kong. It should be noted that we have studied these industries in order to make conclusions for the overall economy rather than detailed recommendations for the individual industries, some of which have been examined in great depth by others. Thus, while we do draw conclusions and implications for individual sectors, the main focus is on the overall lessons for Hong Kong and its economy.

**The Present Approach**

The present approach involved selecting a representative set of industries for examination. Given Hong Kong’s position as a city economy, which like most city economies in advanced economies is dominated by the service sector, it was natural that the service sector would dominate the industry selection. The industries selected for examination included: sea transportation and logistics, air transportation and logistics, financial services, professional services, tourism, the software component of the information technology sector, the garment sector, and the biopharmaceutical sector. The idea was to identify a mix of different types of industries for investigation.

In order to ensure comparability across sectors and to maximize cross-sector learning, we employed a common framework for analysis across the sectors. This involved examining the competitiveness of a Hong Kong industry in terms of firm level drivers (focusing on what goes on inside Hong Kong firms in the sector), industry or micro level drivers (industry practices, competition, and cooperation within the sector), cluster or meso level drivers (involving inputs, markets, and related industries), regional or macro level drivers (involving Hong Kong economy-wide issues), and supra-regional level drivers (focusing on forces outside of Hong Kong and Hong Kong’s control such as international trade agreements and developments on the Chinese Mainland). The industry studies were based on relevant statistical sources, existing literature, and interviews and focus groups with industry participants, industry experts, and outside observers both inside and outside of Hong Kong. The team also had access to survey databases compiled in its previous work.

The next step was to identify some of the common threads that arise across the industry studies and themes that reflect systemic issues for Hong Kong and its economy. From this set, we draw conclusions and implications for Hong Kong and its economy. We note that conclusions made across sets of industries are much more interesting and powerful than conclusions made based on a single industry. In Hong Kong, there is a tendency to focus on industries in Hong Kong that may be losing ground, with the possibility and in some cases reality that losing ground in one industry may be due to Hong Kong gaining ground in others in a way that shifts Hong Kong’s comparative advantage. Higher value

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industries and activities crowding out lower value industries and activities is a natural part of economic development and should be welcomed rather than feared. Looking across industries reduces problems of making conclusions based on a single industry.

**Hong Kong's Economy by Sectors**

Before moving on to the industry studies themselves, it is useful to place Hong Kong’s various industries in an overall context. In particular, it is useful to identify the major contributors to Hong Kong’s GDP and employment.

As can be seen in Exhibit 1, services dominate Hong Kong’s GDP, with a share of greater than 90 percent in 2005. The WRIERH grouping (wholesale, retail, import/export trade, restaurants, and hotels) makes the largest single contribution (28.3 percent in 2005), with the FIREBS (financing, insurance, real estate, and business service) grouping second at 22.2 percent. The WRIERH grouping showed the largest increase in share of GDP from 2000 to 2005, gaining nearly 4 percent. Smaller increases were registered by transportation, communication, and storage (0.7 percent) and the FIREBS grouping (0.8 percent). The manufacturing and construction sectors each fell by 2 percent to 3.4 percent and 2.9 percent respectively.

It is immediately clear that the WRIERH and FIREBS groupings are the core of Hong Kong’s economy, contributing 50 percent of Hong Kong’s GDP. Their contribution is even greater when one realizes that “ownership of premises” at 10.7 percent represents as much an extraction of value from other sectors as the creation of new value. Although manufacturing of various forms, and proposals to “bring back manufacturing” to Hong Kong, appear to receive significant attention in Hong Kong, manufacturing in Hong Kong contributes negligibly to the HKSAR’s GDP. Also of note is the collapse of construction’s relative contribution to GDP, which averaged 5.4 percent from 1980 to 1999, but began to decline thereafter.

As can be seen in Exhibit 2, the leading major category of employment in Hong Kong in 2006 also was wholesale, retail, import, export, restaurants, and hotels (WRIERH), with over 1 million people employed. Second was finance, insurance, real estate, and business services (FIREBS) with 480,534 employees. Third was community and personal services, with employment in excess of 450,000 people. The largest net change from 2001 to 2006 was in community and personal services, with an increase on the order of 78,000. The second largest increase was in finance, insurance, real estate, and business services. The largest decrease was in manufacturing, which fell some 49,000 in the period, followed by construction which fell by over 23,000.
Exhibit 1. GDP Contribution and Percent of GDP By Sector for Hong Kong

<table>
<thead>
<tr>
<th>Economic Activity</th>
<th>2000</th>
<th></th>
<th>2005 P</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>GDP at current prices</td>
<td>%</td>
<td>GDP at current prices</td>
<td>%</td>
</tr>
<tr>
<td>Agriculture and fishing</td>
<td>920</td>
<td>0.1</td>
<td>847</td>
<td>0.1</td>
</tr>
<tr>
<td>Mining and quarrying</td>
<td>241</td>
<td>0.0</td>
<td>100</td>
<td>0.0</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>67,646</td>
<td>5.4</td>
<td>45,841</td>
<td>3.4</td>
</tr>
<tr>
<td>Electricity, gas and water</td>
<td>36,917</td>
<td>2.9</td>
<td>39,852</td>
<td>3.0</td>
</tr>
<tr>
<td>Construction</td>
<td>62,054</td>
<td>4.9</td>
<td>38,612</td>
<td>2.9</td>
</tr>
<tr>
<td><strong>Services</strong></td>
<td>1,087,570</td>
<td>86.6</td>
<td>1,210,568</td>
<td>90.6</td>
</tr>
<tr>
<td>Wholesale, retail and import and export trades, restaurants and hotels</td>
<td>308,600</td>
<td>24.6</td>
<td>377,800</td>
<td>28.3</td>
</tr>
<tr>
<td>- Wholesale and retail trades</td>
<td>40,283</td>
<td>3.2</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td>- Import and export trade</td>
<td>231,720</td>
<td>18.5</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td>- Restaurants and hotels</td>
<td>36,597</td>
<td>2.9</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td>Transport, storage and communications</td>
<td>118,974</td>
<td>9.5</td>
<td>136,576</td>
<td>10.2</td>
</tr>
<tr>
<td>- Transport and storage</td>
<td>92,916</td>
<td>7.4</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td>- Communications</td>
<td>26,058</td>
<td>2.1</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td>Financing, insurance, real estate and business services</td>
<td>268,399</td>
<td>21.4</td>
<td>296,168</td>
<td>22.2</td>
</tr>
<tr>
<td>- Financing and insurance</td>
<td>149,157</td>
<td>11.9</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td>- Real estate</td>
<td>63,868</td>
<td>5.1</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td>- Business services</td>
<td>55,374</td>
<td>4.4</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td>Community, social and personal services</td>
<td>249,997</td>
<td>19.9</td>
<td>257,488</td>
<td>19.3</td>
</tr>
<tr>
<td>Ownership of premises</td>
<td>141,600</td>
<td>11.3</td>
<td>142,536</td>
<td>10.7</td>
</tr>
<tr>
<td><strong>GDP at factor cost</strong></td>
<td>1,255,348</td>
<td>100.0</td>
<td>1,335,821</td>
<td>100.0</td>
</tr>
<tr>
<td>Taxes on production and imports</td>
<td>57,908</td>
<td>4.6</td>
<td>63,111</td>
<td></td>
</tr>
<tr>
<td>Statistical discrepancy (%) @</td>
<td>0.1</td>
<td></td>
<td>-1.2</td>
<td></td>
</tr>
<tr>
<td><strong>GDP at current market prices</strong></td>
<td>1,314,789</td>
<td></td>
<td>1,382,052</td>
<td></td>
</tr>
</tbody>
</table>

Source: Hong Kong Census and Statistics Department.
Exhibit 2. Employment in Various Sectors in Hong Kong

<table>
<thead>
<tr>
<th>Sector</th>
<th>Q3-2001</th>
<th>Q3-2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electricity, Gas</td>
<td>377,014</td>
<td>455,230</td>
</tr>
<tr>
<td>Community, Pers Serv</td>
<td>184,151</td>
<td>185,646</td>
</tr>
<tr>
<td>FIREBS</td>
<td>1,027,281</td>
<td>1,038,786</td>
</tr>
<tr>
<td>Transport, Comm</td>
<td>1,038,786</td>
<td>1,038,786</td>
</tr>
<tr>
<td>WRIERH</td>
<td>185,646</td>
<td>185,646</td>
</tr>
<tr>
<td>Construction</td>
<td>1,038,786</td>
<td>1,038,786</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>480,534</td>
<td>53,286</td>
</tr>
<tr>
<td>Mining, Quarrying</td>
<td>76,524</td>
<td>160,194</td>
</tr>
<tr>
<td>Wholesale Trade, Import/Export</td>
<td>209,329</td>
<td>128</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>196</td>
<td>128</td>
</tr>
</tbody>
</table>

Source: Hong Kong Census and Statistics Department.

As can be seen in Exhibit 3, the moderate increase in employment in the WRIERH grouping came from a drop of 10,611 employees in the wholesale trade offset by an increase of 10,286 employees in import/export trading. The other categories recorded minor increases.

Exhibit 4 shows that the increase in output in Hong Kong’s financial and insurance sectors over the 2001 to 2006 period has been accompanied by limited increases in employment. It also shows that while there were far fewer people involved in building properties in 2006 than 2001, there were many more people selling and buying properties in 2006 than in 2001. Given shortages of property in Hong Kong and its high price, this is not an encouraging sign. The big increase in employment for the 2001 to 2006 period in the FIREBS sectors was in business services with an increase of nearly 28,000 employees.

Exhibit 5 shows that the dramatic increase in employment in community and personal services was spread across several sectors. The largest increase of 23,508 came in amusement and recreation, indicating that the opening of Hong Kong Disneyland and the revitalization of Ocean Park have had a substantial impact on employment. Education services saw the second largest increase, with an additional 17,787 employees added during the period, indicating at least an increase in quantity of educators and/or educational administrators in the period. Other significant increases were registered by sanitation services, welfare services, medical services, and miscellaneous personal services.
The overall picture suggested by the GDP and employment changes in the period 2000 to 2006 is that of a further evolution away from manufacturing into high-value producer services (business services and to a certain extent financial services), increasing international trade business, and increased tourism. The employment figures also suggest a society that is trying to upgrade its capabilities, is spending more on leisure, becoming more consumption-oriented, and becoming more focused on providing public services. There is nothing intrinsically right or wrong with this particular evolution. It appears to be toward higher value activities, consumption linked to higher levels of wealth in society, and the desire to provide more services for people who are less fortunate. It is within this overall pattern of Hong Kong’s development that we should understand individual industries in Hong Kong.

Exhibit 3. Change in Employment, WRIERH

<table>
<thead>
<tr>
<th>WRIERH</th>
<th>Q3-2001</th>
<th>Q3-2006</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wholesale</td>
<td>76,472</td>
<td>65,861</td>
<td>-10,611</td>
</tr>
<tr>
<td>Retail</td>
<td>224,986</td>
<td>228,562</td>
<td>3,576</td>
</tr>
<tr>
<td>Import/Export</td>
<td>507,864</td>
<td>518,150</td>
<td>10,286</td>
</tr>
<tr>
<td>Restaurants</td>
<td>194,164</td>
<td>196,114</td>
<td>1,950</td>
</tr>
<tr>
<td>Hotel and Boarding Houses</td>
<td>28,387</td>
<td>30,099</td>
<td>1,712</td>
</tr>
</tbody>
</table>

Source: Hong Kong Census and Statistics Department.

Exhibit 4. Change in Employment, FIREBS

<table>
<thead>
<tr>
<th>FIREBS</th>
<th>Q3-2001</th>
<th>Q3-2006</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking</td>
<td>76,472</td>
<td>80,408</td>
<td>3,936</td>
</tr>
<tr>
<td>Finance and Investment Companies</td>
<td>28,054</td>
<td>24,116</td>
<td>-3,938</td>
</tr>
<tr>
<td>Brokers, etc</td>
<td>15,628</td>
<td>13,849</td>
<td>-1,779</td>
</tr>
<tr>
<td>Other Financial Institutions</td>
<td>16,186</td>
<td>16,099</td>
<td>-87</td>
</tr>
<tr>
<td>Insurance</td>
<td>26,919</td>
<td>29,011</td>
<td>2,092</td>
</tr>
<tr>
<td>Real Estate</td>
<td>82,243</td>
<td>97,531</td>
<td>15,288</td>
</tr>
<tr>
<td>Rental of Machinery and Equipment</td>
<td>984</td>
<td>824</td>
<td>-160</td>
</tr>
<tr>
<td>Business Services</td>
<td>190,813</td>
<td>218,696</td>
<td>27,883</td>
</tr>
</tbody>
</table>

Source: Hong Kong Census and Statistics Department.
### Exhibit 5. Change in Employment, Community and Personal Services

<table>
<thead>
<tr>
<th>Community, Personal Services</th>
<th>Q3-2001</th>
<th>Q3-2006</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sanitary</td>
<td>46,790</td>
<td>59,307</td>
<td>12,517</td>
</tr>
<tr>
<td>Education</td>
<td>120,624</td>
<td>138,411</td>
<td>17,787</td>
</tr>
<tr>
<td>Research and Scientific</td>
<td>182</td>
<td>728</td>
<td>546</td>
</tr>
<tr>
<td>Medical</td>
<td>71,700</td>
<td>80,603</td>
<td>8,903</td>
</tr>
<tr>
<td>Welfare</td>
<td>40,985</td>
<td>52,403</td>
<td>11,418</td>
</tr>
<tr>
<td>Business Associations</td>
<td>3,382</td>
<td>3,392</td>
<td>10</td>
</tr>
<tr>
<td>Miscellaneous Social and Community</td>
<td>6,001</td>
<td>5,580</td>
<td>-421</td>
</tr>
<tr>
<td>Motion Picture and Entertainment Services</td>
<td>19,836</td>
<td>19,333</td>
<td>-503</td>
</tr>
<tr>
<td>Libraries, Museums, Cultural Services</td>
<td>466</td>
<td>425</td>
<td>-41</td>
</tr>
<tr>
<td>Amusement and Recreation</td>
<td>14,677</td>
<td>38,185</td>
<td>23,508</td>
</tr>
<tr>
<td>Repair</td>
<td>16,596</td>
<td>13,418</td>
<td>-3,178</td>
</tr>
<tr>
<td>Laundry, etc.</td>
<td>6,644</td>
<td>6,086</td>
<td>-558</td>
</tr>
<tr>
<td>Miscellaneous Personal Services</td>
<td>29,131</td>
<td>37,359</td>
<td>8,228</td>
</tr>
</tbody>
</table>

**Source:** Hong Kong Census and Statistics Department.
The Hong Kong Garment Industry

The garment sector has been the quintessential Hong Kong manufacturing sector over the last few decades. Starting with the arrival of entrepreneurs from the Chinese Mainland in the 1950s, Hong Kong has played a pivotal role in world garment production and trade. Even as production in Hong Kong diminished, the role of Hong Kong garment manufacturing firms and Hong Kong trading companies in the sector continued to grow in importance. The main questions going forward are how the Hong Kong firms and industry will fare in a quota-free environment and in a world where China will increasingly dominate production in the sector.

Industry Structure and Performance

As of 2004, the Hong Kong garment industry consisted of more than 1,300 firms. While Hong Kong is home to some large firms including world leaders, most firms in this sector are small and medium-sized enterprises with fewer than 20 employees. The vast majority of the garment firms in Hong Kong are locally owned, and as of 2004 foreign companies accounted for less than 10 percent of the total. In terms of the location of activities, Hong Kong firms have firm management, strategy setting, accounting, finance, support services, purchasing, product development, marketing and sales, and logistics in Hong Kong. Hong Kong firms have manufacturing, some purchasing, some logistics, and some support services in Guangdong Province or elsewhere in China.

In 2004, Hong Kong was the world’s third most important garment exporter, after the European Union and China. This ranking understates the global importance of the Hong Kong garment industry given that many of China’s exports were attributable to Hong Kong companies. Hong Kong’s domestic production in 2004 of garments and textiles was valued at HK$50 billion compared to HK$45 billion in 1980. Over that same period, however, domestic employment in garments fell from around 306,000 workers to 24,000 workers as Hong Kong firms relocated production-related activities from Hong Kong into the Pearl River Delta region to leverage lower labor and land costs and gain better access to markets in the Chinese Mainland (see Exhibit 6). Production moved north, while headquarters, sourcing, and design functions remained in Hong Kong. In the process, Hong Kong has evolved from a manufacturer of garments to a supplier of quality fashion (indicated by the much higher output per employee) and a global hub for garments sourcing.

Hong Kong is still a leading global force in the industry, with its nerve center based in Hong Kong (strategy, coordination, marketing, and finance) and several hundred thousand workers in the Pearl River Delta region working directly or indirectly for Hong Kong firms. In addition, several large Hong Kong firms have developed production or sourcing activities on a global basis, leaving Hong Kong or Hong Kong firms involved with something on the order of 30 percent of world production and trade in the sector.
Exhibit 6. Evolution of Garment and Textile Jobs and Establishments in Hong Kong

Source: Hong Kong Census & Statistics Department.

Competitors

According to industry participants, the main competitors for Hong Kong’s garment sector, in descending order of importance, are Guangdong Province, the rest of the Chinese Mainland, the rest of South China, and to a lesser extent ASEAN (excluding Singapore), Eastern Europe, India and Pakistan, and Korea. Of these competitors, the Chinese Mainland is perceived as by far the most serious challenger. It is feared by garment manufacturers around the world and is becoming dominant in many sectors. The largest of the Mainland producers have achieved colossal production scales and according to Hong Kong garment executives, are able to offer “unbelievably low prices.” By some reports, there are more than 30,000 garment factories in Guangdong Province alone. Nevertheless, Hong Kong has a role to play for Mainland textile and garment
firms. A growing number are listing on the Hong Kong stock exchange, where as of November 2006 they accounted for at least ten out of more than 170 Red Chips & H Share companies listed in Hong Kong.

While Hong Kong is a hub for headquarters activities, including financing, and a global hub for fashion sourcing, its garments industry overall (including production activities) is viewed as less competitive than that of Guangdong Province. On the other hand, the combination of Guangdong and Hong Kong is viewed as more competitive than either is separately. This is the two-edged sword of rising competitiveness in the Chinese Mainland. On the one hand, it helps Hong Kong companies sourcing in the Chinese Mainland against competitors located elsewhere. On the other hand, improving skills and capabilities mean that more firms from the Chinese Mainland will be able to “go direct” in the future. Whether they choose to do that through Hong Kong is a major issue, and potential opportunity as well as threat.

**Advantages and Disadvantages**

In garments, Hong Kong’s strongest competitive advantages are staff skills, tax regime, transportation facilities, trade policy, managerial skills, and communications infrastructure. The banking and financial system, access to information, knowledge of overseas markets and downstream customers, level of technology, related trading sector, and the presence of some strong local firms are also sources of advantage vis-à-vis Hong Kong’s major competitors (see Exhibit 7). Hong Kong’s advantages in garments are heavily concentrated at the cluster or “meso” level. Drivers of advantage at the “macro” level are also important in garments, especially those related to government transparency, cleanliness, and the overall legal and regulatory systems. Strong Hong Kong firms that built up positions through knowledge of the markets and sources of supply and the ability to play the international quota game have also been advantages for Hong Kong.

Hong Kong’s strongest competitive disadvantages in garments include staff costs, land costs, and other costs; local economic growth compared to growth in Mainland markets; and China market potential, which favors Mainland firms. Hong Kong’s disadvantages are concentrated at the cluster or “meso” level as well as at the industry level (see Exhibit 8). In additional, drivers at the supranational level, in particular major changes in the global trading environment brought about by China’s WTO entry and the dismantling of the global quota system, pose greater challenges to the Hong Kong industry than to its Mainland competitor.
Exhibit 7. Hong Kong Garments: Advantages

MACRO-LEVEL DRIVERS
- Tax regime
- Regulatory and legal framework
- Cleanliness of government
- Political stability
- Trade policies

MESO-CLUSTER-LEVEL DRIVERS
- Staff skills
- Transportation facilities
- Management skills
- Communications infrastructure
- Access to information
- Related and supporting industries (banking and finance, trading)
- HK strengths as headquarters hub
- Demand becoming more sophisticated

SUPRAREGIONAL LEVEL DRIVERS
- Access to China production locations
- Leveraging China-based advantages
- Preferential access to Mainland markets under CEPA (but unlikely to be expanded significantly)

INDUSTRY-LEVEL DRIVERS
- Competition drives HK firms to improve
- Cooperation through trade fairs
- Support from VTC, PC, HKTDC

FIRM-LEVEL DRIVERS
- Knowledge of overseas markets and downstream customers
- Design strengths
- Technology levels
- Some strong local firms, with China and international presence
- Ability to leverage South China production locations

Source: Enright, Scott & Associates Ltd.

Exhibit 8. Hong Kong Garments: Disadvantages

MACRO-LEVEL DRIVERS
- Overall economic conditions favor the Mainland

MESO-CLUSTER-LEVEL DRIVERS
- Very high labor, land and other costs
- Small size of local market
- Mainland consumers often prefer Western brands
- China market potential favors Mainland firms

SUPRAREGIONAL LEVEL DRIVERS
- End of quota regime reduces built-in profit
- Protectionism against Chinese production limits ability to exploit China production locations
- Some preferences for other countries still exist in some markets
- Chinese officials’ desire to upgrade may cause problems for HK firms
- Diversification of production location in China a challenge for HK firms

INDUSTRY-LEVEL DRIVERS
- Industry-based education and training programs viewed as neutral though better than in Guangdong
- Competition in Mainland even fiercer than in Hong Kong

FIRM-LEVEL DRIVERS
- Quota-based strategies obsolete
- Limited management capabilities across China
- Some firms not up to facing the changes

Source: Enright, Scott & Associates Ltd.
Developments and Implications

The largest single change in the garment sector has been the end of the garment quota system. Hong Kong and Hong Kong firms were disproportionate beneficiaries of the quota system. Although it limited their ability to sell in major international markets, it also essentially locked-in relatively high prices in the sector and limited the ability of new countries to enter and change the industry. Meanwhile, Hong Kong companies became masters at managing the quota system by building up their market knowledge and customer relations and by dispersing their production operations globally as a logical strategic response to the Multifiber Agreement (MFA) and China’s closed markets.

The end of the global garment quota system, which took effect on January 1, 2005, led to a tremendous spike in exports in the first six months of 2005. This in turn created the impetus for Europe and the US to impose safeguard quota restrictions. Since then, the global garment trade has steadied, with China’s share significantly higher. Over the medium term, it is expected that the new restrictions will be eased. In any case, the dismantling of the global system of garment quotas has ushered in a new era in which global dispersal strategies are likely to be replaced by consolidation of production activities, no longer distorted by artificial quotas, and dominated by China. In interviews, Hong Kong firms report a reversal of the decades-long trend of manufacturing dispersal driven by hedging strategies in response to quotas and Cold War protectionism. Hong Kong and other international garment exporters have begun to invest increasingly in capacity in the Chinese Mainland. Most report that they retain limited manufacturing capacity in countries such as Thailand and Malaysia.

The second major development has been the opening and growth of the Chinese market. China’s implementation of liberalization measures under WTO, which began to take effect in 2005, has opened the Chinese market. This development has coincided with the rapid development of China’s own retail consumer market. Domestic consumption of fiber has grown from 6 kilos per capita in 2000 to 14 kilos in 2005. China’s consumption level remains far behind the US at 29 kilos and Japan (which equals the rich world average) at 25 kilos. However, strong growth can be expected in the domestic market as living standards rise, and as more of China’s population moves from the countryside into cities.

For Hong Kong companies, the Closer Economic Partnership Arrangement (CEPA) has provided a practical head-start in accessing and setting up operations on the Chinese Mainland, for export manufacturing and selling goods into the domestic Chinese market. The latter development is bringing Hong Kong garment firms into direct competition with firms from the Chinese Mainland. However, Hong Kong firms have traditionally faced great difficulty in penetrating Mainland Chinese markets.

A third major development has been increasing sophistication and dispersion of garment production in the Chinese Mainland. Firms from the Chinese Mainland
are growing their production rapidly to serve both local and international markets. No longer impeded by conditional MFN status or limited access to quotas, they have taken an active interest in selling their garments overseas. Chinese companies are building better knowledge of downstream consumer markets, and are beginning to add sophisticated design and just-in-time capabilities to their traditional strengths of low costs and massive volume. Firms from the Chinese Mainland will increasingly go direct to overseas markets.

Within China, Hong Kong garment producers have traditionally concentrated their activities within the Pearl River Delta region. However, the Pearl River Delta economy is facing rising costs and shortages of land and labor. In addition, officials in the Pearl River Delta are showing increasing signs of wanting to shift out of the region traditional sectors like garments, using minimum wages and project approvals to implement this objective. In addition, as the Chinese market grows and Chinese companies have better access to global markets, garment production in other parts of China is increasing rapidly. While Hong Kong firms’ ability to manage production in South China is still an advantage, competition with other areas of China will heat up. There will be challenges associated with moving production into new areas of China. Moving deeper into China’s interior dilutes executive control from Hong Kong. It also may bring executives into more direct competition with strong local manufacturers, and require them to deal with local governments less aligned with their export oriented activities. In addition, international sourcing operations, traditionally focused on Hong Kong and the Pearl River Delta will diversify their supply locations in China.

These developments are reshaping the competitive environment faced by garment firms from Hong Kong, and will have far-reaching implications. On the one hand, the end of the quota regime will open markets to Hong Kong firms and create huge business opportunities. On the other hand, the overseas production networks built up by Hong Kong firms over the past several decades will be less of an advantage. With an end to the MFA, Hong Kong firms with built-in quotas will find those quotas much less of an advantage as well, with direct implications for associated profits. One important implication of the end of the quota regime will be a collapse in world prices in several garment categories. In the first few months after the end of quotas in the US, some segments of the sector saw price decreases in the US of more than 50 percent. In addition, while CEPA may somewhat expand opportunities for Hong Kong firms in China, Hong Kong firms will encounter stiff competition from Chinese rivals in the Chinese domestic market, and will face greater challenges in managing production elsewhere in China. Finally, the emergence of Chinese companies into global markets will increase competition and lower margins globally.

**Strategies and Policies**

There are a number of strategic and policy responses to changes in the garment sector that are appropriate for Hong Kong and Hong Kong firms. The
Hong Kong firms interviewed for this study are focusing their attention on the new opportunities in global markets, the emergence of Mainland companies, and on the competitive responses needed in international markets and the domestic market in China. In addition to low costs, Mainland companies often benefit from immense production scale, strong upstream linkages to the production and supply of good quality raw materials, and are reported to be improving rapidly in reliability and quality. However, they are reported still to lack sophisticated knowledge of the down-stream supply chain and of the forces behind fast-changing fashion tastes that drive patterns of production.

