

The Future of Hong Kong

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1. Why has Hong Kong been so competitive?

I would argue that the competitiveness of economies depends on at least four categories of costs: factor costs (costs of labor, land, capital etc.); costs of transportation and communications; transaction costs of using markets; and coordination costs of using governments. The higher these costs, the higher the prices of locally produced products and services and the less competitive the local economy. Hong Kong's current economic malaise illustrates this.

Factor costs in Hong Kong

The prices for land and housing in Hong Kong are among the highest in the world due to limited supply (by natural endowment and by government control). Since most of the skilled workers and money in Hong Kong could move to anywhere in the world, the return to them has to be higher than any alternative they can get in the rest of the world. Hence, salaries and interest rates for these mobile factors in Hong Kong are among the highest in the world. The wage for unskilled and immobile workers in Hong Kong is low relative to that in the developed economies but much higher than that in the rest of China due to tight control on immigration and labor importation.

Transportation and communication costs in Hong Kong

Thanks to its geographical endowment and past investment, Hong Kong has developed an excellent transportation and communication infrastructure except for its links with mainland China. The transportation and communication costs cross Hong Kong-mainland China are sometimes much higher than those across the Pacific Ocean due to monopoly or a lack of coordination. A telephone call to Hong Kong's neighboring cities in mainland China such as Shenzhen and Zhuhai costs five to ten times of a call to New York. There are only two border passes via land for people to move between Hong Kong and Shenzhen, which close before midnight. Sending or shipping a package to Shanghai could be as expensive and time-consuming as to New

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York due to complicated custom-clearing procedures in China.

Transaction costs of using markets in Hong Kong

The transaction costs of using markets are very low in Hong Kong thanks to its inherited political, social, legal and regulatory institutions which are relatively transparent and supportive to free markets. Government interventions and oligopoly situations do exist in some sectors in Hong Kong. We do observe high concentration ratios in a few sectors (such as supermarkets and telecom), high prices in a few products (such as fresh milk), and high government subsidies in a few areas (such as housing for low income and medical cares). However, on the whole, there are few artificial barriers to markets and transactions in Hong Kong. Almost everything could be traded or speculated in Hong Kong including for a time Snoopy from MacDonald. The low transaction costs per unit of market transactions have led to large volumes of transactions in Hong Kong. This is reflected in Hong Kong's GDP composition: 84% of its GDP is from the service sector which is related to trade, financial, and other transactions.

Coordination costs of using governments

The coordination costs of governments before the handover are minimal. First, there is not much need for the colonial government to coordinate economic development either with the central government in Beijing or with the local governments in Shenzhen and Guangdong. Second, there was freedom but little democracy in Hong Kong before the handover. Little coordination is needed among the Hong Kong Government and the local community. The coordination costs of using governments have been rising rapidly after the handover and will continue to rise because of the "One-Country, Two-Systems" arrangement.

In summary Hong Kong has been very competitive and successful mainly because of its low transaction costs.

2. Hong Kong during the Asian Financial Crisis

The Asian Financial Crisis during 1997-1999 hit Hong Kong extremely hard as exemplified in the plunge of the stock market index, housing prices, growth, and employment. The financial crisis played out in two key dimensions: falling prices and shrinking volumes of transactions. Hong Kong is extremely vulnerable to both because of its heavy reliance on low transaction costs.

Hong Kong cannot compete with other economies on factor costs, which are determined largely by supply and demand. Instead, it has to compete on transaction costs, which are determined by institutional arrangements. With low transaction costs and high factor costs, Hong Kong businesses depend on much larger volumes of trade and financial transactions to maintain their profit margin and keep their competitive edge.

When the volumes of transactions are high, Hong Kong businesses can make profits even when their factor costs of labor, housing, and capital are high. This is because the key parts of the factor inputs (including labor, housing, and capital) for trade and financial transactions in Hong Kong are usually fixed costs that do not change much in tandem with the volumes of trade and financial transactions. In other words, the factor prices (such as the rental costs) in Hong Kong can have multiple levels of market equilibrium associated with various levels of trade and financial transaction volumes in Hong Kong.

