Hong Kong: From Entrepôt to Manufacturing and Then to Producer Services[1]

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1. Introduction

In the past fifty years, Hong Kong's economy has undergone two major transformations, first from entrepôt to manufacturing during the period from1951 to the late 1970s, and then from manufacturing to producer services since the late 1970s. In each case, the transformation was triggered by the change of Hong Kong's relations with mainland China. The former transformation was due to the sudden and dramatic decrease in China trade following the United Nations trade embargo; and the latter was a response to the open-door policy adopted in mainland China since late 1970s.

In this chapter, we first give a brief review of Hong Kong's transformation from entrepôt to manufacturing, and then offer an analysis of the recent transformation from manufacturing to producer services.

2. Transformation from Entrepôt to Manufacturing

Since the beginning of British rule in 1843, Hong Kong had been an important entrepôt for trade, mostly British trade, with China. Situated in the outer estuary of the Pearl River, Hong Kong is close to Canton, which for centuries had been China's most important port for trade with Nanyang as well as with India, Africa, and the Western nations. Hong Kong's entrepôt economy was, however, severely damaged during the Japanese occupation from the late 1930s to 1945. The complex network of external economic relations was disrupted. Meanwhile, many of the entrepreneurs, technicians, and skilled workers essential for the entrepôt economy were either dead or scattered in other parts of China. Despite the harsh conditions, Hong Kong quickly restored its role of entrepôt after the Japanese surrender in 1945, through the establishment, reestablishment, and expansion of both British-owned and Chinese-owned trading houses, insurance companies, shipping companies, and banks. Total

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exports leaped from HK$ 766 million in 1946 to HK$ 4,433 million in 1951. Total imports increased from HK$ 933 million in 1946 to HK$ 4,870 million in 1951 (see Table 2.1).

Table 2.1. Hong Kong's Trade by Major Partners- Region and Country, 1946-52

(HK$ million)

Region and Country		Asia*			Western Europe		North America		World
		Total	China	Taiwan	Total	United Kingdom	Total	United States	Total
1946	Imports	649	323		85	44	131	120	933
	Exports	630	305		32	17	85	84	766
1947	Imports	791	382		304	164	319	299	1,550
	Exports	833	267		129	38	155	152	1,217
1948	Imports	1,003	431		522	301	424	387	2,078
	Exports	1,179	280		138	75	160	152	1,583
1949	Imports	1,302	593		628	388	633	575	2,750
	Exports	1,715	585		222	140	249	234	2,319
1950	Imports	2,140	783	75	745	405	705	655	3,788
	Exports	2,894	1,260	201	342	168	319	309	3,716
1951	Imports	2,476	863	62	1,610	619	461	374	4,870
	Exports	3,646	1,604	139	381	215	179	163	4,433
1952	Imports	2,146	830	45	1,151	470	300	221	3,779
	Exports	2,398	520	207	225	83	133	113	2,899

*Includes Middle East.

Source: Hong Kong Statistics 1947-67 (Hong Kong: Census and Statistics Department, 1969), pp. 97-98, 212.

Hong Kong's postwar recovery was dealt a mortal blow in mid-1951, when China entered the Korean War and the United Nations subsequently imposed a trade embargo on China. As a result, Hong Kong's role as an entrepôt for the China trade was abruptly terminated. As shown in Table 2.1, total exports to China dropped from HK$ 1,604 million in 1951 to HK$ 520 million in 1952. Another major event shaping the Hong Kong economy was the return of former residents after the Japanese surrender in 1945 and the huge influx of refugees from mainland China after the victory of the Chinese Communist Party in 1949. As shown in Table 2.2, Hong Kong's population grew from 600,000 in August 1945 to 1.75 million in mid-1947 and then to 2.26 million in mid-1950.

Table 2.2. Population: Mid-year Estimates, 1945-1950

Mid-year of	Population
1945	600,000
1946	1,550,000
1947	1,750,000
1948	1,800,000
1949	1,857,000
1950	2,262,300

Source: Statistical Planning & Census Department, Department of Commerce & Industry, and Hong Kong Annual Reports

With the loss of the China trade, Hong Kong turned to develop its manufacturing industries. The prime movers of the industrialization process were emigrant entrepreneurs from Shanghai, who brought not only capital but also technical and managerial know-how (Wong, 1988). Before the Japanese War, Shanghai had been the industrial center of China. Shortly after the Japanese surrender, Shanghai industrialists ordered a substantial amount of machinery from overseas to rebuild industry in Shanghai. However, by the time the machinery was ready for delivery, the political and economic situation in mainland China had become uncertain, and many Shanghai businessmen decided to offload and store their machinery in Hong Kong. Other Shanghai businessmen were able to move their machinery from Shanghai to Hong Kong before the victory of the Chinese Communist Party. Once in Hong Kong, with the help of bank loans, Shanghai industrialists were able to rent or construct premises and get their businesses started.

Other factors also played important roles in Hong Kong’s transformation from entrepôt to manufacturing. First, there had been a huge amount of flight capital entering Hong Kong in late 1940s, sent by refugees fleeing China and also by the Chinese communities throughout Nanyang. According to the estimates by Edward Szczepanik (1958), from 1947 to 1955, the annual injection of foreign capital was about 40% of Hong Kong’s national income. Such a large scale of capital injection into Hong Kong certainly helped its industrialization.