As a result, Hong Kong firms are centralizing production in the Chinese Mainland to offset the Chinese companies’ low cost, and are focusing on leveraging knowledge of markets and the ability to manage sophisticated supply chains to serve foreign retailers. Some are developing or purchasing brands of their own for use in global and/ or the Chinese market, and many have responded by strengthening downstream linkages to retail customers, acquiring western brands directly in order to capture better knowledge of final markets, and focusing on higher-value-added niche supply to second-tier retail groups in Europe and the US. For example, fast response for short production runs for second-tier retailers is seen by Hong Kong executives as a key area of retained competitive advantage.

In the future, management capabilities and knowledge of international markets will have to be leveraged to an even greater extent than before. These are traditional strengths of Hong Kong-based garment producers relative to Mainland firms and involve soft skills and a knowledge base that are relatively difficult for the latter to replicate. It will be important to strengthen customer relationships to meet fast-changing needs, and further build up brand ownership in international and China markets, perhaps by acquiring second-tier brands. Hong Kong firms also should leverage their improving design capabilities.

Hong Kong firms will need to acquire or otherwise develop retail activities in China and elsewhere. There also will be new opportunities to expand Hong Kong-based supply chain management capabilities. Some Hong Kong entrepreneurs are already helping firms on the Chinese Mainland enter export markets, drawing up their own knowledge of overseas markets, the global logistics supply chain, and of overseas consumer tastes. As the Chinese market develops, there may also be growing opportunities for Hong Kong to serve as an import hub for China. In terms of production location, it will be essential for many Hong Kong firms to expand into new production locations in China. Finally, CEPA should not be overestimated as an aid to Hong Kong firms. Domestic companies in China are reported to have a firm grip on the local market, with significant numbers of manufacturers having developed strong domestic brands with strong retail loyalties.

From a policy perspective, there is not a great deal of opportunity for direct government action to boost production in Hong Kong. The vast majority of people knowledgeable about the industry we interviewed claimed that opening up a border area for importation of labor into Hong Kong would not have a
significant impact on the industry as a whole and was seen as largely a lobbying tactic for a few firms to reduce their Hong Kong wage bill.

On the other hand, any policies toward the sector should recognize where Hong Kong’s existing and potential strengths are. Hong Kong plays an important role as a headquarters hub for the garment industry and this role has the potential to grow stronger. While some small Hong Kong firms are likely to come under severe margin pressure in the industry, Hong Kong’s larger firms are well-positioned to take advantage of new opportunities in global and eventually Chinese markets. An increase in China’s share of world production and exports also provides additional opportunities for Hong Kong to act as a sourcing hub for overseas markets. Finally, as Chinese firms start to internationalize, they could greatly benefit from the financial markets and international business experience present in Hong Kong. For such firms, Hong Kong offers advantages as a fund-raising base, as a base for organizing international business activity, and as a locus for building closer links with, and better knowledge of, key overseas markets that no cities in the Chinese Mainland can match.

In addition, in recent years Hong Kong has begun to function as a leading fashion hub for Asia. This is built around the strong trade fair platform provided by the Hong Kong Trade Development Council and others, and a strong pool of design skills. Hong Kong also possesses critical strength as a global sourcing hub, grounded in a deep tradition of international buying and selling, and specialized expertise in cross-cultural management and international business.

Thus the policies that will be most beneficial to the Hong Kong garment sector are those that foster Hong Kong’s location as a headquarters, trading, financial, design, and supply chain hub. These include continuation of Hong Kong’s strengths in the legal, administrative, and regulatory environments; enhancing Hong Kong’s skills sets in relevant activities; and policies that promote Hong Kong as an international business center. It means safeguarding Hong Kong’s position as a friction-free free port. It means helping Hong Kong extend its capabilities in supply chain management, its knowledge of markets, and its technical knowledge in the sector (such as through programs at the Productivity Council, the Trade Development Council, the Clothing Training Authority, and the revamped Hong Kong Design Institute). It means promoting Hong Kong as a location for sourcing offices of foreign firms and as an international business and financial center for emerging Mainland Chinese garment firms.

**Conclusions**

The garment sector is changing rapidly world-wide with the end of the quota regime and China’s rising prominence as a market and production location. New competition and the fact that a large proportion of the world’s garment-buying power is concentrated in the hands of the world’s leading retail groups means the global trend will be for the garment industry to become tougher and lower-margin. China’s industry is set to consolidate its position as world-leader,
and will be the competitor against which all manufacturers based in other locations must benchmark their market strategy. In addition, many more Chinese companies will be competing in overseas markets.

While Hong Kong firms do have very strong positions globally, strategies built around quotas and South China as the only production base in China will have to change. Hong Kong firms need to focus on leveraging the end of the quota regime and taking advantage of the shift to China and Asia. They need to focus on diversifying production within China and managing beyond Guangdong Province. It will be important to devote more attention to branding, design, and retailing. Hong Kong firms that can do these things will still be able to leverage Chinese production locations into world markets, ensuring that Hong Kong remains a major center for the garment sector. If Hong Kong can attract major garment firms from the Chinese Mainland to internationalize through Hong Kong, this position will be further enhanced.

Some smaller Hong Kong companies, however, will find it hard to compete effectively in the new environment. Those that can compete may find it a tougher market in the medium-term as price competition, which was muted by the quota regime, becomes tougher.

Most Hong Kong companies tend to focus on firms based in Guangdong Province as their immediate competitors and tend not to see the potential for longer term competition with the Yangtze River Delta or elsewhere in China. This implies that they are not thinking in terms of the competitiveness of the Greater Pearl River Delta region as a whole. Only some of the leading companies are focused on the inter-regional competition. This competition will become increasingly important going forward. For some Hong Kong firms, cooperation with emerging Pearl River Delta firms to face competition from other parts of China is a potential solution.

Policies to foster the competitiveness of the Hong Kong garment industry should focus on strengthening Hong Kong’s ability to attract and retain headquarters operations, to provide advanced supply chain management activities, to be linked tightly with international market trends, and to provide other services related to international trade. Building on Hong Kong’s headquarters, supply chain, and cluster strengths will be critical to Hong Kong’s ability to continue to have an important role in the global garment industry.
The Hong Kong Sea Cargo and Logistics Industry

Sea cargo and logistics has been another quintessential Hong Kong sector. Hong Kong’s modern history has been tied to its development as a port and logistics center. Over the years it benefited from being the dominant (or for many years only) international port in South China. However, recent developments have called into question the future development of Hong Kong as a center for sea cargo and logistics. In particular, the way the industry is structured in Hong Kong was set up at a time with a very different competitive environment. The result is a structure that may be a disadvantage in facing new competition, but that would be difficult or impossible to unwind in a meaningful way.

Industry Structure and Performance

The Greater Pearl River Delta is by far the leading area for container traffic in China. Hong Kong, the world’s second leading container port (see Exhibit 9), is one of the most efficient ports in the world. Hong Kong’s water freight transport sector accounted for 2.5 percent of GDP, and 2.4 percent of total employment (72,900 jobs) in 2004. Hong Kong’s logistics sector accounted for 5.4 percent of GDP and 6.0 percent of total employment, or 198,400 jobs, in 2004. Hong Kong is home to one of the world’s leading port operators as well as a very capable freight forwarding and logistics community. Nevertheless, in the face of rising competition, Hong Kong is losing ground to ports in Shenzhen and the Yangtze River Delta region.

Exhibit 9. World’s Top Ten Ports by Container Throughput, 2005

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>Rank</th>
<th>2004</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>23.19</td>
<td>1</td>
<td>21.33</td>
<td>2</td>
</tr>
<tr>
<td><strong>Hong Kong</strong></td>
<td><strong>22.60</strong></td>
<td><strong>2</strong></td>
<td><strong>21.98</strong></td>
<td><strong>1</strong></td>
</tr>
<tr>
<td>Shanghai</td>
<td>18.08</td>
<td>3</td>
<td>14.55</td>
<td>3</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>16.20</td>
<td>4</td>
<td>13.66</td>
<td>4</td>
</tr>
<tr>
<td>Busan</td>
<td>11.84</td>
<td>5</td>
<td>11.49</td>
<td>5</td>
</tr>
<tr>
<td>Kaohsiung</td>
<td>9.47</td>
<td>6</td>
<td>9.71</td>
<td>6</td>
</tr>
<tr>
<td>Rotterdam</td>
<td>9.29</td>
<td>7</td>
<td>8.29</td>
<td>7</td>
</tr>
<tr>
<td>Hamburg</td>
<td>8.09</td>
<td>8</td>
<td>7.00</td>
<td>9</td>
</tr>
<tr>
<td>Dubai</td>
<td>7.62</td>
<td>9</td>
<td>6.43</td>
<td>10</td>
</tr>
<tr>
<td>Los Angeles</td>
<td>7.49</td>
<td>10</td>
<td>7.32</td>
<td>8</td>
</tr>
</tbody>
</table>

Source: Hong Kong Port Development Council.

Hong Kong’s sea cargo industry has multiple segments, including terminal operators, mid-stream operators, freight forwarders, logistics companies,
truck firms, and shipping lines, all of which have different competitive environments. Hong Kong was home to around 3,000 firms engaged in container terminals, container hauling, and container leasing, and around 17,200 firms in logistics, in 2004. In both sectors, the vast majority of firms are small and medium-sized with fewer than 100 employees. There is a substantial presence of Hong Kong-based offices of overseas firms.

Hong Kong’s leading container terminal operators are among the world’s best, with world class managerial expertise and deep capital resources. They excel in investment analysis skills and skills in developing management and computer systems used to optimize performance. Over the past decade, shareholders in Hong Kong’s leading container terminal operators have made major investments in new port operations in the Pearl River Delta region and elsewhere in the Chinese Mainland. Within the industry, Hong Kong’s leading firms are not viewed as a source of competitive advantage for Hong Kong relative to its main competitors.

Most Hong Kong-based water transport services firms still locate significant activities in Hong Kong in the areas of firm management, accounting and finance, and logistics. Guangdong Province is increasingly attracting logistics and marketing and sales activities of Hong Kong-based water transport services firms. This reveals the growing competitiveness of Guangdong Province for these activities. To a lesser extent, Hong Kong-based water transport services firms are also locating customer services, after sale services, and product and service development in Guangdong.

In sea cargo-related logistics, there has been very significant setting up in Shenzhen of warehousing, consolidation, and transport activities, as well as marketing and sales and service related activities. Many Hong Kong-based firms conduct these activities on both sides of the boundary. Firm management, accounting and finance, and strategy setting remain predominantly in Hong Kong.

**Competitors**

The main competitors for Hong Kong’s sea cargo industry, in descending order of importance, are the Shenzhen ports, the Guangzhou ports, Singapore, the ports in the Yangtze River Delta region, and to a lesser degree, the leading ports in Taiwan, Korea, and Japan. For the China trade, Hong Kong’s major competitors in sea cargo are the ports in the Pearl River Delta (led by Shenzhen), the rest of South China, and the rest of China (led by Shanghai). The lead competitor for pure transshipment is Singapore.

While much attention has been focused on competition from the Shenzhen ports, competition with Shenzhen is only part of the picture for Hong Kong. Elsewhere in the Pearl River Delta, the port of Nansha in Guangzhou is developing rapidly. Singapore remains a major transshipment center as well as the leading port for South-East Asia. In terms of comparisons, Shanghai is
already the world’s third leading container port and is poised to overtake Hong Kong for second place globally. In addition, port development in Shanghai is affecting the decisions of manufacturers to choose Yangtze River Delta or Pearl River Delta production locations. This indirect competition could loom very large in the future.

In logistics, the roster of competitors to Hong Kong is similar, except that the rest of China (led by Shanghai) is relatively more important as a competitor than in sea cargo. The main competitors for Hong Kong’s logistics industry, in descending order of importance, are Guangdong Province, the rest of China, South China excluding Guangdong Province, Singapore, Taiwan, and Korea.

Advantages and Disadvantages

In sea cargo and logistics, Hong Kong’s strongest competitive advantages are in communications infrastructure, transportation infrastructure, tax regime, regulatory and legal framework, access to information, and geographic location. Political stability, the banking and financial system, trade policy, and level of technology are also sources of advantage vis-à-vis Hong Kong’s major competitors (see Exhibit 10). Hong Kong’s advantages in sea cargo and logistics show dense concentration at the cluster or “meso” level. Drivers of advantage at the “macro” level are also important in sea cargo and logistics, especially those related to government transparency, cleanliness, and the overall legal and regulatory systems.

Hong Kong’s strongest competitive disadvantages in sea cargo and logistics include property costs, staff costs, and other costs; the relatively small size of the local market; and strategies of local firms. Hong Kong’s disadvantages are concentrated at the cluster or “meso” level as well as at the industry level (see Exhibit 11). Overall, Hong Kong-based participants in the sea cargo and logistics sector rated Hong Kong as less competitive for water transportation services than its rivals. The main reason was Hong Kong’s high costs. In addition to cost disadvantages versus Shenzhen, several customers noted that port related charges in Shanghai and elsewhere in China are a small fraction of those in Hong Kong and Shenzhen. The prevailing wisdom was that Hong Kong’s cost disadvantages could no longer be overcome by its advantages for the bulk of the shipper community. As a result, in many cases it is now Hong Kong that provides overflow capacity for Shenzhen ports, rather than the other way around.
Exhibit 10. Hong Kong Sea Cargo: Advantages

MACRO-LEVEL DRIVERS
- Tax regime
- Regulatory and legal framework
- Cleanliness of government
- Political stability

MESO-CLUSTER-LEVEL DRIVERS
- Transportation and communications infrastructure
- Staff skills
- Managerial skills
- Access to information
- Geographic location
- Deep-water harbor
- Related and supporting industries (banking and finance, insurance, legal, export trading)
- HK’s strengths as headquarters hub

SUPRAREGIONAL-LEVEL DRIVERS
- Growth in trade means demand for hub for forward positioning into China and Asia
- Early mover advantages in China under CEPA
- China’s export competitiveness and growing market

INDUSTRY-LEVEL DRIVERS
- Industry-specific programs
- Logistics Council organization
- Industry sponsorship of studies, research

FIRM-LEVEL DRIVERS
- World-class firms
- Strong firm-based management
- International strategies
- Firm-specific capabilities, training

Source: Enright, Scott & Associates Ltd.

Exhibit 11. Hong Kong Sea Cargo: Disadvantages

MACRO-LEVEL DRIVERS
- Higher rates of economic growth in Mainland
- Macro stability no longer viewed as an advantage
- Restrictive manpower policy

MESO-CLUSTER-LEVEL DRIVERS
- Very high labor, land, and trucking costs
- Other costs also high
- Small size of local market
- Mainland ports closer to China market
- China market potential favors Mainland ports

SUPRAREGIONAL-LEVEL DRIVERS
- Strategies of Mainland ports focus on throughput rather than profits
- Fast growth for Mainland ports linked to trade growth
- MNCs are drivers of growth and Customs improvement at Mainland ports
- Wider choice of competitive ports and production locations in China
- Mainland restrictions in cross-boundary issues

INDUSTRY-LEVEL DRIVERS
- Lack of competition in cargo terminal and trucking sectors
- High terminal handling charges in HK and GPRD vis-à-vis YRD ports
- Micro policies (trigger mechanism) that foster delays

FIRM-LEVEL DRIVERS
- Harvest strategy in HK
- Oligopoly strategy across HK-Shenzhen
- Opposition to change in sector
- Opposition to rationale discussion based on complete information
- HK firms teaching authorities in China

Source: Enright, Scott & Associates Ltd.
Developments and Implications

Since 2002, the Pearl River Delta seaports have grown rapidly with dramatic improvements in their service quality including port operations, Customs service, and shipping routes and frequencies. Hong Kong-based firms operating ports in the Pearl River Delta have achieved admirable efficiencies. They and large shippers have “taught” officials in the Chinese Mainland how to improve overall efficiency faster than most in Hong Kong believed would be possible. Meanwhile, Hong Kong has been hindered by higher costs, including overland transport costs and port charges, longer transportation time from PRD factories, and the need for Customs formalities at the Hong Kong/Shenzhen boundary. In addition, Shenzhen ports have been adding capacity rapidly, while Hong Kong has not. This combination of forces has reduced Hong Kong’s share of South China cargo from above 80 percent in 2000 to approximately 48 percent in 2006.

Going forward, the main issues that arise are those of cost, capacity, and competition. Much attention in Hong Kong has focused on the costs associated with trucking to Hong Kong’s port compared with trucking to Shenzhen’s ports. Indeed, at Yantian port the cost differential from Dongguan has been estimated at US$180 per 20 foot container, a significant amount for price sensitive shippers.\(^2\) However, Hong Kong faces other disadvantages as well. The cost difference in terminal handling charges between Hong Kong and Yantian port in Shenzhen is US$133 per 20 foot container.

Largely as a result of cost issues, Hong Kong is increasingly playing the role of “overflow port” within the Greater Pearl River Delta for the China trade. Many shippers do prefer to use Hong Kong port for specific, value-adding reasons. Hong Kong’s desirable attributes include superior service quality and Customs sophistication and flexibility, a wide range of destinations, ease of consolidating partial shipments, and Hong Kong’s strengths as a location for the final processing of exports and forwarding positioning of imports. However, for many users, Hong Kong is no longer necessarily the port of choice. Shenzhen is increasingly the desired port for large shippers. As Customs flexibility at Shenzhen improves over the next several years, Shenzhen ports will become stronger competitors not just for China trade but for transshipment business as well.

As Hong Kong increasingly becomes overflow capacity, the addition of new container port capacity in the Pearl River Delta region will be an important determinant of Hong Kong’s absolute volume and market share. According to the Hong Kong Port Master Plan 2020, terminal container handling capacity in Hong Kong is projected to rise from 18.6 million TEUs in 2005 to 19.8 million TEUs in 2010 and 21.7 million TEUs in 2020. In contrast, total terminal container handling capacity in Shenzhen (including Yantian, Shekou, Chiwan, Mawan, and Dachan Bay) will rise from just over 14 million TEUs in 2005 to

\(^2\) Hong Kong Economic Development Branch, Hong Kong Economic Development and Labor Bureau.
over 27 million TEUs in 2010 and over 41 million TEUs in 2020, bringing Shenzhen’s total capacity to nearly double that of Hong Kong (see Exhibit 12). In addition, Phases 1 and 2 at Nansha in Guangzhou will bring on stream an estimated capacity of approximately 8 million TEUs by 2009. Maersk’s terminal operator arm reportedly has agreed to buy a 20 percent share in Nansha Phase 2, virtually ensuring its success. Hong Kong’s throughput may eventually depend on the extent to which Mainland facilities are capable of meeting rapidly increasing demand.

**Exhibit 12.** Project Terminal Container Handling Capacity, Hong Kong and Shenzhen, 2005-2020

<table>
<thead>
<tr>
<th>'000 TEUs</th>
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<tbody>
<tr>
<td>0</td>
</tr>
<tr>
<td>5,000</td>
</tr>
<tr>
<td>10,000</td>
</tr>
<tr>
<td>15,000</td>
</tr>
<tr>
<td>20,000</td>
</tr>
<tr>
<td>25,000</td>
</tr>
<tr>
<td>30,000</td>
</tr>
<tr>
<td>35,000</td>
</tr>
<tr>
<td>40,000</td>
</tr>
<tr>
<td>45,000</td>
</tr>
</tbody>
</table>

2005 2010 2020

- Shenzhen
- Hong Kong

**Note:** * Port facilities designed specifically for handling ocean vessels.

**Source:** Hong Kong Economic Development and Labor Bureau.

Hong Kong and the Chinese Mainland ports, including Shenzhen, have taken different approaches to planning for port expansion. Hong Kong has had its port facilities developed by the private sector. In order to ensure that the private sector had a profit motive to invest, historically, in Hong Kong, port supply lagged demand. The practice has been to apply a trigger mechanism to ensure that capacity would be brought on stream when it is profitable to do so, with price above marginal cost. In the days when Hong Kong faced little direct competition, the system worked reasonably well. However, when faced with direct competitors across the boundary that are expanding rapidly and adding capacity ahead of demand, this strategy creates a dilemma, because it may result in the party relying on the trigger mechanism to protect private sector
profits never investing in additional capacity even if it might be in the public interest to do so.

Hong Kong now views its main competitors in sea cargo and logistics as being located in the Pearl River Delta region, but there is another competition that may prove even more important to Hong Kong’s economy as a whole. That is the competition between the Pearl River Delta and the Yangtze River Delta. As costs rise in the Pearl River Delta and more locations in China become viable for export-oriented production, the entire cost basis of the Greater Pearl River Delta will influence where companies choose to produce. Common shareholders and management of the major operators in Hong Kong and the Shenzhen ports has resulted in a Hong Kong-Shenzhen port oligopoly. Interaction between the port operators and the international shipping cartel results in terminal handling charges (THCs) set by the shipping lines and paid by shippers. These terminal handling charges are far higher in both Hong Kong and Shenzhen than in competing ports in the Yangtze River Delta region (see Exhibits 13 and 14).³

Exhibit 13. Terminal Handling Charges, Selected Chinese Cities, US$ per Container

<table>
<thead>
<tr>
<th></th>
<th>To the US</th>
<th>To Europe</th>
<th>To Asia *</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>20 ft</td>
<td>40 ft</td>
<td>20 ft</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>274</td>
<td>366</td>
<td>265</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>141</td>
<td>269</td>
<td>141</td>
</tr>
<tr>
<td>Shanghai**</td>
<td>48</td>
<td>72</td>
<td>48</td>
</tr>
<tr>
<td>Ningbo</td>
<td>48</td>
<td>72</td>
<td>48</td>
</tr>
</tbody>
</table>

Notes: * Hong Kong figures are not applicable to shipping to Taiwan, Australia, and New Zealand. Shenzhen figures are not applicable to shipping to Australia and New Zealand. ** Data for Shanghai and Ningbo are based on information from shipping lines. Estimates by the Hong Kong Shippers’ Council for Shanghai are US$68 per 20 foot container and US$90 per 40 foot container.

Sources: Hong Kong Shippers’ Council; shipping lines.

Manufacturers and shippers are increasingly aware of these inter-regional differences in terminal handling charges, and are taking them into account in deciding on new investment locations in China. For example, Hefei, the capital of Anhui Province, is only five hours' trucking time to Shanghai ports, where terminal charges are by some estimates 75 percent lower than in Hong Kong.

³ An early statement of this issue was made by Christine Loh of the Civic Exchange and CLSA in the publication Linked fortunes of Hong Kong and Guangdong: Ports, airports and bureaucrats, restructuring Hong Kong and Guangdong, October 2002.
Several managers of manufacturing firms have indicated in interviews that high port-related charges, not just in Hong Kong, but in Shenzhen as well, are pushing them to invest in other locations. Should the port oligopoly in Hong Kong and Shenzhen start putting the entire Greater Pearl River Delta’s position at risk, this will have severe consequences for Hong Kong firms in many sectors and on Hong Kong’s economy as a whole.

**Exhibit 14.** Sea Cargo Charges to US West Coast, Selected Chinese Ports

![Bar chart showing sea cargo charges to US West Coast from selected Chinese ports.](chart_image)

**Notes:** Exchange rate: US$ 1=RMB 7.78 or HK$7.79. Trucking fees are for transporting cargos from factories 100 kilometer away from the ports.

**Source:** Enright, Scott & Associates research.

**Strategies and Policies**

In terms of strategies for positioning Hong Kong’s sea cargo sector, the focus should be leveraging Hong Kong’s advantages in its advanced services cluster, skills, and hard and soft infrastructure. These advantages are still valuable for many shippers. It will be important to minimize cost disadvantages where possible. Hong Kong should be strengthened and positioned as a world-class headquarters location and maritime services center.

With respect to sea cargo policies, the HKSAR Government should continue efforts to facilitate efficient cross-boundary movements and to speed up and simplify boundary crossing by trucks. The objective should be to narrow the
price gap between Hong Kong and Shenzhen while maintaining Hong Kong’s service and cluster-level advantages. In this respect, the “Green Lane” proposal to streamline cross-boundary cargo movements makes good sense. Because it will adversely affect employment among Hong Kong truck drivers and others, measures should be explored to mitigate the adverse impact on affected groups. In addition, the Hong Kong-Macau-Zhuhai bridge would provide better access for goods originating in the Western part of the Pearl River Delta to the port of Hong Kong. This bridge, for several reasons, should be a major policy priority.

There has been much discussion in Hong Kong of the need to reduce the cost of trucking to Hong Kong’s port. While improving the efficiency of cross boundary trucking makes sense, people in Hong Kong should not assume that the resulting cost savings will be passed on to shippers. There is absolutely nothing to stop the terminal operators or shipping conventions from raising their rates to pocket any cost reductions themselves. While they are unlikely to pocket 100 percent of any cost reduction, it is unrealistic to assume that they will pass on anything close to 100 percent to their customers.

The HKSAR Government should recognize the need to promote greater competition, not just in the trucking sector, but in terminal operations and shipping lines as well to position Hong Kong to meet the growing challenges from competing locations within the Greater Pearl River Delta region and beyond the region. Commissioning studies of the sector that explicitly ignore such issues as “commercial matters” (as has been the case in this sector) results in studies that almost by definition miss the point. This shows that the absence of a broad-based competition policy that provides a basis for government obtaining relevant information on the operation of important sectors in Hong Kong can result in counterproductive results for Hong Kong’s economy. This sector suggests that oligopolistic behavior can hurt Hong Kong’s economy and provides an example of a sector in which government needs far better information to determine whether companies in the sector are operating in the public interest. The irony is that through the investments of state-owned companies, the Singapore and Dubai governments have more information on the economics of the port of Hong Kong than the Hong Kong government.

Another issue is whether the trigger mechanism for investment in port expansion continues to be viable for Hong Kong and if not, what alternatives should be considered. Under the present system, the private port operators pay a large premium up front to basically buy the rights for an oligopolistic profit stream in the future. However, the Shenzhen ports are adding capacity in advance of demand. Should Hong Kong retain its present system, then it is hard to see Hong Kong adding any significant capacity in the port. “There will be enough capacity in the Chinese Mainland” will in effect become a self-fulfilling prophesy. On the other hand, should Hong Kong decide that further capacity in the sector was required for its economic well-being, then it should move to put that capacity in place before developments in the Mainland make it obsolete, even if the premium paid by a port developer was very low. While it is difficult to work through all possible alternatives in the present document, the key issue is
that the rise of ports in the Mainland should put into question the basis on which capacity decisions have been made in Hong Kong. This is a very real issue that merits debate.

**Conclusions**

There have been dramatic developments in the sea cargo and logistics sector in the last few years. Rapid expansion and improvement in Shenzhen combined with lower costs have made Hong Kong the overflow capacity for more desirable ports in the Pearl River Delta region for many shippers. Current trends will exacerbate this situation. Even if trucking charges are reduced, Hong Kong will still be high cost compared to Shenzhen, and there is no particular reason to expect that reductions in trucking charges will be passed on to customers. Hong Kong’s historical mechanism for determining when to add capacity puts it at a significant disadvantage with respect to other mechanisms when it comes to comparisons of throughput, though not necessarily profitability. Oligopolistic behavior across the ports in Hong Kong and Shenzhen place the entire region at a severe cost disadvantage versus the Yangtze River Delta. Ironically, the best thing for the Hong Kong economy as a whole might be for the port of Nansha to grow very rapidly, break the Hong Kong-Shenzhen oligopoly and put the entire Greater Pearl River Delta region on a better cost base.