Unfortunately the volumes of trade and financial transactions in Hong Kong and elsewhere in Asia dropped sharply and quickly during the Asian Financial Crisis. That crippled Hong Kong's main mechanism of making money. When volumes are low, low transaction costs in Hong Kong do not help but high factor costs here hurt even more. Clean government, good regulatory and monitoring mechanisms, and a transparent legal system could not solve the problem of shrinking volumes and falling prices.

At the beginning of the crisis, the HKSAR Government and many observers failed to understand the important impact of the exacerbating problem of shrinking volumes of trade and financial transactions on the Hong Kong economy. They were far too optimistic when the crisis loomed.

However, after the crisis hit Hong Kong, the HKSAR Government and the community at large were too pessimistic about the recovery. Hong Kong's GDP growth recovered abruptly and surprisingly when the volumes of trade and financial transactions went up in Hong Kong and elsewhere in China and Asia. The sharp turn around of GDP growth from -5% to +8% growth and rapid rise of Hang Seng Index from 6000 to 15000 in Hong Kong in the past two years, however, did not restore Hong Kong people's confidence about the future of its economy.

3. Why does not confidence return with recovery?

The Asian financial crisis exposed Hong Kong's main weakness: high factor costs. The rapid development of Shanghai points out Hong Kong's another weakness: a lack of effective strategies, planning and coordination by the government.

Among all explanations of the Asian financial crisis, the adjustment of relative prices seems to be the most convincing. Around 1997 it became clear that China (and possibly a few other major developing economies or regions such as India, Russia, and Africa) was about to be fully integrated into the world economy. This implies an addition of more than one fifth of the world's labor forces to the world market for producing exportable manufacturing products. Given the much slower rise in income and then in demand for these manufacturing products in China, it is inevitable that the relative prices for all products, which can be manufactured en masse in China, have to fall.

This relative prices adjustment hit directly on the manufacturing bases across Asian economies and forced investors to lower their expected returns. The downward adjustment of expected returns generated quickly financial losses through the relatively efficient but volatile financial markets across Asia and even the world. The panic and wealth losses during the crisis seem inevitable since someone has to absorb the losses due to the relative prices adjustment which has to come sooner or later.

As China deepens its economic opening and integration with the world economy, Hong Kong will continue to feel the deflationary pressure from cheap factor costs in mainland China. In addition, it will feel the deflationary pressure due to the reduction of transaction costs in China. China's accession to WTO will soon open banking, financial, legal, accounting, retailing and other services sectors to foreign investment. As a result, the transaction costs of doing business in China will inevitably fall. That would help China to compete much more effectively with its comparative advantage of low factor costs.

Less than three year ago, most observers were making jokes on how to fill up the office buildings in Shanghai because the total newly constructed office floors were said to exceed the total stock in Hong Kong. Today, no joking, some of the prime office buildings in Pudong already enjoy occupancy rates as high as 92%, close to the level in Hong Kong. The prime hotels in Shanghai are now almost fully booked

throughout the year. Shanghai is actively attracting Fortune 500 corporations while Hong Kong has yet to respond. About a year ago Shanghai's Government decided to stop collect fees for crossing the bridges and tunnels linking Pudong (East of Huangpu river, a newly developed district of Shanghai) and Puxi (West of Huangpu river, old districts of Shanghai) while the HKSAR Government is considering to collect taxes for crossing the land border with China. These contrasting behaviors of the Shanghai and Hong Kong governments point to a new problem for Hong Kong. The HKSAR Government seems not as effective as that of Shanghai in mapping out development strategies and coordinating whether with the local community or with the central and local governments in mainland China.

4. Can Hong Kong keep its competitiveness?

At present, it seems unclear whether Hong Kong will be able to maintain its competitiveness for long. It depends on how the government and the local community will cope with the challenge of reducing the factor costs as well as the coordination costs of the governments.

The transaction costs in Hong Kong are already very low. Little can be done to reduce them further but still a lot of efforts are necessary to keep the political, social, legal and regulatory institutions transparent and effective as Hong Kong integrates slowly with mainland China.