When considering Hong Kong’s future in sea cargo, it is important to bear in mind the difference between being a maritime center and having the container flow through Hong Kong. London is no longer a major port in its own right, but has consolidated its position as a center for a wide range of maritime services and headquarters for maritime-related companies. A real question is whether it is best for Hong Kong to follow a similar path. Ultimately, there is a question of whether Hong Kong losing share in port throughput is a problem for Hong Kong’s economy or not. If Hong Kong loses share because there are other higher-value sectors that result in the sector being priced out of Hong Kong, that is one thing. If Hong Kong loses share due to artificially high costs resulting from a lack of openness or competition in trucking, terminal operations, or shipping lines, that is another thing.

Going forward, it will be important to broaden the scope of discussion surrounding Hong Kong’s sea cargo industry. To date, discussion has focused largely on the rivalry between the Hong Kong and Shenzhen container ports and on trucking, the weakest link in the chain. There has not been much discussion over whether what is good for some leading Hong Kong firms in this sector is still good for Hong Kong. There has not been much discussion of whether the premises that Hong Kong’s traditional policies in the sector still hold in a vastly different environment. There has not been much discussion of how oligopoly pricing across Hong Kong and Shenzhen is weakening the competitiveness of the entire Greater Pearl River Delta relative to competing regions in China as a manufacturing base. There has not been much discussion of what a post-port Hong Kong would look like.
The Hong Kong Air Cargo and Logistics Industry

Air cargo and logistics is another important sector for Hong Kong. Although treated here on its own, it is closely tied to the rest of the transportation and logistics sector as well as to the growth of high-technology and high-value manufacturing in the Pearl River Delta region.

Industry Structure and Performance

In 2005, Hong Kong International Airport (HKIA) was the world’s busiest airport for international air cargo and the fifth busiest for international passengers. It was also China’s leading airport in terms of cargo throughput, handling more than 3.4 million tonnes (see Exhibit 15). HKIA handles more than three-quarters of the air cargo generated by the Pearl River Delta region, and the Pearl River Delta region generates more than half of HKIA’s cargo. In 2005, annual growth of cargo traffic through HKIA stood at 10.1 percent, with a compound annual growth rate of 8.7 percent for the period 2000-2005. In 2006, the annual growth of cargo traffic at HKIA slowed to 5.2 percent, with a compound annual growth rate of 8.1 percent for the period 2000-2006. Hong Kong’s air freight transport sector accounted for 1.8 percent of Hong Kong’s GDP and 0.8 percent of employment, or 26,100 jobs, in 2004.

Exhibit 15. Air Traffic, Selected Chinese Cities, 2005

<table>
<thead>
<tr>
<th>Airport</th>
<th>2005 Passengers (millions)</th>
<th>2005 Cargo (000 tonnes)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong (b)</td>
<td>39.80</td>
<td>3,402.25</td>
</tr>
<tr>
<td>Guangzhou (a)</td>
<td>23.56</td>
<td>600.60</td>
</tr>
<tr>
<td>Shenzhen (a)</td>
<td>16.28</td>
<td>466.48</td>
</tr>
<tr>
<td>Macau (b)</td>
<td>4.25</td>
<td>227.23</td>
</tr>
<tr>
<td>Shanghai (a, c)</td>
<td>41.46</td>
<td>2,216.71</td>
</tr>
<tr>
<td>Beijing (a)</td>
<td>41.00</td>
<td>782.07</td>
</tr>
</tbody>
</table>

Notes: (a) Cargo data exclude luggage.  
(b) Cargo data exclude postal cargo.  
(c) Combined figures for Pudong International Airport and Shanghai Hongqiao International Airport.

Sources: Hong Kong Civil Aviation Department, Macau International Airport, and General Administration of Civil Aviation of China.
Hong Kong’s air cargo industry structure includes the Hong Kong International Airport, a dominant local carrier, two cargo handlers, other airlines, express package companies, freight forwarders, logistics companies, and shippers. Hong Kong International Airport (HKIA) is a government-invested facility that opened in 1998. It is managed by the Hong Kong Airport Authority (HKAA), a statutory body mandated to maximize the value of Hong Kong International Airport (HKIA) for the benefit of Hong Kong.

Cathay Pacific, the major cargo-handling airline in Hong Kong, has consolidated its position and market power through its acquisition of Dragonair. With respect to Dragonair’s passenger network in the Chinese Mainland and Cathay Pacific’s international passenger network, the routes of the two carriers are largely complementary, and the Cathay Pacific and Dragonair combination creates easier through linkages. With respect to air cargo, on the other hand, Dragonair’s significant freighter network, with cargo flows between its network in the Chinese Mainland and Europe, the US, Japan, and Taiwan via its Hong Kong hub, has always been in direct competition with that of Cathay Pacific. The consolidation has eliminated competition between the two airlines insofar as cargo is concerned.

Cathay Pacific (CX) and Dragonair (KA) combined account for approximately 44 percent of the tonnage through HKIA (Exhibit 16) and 20 percent of the total value of Hong Kong’s trade. If we include Air Hong Kong (AHK), which is majority owned and managed by CX, the figure rises to more than 45 percent. This figure is even more dominant than one might imagine given that the rest of the capacity is spread over dozens of airlines and cargo carriers, most of which can fly only to a limited number of destinations from Hong Kong. Two air cargo handlers have been appointed to operate at HKIA: Hong Kong Air Cargo Terminals Limited (HACTL) and Asia Airfreight Terminal (AAT). HACTL is more than four times the size of AAT. There is also an express cargo handling terminal operated by DHL. To date, airlines have not been permitted to handle their own cargo at HKIA, though Cathay Pacific has requested its own air cargo handling facilities.

Exhibit 16. Market Shares, HK Air Cargo and Cargo Handling

Source: Enright, Scott & Associates Ltd.
In the air transport services sector overall, Hong Kong is home to around 140 firms, mostly small and medium-sized. Nearly three-quarters of the air transport services firms in Hong Kong had fewer than 100 employees in 2004. There is a mix of local and foreign companies, with most major international operators active in one way or another.

Most Hong Kong-based air transportation services firms still locate significant activities in Hong Kong in the areas of logistics, accounting and finance, firm management, other support services, customer services, and strategy setting. However, Guangdong Province is increasingly attracting the customer service, logistics, marketing and sales, and after sales service activities of air transportation services firms. This reveals the growing competitiveness of Guangdong Province for these activities. Air-related logistics companies and cargo forwarders have long-established offices in Guangzhou and Shenzhen but these are mostly still under the control of their Hong Kong offices. Due to customs limitations which make consolidation of air cargo in the Chinese Mainland difficult, freight forwarders prefer to send loose cargo or small shipments to Hong Kong for consolidation with large shipments. This enables them to profit more by way of better use of space on the pallet, at better rates from the airlines. The opportunity to consolidate their cargo in Hong Kong makes it preferable for agents to send their cargo to Hong Kong and then onward via long-haul all cargo services.

**Competitors**

The main competitors for Hong Kong’s air cargo sector (in descending order of importance) are Guangdong Province, Singapore, the rest of China, Taiwan, Korea (Incheon), and ASEAN excluding Singapore. Guangzhou’s Baiyun Airport is becoming a major competitor for Pearl River Delta business. Trucking costs from Pearl River Delta factories to the airport are lower and there is no need to cross the Hong Kong/Shenzhen boundary. Wage levels at Baiyun Airport are lower and there is ample supply of cheap land for additional runways, terminals, and other airport expansion. Baiyun Airport also benefits compared to HKIA from its proximity to the Pearl River Delta market, which is highly affluent by Chinese Mainland standards.

While Baiyun Airport’s network of domestic flights is helpful, it plays only a small role with respect to international air cargo. Domestic flights within China are operated mostly with narrow-body aircraft, with limited belly space for cargo. Air cargo for Southern China comes mostly from within the Pearl River Delta region and to a much lesser extent, the Yangtze River Delta. Cargo transfers between the Yangtze River Delta and the Pearl River Delta operate mainly by truck.

Shenzhen Airport, the closest airport to Hong Kong’s land border, is also rising as a competitor to HKIA in air cargo. Tonnage throughput at Shenzhen Airport grew at a compound annual rate of 21.7 percent from 2000 to 2006, while Hong
Kong managed 8.1 percent over the same period. Although in tonnage terms, Shenzhen Airport is still small compared to HKIA, it has cargo routes to major regional airports in Japan, Korea, and Thailand. With the commencement of Jade Cargo Airlines in August 2006, further cargo routes were established with several European airports including the important Amsterdam Schiphol hub. The airline will have a total of six B747-400ER aircraft by 2008, which will further serve to divert cargo that would otherwise come to HKIA. However, in the short term, Shenzhen Airport will not be in a position to offer significant belly cargo space nor the range of connections that Hong Kong with its status as a major international air hub can offer.

Outside China, the geographical position of each hub determines the extent to which it is competitive for cargo from the Chinese Mainland/Hong Kong to specific destinations around the world. For air cargo transshipped from China to Europe and the US, Taiwan, South Korea (Incheon), and Japan (Narita) are convenient hubs. Singapore and Bangkok are the leaders in South-East Asia, competing for cargo bound for southern destinations. At these competing airports, major expansion plans are being put in place to become leading hubs in the Asia Pacific.

**Advantages and Disadvantages**

According to industry participants, in air cargo, Hong Kong’s strongest competitive advantages are in communication infrastructure, geographic location, transportation infrastructure, access to information, the banking and financial system, and local managerial and staff skills. Other infrastructure, the tax regime, cleanliness of government, regulatory and legal framework, and level of technology are also sources of advantage vis-à-vis Hong Kong’s major competitors. Hong Kong’s advantages in air cargo are heavily concentrated at the cluster or “meso” level and drivers of advantage at the “macro” level are also important (see Exhibit 17).
Exhibit 17. Hong Kong Air Cargo: Advantages

MACRO-LEVEL DRIVERS
- Tax regime
- Regulatory and legal framework
- Cleanliness of government
- Political stability
- Investment programs
- Trade policy

MESO-LEVEL DRIVERS
- Communication infrastructure
- Geographic location
- Transportation infrastructure
- Managerial skills
- Staff skills
- Access to information
- Related industries (banking, financial system, trading, sourcing, HQ functions)

SUPRAREGIONAL-LEVEL
DRIVERS
- Strong export growth in China
- Export-oriented policies
- Ability of foreign firms to produce in China
- Worldwide production strategies of MNCs
- Past protection of Chinese airlines

 MESO-CLUSTER-LEVEL DRIVERS
- Some strong local firms have built international networks
- Strong hub development
- Strong infrastructure management

HIGH LEVEL DRIVERS
- Active competition in some segments (freight-forwarding, warehousing, etc.)
- Cooperation to identify industry-specific issues (e.g. Logistics Council)
- Advantageous route network

FIRM-LEVEL DRIVERS
- Some strong local firms have built international networks
- Strong hub development
- Strong infrastructure management

Source: Enright, Scott & Associates Ltd.

Exhibit 18. Hong Kong Air Cargo: Disadvantages

MACRO-LEVEL DRIVERS
- Small local economy
- Higher rates of economic growth in Mainland

MESO-LEVEL DRIVERS
- Very high labor, land, and other costs
- Small size of local market
- China market potential favors Mainland airports
- Suppliers based in Mainland, not HK
- High cost to expand airport

SUPRAREGIONAL-LEVEL
DRIVERS
- Liberalization of China’s aviation sector
- Customs reform at Mainland airports
- Chinese airports adding capacity aggressively
- MNCs entering Mainland will drive growth and service improvements
- MNCs now have ability to switch out of HK

MESO-CLUSTER-LEVEL DRIVERS
- Lack of local competition in airline and cargo handling sectors

INDUSTRY-LEVEL DRIVERS
- Strategies of local firms create and exploit monopoly or oligopoly
- Capabilities of some local firms in question

FIRM-LEVEL DRIVERS
- Strategies of local firms create and exploit monopoly or oligopoly
- Capabilities of some local firms in question

Source: Enright, Scott & Associates Ltd.

Hong Kong’s strongest competitive disadvantages in air cargo include property costs, staff costs, and other costs; the relatively small size of the local market; lack of local competition; strategies of local firms; and capabilities of smaller
local firms. Hong Kong’s disadvantages are concentrated at the cluster or “meso” level as well as at the industry and firm levels (see Exhibit 18). In addition, as discussed further below, several supranational drivers are likely to favor Mainland airports over HKIA over the medium to long run.

**Developments and Implications**

Due to various factors, HKIA is not serving the number of flights or passengers it was designed to serve. The average number of seats per aircraft is decreasing due to growing use of narrow-bodied passenger aircraft on short haul routes to cities in China, so there are fewer passengers per aircraft arrival than had been anticipated at the design stage. Airspace restrictions over the Pearl River Delta preclude parallel arrivals and departures at HKIA’s two runways. Runway capacity is likely to improve over time as problems are resolved. With respect to cargo handling facilities, Hong Kong International Airport is already operating at close to capacity. Air cargo has been growing rapidly and there is mounting demand for more cargo facilities at HKIA, where a new cargo terminal is to be announced.

HKIA, like its predecessor airport at Kai Tak, has always been predominantly an “origin and destination (O&D) airport” serving passengers arriving or departing Hong Kong. Over time, there has been a gradual build up of passengers who pass through HKIA on their way to other destinations (non-O&D passengers). In 2006, non-O&D passengers at HKIA accounted for between 30 percent and 33 percent of the passenger total, up from approximately 25 percent at Kai Tak. This build up of non-O&D passengers is due mainly to traffic between the Chinese Mainland and Taiwan. In general, non-O&D or transfer traffic leads to higher frequency of services at hub airports, helping them to solidify international hub status. At HKIA, much of the non-O&D traffic would be lost if direct flights are resumed between the Chinese Mainland and Taiwan on a large scale. Other major hub airports throughout Asia have been building up non-O&D traffic for a long time. If HKIA is to maintain its status as a major hub, it will be important to encourage more airlines to fly to and through Hong Kong to other destinations. This is important to HKIA’s status as an air cargo hub as well as a passenger hub because a significant share of total air cargo through HKIA flies in the belly of passenger aircraft.

Competition is gathering pace in China, where the General Administration of Civil Aviation of China (CAAC) has been liberalizing national aviation policy faster than anticipated. In this process, it is injecting more competition into China’s aviation sector, and more airlines are providing services to Shenzhen, Guangzhou, and Shanghai, giving rise to more competition with Hong Kong for air cargo. In Guangzhou, the first moves toward market liberalization at Baiyun Airport have focused on express carriers. The FedEx hub under construction at Baiyun Airport, scheduled to commence operations by year-end 2008, will accelerate Baiyun Airport’s development. Baiyun Airport is constructing a third runway and expanding its cargo capacity from 1.0 million to 2.5 million tonnes by 2008-09. Logistics companies setting up at Baiyun Airport will make possible
rapid shifts of cargo flows from HKIA to Baiyun, something that was not possible until recently. As discussed above, Jade Cargo Airlines, a joint venture between Shenzhen Airlines, Lufthansa, and a German investor group, is based at Shenzhen Airport.

**Exhibit 19.** Air Cargo Routing Costs Comparison to Frankfurt, 2005/06

![Graph showing air cargo routing costs comparison to Frankfurt, 2005/06](image)

**Notes:** * Based on 1,000 kg shipment.
  Cargo routing costs include surface or land transportation from factory to airport, airport charges, and air freight costs. Airport charges include the various service charges incurred in using each airport.

**Source:** GHK, logistics operators.

The multinational transport, freight forwarding, and logistics firms that are entering China are already acting as important drivers of improvement in China Customs in and around their points of entry. A recent example is the push for a system of unified clearance procedures for Shanghai, Nanjing, Hangzhou, and Ningbo in the Yangtze River Delta, which was introduced in 2005. To date, the lack of coordination of clearance procedures between jurisdictions in the Pearl River Delta (for example, Shenzhen and Guangzhou) has been a distinct advantage for Hong Kong. If multinational firms spearhead unified clearance procedures in the Pearl River Delta, as they have in the YRD, the unintended result would be to significantly lessen Hong Kong’s perceived advantages in Customs clearance procedures, an area of traditional strength for Hong Kong’s air cargo sector. The lesson for Hong Kong clear: FedEx and other multinational
firms in Guangzhou will drive growth and capabilities in and around Baiyun Airport much faster than most people expect.

As of 2006, air freight rates on routes from the Pearl River Delta airports to major destinations in Europe or the US were higher than at HKIA, but they have been falling rapidly as new carriers and routes are added in Southern China. As of early 2007, according to industry sources, air freight rates from Shenzhen to Europe and Japan are lower than at HKIA. In addition, the cost of air cargo handling, including costs associated with using the airport and overland transport costs, is higher at HKIA than at Baiyun International or at Shenzhen Airport (see Exhibit 19). These cost differentials are already driving shippers in growing numbers to send their cargo to airports in Guangzhou and Shenzhen as those airports build up their air cargo capabilities. The entry of new carriers such as Jade Cargo Airlines in Shenzhen will divert into the Pearl River Delta air cargo that would otherwise come to Hong Kong, largely because of the lower cost of cargo handling.

The major implication of these developments is that HKIA is likely to be capacity constrained in air cargo and to face much tougher competition than before. In a situation in which market demand is growing very rapidly, the question will be whether Hong Kong can improve its capacity, connectivity, and competitiveness sufficiently to both stay ahead of the competition and grasp the opportunities that are present in air cargo.

**Strategies and Policies**

In this wider context, there are several strategies that would benefit the air cargo sector. HKIA’s service lead over competing airports should be widened. Additional links should be sought with other airports in the Pearl River Delta region to expand linkages with cities in the Chinese Mainland. To foster Hong Kong as a logistics hub for China and much of Asia, it will be important to build up high value-adding logistics capacity, to attract regional distribution centers for China and wider Asia into Hong Kong, and, in particular, to capture a forward positioning role for time sensitive inventory moving into China. It also will be important to understand the lessons of Yantian sea port, and their implications for the air cargo sector, because Baiyun Airport will improve faster than most people imagine.

In terms of policies, the HKSAR Government should work to enhance capacity at HKIA while expanding connectivity, both to additional cities in China and to other destinations. These goals are articulated in the report *HKIA 2025* released in December 2006 by the Hong Kong Airport Authority. According to this report, the Hong Kong Airport Authority will take steps to maximize capacity utilization of existing runways and will coordinate with Pearl River Delta authorities on issues of regional airspace. It also will begin feasibility studies on the construction of a third runway and the decision whether to construct a third runway will depend on the outcome of those studies. This decision will be of critical importance to Hong Kong’s ability to keep pace with growth at Baiyun
Airport and other airports in the Asia Pacific. The government on its own will need to address airspace restrictions in China and Civil Aviation practices that result in far fewer flights per hour being handled at HKIA than at many other major international airports. In addition to these measures, it will be important to press ahead with approval of a new air cargo hub at HKIA and not to let the use of trigger mechanisms delay needed investment. One lesson from the sea-freight experience is that trigger mechanisms may not be suitable in situations where more capacity is required quickly to meet challenges from competing locations.

Measures also should be put in place to enhance competition at the new cargo hub. Awarding a franchise for a third cargo handling terminal on par with the capacity at HACTL would help to boost competition. Major cargo hubs around the world, such as Chicago, Frankfurt, and London keep open markets for cargo handlers, either on airport or off-airport, with appropriate customs arrangements. One possible approach for HKIA would be to develop an Air Freight Cargo Center on the airport perimeter. Space would be leased to freighter operators or their agents for the assembly and handling of full aircraft loads of cargo, to optimize their operating conditions and to keep ground service costs fully under their own control. The objective would be to maximize the economic value generated by freighter activities at the airport, in furtherance of HKIA’s governing mandate.

In logistics, Hong Kong should not aim to compete with Pearl River Delta locations on land-intensive, mainstream logistics activities. Instead, there is distinct potential for Hong Kong to expand its role as a high value-adding logistics hub for China and wider Asia. As the Trade Development Council has shown in a recent report, Hong Kong is well positioned to act as a hub for regional distribution centers for shippers with high-value cargo moving inbound and outbound by air from locations in China and North-East Asia. In addition to the well-known advantages related to Hong Kong’s regulatory and judicial system, free port status, and world class infrastructure, using Hong Kong generates quantifiable cost savings over competing locations in a range of product areas. Provisional analysis by the Trade Development Council suggests that the “estimated potential market” for regional distribution center activity in Hong Kong (servicing high-value air cargo) could be in excess of HK$30 billion, equivalent to more than 2 percent of GDP. Even if the market amounted to a fraction of this, the benefits to Hong Kong would be considerable.

This untapped potential as a logistics hub justifies going ahead with an airport-linked logistics park on Lantau Island, long under consideration. Given the value of the land, the logistics park on Lantau Island must be strategically positioned to support high value-adding logistics functions such as regional distribution centers for multinationals choosing Hong Kong as their regional base. Policies to foster Hong Kong as a high value-adding logistics and regional distribution

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55 Hong Kong Trade Development Council, Research Department, *The Future Position of Hong Kong as a Regional Distribution Centre*, August 2006, pp. 57-61.
center hub should include measures to attract new multinational corporate entrants and their regional business activities.

The most effective way to improve Hong Kong’s competitiveness in air cargo over the medium to long term is to welcome new competition in airlines and cargo handling services. It is essential to encourage more local competition and also to encourage more carriers from outside Hong Kong to come to and through Hong Kong. The logic that Cathay Pacific used in arguing for its acquisition and integration of Dragonair, the efficiency gains of being able to have through connections through Hong Kong argues in favor of additional 5th and 7th freedom rights as well.

**Conclusions**

Growth in air cargo in the Greater Pearl River Delta is likely to continue for the foreseeable future. This growth will ensure large volumes in Hong Kong, at least in the short to medium run. While Hong Kong historically has had large advantages in air cargo versus its most direct competitors, this is changing. Customs and other systems in the Chinese Mainland are improving and air cargo routing costs are falling to, and in some cases below, HKIA levels. In addition, major logistics companies are positioned so they can shift to Baiyun Airport quickly. This was not true until recently.

Perhaps the single most important development that heralds Baiyun Airport’s future as a competitor to Hong Kong is FedEx’s choice of Baiyun Airport as the location for its regional hub. Although it focuses on express cargo rather than general air cargo, FedEx will be a powerful driver of growth and capabilities in Guangzhou and will accelerate the rise of Baiyun Airport as a major rival to HKIA in air cargo. Part of the reason for the decision to locate at Baiyun was the Hong Kong government’s ongoing reluctance to provide FedEx with an opportunity to employ its full business model in Hong Kong. In this case, what is good for a small number of Hong Kong companies with sizeable public relations budgets may prove to have a substantial negative impact on the Hong Kong sector. The notion of “maximum openness” should be the guiding principle for the air cargo sector in Hong Kong. Ironically, Cathay Pacific now claims that third party handling of air cargo imposes extra costs and that it needs its own dedicated cargo facility.

Despite its challenges, the air cargo and logistics sector in Hong Kong is likely to remain the major player in the Greater Pearl River Delta for the next several years. Hong Kong’s established routes, experience, and capabilities remain advantages. However, decisions about capacity, attracting new routes and new carriers, air service rights, and administrative efficiency will have important implications for how it will fare against better competition in the future.
The Hong Kong Financial Services Industry

The Financial Services Industry (FSI) is diverse. It includes banking, investment management, securities sales and trading, insurance, and corporate treasury operations. Globally, the FSI is one of the world’s largest industries, with more than US$3 trillion dollars in financial transactions taking place daily. Even this understates the importance of the FSI, given that the FSI is linked to all other industry sectors. It supports business through the efficient distribution of capital, and the allocation of risk. As globalization takes greater hold, an increasing level of cross-border interdependence in the FSI will occur. However, financial centers are still extremely important as places where transactions take place, money is raised, markets are based, and groups of financial service specialists congregate. Hong Kong, one of the world’s leading financial centers, is one such financial services hub.

Industry Structure and Performance

The FSI is a vital part of Hong Kong’s economy. It employs over 180,000 people. This represents a large slice of overall employment in Hong Kong. Hong Kong’s banking sector comprises 134 licensed banks, 32 restricted license banks, 33 deposit taking companies, and 88 local representative offices of overseas banking institutions. Hong Kong’s banking sector offers a full spectrum of retail and wholesale banking services. Licensed banks are permitted to operate current accounts, and accept deposits of any size and maturity. Restricted license banks are mainly involved in merchant banking and capital market activities. Most deposit taking companies are associated with licensed banks and they tend to focus on consumer finance activities.

In the equity markets, there were 970 companies listed on the Main Board as at December 15, 2006, with a market capitalization of HK$12,427 billion, and 198 companies listed on the second GEM (Growth Enterprises Market) Board, with a market capitalization of HK$86.2 billion. In the debt market, the Central Money Markets Unit oversees turnover of approximately HK$36.3 billion per day. In funds management, there were 1998 authorized unit trusts and mutual funds operating in the first quarter of 2006, with an investment value on the order of HK$5,207 billion. In March 2006, there were 296 hedge funds operating in Hong Kong with an asset value of HK$261 billion. Hong Kong’s Mandatory Provident Fund system had roughly HK$170.6 billion in assets under management as of May 2006. Hong Kong’s insurance sector had 174 authorized insurers as of June 2006, 87 of which were incorporated outside of Hong Kong. Gross premiums were estimated at HK$141 billion for 2005. Hong Kong’s foreign exchange trading ranked 6th in the world. Hong Kong’s money

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7 Hong Kong Exchanges and Clearing Limited.
8 Information Services Department, HKSAR Government.
9 Hong Kong Securities and Futures Commission.
10 Bank for International Settlements.
market is active as well, with daily turnover in the interbank market averaging HK$266 billion in March 2006.\textsuperscript{11}

Hong Kong’s FSI is comprised of several segments that are dominated by large companies that tend to offer a full spectrum of services along with lots of smaller companies that typically offer a more limited range of services. The three main commercial banks operating in Hong Kong are all foreign-owned. All of the leading investment banks are foreign-owned. The industry is a mixture of local firms, regional operations of multinational firms, and local operations of multinational firms. Hong Kong’s FSI also has several regulators, including the Hong Kong Monetary Authority, the Securities and Futures Commission, the Office of the Commissioner of Insurance, and the Mandatory Provident Fund Schemes Authority (MPFA).

In some areas of the FSI, Hong Kong can already claim to be leading the world. In 2006, the world’s largest IPO (ICBC) was brokered in Hong Kong. In 2006, Hong Kong for the first time jockeyed for the global top spot (against London and New York) for funds raised via IPO. One indication of this is a recent quote taken from the \textit{Wall Street Journal} (November 1, 2006) and attributed to Michael Bloomberg (New York Mayor and founder of Bloomberg) and Charles Schumer (Democrat New York Senator): “It is not only London that we need to worry about. Next Year more money will be raised through IPOs in Hong Kong than in either London or New York.”

Hong Kong’s position in the FSI can also be seen in the following:

- Second in Asia for number of foreign banks present
- Third in Asia in external banking transactions
- Second in Asia (eighth in the world) in stock market capitalization
- Fifth (first in Asia) for equity funds raised in 2005 and probably first in 2006
- Largest derivative warrant market in the world
- Leading fund management center in Asia. With over 200 firms, it has the largest concentration of fund managers in the region.
- Largest venture capital centre in Asia. Over 32 percent of the total venture capital pool in the region is managed out of Hong Kong, and
- Sixth in the world in foreign exchange trading.

\textbf{Competitors}

According to industry participants, the main competitors for Hong Kong’s Financial Service Sector (in descending order of importance) are Singapore, North America, the rest of China, Guangdong Province, Japan, Western Europe, and Australia. The enumeration of competitors shows that Hong Kong’s financial service sector is of global importance and runs up against global as well as regional competitors. Singapore is viewed as a competitor in the international IPO, fund management, treasury, and foreign exchange markets.

\textsuperscript{11} Financial Service and Treasury Bureau, HKSAR Government, March 2006.
New York and London are viewed as potential alternative locations for the overseas listings of Hong Kong companies.

Worthy of note is that cities on the Chinese Mainland are not viewed as the most direct competitors for Hong Kong's financial sector. However, an increasing portion of Hong Kong's financial sector business is related to the Chinese Mainland, and several cities in China are attempting to become financial centers. The Chinese Government is aggressively trying to develop Mainland capital markets by undertaking a series of market-based reforms. During the period of consultation and reform, fund raising on Mainland exchanges was suspended and Hong Kong became the market of choice for most Mainland entities seeking to raise funds. Consequently, Hong Kong's position as a centre for new listings was entrenched.

Advantages and Disadvantages

There are many enablers of the FSI in Hong Kong. These include strong rule of law, ample liquidity, geographic location, established markets, local management skills, low tax regime, simple tax arrangements, communications infrastructure, a large and sophisticated banking and financial system, a cluster of related businesses and professionals, unfettered market access by foreign businesses, excellent transportation infrastructure, open access to information, favorable international reputation, no restrictions on capital flows in and out of Hong Kong, and no exchange controls (see Exhibit 20). Additionally, the onerous requirements and regulations imposed by some competitors enhance Hong Kong's relative attractiveness.

According to the Hong Kong Security and Futures Commission analysis of data from IMD and the World Economic Forum, Hong Kong ranks first in the Asia-Pacific in several of the factors that have been identified as fostering the competitiveness of financial centers, such as human capital, regulatory environment and government responsiveness, access to international financial markets, business infrastructure, and taxation policy.

Hong Kong has developed and attracted a deep pool of workers in the FSI. The whole sector employs on the order of 180,000 people, with the banking sector alone employing more than 73,000. According to industry participants, Hong Kong has a clear advantage over other Asian economies in the size and expertise of its FSI workforce. This advantage is self-perpetuating as the critical mass of employees in the sector supports ongoing investment into continuing professional development, and serves to attract new talent to the sector to learn and benefit from the sector's competitive remuneration packages.\(^\text{12}\) It has been noted, however, that many of the highest powered people in the sector are expatriates, i.e. people who could readily leave Hong Kong if the business started to move elsewhere. Thus, Hong Kong's workforce advantage is not iron-clad.

\(^{12}\) Hong Kong Securities and Futures Commission, Research Paper No.33, August, 2006.
Exhibit 20. Hong Kong Financial Service Industry: Advantages

MACRO-LEVEL DRIVERS
• Strong rule of law
• Low tax regime
• Simple tax arrangements
• Regulatory and legal framework
• Cleanliness of government
• Minimal bureaucracy

MESO-CLUSTER-LEVEL DRIVERS
• Ample liquidity
• Geographic location
• Established markets
• Local management skills
• Communications infrastructure
• Large and sophisticated banking system
• Strong cluster of related and professional services
• Transportation infrastructure
• Access to information
• HK’s strengths as headquarters hub

SUPRAREGIONAL -LEVEL DRIVERS
• Restrictions on Mainland financial sector
• Growing financial needs of China’s economy
• Privatization of Mainland SOEs
• Listings of Mainland firms on Hong Kong Stock Exchange
• Central Government policy support (CEPA and QDII)

INDUSTRY-LEVEL DRIVERS
• No restrictions on capital flows
• No exchange controls

FIRM-LEVEL DRIVERS
• World-class firms with offices in HK
• Strong firm-based management
• International strategies

Source: Enright, Scott & Associates Ltd.

Hong Kong’s regulatory environment is another advantage. Many industry players rank Hong Kong’s regulatory regime as an important advantage in its status as a leading financial center. Investors have relatively few concerns with Hong Kong’s regulatory environment, due to its transparency, dependable legal system, appropriate set of laws, robust professional services compliance regime, and operations in line with accepted world best practice.

The free flows of capital, minimal restrictions on foreign direct investment, and minimal bureaucracy make Hong Kong particularly appealing to players in the FSI. The Fraser Institute and Heritage Foundation repeatedly rank Hong Kong as the freest economy in the world. Hong Kong’s status as a free market economy with better relative access to China is underscored by the Closer Economic Partnership Arrangement (CEPA), which provides added incentives for international investors to enter China via Hong Kong. This should attract more capital from overseas and further stimulate the economy by generating greater demand for the financial services that Hong Kong has to offer.

Hong Kong’s geographic and geopolitical position provides it with an advantage over non-Chinese locations for China-related financial service business. According to the HKSFC, “Hong Kong [is] uniquely suited to serve as a platform between the Mainland and the rest of the world, thus creating a win-win situation for both the Mainland and Hong Kong. More importantly, it gives Hong Kong an edge in maintaining its position as a prime fund-raising centre for Mainland companies – notwithstanding the resumption of IPO activities on the
Mainland. It is expected that, going forward, the A+H model will continue to be adopted by Mainland companies as the dominant mode of fund-raising.\textsuperscript{13}

China's surging economy is creating an unprecedented demand for financial services that cater to participants on both the buy and sell sides. Hong Kong's proven regulatory mettle, open markets, geographic closeness to Mainland China, and shared cultural heritage with China, make it desirable to customers located in all parts of the world who have a need for financial services. Hong Kong's position as a long-term leader in the FSI also means that many investors are familiar with the market and feel comfortable transacting in Hong Kong. A much better overall regulatory, legal, business, and talent situation than in the Chinese Mainland; combined with restrictions on the financial sector in the Mainland; and growing financial needs of China's economy are a powerful combination for Hong Kong's financial sector.

Hard and soft infrastructure is required in order to sustain a competitive position in the FSI. Hong Kong has an advanced telecommunications network, and the necessary utilities, road, and transport systems required of a leading financial center. Hong Kong also leads Asia on measures of soft infrastructure such as the judicial system, the presence of a level playing field, and the credibility of managers. Organizations such as the IFC and EIU rank Hong Kong very highly on measures of ease of doing business.

Differences in tax regimes across countries are often cited as a driver of location for the FSI. Hong Kong's low personal and corporate tax rates, no taxation on dividends, and no capital gains tax make Hong Kong attractive for FSI companies and professionals. Hong Kong's tax system is very simple and straightforward to comply with, another critical advantage. The agreement in August 2006 of a double taxation treaty between Hong Kong and Mainland China has further enhanced Hong Kong's attractiveness as a relative tax haven. The gap between Hong Kong and other tax regimes in the region is unlikely to go away even if a modest GST is introduced.

A key requirement for a successful equity market is sufficient liquidity to absorb large listings. Hong Kong's liquid market has high trading volumes and a proven capacity to attract international investment in support of both equity and debt securities. Some other highly liquid financial centers, such as New York, have a regulatory environment that is perceived to be too onerous, making it difficult for them to attract large issuers of securities, particularly first time issuers, and providing an advantage to Hong Kong.

Hong Kong's strongest competitive disadvantages in financial services include property costs, staff costs, and other costs. Out of 13 regional comparator countries, Hong Kong has the 3rd highest cost of living (behind Japan and Korea), and, after Japan, has the second highest office rent. Hong Kong also faces competitive disadvantages against some competitors (but not the Chinese Mainland) in quality of life (particularly air pollution), English language

\textsuperscript{13} Hong Kong Securities and Futures Commission, \textit{Quarterly Bulletin}, Summer 2006.
capabilities (when compared with Singapore), and quality of the local education system.\(^{14}\) Other disadvantages include the relatively small size of the local market, which makes Hong Kong’s FSI dependent on decisions taken in the Chinese Mainland, and the reliance on foreign expatriates, which could make the industry mobile if Hong Kong were to lose other advantages (see Exhibit 21).

### Exhibit 21. Hong Kong Financial Service Industry: Disadvantages

<table>
<thead>
<tr>
<th>MACRO-LEVEL DRIVERS</th>
<th>Meso-Cluster-Level Drivers</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Higher rates of economic growth in Mainland</td>
<td>• Property costs and staff costs</td>
</tr>
<tr>
<td>• Local economic conditions no longer viewed as an advantage</td>
<td>• High cost of living</td>
</tr>
<tr>
<td>• Air pollution and quality of life concerns</td>
<td>• Small size of local market</td>
</tr>
<tr>
<td></td>
<td>• Shortages of skilled staff</td>
</tr>
<tr>
<td></td>
<td>• Shortages of bilingual capabilities</td>
</tr>
<tr>
<td></td>
<td>• Reliance on foreign expatriates</td>
</tr>
<tr>
<td>SUPRAREGIONAL-LEVEL DRIVERS</td>
<td>INDUSTRY-LEVEL DRIVERS</td>
</tr>
<tr>
<td>• Eventual growth of Mainland financial markets, but Hong Kong well positioned</td>
<td>• Manpower policies need improvement</td>
</tr>
<tr>
<td></td>
<td>• Finance courses under-funded</td>
</tr>
<tr>
<td></td>
<td>• Inadequate research funding</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>FIRM-LEVEL DRIVERS</td>
</tr>
<tr>
<td></td>
<td>• Firm capabilities and strategies (SMEs)</td>
</tr>
</tbody>
</table>

**Source:** Enright, Scott & Associates Ltd.

### Developments and Implications

While Hong Kong has long been a major financial center, there has been much conjecture over the last decade or so regarding the future outlook for its role in the global financial services field. Speculation was particularly intense in the lead-up to the handover of Hong Kong by Britain to China. In fact, the handover was to have no discernible negative impact on Hong Kong’s FSI. On the contrary, massive growth of China-related financial markets has created opportunity in most areas, but has especially driven demand for capital raising and banking services.

The rapid economic growth of the Chinese Mainland has been a boon to Hong Kong’s financial sector. The financial sector in Hong Kong is more developed

\(^{14}\) Hong Kong Securities and Futures Commission, *Hong Kong as a Leading Financial Centre in Asia*, 2006.
and sophisticated than in China, and its geographic proximity and shared culture make it a logical choice as the financial center for many deals originating out of the Mainland. While several Mainland cities appear to be jockeying for position as financial centers, Hong Kong continues to have advantages such as market transparency, free flow of information, liquidity to absorb new listings, currency convertibility, presence of regional head offices for many leading global financial institutions, strong regulatory environment, experienced human resources, a successful track record in managing the sector, and as a more attractive place to live for mobile professionals. In addition, the clear trend has been for Mainland officials to be more concerned about developing its overall economy, than about creating financial centers at the expense of Hong Kong. The suspension of company listings in China pretty much ceded equity raising by Mainland companies to Hong Kong. Even with the resumption of listings in the Mainland, Premier Wen Jiabao is reported as affirming Hong Kong’s unique position in the eyes of Beijing as an international financial hub in China. The support for Hong Kong extends beyond rhetoric to include the QDII initiative as well as CEPA, and the advantages that it allows Hong Kong banks on the Mainland. The QDII scheme, which allows qualified Mainland institutional investors to invest outside the Mainland, will disproportionately benefit Hong Kong, as a result of direct investment in Hong Kong, by Hong Kong serving as a partner for Mainland investors investing internationally, and by fostering innovation in the range of financial services and products that Hong Kong has to offer.

Eventually the size of the financial markets in the Mainland will dwarf Hong Kong’s. However, even if Hong Kong will lose some market share, Hong Kong’s advantages are likely to ensure it will retain a strong position going forward. In addition, greater openness in China could disproportionately help Hong Kong relative to other outside competitors given its proximity to, and interaction with, the Chinese Mainland. Once again, policies already in place underscore this prospect. This supports the notion that even if other cities in China develop into major financial centers, Hong Kong will continue to play an important role.

One recent development of concern to Hong Kong’s FSI is rising discontent with Hong Kong’s air pollution and government’s seeming lack of understanding or concern over the issue. One investment bank has downgraded its rating on Hong Kong property stocks due to the number of professionals (especially financial service professionals) it expects to leave Hong Kong due to air pollution. While pollution is a problem, it is unlikely many will leave Hong Kong for cities on the Chinese Mainland due to pollution. In the meanwhile, international professionals still tend to prefer Hong Kong to the Chinese Mainland, and it is still difficult to convince fully trained professionals to live in the Chinese Mainland on a permanent basis. Consequently, many jobs in the FSI in China are being filled with local talent that is not yet educated and trained to a standard comparable with that in evidence in major financial centers, like Hong Kong. Very likely, it will take some years for China to catch up in this area.

15 South China Morning Post, January 11, 2007.
Strategies and Policies

The most important component of Hong Kong’s strategy for retaining and enhancing the competitiveness of its FSI is to retain and extend its traditional advantages. These include free flow of information, access to talent from abroad, simple and low-rate tax scheme, and cosmopolitan nature. Hong Kong also needs to continue to move towards world-best standards in its legal, regulatory, and market systems for the FSI. This is a key advantage that Hong Kong has over markets in the Chinese Mainland and is something on which Hong Kong needs to retain at least parity with competing markets to ensure investor confidence. It should be noted that Hong Kong succeeds in financial services because it is in a growing market and it is considered better than regional competitors, not because it has all the skills, capabilities, and systems present in more advanced financial centers, like New York or London.

Continued and improved access to the Chinese Mainland market will be a cornerstone of Hong Kong’s strategy for the FSI going forward. CEPA, China’s WTO obligations, and the statements of PRC leaders all provide a basis for Hong Kong FSI providers and the Hong Kong Government to seek additional ways in which Hong Kong’s FSI can facilitate China’s development. Helping China further integrate into world financial markets through knowledge transfer, training programs, secondment schemes, and other programs would improve Hong Kong’s FSI links in the Mainland. The potential for further RMB business, the development of a true offshore market, approval for further Mainland listings in Hong Kong, extension of the QDII and QFII programs, and greater access to China’s markets would all benefit Hong Kong. At the same time, improvements in the ability to do due diligence and to enforce market sanctions on Mainland companies would provide better protection to investors.

The dependency of the FSI on properly qualified and skilled talent demands that Hong Kong continue to be flexible in allowing foreign workers with specific abilities to enter Hong Kong and work in the FSI. Policy initiatives that target improvements in education and training of the FSI workforce are also necessary and will further strengthen Hong Kong’s competitive position. Finance-related programs at universities are often oversubscribed and understaffed, while programs in a number of other disciplines are undersubscribed and in comparison overstaffed. It is also interesting that the amount of money the Hong Kong Government spends on research in the natural sciences through the University Grants Committee dwarfs that spent on research in finance. Since one of the justifications for the spending has been contribution to Hong Kong’s economic development, it is surprising that an area in which Hong Kong has a leading position that could be helped substantially by investment in local skills and research capabilities gets far less funding than areas that are more expensive to fund, and in which Hong Kong is far behind the world leaders with little prospect of catching up. If economic development is a priority in funding research in Hong Kong (and obviously there are other reasons to fund research as well), then a dramatic rethinking of how research funds are allocated in Hong Kong is called for.
Today, many Hong Kong financial service operators and the Hong Kong offices of foreign companies use the Hong Kong financial services platform (markets, liquidity, standards, human resource base, legal system, regulatory structure, etc.) to serve a burgeoning economy in the Chinese Mainland, as well as Hong Kong’s own sizable (for a region of its size) financial service needs. At the same time, many Hong Kong companies and offices have been integrating China into their operations through outsourcing backroom operations and other activities to the Mainland. Going forward, the ability at the corporate level to integrate technology, systems, training programs, and other activities across Hong Kong and China operations will be critical.

Hong Kong is an Asia-Pacific center for many leading international financial service companies, including many investment banks and fund managers, but the geographic scope of some of Hong Kong’s FSI businesses is not nearly as great. For example, only 1 percent of the companies listed on Hong Kong’s Main Board are foreign companies (non-Hong Kong or non-Chinese). In contrast, a full 33 percent of the companies listed on the Singapore Exchange are non-Singaporean companies. It would appear that there are substantial opportunities for non-China listings for Hong Kong that are not being realized. There is a danger that focusing exclusively on China will result in missed opportunities elsewhere. Hong Kong needs the systems, skills, and personnel to operate a regional financial center, not just a China financial center.

The need for a robust domestic market as a springboard that propels Hong Kong to the forefront of global competition in the FSI should not be forgotten. With this in mind, Hong Kong might look to do more in terms of encouraging investment across a broader range of asset classes by packaging and structuring investments so that they are easily accessible (and perhaps tax deductible) via additional elective contributions by individuals towards their MPF. In addition, the domestic financial sector provides an underpinning to the rest of Hong Kong’s economy. It is worth noting that the quality of service provided in the domestic portion of the sector, banking for example, is not considered anywhere near that found in the world’s most advanced economies. Lack of capable individuals and lack of competition has bred both complacency and inefficiency that can frustrate the typical business person.

The FSI is one of the highest value-added per person and per square meter sectors throughout the economy. As such, much of the sector tends to be housed in Central Business Districts, where it becomes a driver of CBD rents and land prices. The same is true in Hong Kong. It should be noted that policies that have helped to limit commercial land development in Hong Kong’s Central District have helped drive property prices paid by some FSI companies to record levels. While there is an argument that says that when business is good, rents go up and when business is bad rents go down, it is interesting to note that the rapid increase in FSI output in Hong Kong over the last five years has not been matched by a significant increase in employment in FSI in Hong Kong, which in Q3 of 2006 was approximately the same as in Q3 of 2001 (see Exhibit 22). FSI professionals attribute this anomaly to their efforts to push as many
activities out of Hong Kong as possible and to service as much of the Hong Kong business remotely as they can; both due to cost considerations. Thus while the sector has had a strong positive impact on Hong Kong’s economy, the impact has been less than it might have been.

Exhibit 22. Hong Kong Financial Services Employment

![Financial Services Employment Chart]

Source: Hong Kong Census and Statistics Department.

Finally, it is important that the HKSAR Government does not allow resources that should be dedicated to the FSI to be siphoned off in an effort to subsidize other industries. Many groups in Hong Kong ask the Hong Kong Government to support their own favored sector, either through direct subsidies, subvented land, or other means. It is important to remember that subsidies come from somewhere and that strong industries wind up paying directly or indirectly for subsidies to the weak. The FSI is a main driver of Hong Kong’s economy – both in employment terms, and in terms of value creation for other industries. The FSI is also an important anchor that is used in positioning and profiling Hong Kong internationally. If the FSI were to weaken measurably, all other industries in Hong Kong would suffer. This is unlikely to be as true – certainly not when measured in terms of proportionate impact – for any other industry.

Conclusions

Hong Kong’s financial services industry is currently very strong, and much progress needs to be made before major cities on the Mainland become real
rivals. There is no other city poised to take over Hong Kong’s roles at present, but it is likely that greater rivalry between cities will emerge. This will be true as cities on the Chinese Mainland (not just Shanghai, but Beijing, Shenzhen, and Tianjin as well) strive to become financial centers and as other centers in the region, such as Singapore, go after the less proximity-oriented business, such as fund management, treasury operations, private banking, and others.

Hong Kong rates higher than most other locations in Asia in factors related to the FSI, but Hong Kong is not truly a global, or even regional financial center. Instead, it is a China financial center. As indicated above, only 1 percent of the companies listed on Hong Kong’s Main Board are non-Hong Kong or non-Chinese. The reliance on China places Hong Kong potentially at risk if the PRC leadership decides to push business away from Hong Kong. While there are no signs of this occurring at present, and in fact the opposite may be closer to reality, there is always the possibility it could occur in the future.

The fact that Hong Kong’s FSI increasingly relies on China business and that significant parts of the sector are foreign-owned and dependent on skilled expatriates makes Hong Kong’s position as a major international financial center more at risk than the positions of New York or London. It means that Hong Kong will have to continue to provide a better financial services platform than competitors in order to retain FSI business. The fact that much of the business is foreign-owned may explain the seeming lack of any political power on the part of the FSI to influence policy in ways that would reduce rental and other costs. Instead, they do their own cost-benefit analysis and locate activities and people where that analysis leads. Interestingly, it has led to only marginal increases in employment in the FSI in Hong Kong over the last five years despite a large increase in output.

Financial issues are not the only hurdle, however. The importance of quality of life factors such as clean air, controlled noise pollution, and open spaces for recreation, in determining the ultimate success of Hong Kong’s FSI should not be underestimated. Already it is the case that some firms are relocating some individuals and activities to Singapore and elsewhere as a result of the poor living environment in Hong Kong. Hong Kong may outperform on all other factors, but factors heavily weighted by the managers who are needed to ensure the smooth functioning of the FSI, such as pollution, poor language skills, and an education system that are seen to be sub-par on an international scale, may conspire to relegate Hong Kong to a poorer than expected competitive position if care is not taken to address them proactively.

Despite the shortcomings identified here, Hong Kong retains an extremely strong position in the FSI. This position is unlikely to deteriorate anytime soon. In fact, most trends seem to be working in Hong Kong’s favor. This should not mean complacency, but rather should stimulate efforts to extend Hong Kong’s advantages and to reduce Hong Kong’s shortcomings in the sector.
The Hong Kong Professional Services Industry

Professional services are high-value activities of central importance to Hong Kong’s knowledge economy. They both support and depend upon Hong Kong’s roles as a financial and regional headquarters hub for the Asia Pacific and its institutional strengths including rule of law. This analysis of professional services focuses on accounting and law, with reference to management consulting and engineering and chartered surveying services.

Industry Structure and Performance

In professional services, Hong Kong is a leading center for Asia excluding Japan, and a leading center for China. The rise of China’s economy, and the initial public offerings of major Chinese state-owned enterprises on the Hong Kong stock exchange, has been a major driver of growth for Hong Kong’s professional services sectors. New pockets of knowledge are developing in Hong Kong and China that are genuinely unique worldwide, and Hong Kong’s globally-focused professionals are highly competitive. As of June 2006, accounting provided 23,700 jobs, up 33 percent since 2001, and legal services provided 16,500 jobs, up 5 percent over the same period.

In Hong Kong, professional services are segmented among the Hong Kong offices of foreign multinational firms, Hong Kong firms with multinational clients and China activities, and Hong Kong firms with local activities only. The world’s leading law and accounting firms are well represented in Hong Kong. The past two decades also have seen the emergence of Hong Kong firms that serve multinational clients. These firms are relatively large, rely on extensive global affiliations, work largely in the English language, and tend to recruit expatriate and foreign-educated professionals. In a separate tier are less-well-paid sole proprietors working from small offices and serving the basic local needs of local companies and individuals. The polarization of the legal services sector into separate tiers is even clearer than in accountancy, partly because many legal services serve the local market and are less tradable in nature.

Exhibit 23. Accounting, Auditing, and Bookkeeping Professions in Hong Kong

<table>
<thead>
<tr>
<th></th>
<th>Establishments</th>
<th>Persons engaged</th>
<th>Vacancies</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>3,522</td>
<td>17,813</td>
<td>76</td>
</tr>
<tr>
<td>2002</td>
<td>3,651</td>
<td>18,932</td>
<td>163</td>
</tr>
<tr>
<td>2003</td>
<td>3,638</td>
<td>18,115</td>
<td>149</td>
</tr>
<tr>
<td>2004</td>
<td>3,542</td>
<td>20,822</td>
<td>373</td>
</tr>
<tr>
<td>2005</td>
<td>3,948</td>
<td>20,848</td>
<td>259</td>
</tr>
<tr>
<td>2006 (as of June)</td>
<td>3,882</td>
<td>23,702</td>
<td>495</td>
</tr>
</tbody>
</table>

Source: Hong Kong Census and Statistics Department.
Exhibit 24. Legal Services in Hong Kong

<table>
<thead>
<tr>
<th>Year</th>
<th>Establishments</th>
<th>Persons engaged</th>
<th>Vacancies</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>1,444</td>
<td>15,573</td>
<td>20</td>
</tr>
<tr>
<td>2002</td>
<td>1,506</td>
<td>15,961</td>
<td>23</td>
</tr>
<tr>
<td>2003</td>
<td>1,510</td>
<td>15,309</td>
<td>21</td>
</tr>
<tr>
<td>2004</td>
<td>1,543</td>
<td>15,769</td>
<td>130</td>
</tr>
<tr>
<td>2005</td>
<td>1,625</td>
<td>16,746</td>
<td>89</td>
</tr>
<tr>
<td>2006 (as of June)</td>
<td>1,699</td>
<td>16,467</td>
<td>190</td>
</tr>
</tbody>
</table>

Source: Hong Kong Census and Statistics Department.

Within professional services, competition depends on the segment. Among the large accounting firms, competition for work and clients is limited but competition for experienced staff is fierce. Smaller firms pick up some of the overflow of clients and projects. In legal services, the fiercest competition is found in among small, local firms. In consulting, competition is moderate for high-end consulting firms and fierce for small firms providing local consulting services.

In terms of the shifting of activities out of Hong Kong, professional services did not undergo the historical dispersal of activities from Hong Kong into South China that has reshaped Hong Kong’s manufacturing industries since the 1980s because the opening up of Southern China at that time did not extend to services. China’s liberalization of service markets got its early in this decade with the Mainland’s commitments under WTO and CEPA. Among professional services, the most dramatic shift has been among multinational management consulting firms, with some global leaders moving management of China-related work out of Hong Kong to Beijing and Shanghai. Among large accounting firms, China work tends to be managed out of Hong Kong and a great deal of day-to-day work is performed in the Mainland.