However Hong Kong can go a long way in reducing its factor costs through economic integration with Southern China, especially with Shenzhen. For example, if Hong Kong people could live in Shenzhen, their purchasing power could increase three to five times. Then it would be possible to reduce Hong Kong people's income by one third while still maintaining their current living standards. With lower labor and housing costs, Hong Kong will be able to attract more business from mainland China and the world. Many Hong Kong people are doing this right now. With just a little more investment in infrastructure and better coordination with the Shenzhen Government, this could happen on a significantly larger scale and lower the factor costs in Hong Kong. This may be the only way to enhance the overall competitiveness of Hong Kong and the Southern China region including Hong Kong in the long run. Many people worry about the short-term impact of this adjustment on the housing prices and employment in Hong Kong and attempt to resist or slow economic integration of Hong Kong with Southern China. They think a slow integration could protect Hong Kong people at least in the short run. That is an illusion like a bubble.

Hong Kong's housing prices may depend more on long-term prospects of Hong Kong than many of the short-term factors. New York, London, and Tokyo could all maintain high housing prices without a border to separate them from their neighboring cities simply because they are all at the heart of the world's super economic regions.

Hence, the real challenge for Hong Kong is to help Southern China attract Fortune 500 multinational corporations and develop the region into one of the world's super economic regions. Without a solid industrial base in Southern China, Hong Kong's status as an international trade and financial center would be shaky, depending on such factors as inconvertibility of the Chinese currency and the non-transparency of China's legal system. These multinational corporations, once settled in southern China, are not likely to relocate in five or ten years. On the other hand, the investment bankers in Hong Kong could relocate in just a few months to Shanghai. Some of them already stay longer in Beijing or Shanghai hotels than in their Hong Kong home. In principle, like New York, London, and Tokyo with their hinterlands, Hong Kong could develop and integrate with Southern China even if there were no borders between the two areas.

This economic integration needs a clear blessing from Beijing, courage and wisdom from Hong Kong, not just its government but also its people, and above all, cooperation with Southern China. The key in this integration process is to help Southern China reduce transaction costs while facilitate Hong Kong's reduction of factor costs. China's growing economy needs another Shanghai-scale center of super economic region in the South. Hong Kong could fully play such a leading role for Pearl River Delta as Shanghai did for the Yangtze River Delta.

The current "One-Country, Two-Systems" arrangement makes it difficult to coordinate economic development and policies among the governments of Beijing, Hong Kong and Southern China, at least in the short run. Also, since the political arrangement has been designed to protect the economic interest of local businesses and people after the handover, it makes it difficult to sacrifice the short run economic interest of some Hong Kong businesses and people in order to gain the long run prospect of Hong Kong. This means that there is a significant risk that Hong Kong could fail to improve its competitiveness through rational economic integration with Southern China. This risk is even bigger when considering China's imminent accession to the WTO. The WTO accession would certainly speed up Shanghai's development and leave Hong Kong much less time for adjustment.

Today Hong Kong is still the most important local economy within the PRC. Hong Kong's total foreign trade volume is as large as that of China (almost half of it is re-exports or re-imports relating to China). Measured by market capitalization, half of Hong Kong's listed companies are either operating in mainland China or outside of Hong Kong. Hong Kong is fully integrated with the world economy except China. These first mover advantages not only provide Hong Kong with some cushion in the competitiveness game but also suggest that China and Hong Kong could hardly afford a slower economic integration.

Some kinds of coordinating mechanism should be established for the development and integration of the Pearl River Delta economy including Hong Kong into a genuine regional or metropolitan economy. The governments of Beijing, Hong Kong, Shenzhen, and Guangdong should have more regular and substantive interactions on the regional development strategy and coordination. There are many good things that the market couldn't do. Examples include Deng Xiaoping's call for the establishment of special economic zones in China twenty years ago, Shanghai's Pudong development plan formulated less than eight years ago, and perhaps also China's strategy to develop its western region proposed less than three years ago. These government initiated long-term, rational and credible development plans and the associated commitments in policy and investment provide essential directions and guidelines for the private sector. If Shanghai did not draw its Pudong development blueprint and did not commit its money into the related infrastructure projects many years ago, the private sector would have invested much less in Shanghai. If the governments of Hong Kong, Beijing, and Southern China fail to initiate these kinds of rational, credible long-term development plans, the non-governmental organizations and the local community in Hong Kong needs to initiate and act.