Competitors

The main competitors for Hong Kong’s professional services sector in descending order of importance are Guangdong Province, the rest of China, South China excluding Guangdong, Singapore, Taiwan, Western Europe, and North America. For professional services firms with a scope beyond Hong Kong, China-related business is the main focus. The locations in China are seen as the main competitors for China business. Regional activities have tended to center in Hong Kong and Singapore, for proximity to the Asia-Pacific regional headquarters of multinational firms, and Singapore is seen as the main competitor for regional business. Western Europe and North America are seen as the main competitors for other international business.
The Chinese Mainland and Singapore are not yet serious rivals to Hong Kong in professional services. In China’s traditional state-planned economy, professional services were viewed at best as unnecessary and at worst as parasitic. During the 1980s and 1990s, their evolution was slow. While professional services are now developing much faster, China faces vast challenges in building the necessary skills sets and regulatory frameworks, as well as the mindsets and institutions to enforce them. Its greatest challenge will be in building up the internationally-oriented, world-class expertise that is Hong Kong’s strength.

In contrast, Singapore has a well-developed professional services sector with roles similar to those of Hong Kong, albeit on a smaller scale. Singapore’s geographic location positions it for South-East Asian regional work. For China work, distance is a challenge with Shanghai a six-hour flight. In addition, Singapore’s leading accounting firms are short of professionals with the experience to manage international projects, and the legal sector is facing a nationwide shortage of lawyers, especially at entry and junior levels.

**Advantages and Disadvantages**

In Hong Kong, while there are different structures of advantages and disadvantages for different sectors in professional services, some overall patterns emerge. According to industry participants, in professional services, Hong Kong’s strongest competitive advantages are in access to information, knowledge of international business standards and needs, the banking and financial system, communication infrastructure, tax regime, transportation infrastructure, and geographic location. Local managerial skills, staff skills, multilingual capabilities, and level of technology are also important. Hong Kong’s advantages in professional services are heavily concentrated at the cluster or “meso” level and the “macro” level. Supranational drivers also have been a major impetus for growth (see Exhibit 25).

Hong Kong’s strongest competitive disadvantages in professional services include property costs, staff costs, and other costs; the relatively small size of the local market; lack of local competition in some segments; and strategies of local firms, many of which have an insular and parochial outlook. Additional disadvantages include difficulties in bringing in foreign professionals in the legal sector, and an acute manpower shortage in accounting. Among consulting firms, Hong Kong is increasingly viewed as far from where the action is in the Chinese Mainland (see Exhibit 26).
Exhibit 25. Hong Kong Professional Services: Advantages

**MACRO-LEVEL DRIVERS**
- Tax regime
- Regulatory and legal framework (rule of law)
- Strong judicial system
- Transparency of government
- Liberal policies on immigration of skilled professionals

**MESO-CLUSTER-LEVEL DRIVERS**
- Access to information
- Banking and financial system
- Communication infrastructure
- Transportation infrastructure
- Geographic location
- Local managerial skills
- Staff skills
- Support from related industries (finance, trade, other professional services)
- Regional HQ hub
- Presence of leading international firms

**SUPRAREGIONAL-LEVEL DRIVERS**
- China market potential
- International overhaul of corporate governance standards (Sarbanes Oxley in US, IFRS in UK)
- Beijing’s push to adopt international standards of accounting and governance and privatization of SOEs
- Mainland enterprise listings in Hong Kong

**INDUSTRY-LEVEL DRIVERS**
- Strong support from HKGCC and professional service associations (CEPA)
- Active competition in some segments

**FIRM-LEVEL DRIVERS**
- Knowledge of international business standards
- Pockets of leading-edge expertise (related parties, joint ventures)
- Multilingual capabilities
- Level of technology
- Global networks and expertise (large firms)

Source: Enright, Scott & Associates Ltd.

Exhibit 26. Hong Kong Professional Services: Disadvantages

**MACRO-LEVEL DRIVERS**
- Hong Kong’s economic growth low compared to China
- Small total economy

**MESO-CLUSTER-LEVEL DRIVERS**
- High property costs, staff costs, and other costs
- Size of local market
- Manpower shortage (accounting)
- Distance from major Mainland cities (consulting)

**SUPRAREGIONAL-LEVEL DRIVERS**
- Asian Economic Crisis, World Trade Center attack in 2001, and SARS in 2003 led to staffing retrenchments
- Very limited benefits from CEPA (legal sector)

**INDUSTRY-LEVEL DRIVERS**
- Immigration policies restricting lawyers

**FIRM-LEVEL DRIVERS**
- Strategies of local firms (local law firms’ focus on property conveyancing)
- Small firm size and limited resources (solo practitioners)

Source: Enright, Scott & Associates Ltd.
Developments and Implications

Over the past eight years, Hong Kong’s globally-focused legal and accounting professions have been through an extraordinary bust-boom cycle. The Asian financial crisis in 1998 and 1999, the dot.com crash, the terrorist attack on New York’s World Trade Center in 2001, and the SARS crisis in 2003 caused global accounting and law firms to retrench from the Asia Pacific and local firms of all sizes to cut back on staff. Despite the macro recovery in recent years, local professionals providing non-traded services in Hong Kong are still in a rut. In contrast, prospects are strong for Hong Kong-based internationally-oriented services providers.

The collapse of Enron and the far-reaching regulatory overhaul embodied in the Sarbanes-Oxley legislation in the US and the International Financial Reporting Standards (IFRS) in the UK have forced massive new reporting requirements on companies, as well as governance changes and transparency obligations. Accounting firms that serve these companies must undertake much more rigorous risk assessments of corporate clients, standardize audit practices across markets and rigorously separate audit activity from consultant and advisory work. Hong Kong’s own accounting rules have evolved as well, also increasing the work for accountants.

This dramatic explosion of business has been hugely beneficial to the Hong Kong economy, but has been dominated by the largest firms, with the Big Four firms rotating for deals for large companies. Local accountancy firms have nevertheless benefited as Sarbanes-Oxley has generated more work, as auditing services have been separated from traditionally-lined consultant services, and as the Big 4 firms have “deselected” higher-risk clients. Local accounting firms have been building up their multinational skills and engaging in mergers to build critical mass. While this has placed transformational strain on the accounting profession in particular, it has led to a strengthening and deepening of the Hong Kong industry.

In China, since 2003 the Central Government has undertaken to dismantle and privatize state-owned enterprises, and to use international fund-raising centers to facilitate this process. Beijing has recognized that China’s globalizing enterprises will need to understand and adopt international standards of accounting and governance if they are to win acceptance as competitors in global markets. Officials also have recognized that listings on highly reputed international stock exchanges are an indispensable precondition. Hong Kong has become locus of choice for Mainland Chinese enterprises as they seek in increasing numbers to tap global capital markets.

Faced with distinctive demand, Hong Kong professional services firms are developing pockets of expertise that are genuinely unique worldwide. Hong Kong-based accountants are assisting global technical teams in adjusting the globally applicable standards that have been developed in the wake of
Sarbanes-Oxley. A good example of this is in the area of related party transactions. Rules in the process of being developed in the US and the UK are in the process of being modified in significant ways because of issues that arise in auditing Mainland companies. As state-owned enterprises with significant national, state, and municipal share-ownerships, the concepts of related parties and connected interests take on new depths of meaning that cannot be addressed by rules previously being developed in the US. Similar issues have arisen in managing international joint ventures in the Chinese Mainland.

The coincidence of new and more rigorous governance requirements and Beijing’s decision to “marketize” its state-owned economy has created huge amounts of new work for the accounting profession in Hong Kong and across the Mainland. However, this has caught the profession in Hong Kong seriously under-resourced to manage the explosion in demand. All leading accounting firms have undertaken massive recruitment drives for trainees both in Hong Kong and on the Mainland. There is an acute awareness that trainees require five years to qualify, and even longer to accumulate the experience needed to handle the workloads being generated. Overseas recruitment from the West is unlikely to provide a solution to the skills shortage because of the shortage of similar skills in the world’s major markets and the requirement for bilingual English and Chinese capabilities to handle China-related work.

In the short term, the accounting skills shortage cannot be met by transferring operations to the Mainland because the skills shortage there is even more acute than in Hong Kong. Companies like PwC have 8,000 staff in the Chinese Mainland and are recruiting at a pace of 1,500 per year. Ernst & Young, with 5,000 Mainland staff, is recruiting at a similar rate, with plans to employ 25,000 professionals in the Mainland by 2015. Deloitte has doubled its Mainland workforce from 3,000 to 6,000 since 2004. This places pressure on Hong Kong-based professionals to transfer to the Mainland in support of on-the-ground needs.

Compared to accountants, local lawyers have been less well placed to benefit from globalization and the international public offerings of Chinese firms, given the non-tradable nature of so many legal services. The collapse of the conveyancing business and abandonment of mandatory scale fees in the late 1990s increased competition and cut fee income across the local sector. Nevertheless, since 2003 there has been massive growth among internationally-oriented law firms meeting the needs of multinationals headquartered in Hong Kong, and of Mainland firms seeking to build businesses internationally.

The Closer Economic Partnership Arrangement (CEPA) between Hong Kong and China has been largely a disappointment to Hong Kong’s law firms. Just six firms have taken up CEPA-related opportunities in past two years, due in large part to China’s reluctance to allow Hong Kong lawyers full breadth of practice and to allow joint ventures between Hong Kong and Mainland law firms. For their part, Mainland lawyers have taken little interest in opportunities in Hong Kong, mainly because of large and growing markets at home.
In sectors including accounting, consulting, and engineering, there is much larger demand in China than in Hong Kong. Auditing work related to the IPO’s of Mainland firms in Hong Kong has resulted in very large teams of Hong Kong accountants working on site in China. In management consulting, the privatization of Chinese state-owned enterprises, heightened competition as markets open to foreign firms, and the return of Chinese managers with MBAs earned overseas have caused a surge in demand for consulting services on location in the Chinese Mainland. For engineers and chartered surveyors, the concept of mixed-use centers combining shopping, residential, leisure, and hotel facilities, taken for granted in Hong Kong in recent decades, has been taken up in China where it is fuelling a large volume of consultant activity.

While many of the developments driving professional services are positive, they also have implications for Hong Kong. In China, the regulatory changes in corporate governance that have generated demand from state-owned enterprises for Hong Kong’s international expertise also generate pressure on Hong Kong professionals to acquire such expertise. Mainland corporate listings on the Hong Kong stock exchange create work for Hong Kong-based professionals but also mean that these sectors depend on the competitiveness of the Hong Kong stock market and a continued flow of Mainland IPO’s into Hong Kong after the first wave of giant listings. The rise of China-related business is causing some professional service firms to shift more activities into the Chinese Mainland.

Across all professional service sectors, the worsening pollution in Hong Kong is raising quality of life issues and making the recruitment and retention of overseas talent more difficult. Senior members of the management consulting sector, for example, predict that the war for talent among the leading cities of the Asia Pacific will become increasingly intense over the next decade and the outcome will have a major impact on which cities emerge on top. In this war for talent, Hong Kong will increasingly compete on quality of life issues with leading cities in China, Singapore, and the West.

**Strategies and Policies**

Several key strategies emerge for Hong Kong’s professional services sectors. In accounting, it will be important for Hong Kong’s firms to expand their critical mass of expertise relating to the privatization of Mainland state-owned enterprises. It also will be important for Hong Kong-based firms to leverage Hong Kong’s unique skills and knowledge of international standards and the China market.

For law firms, the priorities should be to leverage Hong Kong’s role as a “neutral legal platform” for legal services relating to corporate activity in the Mainland. This would involve enhancing the capacity of law firms to bring into Hong Kong, often on a project-by-project basis, legal professionals from the US or Europe and from the Chinese Mainland, to work with local legal professionals to ensure
multi-jurisdictional management of ventures or investments. It also will be important to work with the Hong Kong-based headquarters of multinational firms and Hong Kong firms with activities in China, to build and leverage relations with Mainland law firms, and to seek business from internationalizing Chinese firms.

For management consulting firms, strategies should include working with Hong Kong-based headquarters of multinational firms as well as Hong Kong firms with activities in China, identifying China’s internationalizing companies and forward-looking regions, and exploiting Hong Kong’s position as a “one stop shop” for information and expertise on all of China. In addition, it will be increasingly important to leverage knowledge of and information links with second and third tier cities in the Chinese Mainland.

For Hong Kong’s engineers and chartered surveyors, a key strategy will be ensuring participation in China’s infrastructure and building boom. It will be important to build relationships with Hong Kong and multinational developers and infrastructure companies that are active in the Mainland. Another strategy would be to build links with Chinese engineering expertise that may be exportable to developing economies around the world.

In terms of policies, the Hong Kong Government should strive to maintain Hong Kong’s leading position as a headquarters hub for global multinationals and Hong Kong’s status as a leading financial center. Policies also should be considered to enhance Hong Kong’s role as a “neutral legal platform” including the role of international arbitration center. Steps should be taken to develop and promote Hong Kong as a knowledge base in professional services for China and Asia. It will be very important to allow the free movement on non-Hong Kong trained professionals into and out of the economy, while enhancing local education, training, and recruitment programs for local talent.

Because Hong Kong professional services firms will need to position themselves to capture Mainland markets, policies aimed at securing better access to Mainland markets must be pushed ahead. At the same time, Hong Kong’s institutional advantages including the rule of law must be safeguarded under the “one country two systems” arrangement. With respect to CEPA, the reciprocal recognition of professional qualifications should be pursued only when and where Mainland qualifications are up to par.

Conclusions

In accounting, the rising tide across the Mainland is likely to lift all ships including Hong Kong. China’s ongoing attempts to meet international standards of corporate governance and accounting will increase demand that can be met only from Hong Kong today. The accounting profession in Hong Kong has developed a critical mass of expertise that is relevant in shaping the accountancy profession’s global rules going forward. Even as the Mainland’s
accounting sector grows, Hong Kong is likely to preserve a distinctive role in the provision of internationally-focused accounting activity.

Hong Kong’s long term future as a hub for legal services in support of global multinationals and emerging Chinese corporations also appears to be very promising. Skills shortages appear not to be as acute as those in accountancy, and can be met with reasonable fluency by bringing professionals into Hong Kong on a short-term basis as necessary. Landing international business from Chinese firms is a new opportunity for Hong Kong-based law firms. Hong Kong’s rule of law and world-class judicial system stand in sharp contrast to the weak legal institutions in the Mainland, and contribute to Hong Kong’s long-term competitive advantage.

Prospects are also good for Hong Kong’s internationally-oriented consulting firms. Among multinational firms, large numbers of small and medium-sized enterprises will need help in China and the Asia Pacific region. In the Chinese Mainland, greater market orientation will increase demand for management consulting. However, as this is a relatively new industry in China, it will be necessary to educate the Mainland market on the value of services. One new opportunity for Hong Kong-based consulting firms will be to assist Chinese corporate clients in their efforts to internationalize. Hong Kong is likely to remain a vibrant location for the consulting sector.

In engineering and chartered surveying, China’s infrastructure and building boom will fuel growth, and Hong Kong-based firms that can gain access to the China market will benefit. In the future, some international firms may bypass Hong Kong due to the preponderance of work in the Chinese Mainland. While engineering expertise in China is improving rapidly, prospects for Hong Kong firms should be good.

Overall, the long-term liberalization of China’s financial markets will enhance demand for Hong Kong’s professional services. In sectors including accounting and law, the limited size of the Hong Kong market means business that overflows at larger firms will benefit smaller, more locally focused firms. However, there are challenges. The Big Four accounting firms may potentially shift headquarters and management operations from Hong Kong to the Chinese Mainland, as some consulting firms have done. China’s own domestic training of accountants and lawyers will take time, but will happen eventually. Pollution and quality of life issues are becoming more important in the war for talent, and expatriate professionals report that with respect to air pollution Hong Kong is being viewed as not much better, if at all, than Shanghai. The professional services industry is a dynamic sector that will eventually face more competition. The continued flow of listings of Mainland firms into Hong Kong is a reflection of the competitive strengths of Hong Kong’s stock exchange but also depends on Central Government decisions that are external to Hong Kong.
The Hong Kong Tourism Industry

Tourism is a multifaceted sector that encompasses transportation, hotels, attractions, cultural centers, restaurants, retailing, and related activities. Tourism is one of the world’s larger industries; most countries have some form of tourism sector. Tourism in Asia first took off in the 1970s as Asian cities with significant business activities were able to provide a taste of Asian culture in a secure and comfortable environment. This “Instant Asia” model catered for Westerners instead of Asians, since economic development at the time had yet to create an Asian middle class with the leisure and disposable income to travel. At a time when the Chinese Mainland was closed to the rest of the world, and direct flights to most Asian cities were non-existent, Hong Kong’s tourism industry established itself as a must-go destination in Asia.

More recently, the rise in affluence in Asia and the opening and subsequent development of China have transformed the sector. Intra-Asian travel has become the dominant form of tourism in Asia. As a result of a new travel mix, tourism offerings have had to be extended, refined, or changed. Going forward, China, which is expected to have on the order of 100 million outbound tourists by 2015 (EIU) or 2020 (World Tourism Organization) is going to be one of the major sources and destinations for international travel.

Industry Structure and Performance

Hong Kong’s tourism industry enjoyed a boom in the years leading up to 1997, when tourists arrived in large numbers to experience the “final days” of the British colony. Thereafter, the tourism sector suffered a series of external shocks, including the Asian financial crisis of late 1997, avian flu in 1998, the terrorist attacks on New York of September 11, 2001, and SARS in 2003. Since 2004, Hong Kong has made a resilient rebound in a challenging environment. As of 2006, Hong Kong was the world’s 21st leading tourism economy, with 0.9 percent of the world market share and 5 percent of the Northeast Asian tourism market. Tourism directly employed 4.8 percent of Hong Kong’s workforce and contributed 3.3 percent to GDP. The World Travel and Tourism Council (WTTC) expects Hong Kong’s tourism industry to grow at a real rate of 6.9 percent per year to 2016, ranking 11th worldwide in forecast growth.16

In terms of industry structure, tourism in Hong Kong is multifaceted, including the transportation, hotel, retail, entertainment, restaurant, and travel industry segments. It serves multiple customer types such as leisure, business, and meetings, incentives, convention and exhibition (MICE) long-haul and short-haul customers. In Hong Kong, the aviation segment has a dominant player, Cathay Pacific Airlines, while other segments have multiple players. Depending on the segment, there is a mix of competition, cooperation, and lack of competition. There is also a mix of local operators and international operators and brands.

16 World Travel and Tourism Organization, Hong Kong Report, 2006.
Tourism is an important source of jobs for the Hong Kong economy as it employs large numbers of moderately skilled workers. This makes it even more important politically than it is to Hong Kong’s economy.

**Competitors**

According to industry participants, the main competitors for Hong Kong’s tourism sector are Singapore, Bangkok, Tokyo, Shanghai, Beijing, and Taipei, recently joined by rapidly-emerging Macau. Judging from the statistical comparisons, Hong Kong’s tourism sector appears to have performed strongly in the face of competition. On the demand side, while the economic downturn, the crises of avian flu in 1998 and SARS in 2003 affected tourism demand across the region, Hong Kong’s visitor arrivals appeared to have rebounded more dramatically than others (see Exhibit 27). On the supply side, while the number of hotel rooms in competing Asian tourist hubs has remained flat, Hong Kong has managed modest growth in the number of rooms. These and additional key performance indicators such as occupancy rates and average lengths of stay indicate that, at least for the time being, Hong Kong is well positioned. However, these indicators do not reflect the future ambitions of the leading competitors to Hong Kong.

Hong Kong’s main tourism competitors are other cities rather than nations. Some of these locations, such as Singapore and Macau, are investing a great deal in tourism developments. Singapore has successfully cultivated an image of “Safe Asia,” building a reputation for law and order and cleanliness, providing an English-language headquarters platform for multinational firms, and attracting inbound leisure visitors by leveraging the exotic imagery associated with the region. Like Hong Kong, Singapore faces cost constraints on land and labor. Singapore has a history of using master plans to map the future for the industry, with the latest Tourism 2015 master plan laying out goals to double visitor arrivals, triple tourism receipts, and create 100,000 new jobs in the 10 years up to 2015. The main driver of growth will be integrated resorts, two of which were approved in 2006. Macau is also seen as an up and coming competitor with the large-scale integrated resort developments on the Cotai Strip coming on stream. In contrast, the major Chinese Mainland cities of Shanghai and Beijing are seen as less direct competitors, indicating that Hong Kong is no longer the place for Western tourists to obtain the “China experience.”
Exhibit 27. Tourism Arrivals, Selected Asian Destinations

Notes: Singapore’s visitor arrival figures exclude all Malaysian citizens arriving by land and all non-resident air and sea crew. Shanghai visitor numbers exclude domestic visitors.

Sources: Hong Kong Tourism Board, Singapore Tourism Board, Macau Census and Statistics Service, and City of Shanghai Statistics Bureau.

Advantages and Disadvantages

Hong Kong has very strong advantages in tourism, especially at the “meso” or cluster level and at the macro level. Cluster level advantages include geographic location, China market potential, transportation facilities, communication infrastructure, strong related and supporting infrastructure including the banking and financial system, managerial skills, and Hong Kong’s longstanding position as a sourcing hub and a platform for the regional headquarters of multinational firms. At the macro level, government-related factors including political stability, safety, free port status, cleanliness of government, and the tax regime (including absence of a sales tax) also have been important sources of advantage (see Exhibit 28).

In addition, Hong Kong benefits from advantages in tourism superstructure that include cuisine, nightlife, high-quality accommodation, visual appeal, and a good retail sector. Hong Kong has traditionally enjoyed a reputation as a “shoppers’ paradise,” and its retail sector has been bolstered over the years by
tourists’ expenditure on shopping. Over the past 10 years, tourists’ shopping dollars have been estimated to constitute between 18 percent and 25 percent of sales revenue in the retail sector. This would mean approximately one in five dollars spent at a retail outlet in Hong Kong is from a visitor.

**Exhibit 28. Hong Kong Tourism: Advantages**

- **MACRO-LEVEL DRIVERS**
  - Political stability
  - Safety
  - Free Port status
  - Cleanliness of government
  - Tax regime (no sales tax)
  - Cosmopolitan nature of city

- **MESO-CLUSTER-LEVEL DRIVERS**
  - Geographic location
  - China market potential
  - Transportation facilities
  - Communication infrastructure
  - Related and supporting industries (banking and financial system)
  - Managerial skills
  - Sourcing and HQ hub
  - Presence of leading international hotel chains

- **SUPRAREGIONAL-LEVEL DRIVERS**
  - Lifting by Central Government of restrictions on individual travel to Hong Kong (IVS).
  - Potential for complementary developments in the Greater PRD

- **INDUSTRY-LEVEL DRIVERS**
  - Advantages in tourism superstructure including cuisine, nightlife, high-quality accommodation and visual appeal as well as good retail sector and excellent international access

- **FIRM-LEVEL DRIVERS**
  - Level of technology
  - Global networks and tour coordination
  - Expertise (outbound travel agents)
  - Some important firms that act as focal points for the sector

**Source:** Enright, Scott & Associates Ltd.

As seen in Exhibit 29 below, Hong Kong’s disadvantages at the “meso” or cluster level include high staff costs, property costs, and other costs. This is as would be expected, given Hong Kong’s reputation as a high cost center. In terms of importance as drivers of competitiveness, costs are important but rank below the most important drivers such as political stability, safety, and attractions. On the other hand, Hong Kong fares quite poorly with respect to costs relative to its major competitors.

In addition, there are a number of disadvantages relating to Hong Kong’s tourism superstructure which are cause for concern. In this study, an insufficient supply of museums, galleries, and dedicated tourism facilities has emerged as a major disadvantage for Hong Kong in tourism. Hong Kong has been relatively slow in developing its potential heritage sites into tourist attractions, as seen in the controversy over the fate of Tiger Balm Garden and the Central Police Station. In this respect, Hong Kong is disadvantageously positioned with respect to Macau, with its well-preserved and marketed historical legacies and UNESCO World Heritage site. Environment pollution and air pollution in particular are also a growing source of disadvantage for Hong Kong.
Deterioration in air quality has affected visitors’ enjoyment of scenic destinations and indeed their willingness to leave their hotel rooms. Reported by the news media worldwide, it is hurting Hong Kong’s international reputation as a leisure destination.

Hong Kong’s small size and scarce land resources give rise to land use conflicts. From a government perspective, there are many competing uses for limited space. In addition, while many of Hong Kong’s major property developers are involved in owning, operating, or managing hotel properties, hotels typically form a very small part of the conglomerates. Thus, the use of a commercial property as a hotel can readily be in conflict with other uses, such as developing downtown office building or residential units.

Exhibit 29. Hong Kong Tourism: Disadvantages

MACRO-LEVEL DRIVERS
• Small land area
• Land use policy

SUPRAREGIONAL-LEVEL DRIVERS
• Rapid growth of Macau’s hospitality sector is attracting Hong Kong’s management and skilled staff
• Limited opportunities in cross-boundary outbound tourism for HK travel agents under CEPA

MESO-CLUSTER-LEVEL DRIVERS
• High staff costs, land costs, and other costs

IndUSTRY-LEVEL DRIVERS
• Disadvantages in tourism superstructure including lack of museums, galleries, dedicated tourism facilities, distinctive culture, and three-star hotel rooms, and air pollution
• Lack of comprehensive tourism policy
• Protection in aviation sector

FIRM-LEVEL DRIVERS
• Some tour operators use questionable tactics
• Oligopolistic behavior in some segments

Source: Enright, Scott & Associates Ltd.

Given the high land cost in Hong Kong, there has historically been a tendency to build five-star and four-star hotel accommodation. Hong Kong statistics indicate a continuing shortage in three-star hotels. Only in recent years have smaller scale, three-star, and more boutique hotels started to spring up to fill the demand from Mainland tourists. Providing affordable accommodation is important to prevent tourists from choosing to stay in hotels in Macau or across the border, and offers travelers the choice of spending more of their tourist dollar on other expenditure items, such as shopping and the consumption of services.
Protection in Hong Kong’s aviation sector is also a source of disadvantage to Hong Kong’s tourism industry. Hong Kong’s air service regime is not as liberal as that in several other centers in Asia, and is in danger of falling behind that of the Chinese Mainland. In addition to restricting the number of flights into Hong Kong and locations that can connect directly to Hong Kong, it also tends to result in higher prices. In addition, the development of the Macau International Airport into a low cost carrier hub for China and for Asia has also been seen as a competitive challenge to Hong Kong. The millions of tourists to Macau no longer necessarily need to fly via Hong Kong, and the offerings of a low cost option could entice some visitors destined for Hong Kong to choose to fly via Macau, and vacation in Macau, instead.

**Developments and Implications**

Several external drivers are reshaping the Hong Kong tourism industry. Throughout the Asia-Pacific, the meetings, incentives, convention and exhibition sector (MICE) is growing in importance and competing locations including Singapore and Macau are lining up to capture it. Budget travel is opening up new markets and is also being used by competing locations such as Singapore, which opened a budget air terminal in 2006, as a driver of growth. The proposition of Hong Kong or other high-cost destinations in the Asia-Pacific continuing as a shopping paradise is becoming less sustainable. The leading cities in the Chinese Mainland, including Beijing and Shanghai, have emerged as business and leisure destinations in their own right, and Hong Kong no longer enjoys an automatic place on the short list of Western visitors to China.

Closer to home, with improvements in transportation infrastructure and the trend toward cross-boundary efficiency, the Greater Pearl River Delta is integrating into a single region with far more connectivity than in the past. There is a question whether the result will be primarily a complementary or a competing situation between cities in the Greater Pearl River Delta.

In this rapidly changing environment, two developments have emerged as especially powerful drivers of change for Hong Kong: the liberalization of Mainland outbound tourism, and the rise of Macau. The Mainland market has become an increasingly important source of visitors to Hong Kong following policy moves by the Central Government to lift restrictions on individual outbound travel. The Individual Visitor Scheme, launched July 28, 2003, for the first time allowed Mainland residents to visit Hong Kong on an individual basis, instead of having to travel on business visas or in groups.17 Under the IVS, Mainland tourist arrivals to Hong Kong roughly tripled within three years (see Exhibit 30). Mainland China’s market share of Hong Kong visitors rose from 9.8

17A similar scheme applies to Macau. Initially, the IVS for Hong Kong covered four Guangdong Province cities, Beijing and Shanghai. By mid-2006, 230 million people in 44 cities were eligible to travel to Hong Kong on IVS. From July 2003 to March 2006, more than 12.2 million Mainland visitors have already done so.
percent in 1987, to 11.5 percent in 1990, to 22.0 percent in 1995, to 32.4 percent in 2001, to nearly 53.7 percent in 2005.\textsuperscript{18}

\textbf{Exhibit 30.} Mainland China Visitor Arrivals to Hong Kong, 1985-2005, Thousands

\textbf{Sources:} Hong Kong Immigration Department; Hong Kong Tourism Board.

Another major development is the extraordinarily rapid rise of Macau as a regional destination. A decade ago, it would have been unthinkable that the Hong Kong tourism industry would regard Macau as a competitor. The former Portuguese colony had relied on its proximity to Hong Kong as a competitive strength, with the Hong Kong International Airport bringing in most of its long haul visitors from the US and Europe. Until the liberalization of its gaming industry in 2003, Macau had depended upon Hong Kong as its main source of visitors. Today, Macau is in the process of repositioning itself from a weekend getaway for Hong Kong tourists and punters to a world-class premier gaming-and-resort destination, a “Las Vegas of the East.” Major international casino developers including Las Vegas Sands, Wynn Resorts, MGM Mirage and PBL have obtained licenses to build high-profile, large-scale casino and integrated resort projects. Gaming contributes over 75 percent of government income, enabling a low tax environment for businesses and individual taxpayers, as well as providing a consistent resource pool for major government-funded

\textsuperscript{18} Hong Kong Tourism Board.
infrastructure projects, such as the East Asian Games sports venues and the upcoming monorail.

Once the major casino resort projects open in early 2010s, Macau will have supply-side advantages over Hong Kong in terms of hotel rooms and convention and exhibition venues. Exhibit 31 shows the exponential growth of hotel rooms projected to 2020, a supply trend that in 10 years’ time will exceed Hong Kong’s supply.¹⁹ The Venetian Cotai resort, projected to soft launch in 2007, will provide 100,000 square meters of convention space and 1,200 hotel rooms. Sheldon Adelson, chairman of the Venetian’s parent company Las Vegas Sands, has projected his resort alone will attract 35 to 40 million visitors a year to Macau. Exhibit 32 summarizes the major venues in Macau for corporate events, conventions and exhibitions.

Several implications flow from these developments. Competition in the MICE segment will be increasingly fierce and Hong Kong’s continuing status as a leading sourcing and headquarters hub will be key to its future. Hong Kong Disneyland and the revamped Ocean Park will be positives for Hong Kong, but not panaceas. The Individual Visitor Scheme (IVS) benefits Hong Kong, but also pressures Hong Kong’s capacities. In addition, many Mainlanders eventually will prefer long-haul destinations to Hong Kong. The emergence of Macau is already creating a drain on talent. A major question with respect to Macau is whether it will become an eventual competitor to Hong Kong or a “complementor” that serves to attract more visitors to the Greater Pearl River Delta region.

¹⁹ New hotel supply includes Rio Hotel (450 rooms, 2006), Grand Emperor Hotel (400 rooms, 2006), Wynn Resorts (600 rooms, 2006), Galaxy StarWorld (500 rooms, 2006), Grand Lisboa (600 rooms, projected 2006), Venetian Cotai Resort (3,000 rooms in phases, 2007-08), Ponte 16 (420 rooms, 2007), MGM Grand (600 rooms, 2007), City of Dreams (3,000 rooms, 2008), Park Hyatt (700 rooms, 2009) and other Cotai strip hotels at the Venetian resort complex (2010-12 in phases).
**Exhibit 31.** Hotel Rooms Projected by 2020, Hong Kong and Macau

Sources: Existing supply data from Macau Census and Statistics Service; projections compiled from media reports, individual casino developer statements and Research Report on Strategic Development of Convention & Exhibition Industry in Macau.

**Exhibit 32.** Major Convention and Exhibition Venues in Macau

<table>
<thead>
<tr>
<th>Venue</th>
<th>Available exhibition floor space and associated facilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Venetian Cotai (Projected completion 2007)</td>
<td>100,000 square meters, including an exhibition hall accommodating 15,000 people</td>
</tr>
<tr>
<td>Fisherman's Wharf</td>
<td>5,000 square meters, including a restaurant accommodating 2,750 people for seated dinners</td>
</tr>
<tr>
<td>Macau Tower Convention and Entertainment Centre</td>
<td>4,000 square meters, including a banquet hall accommodating 1,000 people for seated dinners</td>
</tr>
<tr>
<td>East Asian Games Dome</td>
<td>Two exhibition venues at 2,700 square meters and 3,000 square meters</td>
</tr>
<tr>
<td>Macau Forum</td>
<td>Two exhibition venues at 7,280 square meters and 755 square meters</td>
</tr>
</tbody>
</table>

Source: Macau Government Tourist Office.
Strategies and Policies

In the short term, it will be important for Hong Kong to continue to ride the surge in Mainland visitors resulting from China’s liberalized outbound travel policies. One argument for continued tourism promotion in the Chinese Mainland has been that with the high potential of outbound tourism from China, Hong Kong should invest in marketing efforts and take early action to build a brand name in China. In the longer term, Hong Kong should not count on obtaining the same share of China’s outbound travel as has been the case recently. As of March 2006, the number of countries approved for outbound tourism by the Mainland authorities reached 81, a significant increase from 2000 when only 14 countries were granted Approved Destination Status. Chinese tourists will have an increasingly wider variety of destinations to choose from. Thus despite rapidly growing total outbound tourism from China, Hong Kong will need to revise its strategies in the Mainland market if it is going to attract high-value tourism from the Mainland.

In terms of positioning, it will be essential for Hong Kong to find new ways to integrate and package the “Greater Pearl River Delta experience” for Mainland and overseas visitors. In particular, Hong Kong must explore complementarity with Macau. This suggests a multi-pronged strategy of promoting Hong Kong in its own right and also as part of the Greater Pearl River Delta, China, and Asia tours. Already visitors from China often combine Hong Kong and Macau on the same trip. Marketing the combination, or that Macau is only an hour or so away for the visitor to Hong Kong, could be one way to attract visitors. In addition, active promotion of Hong Kong in Macau itself will become increasingly important.

In order to capture opportunities from budget travel trends, the options for Hong Kong include reducing cost or carving out the mid-market segment. Another option is to focus exclusively on the premium market. To capture MICE-related opportunities, Hong Kong must preserve and extend its role as a sourcing hub and headquarters platform for multinational firms, while continuing to attract the headquarters activities of Mainland firms and maintaining Hong Kong’s status as the business and financial services hub of choice in the region.

Hong Kong faces several major challenges in setting the course of tourism policy. Currently, the Tourism Commission, set up under the Economic Development and Labor Bureau, is chiefly responsible for drawing up tourism policies for Hong Kong. Active engagement of related government departments, such as the Education and Manpower Bureau; the Environment, Transport and Works Bureau; the Housing, Planning and Lands Bureau; as well as the Leisure and Cultural Services Department, would be essential to fulfill the needs of the tourism sector. For example, the pace of construction of new sightseeing attractions has to be coordinated with upcoming events, such as the 2008 Olympics and the 2009 East Asian Games, as well as the completion of hotels, convention centers and road and rail links. Enhanced coordination among government departments will also be needed to ensure sufficient attractions,
improve cultural offerings, enhance the protection of heritage sites, resolve conflicting land uses, and tackle environmental issues.

Hong Kong is viewed as being short of tourism venues. The opening of Hong Kong Disneyland and the revitalization of Ocean Park have benefited the sector. Additional venues such as the West Kowloon Center, developments around Aberdeen, and a more accessible Hong Kong Harbor could help as well. With regard to Hong Kong Disneyland, it should be noted that in its first year of operation, Hong Kong Disneyland had 5.1 million visitors, very close to the 5.2 million projected back in 1999 for the first year of operation in documents provided to the Hong Kong Legislative Council. The worst publicity that Disney has received has been for underestimating crowds during “Golden Week.” While this was a public relations fiasco, it actually reflects commercial success, most businesses would love to be oversold and to have patrons climbing the fences to get in. It should also be noted employment in the “Amusement and Recreation” sector in Hong Kong went from 14,677 in Q3 of 2001 to 38,185 in Q3 of 2006, an increase of 23,508,20 most of this likely to be due to Hong Kong Disneyland.

It is an ironic problem that while competitors struggle to provide high quality training in tourism and hospitality staff, Hong Kong’s labor and talents are so well trained that they have become the target of poaching and talent importation policies in Macau and Mainland China. The Chinese University and the Polytechnic University, which train management talents for the tourism sector and provide research and development assistance to tourism marketing in Hong Kong, should continue their close cooperation with the Vocational Training Council, as well as related government entities in tourism policies and education and manpower, in order to map out the labor needs in the region and find ways to meet them.

Overall, there is a wide divergence of opinion within the industry regarding what should be Hong Kong’s ideal mix of various markets, and whether Hong Kong should further diversify and offer new products, or should the tourism sector specialize in only the premium market and forgo other segments to competitors. The government should consider working with the travel industry to formulate a more coordinated strategy and vision in this respect.

**Conclusions**

Hong Kong’s tourism industry is on track for continued growth. Greatly increased outbound travel from the Chinese Mainland will benefit Hong Kong, but will also create stresses. A major question with respect to the Mainland market is whether Hong Kong needs to focus on the mass market, quality segment, or both. There are also questions about how much hotel capacity will be needed in different segments, as well as occupancy rates and prices. Macau’s rise will increase competition in some parts of the industry, MICE in

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20 Hong Kong Census and Statistics Department.
particular, while bringing more visitors into the region as well. In this respect, Macau will be both competing and complementary to Hong Kong.

For the tourism industry as a whole, it is a reasonable premise that Hong Kong should seek a balanced market mix of the Chinese Mainland, the rest of Asia-Pacific, North America, and Europe. However, for overseas markets, the traditional rationales for visiting, such as shopping, dining, and the “China experience,” are declining. Visits to Hong Kong as part of larger tours to the Greater Pearl River Delta region are still not particularly important, but have the potential to promote Hong Kong as part of the “China experience” and to promote Hong Kong and Macau as a combined destination.

For all market segments, Hong Kong must resolve land use conflicts between economic development, heritage preservation, building MICE venues, and affordable hotels, among other functions. Pollution also is becoming a major issue for Hong Kong’s tourism sector as Hong Kong becomes known as a polluted city. In addition, tourism is an industry that is particularly susceptible to external shocks. The potential for bird flu or another health crisis is also a cause for concern.

Hong Kong’s future as a tourism hub will depend on its ability to capture flows of people, capital, goods, and ideas. Over the years, strong local airlines have promoted Hong Kong as a tourist destination. However, lack of competition in the aviation sector means fewer flights to and from Hong Kong than might otherwise be the case and with visitors potentially paying artificially high prices. It will be important to liberalize Hong Kong’s air-traffic regime to encourage more airlines to come to and through Hong Kong.
The Hong Kong Software Industry

The software industry is composed of the development, production, and sales of software products and services. Three main product types are Operating Systems (Windows, Linux etc.), Programming Tools (C++, Visual Basic, Java Development Tools), and Applications (Enterprise, Business, and Desktop software). Enterprise software integrates the business functions and finances of the firm into one system. Business software usually provides specific functional support for company departments. Desktop software is designed for use on an individual home or corporate desktop computer. Software services are split into Software Architecture Design (consulting with clients to understand needs and then design software accordingly), Software Production (writing the software code), Software Installation (product delivery, installation, configuration, debugging, and testing), Software Maintenance (system maintenance to insure smooth operation), and Software support (vendor provided support for users).

Industry Structure and Performance

Hong Kong’s software and software services industry is small in international terms, accounting for approximately 0.2 percent of world sales, lower than leading economies as well as cities such as Singapore and Shenzhen. Hong Kong’s software sector grew rapidly in the 1990s, but has stagnated in the 2000s. Hong Kong’s industry is largely domestically oriented, providing upgrading and maintenance rather than filling new market needs. Hong Kong’s total domestic exports of computer software totaled US$156 million in 2005, 36 percent of which was to the Chinese Mainland, 31 percent to Japan, 26 percent to the United States, and 7 percent to other countries or regions. Hong Kong’s exports have been falling since 2003. Hong Kong’s total imports of computer software totaled US$247 million in 2005, 31 percent of which were from the Chinese Mainland, 18 percent from the US, 13 percent from Singapore, and 38 percent from other countries and regions.

According to a Vocational Training Council survey issued in 2004, there were a total of 62,098 persons working in IT activities across all industries in Hong Kong. Software vendors had the largest number of employees for a single sector (16,802 or 27 percent), though wholesale, retail, import/export, restaurant, and hotels (22 percent), and financing, insurance, real estate, and business services (22 percent) together accounted for far more IT employees than software vendors.21 According to the Hong Kong Census and Statistics Department, the 4,300 companies in IT and Related Services (HSIC Code 8333) in 2004, employed 19,424 staff.22 Ninety-two percent of the companies had 10 or fewer employees and these companies accounted for only 10 percent of total revenue for the sector.

22 2004 data, Hong Kong Census and Statistics Department, 2006.
The vast majority of Hong Kong firms in the sector provide software support services. In terms of products, Hong Kong companies are for the most part not active in the development of OS or Programming Tools but are active in deploying application software developed by foreign firms and developing and deploying home grown applications. Many Hong Kong software companies got their start as local distributors, implementers, and service agents for foreign software houses in the 1980s and 1990s. Other Hong Kong companies started by providing products and services directly to local companies and the Hong Kong offices of foreign firms. One of the earliest was TA Consultants which specializes in IT banking solutions.

Major international software companies use Hong Kong as a regional headquarters; and a marketing, distribution, and service location; not for research and development. Of the 20 foreign IT companies profiled on the Invest Hong Kong website as having relocated to Hong Kong since 2001, the vast majority chose Hong Kong as a sales and support base for Asia-Pacific operations. Two set up a global headquarters in Hong Kong and 11 set up a regional headquarters. Only two of the 20 referred to research and development as an activity they would carry out in Hong Kong. Hong Kong is not really a competitor in the international offshoring or outsourcing sector. In fact, many companies have moved some of their software activities into the Chinese Mainland. Comparisons with selected economies are given in Exhibit 33.

**Competitors**

Competition in the software sector varies by segment. Many software products are supplied by a limited number of companies from advanced nations, most notably the United States. At the other extreme, some types of software service provision are local in nature, and will tend to be dominated by local firms or local offices of foreign firms. Since the bulk of Hong Kong’s industry is in the latter category, one would expect competitors in the region to be primary on the radar screens of Hong Kong firms.

From our research and interviews, the leading competitors for Hong Kong’s software sector are Guangdong Province, the rest of China, Singapore, Taiwan, India, Korea, and Australia. Although the Indian software sector is well-known for its offshoring and outsourcing business, China’s software sector, which is largely focused on the domestic market, is larger than India’s by a significant margin. By 2004, China’s domestic market for software was 18 times that of Hong Kong and its export sales were 8 times those of Hong Kong. Shenzhen’s software sector passed that of Hong Kong in both domestic and export revenues in 2002. By 2004, Shenzhen’s software products and services sector had 7 times the employees, 4 times the revenue, and 5 times the export sales of the Hong Kong sector. In the mid-2000s, Shenzhen’s software sector was growing on the order of 40 percent per year, while Hong Kong’s sector was hardly growing at all.

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23 *Hong Kong IT Client Profiles, www.investhk.gov.hk.*
**Exhibit 33:** Scale of Software Product and Services Industry in Selected Countries and Regions

<table>
<thead>
<tr>
<th>Country/Region</th>
<th>Number of Employees</th>
<th>Total Revenue (US$ Million)</th>
<th>Exports Revenue (US$ Million)</th>
<th>Exports as Percentage of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>1,433,721</td>
<td>285,433</td>
<td>24,267</td>
<td>9</td>
</tr>
<tr>
<td>India</td>
<td>±742,000</td>
<td><strong>14,800</strong></td>
<td>10,000</td>
<td>68</td>
</tr>
<tr>
<td>Singapore</td>
<td>±29,160</td>
<td><strong>5,113</strong></td>
<td><strong>2,921</strong></td>
<td>57</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>19,424</td>
<td>1,883</td>
<td><strong>359</strong></td>
<td>19</td>
</tr>
<tr>
<td>Shenzhen*</td>
<td>140,000</td>
<td>7,000</td>
<td>1,800</td>
<td>26</td>
</tr>
<tr>
<td>China (Excl. HK)</td>
<td>720,000</td>
<td>34,747</td>
<td>2,800</td>
<td>8</td>
</tr>
</tbody>
</table>

**Notes:** All data for the Year 2004 unless otherwise stated, * 2005 data, ** Revenue prepared from aggregated data, ± Employee figures contain some proportion not strictly related to software.

**Source:** Data collected from national and regional Government statistical record for software products and services.

**Exhibit 34:** Annual Salary Levels of Software Industry in Selected Countries and Regions, HK$

<table>
<thead>
<tr>
<th>Title</th>
<th>Experience</th>
<th>Hong Kong</th>
<th>Singapore</th>
<th>Shanghai</th>
<th>Shenzhen</th>
<th>India</th>
<th>Japan</th>
<th>UK</th>
<th>US</th>
<th>Paris</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO</td>
<td></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>VP</td>
<td>15 years</td>
<td>1.9M-3.1M</td>
<td>2.8M</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>1.5M-1.8M</td>
<td>1.6M-3.3M</td>
<td>1.0M-1.4M</td>
<td>1.4M-1.9M</td>
</tr>
<tr>
<td>Director</td>
<td>10+ years</td>
<td>900K-1.4M</td>
<td>700K-940K</td>
<td>480K-960K</td>
<td>360K-600K</td>
<td>-</td>
<td>1.3M-1.6M</td>
<td>1.2M-2.0M</td>
<td>900K-1.0M</td>
<td>800K-1.2M</td>
</tr>
<tr>
<td>Project Manager</td>
<td>10 years</td>
<td>700K-1.1M</td>
<td>470K-700K</td>
<td>300K-480K</td>
<td>240K-480K</td>
<td>83K-150K</td>
<td>1.0M-1.2M</td>
<td>940K-1.2M</td>
<td>550K-780K</td>
<td>700K-1.2M</td>
</tr>
<tr>
<td>Senior Programmer</td>
<td>6+ years</td>
<td>400K-700K</td>
<td>300K-410K</td>
<td>100K-250K</td>
<td>120K-240K</td>
<td>72K-150K</td>
<td>850K-1.0M</td>
<td>870K-1.0M</td>
<td>470K-700K</td>
<td>460K-560K</td>
</tr>
</tbody>
</table>

**Sources:** Hudson; Robert Walters; Janco Associates; ComputerWorld.com; CareerJournal.com; Kelly Services.
Singapore’s software sector had 2.7 times the revenue and 1.5 times the staff of Hong Kong’s in 2004. Exports accounted for 57 percent of revenue in Singapore compared with Hong Kong’s 19 percent. Singapore holds the Asia Pacific headquarters for several foreign multinational software firms and has become a regional research and development center for foreign software firms. Other competitors in the region include Taiwan, Korea, and Australia.

**Advantages and Disadvantages**

Hong Kong has some advantages when it comes to the software sector. According to industry participants, Hong Kong’s access to information, communication infrastructure, the banking and financial system, geographic location, and the tax and trade regimes are advantages for the industry. Various aspects of government policy were also considered advantages, including intellectual property protection vis-à-vis the Chinese Mainland (Exhibit 35). Hong Kong’s overall situation for the utilization of software is considered excellent. Hong Kong has been ranked 10th globally and 2nd in Asia-Pacific in terms of e-business readiness, 5th globally in the Digital Opportunity Index, 11th globally in the Network Readiness Index, and 11th globally in the Information Society Index.

Hong Kong was also viewed as having significant disadvantages (see Exhibit 36). The main disadvantage was in terms of cost. Hong Kong’s costs were viewed as too high to support international outsourcing or offshoring, or other price sensitive segments of the market. The Hong Kong market was not viewed as large enough to support investments in product development. Hong Kong’s education, skills, technical capabilities, availability of trained personnel, and research organizations were not viewed as comparable to major competitors in advanced countries. Nor did industry experts believe that Hong Kong’s disadvantages were likely to change any time soon. In essence, this is a sector in which Hong Kong’s costs are too high to compete in the low end and its skills and market insufficiently developed to compete in the high end. The result is a focus on niche service markets in the local economy.

While many Hong Kong companies have hoped to target the Chinese Mainland market for software, it has proven difficult. Hong Kong companies find it difficult to compete in the China market against Chinese companies and operations at the low end, and against the Chinese and foreign operations of major multinational companies at the high end. Government preferences and software company subsidies in China are seen as obstacles to entry.

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24 Singapore’s employment covers “Software & Application” staff only and thus excludes non-technical staff that would be included in the Hong Kong’s statistics such as Sales & Marketing, and Administration, among others.
25 Economist Intelligence Unit, 2006.
Exhibit 35. Hong Kong Software: Advantages

MACRO-LEVEL DRIVERS
- Tax regime
- Regulatory and legal framework
- Cleanliness of government
- Political stability
- IP protection

MESO-CLUSTER-LEVEL DRIVERS
- Transportation and communications infrastructure
- Local managerial skills
- Access to information
- Pockets of advanced demand
- Related industries (banking and finance, insurance, legal, export trading)
- HK’s strengths as headquarters hub

SUPRAREGIONAL-LEVEL DRIVERS
- China market potential

MESO-CLUSTER-LEVEL DRIVERS
- Property or land related costs
- Staff costs and other costs
- Size of local market demand
- Sophistication of local demand
- Research organizations
- Availability of capital
- Education & training institutions

INDUSTRY-LEVEL DRIVERS
- Some cooperation through associations
- Government outsourcing policy

FIRM-LEVEL DRIVERS
- Some entrepreneurial firms
- Some firms with international niche capabilities

Source: Enright, Scott & Associates Ltd.

Exhibit 36. Hong Kong Software: Disadvantages

MACRO-LEVEL DRIVERS
- Small population base
- Higher rates of economic growth in Mainland
- Restrictive manpower policy

SUPRAREGIONAL-LEVEL DRIVERS
- Growth of competing sectors in other economies
- Proximity of Mainland software development
- Targeting of software by other governments
- MNCs strategy of placing software development elsewhere

MESO-CLUSTER-LEVEL DRIVERS
- Property or land related costs
- Staff costs and other costs
- Size of local market demand
- Sophistication of local demand
- Research organizations
- Availability of capital
- Education & training institutions

INDUSTRY-LEVEL DRIVERS
- Limited collaboration potential

FIRM-LEVEL DRIVERS
- Strategies focused on service of local clients
- Inability to develop products for international markets
- Inability to penetrate Mainland market

Source: Enright, Scott & Associates Ltd.
Developments and Implications

The global software industry is separating into high-low sectors with the most advanced (i.e. US, UK and Western Europe) and low wage nations (India and China) dominating. The US, for example, is the creative center for most new software and service products, possesses an experienced and capitalized venture capital sector, has a large experienced talent pool, a large domestic market in which to initially launch products, and the marketing experience to launch products and services internationally. The international software and business process outsourcing industry has developed over the last 15 years without major participation from Hong Kong. India and China on the other hand possess a low wage workforce that can produce software code and services to order. Hong Kong is caught between competitors with greater capabilities and/or lower costs and much larger markets.

Hong Kong has not developed a plausible intermediary role for the Chinese Mainland in the software sector as it has in many others. The Mainland sector is still mostly domestically focused. Foreign multinationals are going directly to the Chinese Mainland for software development. Offshoring and outsourcing in the Chinese Mainland takes place largely independently of Hong Kong. On the other hand, Hong Kong has been a convenient place for foreign software companies to set up Asian headquarters as well as marketing, and distribution, and some Mainland companies have set up Hong Kong offices to help them internationalize their business.

The bulk of Hong Kong’s software professionals either work inside companies in other sectors or provide software services for other sectors. This is not surprising given that many of Hong Kong’s financial, business service, transportation, and headquarters activities are sophisticated users of software. However, Hong Kong companies, offices, and software vendors are increasingly sending internal software development and computer processing abroad to take advantage of cost savings and/or better skill sets. This is true despite concerns about IP protection and other issues elsewhere.

Increasing competition from Shenzhen and China in general even for Hong Kong-based customers places substantial pressure on starting salaries in the sector in Hong Kong. In recent years, for example, starting salaries of Computer Science graduates at the University of Hong Kong have been lower than the average salaries of all graduates (see Exhibit 37). From our discussions with employers and academics, the comparatively lower wages offered in programming and the threat of Hong Kong software companies outsourcing junior programming work across the border is pushing computer science graduates to move into other more secure and profitable fields. The quality of the graduate talent pool is also declining as the brightest students are choosing to study more marketable subjects. The market is speaking and trying to educate more computer scientists will not reverse the verdict.
Exhibit 37. Graduate Monthly Starting Salary, HK$

<table>
<thead>
<tr>
<th>Year</th>
<th>Average Graduate</th>
<th>Average Computer Science Graduate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>1996</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>1998</td>
<td>$4,000</td>
<td>$4,000</td>
</tr>
<tr>
<td>2000</td>
<td>$6,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>2002</td>
<td>$8,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>2004</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>2006</td>
<td>$12,000</td>
<td>$12,000</td>
</tr>
</tbody>
</table>

**Source:** University of Hong Kong, Annual Graduate Statistics.

**Strategies and Policies**

The main strategies of software companies operating in Hong Kong are clear. The vast majority of software professionals in Hong Kong are working as in-house resources for other sectors of Hong Kong’s economy or as service providers providing software-related services to other sectors of the economy. A few Hong Kong firms have developed niche products and services that they are able to take successfully into international markets. The bulk of the foreign multinational software companies present in Hong Kong use the HKSAR as a headquarters, sales, and distribution center, not a center for software development or research. Hong Kong packaged software almost does not exist as a segment.

The existing strategies are likely to be the most viable strategies in the future. Hong Kong has large sophisticated users of software among its financial services, business services, headquarters, and transportation operations. These need high-quality software support to thrive and they create an active market for local software support. The ability to serve these customers and develop niche capabilities in the process provides the best opportunity for Hong Kong companies and offices to go international. The most likely customer bases around which such niches could be developed in Hong Kong are government, finance, trade, logistics, or entertainment.

Although it may prove difficult to do so, finding ways of leveraging the Hong Kong-Pearl River Delta combination with software architecture in Hong Kong
and programming in Shenzhen could be one path for developing the sector for the China and the international market. Software programming is a labor intensive industry, be it a skilled one, and so benefits most from cheap skilled labor. There are challenges, however, with managing Mainland staff and controlling IP theft, though this is perhaps less a problem for service-oriented companies as opposed to product-based companies. One extension of this type of strategy is to attempt to become an interface between the Chinese software sector and the rest of the world for software and business process offshoring and outsourcing. China’s offshoring and outsourcing sector is not as well-developed today as India’s and there are opportunities to provide an interface role from Hong Kong.

The Hong Kong Government has instituted several policies that have an impact on the software sector. While Government initiatives have put in place various measures to stimulate Hong Kong’s IT industry with some success, this has not translated into a strong and outward looking software industry, with only a few domestic companies of note active in the international arena.

The Digital 21 Strategy focused on improving Hong Kong’s IT infrastructure, e-Government, skills training, government outsourcing of IT, IT talent import, and funding of IT industry startups and research and development. As mentioned above, Hong Kong’s IT infrastructure is outstanding. Outsourcing of Government services has benefited local software companies, enabling them to earn revenue, while improving their skills and services. Due to the complexity and scale of some of these projects, international vendors have had more success in winning these projects than local companies. Despite the skills program for talent import, Hong Kong companies and offices note that it can still be “a very painful process” to transfer skilled Mainland staff to Hong Kong, or to have an essential Mainland engineer or programmer to come to Hong Kong to solve a problem, something that can take weeks to clear. These restrictions reduce Hong Kong’s ability to benefit from skilled Mainland talent and to serve as a base for Mainland companies seeking to access world markets. They also add to the costs of doing business.

The Cyberport was designed to create a strategic cluster of more than 100 IT companies with employment of 10,000 staff. As of early 2007, there were 71 companies based at Cyberport, of which 22 were technology companies. Twelve of those were software companies. The majority of the technology and software companies on site are involved in sales and marketing activities, not research and development. Foreign companies have not located their overseas research and development centers at Cyberport, preferring India and China, which offer large market access, large numbers of semi-skilled personnel, and far cheaper labor. The highly subsidized rents have had no noticeable impact on Hong Kong’s technology or software capabilities. The entire Cyberport project is largely viewed as a property development, as the high rise apartment space dwarfs the occupied office space. A recent visit to the shopping center at the Cyberport revealed no shops selling computer supplies, but two shops selling wedding dresses.
Hong Kong Technology and Science Parks have locations around Hong Kong that offer cheap simple accommodation for Hong Kong start-up technology companies. The Science Park at Sha Tin currently has 13 start-ups involved in software development out of 78 tenants. A total of 103 IT and telecommunication companies have passed through HKTSP’s incubator program since 1993. No major companies have yet emerged, though some like Titanium Technology Limited and Asia Vision Technology have attracted private funding and have secured orders from the Hong Kong Government, large corporations, and international clients. This appears to have been a more realistic and cost effective approach to supporting IT entrepreneurship, though again its impact on Hong Kong’s economy has been minimal.

Hong Kong’s intellectual property laws get relatively high marks, though piracy rates for software in the HKSAR are still estimated at 54 percent overall.\textsuperscript{29} Better control over piracy would help encourage the domestic software industry as well as give faith to software MNCs that Hong Kong is a progressive and modern economy that accepts the economic value of IP.

Going forward, there is a role for government institutions in ensuring sufficient levels of IT education and training, but mostly for internal use in other industries rather than for standalone software companies. Policy should focus on software skills and capabilities as an important support to other parts of Hong Kong’s economy, not as potential world-beaters in their own right. While Hong Kong has produced some international software products, the main value provided by software professionals in Hong Kong comes from the supporting role IT brings to Hong Kong business. A wealth of software skills is needed to ensure the smooth operation of Hong Kong’s leading sectors. Given the fact that Hong Kong people are shying away from the software sector, there is a need to streamline the foreign and Mainland talent import system. It is not clear that ramping up IT education in Hong Kong is going to do the trick.

There is also a role in promoting Hong Kong as a center for sophisticated customers of software and software services. The financial, professional services, and HQ sectors are users of some fairly advanced IT products and services, supported by a range of experienced MNC and local software vendors. Software companies will be attracted to Hong Kong and new start-ups will form if there is a sufficient critical mass of advanced customers in the HKSAR. Support of the sector from such companies is far more beneficial than support from government.

Hong Kong should actively attract strong Mainland software companies to set up international offices in Hong Kong. The Chinese Mainland already has a large market with the scale and cost base necessary to become a real generator of IT products and services. At present, China’s international position in software is quite limited. Attracting the international offices of Mainland firms could give Hong Kong a position as a launching pad for

\textsuperscript{29} BSA and ISC Global Software Piracy Study, Business Software Alliance, May 2006.
marketing and exporting Mainland software and services to the rest of the world.

Government should learn that the software sector does not need Cyberports. Foreign companies are not placing research and development activities into Hong Kong even with subsidized rents. Start-ups do not require such gilt-edged facilities. Ironically, rezoning old industrial buildings for software start-ups would probably have had a bigger impact on the sector than Cyberport.

**Conclusions**

Hong Kong’s software sector is fundamentally local in nature, providing niche products and providing services for Hong Kong companies, Hong Kong offices of foreign companies, and Hong Kong government agencies and other institutions. Hong Kong’s costs, skill levels, and small market make it difficult for Hong Kong firms to move from local services to international products. In essence, Hong Kong gets caught between competition from low-wage locations and high-skill locations and is unlikely to make much headway in either direction.

The market is speaking and it is speaking loudly. Hong Kong firms are moving more and more of their software development and programming out of Hong Kong, graduates in the sector are getting low wages or looking to other occupations, and projects like Cyberport have had little impact. Even sizeable government subsidies appear to make little difference.

Hong Kong is much more competitive as a marketing, sales, distribution, and regional headquarters location for software companies than as a software development location. While there are always niche products and services that Hong Kong firms may develop and exploit in local and/ or international markets, the idea of software becoming a major driver of Hong Kong’s economy does not seem reasonable in the medium-term. The China market will not be a panacea for Hong Kong software companies as Mainland skills improve and costs remain much lower than in Hong Kong.

The software sector should be viewed, and valued, as an important supporter of the key sectors of Hong Kong’s economy, but is unlikely to be a driver of economic growth and development in its own right. This is actually similar to what happens in many major economies around the world, where the software sector in major cities is primarily a local support sector. It is the second tier cities that become the home of larger scale software product and service providers.
The Hong Kong Biopharmaceutical Industry

Many people in Hong Kong discuss the biopharmaceutical industry as a potential industry for the future in Hong Kong, but few understand the nature of the industry. Globally, there have been only around 30 successful biopharmaceuticals (defined as drugs based on recombinant DNA genetic engineering) introduced world-wide in the 40 years since the first patents for genetic engineering technology were issued. Among these 30 biopharmaceuticals, only a handful account for the lion’s share of sales. One of the best kept secrets of the biotechnology sector as a whole (which includes a wide range of products in addition to biopharmaceuticals), is that it runs a massive deficit. The biotechnology sector has never turned a profit as a sector. Instead, it continues to run deficits of several billion US dollars per year as research and other expenses outstrip revenues. In 2005, global revenues in all areas of biotechnology in public companies reached roughly US$63 billion, while net income reached a negative US$4.3 billion.\(^\text{30}\)

Today, there are a number of related segments to biopharmaceuticals, such as diagnostics, biochips, bioinformatics, clinical testing, and contract manufacturing, which are much more accessible for newcomers. However, this is not what most proponents of public investment in the biopharmaceutical sector are talking about when they advocate public support. When the details of the sector are known, and Hong Kong is compared with the existing and potential competitors, the inescapable conclusion is that Hong Kong should best invest its resources elsewhere.

Industry Structure and Performance

The entire drugs and medicines manufacturing sector consisted of 236 establishments and 2,864 employees in Hong Kong in 2005. In comparison, there were 979 companies and 5,280 people employed in drug and medicine import and export. Hong Kong’s domestic exports of all medicinal products were HK$1.4 billion in 2005.\(^\text{31}\) It should be noted that the 236 firms, 2,864 employees, and HK$1.4 billion in exports covered the entire drugs and medicines manufacturing sector, the vast majority of which were accounted for by traditional Chinese medicine products, or chemically based generic drugs, not biopharmaceuticals. There are approximately 150 “biotechnology-related” companies in Hong Kong, including 70 listed on the GEM Board, but these include medical devices, diagnostics, and drug precursor companies, and many have their primary business activities in the Chinese Mainland.\(^\text{32}\) It is hard to find even a handful of examples of pharmaceutical companies in Hong Kong that have a significant business based on innovation and their own drug development in the HKSAR.

\(^{30}\) Ernst & Young, Beyond Borders: A Global Perspective, 2006.

\(^{31}\) Hong Kong Census and Statistics Department.

\(^{32}\) Hong Kong Innovation and Technology Commission.
Support structures for the biopharmaceutical sector in Hong Kong include the Innovation and Technology Fund (which made grants of HK$190.1 million to 77 projects across all areas of biotechnology from 1999 to September 2006), the University Grants Commission (which awarded HK$145 million to 138 projects spread across all areas of biological sciences and medicine in 2004-2005), the Research Fund for the Control of Infectious Diseases (established in 2003 with funding of HK$450 million), the Hong Kong Science and Technology Parks Corporation (which had 15 tenants in biotechnology and related fields in 2006), the Hong Kong Biotechnology Association (established in 1999 to provide information and support for the sector), the Hong Kong Institute of Biotechnology (a non-profit established in 1988 under the auspices of Chinese University of Hong Kong that has facilities for research and small scale production of biotechnology products), and the Biotechnology Research Institute (at the Hong Kong University of Science and Technology which has been funded through the Innovation and Technology Support Fund and the Hong Kong Jockey Club).33

**Competitors**

The biopharmaceutical business is a global business. It does not depend on preferential access to a particular market, such as China. As such, the competitors are from all over the world. The leading global competitors in the biopharmaceutical business are the United States, the United Kingdom, the rest of Europe, and Canada. In the Asia-Pacific, Australia, New Zealand, and Japan are active, though they are far behind the Western leaders. Other Asian economies, such as India, China, Taiwan, Korea, and Singapore are investing in the sector, though none of these has shown the ability to develop brand new drugs to date.

In terms of biopharmaceutical drug discovery, the United States is by far the world leader, with the UK and the rest of Europe next. While it is difficult to obtain precise figures on biopharmaceutical sales, the United States accounted for 75.6 percent of global “biotechnology revenues by public companies” in 2005. Europe as a whole accounted for 15.5 percent, Canada 4.1 percent, and all of Asia-Pacific (including Australia and New Zealand) 4.8 percent.34 In the United States, nine centers dominate the biotechnology sector. These include: Boston, San Francisco, New Jersey, the area around Philadelphia, Raleigh-Durham, San Diego, Seattle, Washington-Baltimore, and Los Angeles. A 2002 Brookings Institute report found that these nine centers were extending their lead despite the fact that 41 of 50 states and 83 percent of local economic development organizations in the United States claimed to have very active biotech support programs. The nine centers contained:35

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33 Hong Kong Innovation and Technology Commission, Hong Kong Biotechnology Association, Hong Kong Institute of Biotechnology, Biotechnology Research Institute.
• 75% of top US research universities
• 62% of US National Institute of Health biotech funding (2000)
• 68% of US biotech patents (1990-99)
• 77% of US new biotech firms (1991-2001)
• 77% of US biotech companies with >100 employees (2000)
• 81% of US members of BIO (2001)
• 82% of US biotech IPOs (1998-2001)
• 85% of US biotech market capitalization (2001)
• 88% of US biotech venture capital (1995-2001)
• 94% of US active biotech venture capital firms (1995-2001), and

On average, the leading centers had several world-class research centers, graduated more than 200 biological sciences PhDs per year, obtained US$800 million per year in government research grants, received US$300 million in biotechnology venture capital per year, generated US$600 million per year in research funding from existing firms, received US$300 million per year in biotechnology research contracts, and had been active in the sector for more than 20 years. This sums to over US$2.2 billion per location per year for locations that have been receiving this level of funding for many years. Even in the most successful biotechnology locations in the US, no biotechnology firm is in the top 25 in local employment and the average of all biotechnology and biotechnology-related industries provide only an average of 3.5 percent of local employment.36

Japan, long known as a world leader in high-technology industries, is a virtual non-presence in the biopharmaceutical sector. Only a handful of biopharmaceutical startups in Japan have ever progressed to the IPO stage, and none has a successful product on the market. Japan has put together a cabinet level group to create a biotechnology strategy and is pouring increasing amounts of money into developing biopharmaceutical clusters in Tokyo, Osaka, Kyoto, and elsewhere. However, limited links between government programs, universities, and the existing pharmaceutical sector have made progress slow. In addition, incentive structures in universities, which until recently made cooperation with the private sector difficult or impossible, have stunted development in the sector. The vast majority of funds invested by large Japanese conglomerates and financial investors in the biopharmaceutical sector have been in the United States.

In Asia, India has developed an interesting position in biopharmaceuticals. India has long had a sizeable pharmaceutical sector that was initially driven by the fact that India did not respect the product patents of foreign pharmaceutical firms. India developed a large industry that produced generic versions of drugs first patented elsewhere in the world. As biopharmaceutical products began to appear in the 1980s, Indian firms set out to reverse engineer their production processes to develop their own versions. In the mid-1990s, as India began to adopt intellectual property rules more similar to

those in more advanced economies, the biopharmaceutical focus shifted to creating generic products that were coming off patent, and so could be sold in India and exported as well. In the mid-2000s, India’s leading biopharmaceutical firms still have the vast majority of their business in generic copies of drugs first introduced by foreign companies. They also concentrate on contract manufacturing, diagnostic agents, and cooperating in conducting clinical trials. The sector is a mix of companies that began as chemical based pharmaceutical companies, biopharmaceutical startups, and offshoots from foreign firms. Many of the world’s leading pharmaceutical companies have set up research alliances in India.

China has a similar history in that its local pharmaceutical industry has been largely based on generic copies of foreign pharmaceutical products. However, China is behind India on several dimensions. China has yet to see the development of companies like Ranbaxy, that sell generic pharmaceuticals worldwide, or Biocon, India’s leading biopharmaceutical company. While it is still early days for China’s biopharmaceutical sector, the major international pharmaceutical companies, and foreign research institutes, are setting up alliances in the Chinese Mainland to be able to directly tap developments on the Mainland.

Singapore, Taiwan, and Korea are investing large amounts of money on the biopharmaceutical sector. Singapore has set up its “Biopolis” science park, has attracted activities from a number of overseas institutes and universities, and has recruited top scientists from the United States, Europe, and elsewhere in Asia to run research groups and institutes. Singapore also builds from its position as a favored manufacturing location for major international pharmaceutical companies for their traditional products. Taiwan has targeted the biopharmaceutical sector as the “next electronics” sector for its economy. This has involved multi-tiered funding of research institutes, special policies at its industrial and science parks, and additional funding for its universities researching in the area. Taiwan hopes to benefit from close ties between its institutes and those in the United States, many of which have many Taiwanese on staff. Korea has also targeted the sector for future development. The most noted, and notorious, developments have surrounded the falsification of research data on cloning. Despite the large investments being made, industry experts believe that Singapore, Korea, and Taiwan are not likely to achieve the critical mass and complete biopharmaceutical sector development necessary to become significant players beyond niche markets, contract manufacturing, some generic development, and trials. Even here, they are likely to face competition from China and India.

**Advantages and Disadvantages**

Hong Kong does not have advantages in technology related to biopharmaceuticals. Patenting in the United States, the world’s biggest market, is often used as a proxy for technological capabilities. There is no single patent category that covers biopharmaceuticals per se, but the closest
categories for US patents are “Drug, Bio-Affecting and Body Treating Compositions” and “Molecular Biology and Microbiology.” As can be seen in Exhibits 38 and 39, Hong Kong’s position in patenting in these categories does not come close to the world’s best. In the former category, Hong Kong is far behind Japan, South Korea, India, Australia, Taiwan, China PRC, New Zealand, and many others, but ahead of Singapore (ranked 34). In the latter category, Hong Kong is behind Japan, South Korea, India, Australia, and Taiwan, but ahead of China, New Zealand, and Singapore. In terms of costs for scientists, Hong Kong’s costs are lower than in the United States, Europe, and Japan, but higher than elsewhere in Asia (see Exhibit 40).

Against the world’s leading biopharmaceutical nations and regions, Hong Kong has few if any advantages (see Exhibits 41 and 42). It does not have the critical mass of capabilities found in advanced biopharmaceutical countries and regions. It does not have the critical mass of funding found elsewhere (which dwarfs that even contemplated for the sector in Hong Kong). It does not have the resources of a large nation focused on its biopharmaceutical sector. It does not have an existing research-based pharmaceutical sector to fund research and development, oversee the expensive (on the order of US$300 million or more per product) and cumbersome clinical trials process, or distribute and market products effectively. It does not have an extensive network of venture capitalists with long experience in the sector to match money, technology, and management. It does not have an incentive structure in the universities that fosters commercializing the products of research. Since competition for drug discovery is global, drug discovery efforts in Hong Kong face direct competition from the world’s best economies and companies.

Hong Kong has no particular advantages versus other players in Asia, such as Singapore, Taiwan, Japan, and Korea. Japan and Korea can and will devote far more resources than Hong Kong can bring to bear. Singapore and Taiwan have active pharmaceutical sectors of their own, even if they are branch plant manufacturing sectors (in the case of Singapore) or locally oriented (in the case of Taiwan). All have either a longer history or have invested more resources in the sector. Moreover, it is not clear that any of these other locations, Singapore, Taiwan, Japan, or Korea, can become centers for biopharmaceutical drug development.

Hong Kong may have advantages in terms of quality of medical research, intellectual property protection, access to information, an internationally-oriented financial sector, and the ability to attract expertise when compared to China, or perhaps India. However, these locations have far lower costs, their larger markets make them more attractive to trade research for access, their existing pharmaceutical sectors provide a basis for further development, their large numbers of scientists cannot be matched in Hong Kong, and their large populations make them more attractive places for clinical trials. In addition, the world’s leading pharmaceutical firms are already making direct links with institutes and universities in these countries without the need for intermediation from Hong Kong entities. Finally, high quality medical research is not the same as research that creates new drug discoveries.
### Exhibit 38. US Patents in Class 424, Drug, Bio-Affecting and Body Treating Compositions, 2001-2005, by Location of Inventor

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country/Region</th>
<th>Patents</th>
<th>Rank</th>
<th>Country/Region</th>
<th>Patents</th>
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<td>3</td>
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<td>Taiwan</td>
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**Source:** US Patent Office.

### Exhibit 39. US Patents in Class 435, Molecular Biology and Microbiology, 2001-2005, by Location of Inventor

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<tr>
<th>Rank</th>
<th>Country/Region</th>
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<th>Rank</th>
<th>Country/Region</th>
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<td>Switzerland</td>
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<td>India</td>
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<td>Taiwan</td>
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<td>Italy</td>
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**Source:** US Patent Office.
Exhibit 40. Total Remuneration in US$, Senior Biotechnology Scientist, 2003

<table>
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<tr>
<th>Location</th>
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<td>London</td>
<td>82,911</td>
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<td>Frankfurt</td>
<td>114,530</td>
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<td>Tokyo</td>
<td>86,755</td>
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<td>Hong Kong</td>
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<td>Taipei</td>
<td>57,152</td>
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<td>Sydney</td>
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<td>Shanghai</td>
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<td>Manila</td>
<td>13,808</td>
</tr>
<tr>
<td>Mumbai</td>
<td>10,653</td>
</tr>
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Note: Total remuneration includes gross salary and statutory payments, but not bonuses. Converted from A$ at A$ = US$0.7012.

Sources: Watson-Wyatt; IBM; Government of New South Wales.

Exhibit 41. Hong Kong Biopharmaceuticals: Advantages

Source: Enright, Scott & Associates Ltd.
Exhibit 42. Hong Kong Biopharmaceuticals: Disadvantages

MACRO-LEVEL DRIVERS
• Small economy
• Policies toward sector not effective

SUPRAREGIONAL-LEVEL DRIVERS
• Massive investments by competing countries
• MNCs bypassing HK for research and production

MESO-CLUSTER-LEVEL DRIVERS
• High labor, land, and other costs
• Limited research base
• Limited pharmaceutical sector
• Limited numbers of skilled people
• Limited pharmaceutical demand
• Venture capital sent elsewhere
• Limited networks to support the sector

INDUSTRY-LEVEL DRIVERS
• Not much of an industry to notice
• Mix of competition and cooperation
much more vibrant elsewhere
• Lack of understanding of the sector in HK

FIRM-LEVEL DRIVERS
• Hong Kong has few firms in the sector
• Limited evidence of firm-specific capabilities

Source: Enright, Scott & Associates Ltd.

Developments and Implications

Major economies all over the world are investing heavily in biotechnology in general and biopharmaceuticals in particular. Many are hoping that this sector will be their next big bonanza. What is striking, however, is how limited an impact even massive amounts of funding have had on the sector in many locations. The large amount of funding the sector has received in Asia means that it is likely that the segments that are most open to newcomers -- contract manufacturing, clinical trials, development and sales of biogeneric (off-patent) drugs, and contract research -- will be subsidized in many places. As a result, these segments will be increasingly difficult to compete in on a commercial basis.

International pharmaceutical companies with activities in Hong Kong have headquarters, sales, marketing, and distribution functions in the HKSAR. They do not manufacture or do significant research and development in the territory. Despite the presence of some limited collaboration with Hong Kong universities, or university-related groups, by some companies, on the whole there are no real signs that they will change this posture. International experts interviewed for the present study indicate that Hong Kong’s role in the sector
is much more likely to be as a financier and business services center, than as a manufacturing or research and development center.37

Hong Kong Government funding in the sector has had no noticeable impact. Specialist institutes set up in Hong Kong to promote the sector are regarded as not particularly relevant by international experts (in fact, some Hong Kong-based executives of major pharmaceutical companies are hardly aware of their existence or operation). This is true in part because the public funding of the sector in Hong Kong has been a drop in the bucket compared to what is invested in the leading biotechnology centers. The same is true in the private sector. Hong Kong is the leading venture capital management location in Asia, but virtually none of that capital gets funneled into Hong Kong-based biopharmaceutical operations. The market is speaking, and it is speaking clearly.

The focus of medical research in Hong Kong has largely been on academic publications and on issues concerning public health, particularly with regard to infectious diseases. Significant pockets of expertise have been developed in Hong Kong in the process. These are valuable in their own right and contribute greatly to society. However, this type of research and expertise is very different than what is required to generate a vibrant biopharmaceutical industry. The two should not be confused. The large number of medical-related academic publications authored in Hong Kong has not resulted in a significant number of patented, viable products in the biopharmaceutical sector.

Strategies and Policies

The present strategies of biopharmaceutical-related companies with respect to Hong Kong are clear. There is virtually no indigenous research-based pharmaceutical industry of any type in Hong Kong, no less a research-based biopharmaceutical industry. The Hong Kong companies that exist related to the sector are mostly in diagnostics, bioassay chips, medical devices, and other products that do not require the same large-scale sustained research expenditures. This niche strategy seems appropriate for Hong Kong’s situation in the sector. Leading foreign pharmaceutical players are happy to place marketing, sales, distribution, finance, and regional headquarters activities in Hong Kong, but not manufacturing and not research and development. Some may cooperate with Hong Kong institutions on some research matters and on clinical trials, but that is different from setting up full-blown research capabilities. The strategies of venture capital companies with offices in Hong Kong appear to revolve more around seeking technology-based investments in the Chinese Mainland than in Hong Kong.

37 This sentiment has been echoed elsewhere. See Bruce Einhorn, “Hanging Hong Kong’s future on…Biotech?,” Online Asia, March 18, 2002; Mazlyn Mena, “Hong Kong and Biotech, the right Combination?,” Frost and Sullivan Asia Pacific, October 31, 2002.
The Hong Kong Government has set up several programs and institutes that are related to the sector, but has not made the same commitments as many governments elsewhere in the world. This is most likely a good thing, since Hong Kong lacks most of the pre-requisites for anything more than small niche successes in the industry. Any attempts to make the biotechnology sector in general, or biopharmaceuticals in particular, an engine of development have not shown success to date. By far the optimal strategy would seem to be to fund research based on concerns about public health and to ensure academic competence in relevant medically-related fields as part of Hong Kong’s basic economic infrastructure, but not to fund activities designed primarily as industrial promotion. Just because other governments are doing it does not make it right for Hong Kong. In this case, it actually makes it even more wrong for Hong Kong as the competition is likely to be heavily subsidized.

The best policies to help Hong Kong capture those activities associated with the biopharmaceutical sector that it has the potential to capture are policies that improve Hong Kong’s position as a headquarters, marketing and sales, distribution, and business services center. A potential expansion of this role, to what Hong Kong TDC Chairman Peter Woo has called “a technology trading platform,” is an interesting possibility, though it is not clear how one would actually carry this out.

Conclusions

World-wide, the biotechnology sector has never turned a profit. The global deficit in 2006 was around US$4.3 billion and that was just for public companies (private companies in the sector, pre-IPO are even less likely to be profitable). The biopharmaceutical sector is even worse on this count. Product sales of the 30 or so products that have been successfully introduced in 40 years of the industry do not match research and other expenses associated with the sector. The leading biotechnology cities in the world have decades of experience in the sector, are homes of world-leading research universities, are homes of extensive venture capital networks with decades of experience in the sector, and attract US$ billions in government R&D funds, venture capital, contract research, and private investment each year. Even so, in the most successful biotechnology cities in the world, biotechnology and related sectors account for an average of 3.5 percent of local employment.

The leading biotechnology countries make massive government investments in the sector on public health grounds, with sectoral development often only a secondary motive. Massive investments and subsidies by governments in all major developed countries, and most leading Asian economies, are going to create even tougher business conditions going forward. All Asian nations, including Japan, are far behind North America and Western Europe in the biopharmaceutical industry, particularly in drug development. The competition in Asia is going to be for the location of branch plant production systems and for which economies will develop low-priced generic substitutes for existing
biopharmaceuticals, not to see who is going to develop into leading centers for basic drug development. Biopharmaceuticals are different from electronics. It is not a game for a small number of trained people and large numbers of low wage assembly workers. The vast majority of the experiences of Asia in the electronics sector are not going to be transferable to biopharmaceuticals.

Hong Kong does not have the technology base, an existing research-based pharmaceutical industry, a significant presence of existing pharmaceutical production or research by leading foreign companies, or the other related industries that lead one to believe that Hong Kong can succeed in biopharmaceutical research and development, or in managing the massively expensive international approvals process necessary to bring drug discoveries to market. Hong Kong is too small as a market or a research base to receive serious research and development investment in the sector from major pharmaceutical firms. China and India will be favored from an overall talent and market access standpoint, while Korea, Taiwan, Singapore, and Japan will be favored from a technology standpoint. It would take years of extremely large investments to even come close. Hong Kong’s best chance in such circumstances would be as a reliable manufacturer of biopharmaceuticals developed elsewhere. However, even this approach would face great difficulty due to the willingness of governments in other Asian economies to heavily subsidize the sector, the presence of greater pharmaceutical production capabilities elsewhere in the region, and Hong Kong’s high cost base.

The hope that Hong Kong will become a center for turning Chinese medicine into biopharmaceutical based development and result in a driver for economic development in Hong Kong is farfetched. The isolation of active ingredients, their purification and codification, and subsequent synthesis and development as pharmaceutical products is more likely to follow the path that the Western pharmaceutical sector started over a hundred years ago, and remain an extraction and chemical synthesis business, not one based on genetic engineering. Thus it may be a pharmaceutical business, but not a genetic-engineering based biopharmaceutical business. In addition, the Chinese Mainland is home to a much larger and more varied Chinese medicine sector than Hong Kong. Major international companies, with their vast research experience, are going directly to the Mainland for partners and to research the potential for pharmaceutical outputs from Chinese medicine precursors. It is not clear that Hong Kong will have a serious role in this process.

Hong Kong’s main role in the biopharmaceutical sector is likely to be as a financial center, venture capital manager, and technology transfer location from the West into other Asian economies. Major international firms view Hong Kong as potentially a marketing, distribution, and headquarters location in the region, but not as a center for serious research and development. These are the activities that Hong Kong should focus on in the sector.
Hong Kong’s Industry-Level Competitiveness

There are several overall conclusions that can be drawn about Hong Kong’s industry-level competitiveness.

Industry-Level Results

In several manufacturing industries, such as garments, Hong Kong retains a strong position as a management, coordination, marketing, sales, supply chain, sourcing, and trading center. In addition, Hong Kong is improving in design, the ability to brand, and the ability to create a retail presence. While strong competition is emerging from the Chinese Mainland, Hong Kong still has important roles to play. In sea cargo and air cargo, rapidly increasing demand is being offset to a certain extent by rapidly increasing supply and rapidly improving competitors in the Pearl River Delta. While some shippers still prefer using the port of Hong Kong, for others Hong Kong is already overflow capacity. This indicates Hong Kong will continue to lose share, while volume is likely to be maintained. In air cargo, Hong Kong still has a large lead over local competitors, particularly in terms of route network, but the growth of Baiyun International Airport and the location of some of the world’s leading logistics companies there, will create strong competition.

Hong Kong’s financial and business service sectors appear poised for further growth and development. Demand stemming from China-related business is continuing to grow and there is no other location that can serve this demand as well as Hong Kong. This is likely to continue to be the case for some time. The tourism sector is also likely to continue its growth as more and more Chinese citizens have both the affluence and permission to travel to Hong Kong. The question may be what type of tourism sector Hong Kong wishes to have going forward. In these sectors, the challenge is that of expanding upon advantages, building more diversified business bases, and managing growth.

Finally, Hong Kong’s software and biopharmaceutical industries are not competitive in international terms, and are unlikely to show considerable change in the future. Both are caught in global competition between nations and regions that have greater innovative resources, skills, and capabilities on the one hand, and nations and regions that have much larger markets, larger pools of people, and much lower costs, on the other. In both sectors, work that supports local business or the local society is more likely to pay off than attempts to become true international competitors. Even substantial interventions by government would be unlikely to change the balance significantly.

Drivers of Competitiveness

The industry studies point out some clear areas of strength and weakness across the various drivers of competitiveness.
Macro-Level Drivers

Hong Kong has a number of advantages at the macro level. In terms of macroeconomics, its strong and stable economy has provided a helpful platform for individual industries to develop. The SAR’s growing affluence has provided funding for infrastructure, public services, and increasingly sophisticated demand. A stable currency regime has saved Hong Kong from the fluctuations associated with currencies in the rest of the region. The sound financial system has more capital than can be reasonably deployed in Hong Kong.

In terms of government and administration, the industry studies show that Hong Kong’s legal, regulatory, administrative, and tax systems remain advantages. The relative transparency and level playing field found in Hong Kong allow firms to get on about their business with minimal interference. Hong Kong’s free flow of goods, capital, and information are critical to success in financial and business services. The Hong Kong Government’s efforts to improve access to the Chinese Mainland market and to facilitate cross-boundary business activity have created new opportunities in several sectors. The provision of information on developments in the Chinese Mainland and elsewhere by government and affiliated agencies has also been viewed as advantage, as have efforts to promote Hong Kong to international investors and businesses.

On the other hand, some policy areas get a more mixed review. Hong Kong’s basic education is considered adequate, but its ability to produce highly skilled professionals is not keeping pace with demand. Land policies have inadvertently led to higher costs than might have been achieved otherwise. The lack of a comprehensive competition policy has made it difficult even to investigate potential anti-competitive behavior, no less do anything about it. A seeming lack of understanding or concern about deteriorating environmental conditions does not inspire confidence from the business community or from mobile professionals. Some infrastructure and public facility decisions have been delayed or postponed due to opposition that might have been anticipated or mitigated. Some high-profile government investments to stimulate development of favored sectors, such as the Cyberport, have been largely failures, while some maligned investments, such as Hong Kong Disneyland, are actually on their original performance schedule.

Cluster-Level Drivers

There are a number of patterns that repeat across the sectors examined. With respect to cluster-level drivers of competitiveness, Hong Kong is seen as having a mixed bag of attributes. Hong Kong’s biggest advantages in terms of inputs involve access to information, access to international market knowledge, and access to people with internationally-oriented experience. It
should be noted that these are largely advantages versus other Chinese cities and to a lesser extent against other Asia-Pacific economies. Geographic location is an advantage versus non-Chinese cities, but not against other Chinese cities. Hong Kong retains infrastructure advantages, but these are diminishing against a handful of major Chinese cities. Hong Kong has general advantages in skills and capabilities and sizable advantages in specialist skills in financial and professional services over other Chinese cities that will not be overcome anytime soon. However, the leading sectors of Hong Kong’s economy are experiencing bottlenecks in terms of skilled personnel, and managers in these sectors register frustration over the local education system and difficulties in bringing in needed skills from abroad.

On the other hand, property costs, staff costs, and other costs are viewed as not competitive virtually across the board. These are pricing out some sectors from Hong Kong, and even in sectors where output has grown, such as financial services, employment has hardly increased over the last 5 years. Government’s willingness to provide subsidized land for favored sectors shows that it does not believe these sectors can survive at prevailing Hong Kong land prices. Quality of life, particularly with respect to air pollution, is starting to be a disadvantage as some professionals start to demand higher salaries to come to Hong Kong or leave the territory. In manufacturing sectors, China is now viewed as having as good if not better access to locally produced materials and inputs than Hong Kong. Hong Kong’s small market means that it is difficult to support significant research and development activities unless sales are immediately international (or at least outside the SAR).

Hong Kong benefits from a set of strong clusters. The trading, transportation, logistics, and manufacturing (at least manufacturing headquarters) activities in Hong Kong all interact and benefit each other. There is a strong cluster of financial and professional services that take advantage of similar infrastructure, similar information advantages, and direct interaction with each other. The tourism sector is a cluster in itself, involving transportation, hotels, retail, restaurants, and related sectors that feed off each other. Hong Kong also has clusters that are activity-based as much as industry based, focusing on the headquarters, management, and coordination functions for China business, Asia business, and global business.

Industry-Level drivers

At the industry level, there are some sectors or segments of sectors in which tough competition among local Hong Kong companies and/or Hong Kong offices creates substantial incentives to improve. Garments, freight-forwarders, local legal and accounting services, some financial services, and retailing are some examples. In some other sectors and segments, competition is less fierce because of rapid growth and/or limited numbers of competitors. Container terminals, airlines, air cargo handling, some segments of financial services, internationally-oriented accounting, and some classes of
hotels would be some examples. While we have not investigated in sufficient depth to comment on whether there is collusion in any of the sectors, we have noted examples of parallel pricing activity, which may be evidence of oligopolistic profit taking.

Cooperation is present in some sectors. Industry associations and groups get involved in providing information for various sectors, communicating with government, identifying issues facing the sector, and even in commissioning studies to improve the sector's competitiveness. The Hong Kong Tourism Association, the Logistics Council, the Bankers Association, the Law Society, and the Hong Kong Institute of Chartered Accountants represent different types of cooperation within different sectors. In sectors that cover multiple individual industries, like tourism, financial services, logistics, and professional services, there are examples of cross-industry cooperation to provide bundled products or services to customers.

Firm-Level drivers

Firm-based skills and capabilities are important advantages in some Hong Kong industries. Hong Kong is home to world class firms in the garment, sea cargo, air cargo, and tourism industries. In financial and professional services, Hong Kong has provided a good base for major international companies, many of whom now do significant product or service development in Hong Kong. Hong Kong is the home to a number of strong local companies in these industries as well. In these industries, it can be argued that Hong Kong-based firms and offices through their own capabilities and activities have added value above and beyond what Hong Kong's general environment affords and beyond that which they may have imported from abroad. In some cases, Hong Kong firms have generated strong international profiles and businesses that are managed from Hong Kong, adding high-value jobs and service demand to Hong Kong's economy over and above what their business in Hong Kong would require. These Hong Kong-headquartered firms also carry a Hong Kong brand with them into international markets.

In some sectors, such as garments, transportation, freight forwarding, retailing, and others, there are Hong Kong firms that are finding it difficult to adjust to changing circumstances. Some strategies that have relied solely on leveraging low cost labor in South China may need to be changed as production locations diversify across China, and as costs rise in the Pearl River Delta. While a number of leading Hong Kong firms have added value over and above the advantages that Hong Kong has provided, there is a danger in some sectors that strategies that rely on exploiting oligopoly or monopoly positions to extract rents will hurt Hong Kong as a whole. In some cases, Hong Kong's already high cost position appears to be exacerbated by non-competitive behavior.
Supraregional-Level Drivers

No discussion of the competitiveness of Hong Kong industries is complete without an assessment of the importance of Hong Kong’s unique links with the Chinese Mainland. In fact, many “Hong Kong industries” actually span the boundary. China features prominently in all of the industries investigated. China is the main source of production, main competitor, and a new market opportunity for Hong Kong’s garment producers, as well as Hong Kong’s sea cargo and air cargo industries. China or China-derived activities are major business drivers for Hong Kong’s financial and business service industries. China is the main source of customers for Hong Kong’s tourism industry. China represents almost overwhelming competition, but also niche opportunities for Hong Kong’s software and biopharmaceutical industries.

Mainland policies are critical to several of the sectors studied. China’s historically closed market, its entry into the WTO at the start of this decade, and the subsequent removal (or reduction) of quotas have changed the garment sector. The desires of some Chinese jurisdictions to move up the development ladder may make it more difficult for Hong Kong firms to continue operating in South China. Desires by some governments in the Pearl River Delta to create transportation and logistics hubs have placed pressure on Hong Kong’s port and airport. Streamlining cross-boundary flows that might benefit the transportation and logistics sectors in Hong Kong remains subject to negotiation with Mainland authorities. Mainland policies have had a substantial impact on Hong Kong’s financial and business service sectors. The use of the Hong Kong Stock Exchange to list major Mainland companies has provided huge amounts of business for Hong Kong and has enhanced Hong Kong’s position as a leading financial and business service hub. CEPA has facilitated entry by Hong Kong firms and offices into financial and business service sectors on the Mainland. The Individual Visitation Scheme and other Mainland policies concerning freedom to travel and the ability to take funds out of China have had a dramatic influence on Hong Kong’s tourism industry.

Hong Kong’s economic interaction with the Pearl River Delta and the Chinese Mainland as a whole has been enormously positive. However, it is clear that a number of major decisions that affect Hong Kong’s economy are taken outside of Hong Kong. This is one risk factor that the Hong Kong economy faces.

Another supraregional driver for Hong Kong has been the presence of foreign companies. Many of the important players in financial services, business services, transportation, logistics, tourism, biopharmaceutical, and software are foreign players that have set up operations or offices in Hong Kong. In some sectors, like business services, financial services, logistics, and tourism, they perform core activities in Hong Kong, and are some of the leading players in Hong Kong. In others, such as software and biopharmaceuticals, they use Hong Kong as a headquarters, marketing, sales, and distribution center. Both add value to Hong Kong’s economy. Hong Kong’s ability to
attract and retain foreign companies will continue to be critical to its competitiveness.

**Issues Associated with Hong Kong’s Competitiveness**

There are several issues associated with Hong Kong’s competitiveness that cut across the industries examined in this project.

**Interaction with China and the Pearl River Delta**

China’s rise in general, and that of the Pearl River Delta in particular, creates benefits and challenges. China has become a huge market for Hong Kong’s financial services, business services, and tourism sectors. It is the production base for the garment, sea cargo, and air cargo sectors. The Hong Kong and Pearl River Delta combination in particular has been a great benefit for both. However, Hong Kong firms in many sectors view the Pearl River Delta as the major source of competition as well. While noting their dependence on the Pearl River Delta, relatively few Hong Kong-based managers recognize the inter-regional competition emerging in some sectors between the Greater Pearl River Delta and the Yangtze River Delta. Thus they tend to see PRD firms more as potential enemies than allies. This is natural, but could ultimately prove short-sighted. Developments that benefit the Pearl River Delta are likely to benefit Hong Kong, though many individual Hong Kong firms may not see it that way. There is a growing view that Hong Kong, Macau, and the Pearl River Delta are part of an economically integrated region, and many Hong Kong firms have leveraged activities and operations in the PRD. However, relatively few of the firms in the sectors examined think about leveraging potential cooperation with PRD firms as part of their strategies. In the future, inter-regional competition may become as important as inter-city competition.

**The Importance of Headquarters and Support Services**

Across the industries, Hong Kong’s most powerful and potential enduring role is that of a headquarters, supply chain management, and support service location. The production in the garment sector has left Hong Kong, but the critical headquarters roles remain. Similarly in the sea cargo and logistics sector, many activities have or will shift across into Guangdong Province, but many important headquarters operations remain in Hong Kong. For air cargo, some participants will build up capacity to shift cargo back and forth between Hong Kong, Guangzhou, and Shenzhen, but are likely to maintain headquarters functions in Hong Kong. Software companies are unlikely to set up sizable programming operations in Hong Kong, but they are likely to place management, distribution, and support service activities in Hong Kong. Thus, a key component to improving Hong Kong’s position in any sector is
improving Hong Kong’s attractiveness as a headquarters and support service location.

Costs

As indicated, Hong Kong’s costs are a major disadvantage. While Hong Kong is by its nature a high cost location, government land policies have exacerbated this situation. The result has been a collapse in construction in the last several years and shortages of supply in some segments of the market that have driven prices to record levels. While buoyant property prices might provide a short-term feel good factor, the reality is that they place a drain on Hong Kong’s economy. Several firms indicated that the recent upturn in their business has resulted in no additional profitability because all of the increase has been eaten up by higher rents. For a business community that claims a minimum wage would make Hong Kong less competitive, the absence of similar complaints about property prices is surprising to say the least. It should be noted that a minimum wage at a level likely to be politically palatable in Hong Kong should not affect the competitiveness of any of the industries investigated in this project. The only sector that might feel some impact is tourism, where some hotels and retail outlets might have to pay some workers more. However, it is not expected that this would affect Hong Kong’s overall competitiveness significantly.

While Hong Kong price levels have not markedly affected the highest value sectors of the economy to date (financial services or business services), they are affecting other sectors that employ lower skilled people. Anything that artificially raises Hong Kong’s costs puts those people’s livelihoods at risk. What is striking is that one of the standard requests for any industry to “improve its competitiveness” is to ask for subsidized land. Government has obliged by providing subsidized land for a number of favored sectors. This implies a recognition that land costs in Hong Kong are too high. If they are too high for favored sectors, then they are too high for all sectors.

Oligopolies and Protectionism

Hong Kong has always prided itself on having an open economy with a great deal of competition, and for much of its economy this is true. However, in some sectors, lack of competition combined with protectionism has inflicted costs on the rest of Hong Kong’s economy. The mere presence of two or more firms in a given sector does not ensure that there will be real competition. Several leading Hong Kong firms have made substantial profits as oligopolistic toll collectors on the routes into and out of Hong Kong. Hong Kong is also rife with smaller monopolies or oligopolies that impose costs on the rest of the economy. While this might not have had much of a negative influence in the days when Hong Kong had no direct competitors in the region, the same cannot be said with confidence today. At the same time, there are strong protectionist interests in Hong Kong. Be it professional
groups trying to exclude competition for their members or companies seeking to minimize access of foreign companies to the Hong Kong market, or a system that makes it more difficult to bring in outsiders to fill positions even if the requisite skills cannot be found in Hong Kong, such interests do exist.

Too often, a “protect and preserve” approach protects the interests of a small number of firms at the expense of a larger number of firms. Commissions and steering groups focused on particular sectors are dominated by people with specific vested interests rather than those with the wider public interest in mind. The presence of such interests often results in the lack of serious discussion or debate on critical issues facing Hong Kong. There is also a tendency to equate what is good for particular Hong Kong companies with what is good for Hong Kong. While in many cases, the two might coincide, in others they might not.

Examination of some of the sectors studied here indicates that Hong Kong could use a broadly-based competition policy with an independent government agency with the power to investigate non-competitive behavior and to require businesses to provide them with the information necessary to do so. It also suggests that a “maximum openness” policy which has stood Hong Kong in good stead for many if not most sectors, should cover all sectors. The Hong Kong Government needs to be stronger in resisting vested and protectionist interests. There is nothing intrinsically free-market about Hong Kong companies. They all will ask for special treatment if they think they can get it, and they will exploit monopolies, oligopolies, and protectionism whenever they can.

Calls for Support

The typical set of suggestions for improving Hong Kong’s competitiveness in a given sector that have come out of studies or industry groups over the past few years generally include most of the following:

- Set up a high level commission of representatives from major existing companies in the industry
- Subsidize research in the industry through the University Grants Committee, the Innovation and Technology Support Fund, or some other auspices
- Provide subsidized land for the industry
- Set up training programs or specialized education programs for the industry
- Provide special access to foreign professionals or employees for the industry
- Promote the industry in China and in international markets, and
- Ask for special access for the industry in Chinese Mainland.
While some of this makes good sense, it is interesting that a number of the “typical” suggestions involve subsidies of one form or another. Subsidized land seems to be a favorite request given Hong Kong’s high land prices, and the fact that subsidized land represents an opportunity cost rather than an out of pocket expense for government. The problem is threefold. First, if one industry is to be subsidized, why shouldn’t other industries be subsidized? Most industries can make a case for having important spillovers into the rest of the economy. Second, if subsidies, particularly land subsidies, are necessary to support favored industries, wouldn’t it be better to review land policies for all industries? Whenever possible, systemic issues should be treated in a systemic way, not in a piecemeal way. Third, if one industry is to be subsidized, then who pays the subsidy? Presumably the answer is stronger industries, which can be weakened by having additional resources extracted from them.

Another interesting item involves pleas for special treatment to bring in skilled individuals. Again, if this is an issue across sectors, then presumably a cross-sectoral response is needed. Immigration is a difficult issue for any government. Hong Kong has been relatively open to skilled professionals in the past and should seek to extend this position going forward.

Still another interesting item is asking government to obtain better treatment on the Chinese Mainland. While it is clearly appropriate for the Hong Kong Government to get the best deals possible for Hong Kong companies and offices, there are limits to what can be done, and there are limits on the patience of Mainland officials for requests from Hong Kong, particularly requests that may be viewed as self-serving. Requests for greater access should be bilateral in nature, opening Hong Kong to Chinese companies and professionals where appropriate, and should come with concrete explanations of why it would benefit China to provide greater access to Hong Kong firms and offices. This win-win reasoning is likely to be better received than unilateral measures viewed solely as benefiting Hong Kong interests.

**Looking Ahead**

To a great extent, the industry studies reinforce traditional notions of what has made Hong Kong a strong, vibrant economy over the last few decades. The industry studies indicate that Hong Kong does well in industries or segments where other advanced economies cannot compete so well because of distance from source of production or market, and where skills and capabilities on the Chinese Mainland or elsewhere in the region have not caught up to Hong Kong. For the most part, Hong Kong succeeds in industries due to a favorable location, being quite good at the business basics, and adequate in terms of higher order business capabilities or issues. In terms of business basics, industry participants still believe that Hong Kong’s legal, regulatory, administrative, and tax systems are strong advantages, particularly compared to the Chinese Mainland. Access to information, experience in the international market place, and free flows (of
information, goods, and capital) are also strong advantages. In terms of higher order capabilities and issues, such as education, training, immigration, and the environment, Hong Kong may be better than local competition, but still not quite able to deliver what business desires. These are areas in which improvement could yield substantial gain.

The industry studies indicate that Hong Kong may need to rethink the way it has traditionally done business, both within individual sectors and across the economy as a whole. The way it determined when to invest in port or airport capacity, i.e. lagging demand somewhat, may have made sense when Hong Kong faced little direct competition. However, as Hong Kong faces more direct competition, capacity expansion is part of the competitive game. Waiting for the traditional signals of when to invest may limit Hong Kong’s potential. In other aspects of the economy, i.e. the Hong Kong Government’s traditional unwillingness to pick winners, appears to some to be in question. The industries investigated show a strong positive influence of government when it comes to creating the right legal and regulatory systems, providing infrastructure, ensuring openness, providing information, and gaining access for Hong Kong firms. It shows less positive results when trying to develop industries that lack inherent advantages in Hong Kong.

People in Hong Kong have long tended to equate the interests of large Hong Kong companies with those of Hong Kong and Hong Kong people. Hong Kong has many companies that should be proud of their achievements and of whose achievements Hong Kong should be proud. Many of these companies have contributed greatly to Hong Kong’s economy. However, the industry studies indicate that some have made their profits by obtaining monopolies and oligopolies that make them toll collectors on the development of Hong Kong and the Pearl River Delta. In a world in which Hong Kong, and in fact the Greater Pearl River Delta, faced limited direct competition, and in which Hong Kong was a moderate cost location, the impact on Hong Kong’s competitiveness may have been minimal. However, as Hong Kong faces more and more direct competition, and as its costs return to among the world’s highest by some measures, Hong Kong’s competitiveness is hindered. In at least one case, air cargo, Hong Kong policies helped hand Hong Kong’s biggest potential competitor its best competitive weapon. In order to continue to thrive in the present environment, Hong Kong needs to be more competition-oriented, less protectionist, and more attuned to the public interest.

There appears to be a sentiment in Hong Kong that the SAR’s economy is not adjusting to a changing environment. Several of the industry studies indicate otherwise. While many garment companies are trying to adjust from their traditional strategies drive by the quota regime, many others have already rationalized production, begun to invest across China, started improving their design, and initiated efforts to expand into branding and retail. Hong Kong’s leading logistics-related companies have expanded their presence on the Chinese Mainland, and are creating business portfolios that include Hong Kong, but are not limited to Hong Kong. Many in the financial and business
service sectors are adjusting to take the rise of China-related business and the opportunities to serve Chinese organizations. The tourism sector is expanding its offerings, hopefully cleaning up some shoddy business practices in some segments, and learning to cope with greater challenges. In several sectors, much of the change is going on within individual firms, outside of the public eye. While many Hong Kong firms have much more to do, many others are making progress.

Hong Kong and Hong Kong firms will have to continue to adjust. As China’s economic development and infrastructure spreads inland, there will be new production locations and new potential markets. This means that Hong Kong needs to ensure adequate connectivity, not just to the top tier cities in China, and not just in the Pearl River Delta, but to the second and third tier cities as well. It means that Hong Kong, the Hong Kong Government, Hong Kong companies, and Hong Kong people will need to know these cities and form productive relationships in these cities if Hong Kong is to benefit from their development. This is a task for both government and for firms. As Chinese firms become more capable, the notion of partnering with these firms and helping them internationalize is also an interesting one. Hong Kong has already helped major Chinese firms internationalize their capital bases. It already houses the international offices of several Chinese firms. While some may view emerging Chinese firms as competitors, and in many instances they are, opportunities for collaboration should also be explored.

While Hong Kong and Hong Kong firms need to look beyond just the Greater Pearl River Delta, the GPRD itself is still a source of potential strength. The Hong Kong-Pearl River Delta connection has proven beneficial in a wide range of industries. As new places in China come on-stream, we may well see inter-regional competition, competition between the Greater Pearl River Delta and the Yangtze River Delta, or the Bohai Rim, or the Northeast, or the West. People in Hong Kong need to remember that PRD or Macau firms or businesses may be competitors, but they may also be allies in the competition against other regions. This means physical connectivity (including the eventual Hong Kong-Macau-Zhuhai Bridge) as well as business and psychological connectivity will be crucial. In sectors like the tourism sector, there is substantial scope for Greater PRD tourism offerings that could prove quite attractive for Chinese tourists as well as those from farther away.

The industry studies also indicate a need to look beyond China alone. China may be by far the leading source of tourists for Hong Kong, but a geographically diversified tourism base is likely to be better for the industry in the long run. Hong Kong has the Asia-Pacific regional offices of a number of major financial institutions, but several segments of Hong Kong’s financial service sector are national, not regional in scope. It will be interesting to see if the critical mass provided by China business can be turned into regional advantages as well. Even though garment companies are concentrating activities in China, it is likely to continue to be necessary to have overflow or contingency capacity elsewhere in the region to protect against production disruptions, or protectionism. Software companies that find it difficult to
penetrate Mainland markets may find better luck in penetrating other markets in the region.

The industry studies also show the critical importance of enhancing Hong Kong’s competitiveness as a headquarters and support service center. Industries that no longer produce much in Hong Kong still have high-value headquarters, management, coordination, finance, marketing, sales, and distribution functions in Hong Kong. The heart of Hong Kong’s most dynamic sectors involves performing these activities in Hong Kong. In some industries, such as software and biopharmaceuticals, the only reason many leading companies have a presence in Hong Kong is to use its management and service platform. The studies show that as long as Hong Kong is competitive in these activities, then it can attract offices of almost any industry that grows in China or in the Asia-Pacific region. This is seen in other great economic cities around the world. New York City prospers when any industry grows in the United States due to its role as a headquarters, management, financial, and business service center. Similarly London prospers when any industry grows in the United Kingdom and Paris prospers when any industry grows in France. It suggests that competition among locations takes place not just at the industry level, but also at the activity level. It is to this activity level that we will turn in the next Phase of this project.