Second, the huge influx of refugees, mainly from the adjacent province of Guangdong and from Shanghai, boosted Hong Kong’s average rate of population growth from a natural rate of about 3% to an actual rate of 5% over the entire postwar period. A profile of refugees in terms of their prior occupation is shown in Table 2.3. While there were substantial numbers of businessmen (5% as opposed to 2% in Hong Kong), and professionals and intellectuals (10% as opposed to 3% in Hong Kong), most of the refugees were unskilled laborers. Fortunately, there were Shanghai foremen and skilled workers that followed their employers to Hong Kong and subsequently became the cadres for the new Hong Kong factories training the ready pool of unskilled labor.

Table 2.3 Occupations of Chinese Refugees in Hong Kong

% of Immigrant Population

Occupation	In China	In Hong Kong
Housewives	33	25
Army and police	16	0
Professionals and intellectuals	10	3
Clerks and shop assistants	10	5
Farmers	10	2
Businessmen	5	2
Industrial laborers	3	13
Hawkers	2	7
Craftsmen	3	12
Coolies and Servants	1	11
Others	5	5
Unemployed	2	15
Total	100	100

Source: Hambro (1955), The Problem of Chinese Refugees in Hong Kong (Leyden), Tables 29–31, pp. 168–70.

Third, there existed a mechanism for marketing Hong Kong products overseas. Trading houses with far-reaching contacts overseas had long been established in Hong Kong and had been engaged in the entrepôt trade with China. With the UN enbargo, however, those trading houses turned to develop an alternative trade with local manufacturers. Meanwhile, the Department of Industry & Commerce was supportive in promoting Hong Kong products by arranging Hong Kong participation in various trade fairs and exhibitions in North America and western Europe (Hopkins, 1971).

Due to the combination of the above factors, Hong Kong quickly transformed itself from an entrepôt for China trade to a center of manufacturing industries. As revealed by the 1961 Census, the manufacturing industries employed 40% of the total working population. Exports of locally produced goods had grown from a quarter of total exports in 1953 to about three-quarters in 1961, indicating a much smaller role of entrepôt trade. Gross domestic product data also shows that Hong Kong reversed its slowdown in growth due to the UN embargo and enjoyed spectacular growth in the late 1950s and early 1960s. GDP grew at a rate of 22.6% for the period 1948–49, 5.3% for the period 1950–54, 9.0% for the period 1955–59, and 13.6% for the period 1960–64 (Chou, 1966).

By late 1960s, the growth of the manufacturing industries was so great that it created an increase in the demand for labor exceeding the increase in supply. Many industrialists were forced to defer their plans for expansion, while some even had difficulty maintaining their existing operations. This set the stage for the second transformation of Hong Kong's economy: from manufacturing to producer services.

3. Transformation from Manufacturing to Producer Services

Decline of Hong Kong's Manufacturing Industry Relative to Its Service Industry

Table 3.1 summarizes the relative contribution of manufacturing and services to nominal GDP in selected years of the past two decades. The percentage share of nominal GDP contributed by services increased from 67.5% in 1980 to an estimated 85.2% in 1997, while the corresponding figure for manufacturing decreased substantially, from 23.7% in 1980 to an estimated 6.5% in 1997.

Table 3.1: Percentage Share of Services and Manufacturing in Nominal GDP in Selected Years

	Services	**Manufacturing**
1980	67.5	23.7
1985	69.6	22.1
1990	74.5	17.6
1995	83.8	8.3
1996	84.4	7.3
1997*	85.2	6.5

*1997 figures are our own preliminary estimates

Similar findings are obtained when the relative contributions to real GDP are used. The percentage share of real GDP contributed by services increased from 74.1% in 1980 to an estimated 83.6% in 1997, while the corresponding figure for manufacturing decreased substantially, from 17.2% in 1980 to 9.0% in 1997.

In the period 1980–97, the share of service sector employment in Hong Kong grew from 42.1% to 79.3%, while the share of manufacturing employment fell from 45.9% to 9.8% (see Table 3.2). A linear extrapolation of the employment trends for this period would imply that by the year 2004, all employment in Hong Kong would be in the service sector. These figures have led to the widespread perception that manufacturing in Hong Kong has declined, and created public concern that the decline of Hong Kong's manufacturing industry relative to the service industry may erode the city's competitiveness.

Table 3.2: Percentage Share of Service and Manufacturing Employment in Selected Years

	Services	Manufacturing
1980	42.1	45.9
1985	54.0	36.1
1990	62.7	27.8
1995	77.6	13.4
1996	78.8	11.2
1997	79.3	9.8

What has actually happened is that, in the past two decades, Hong Kong has transformed itself from an industrial city into a service hub dominated by producer services. In the late 1970s, when mainland China launched its economic reform and adopted an open-door policy, many Hong Kong manufacturing firms relocated their labor-intensive production processes and lower-value-added activities to the mainland to take advantage of the low production costs available there. However, higher-value-added business activities related to manufacturing—producer services—continued to take place in Hong Kong. The relocation of manufacturing out of Hong Kong is, of course, not limited to the Chinese hinterland; it occurs throughout Asia. The Chinese hinterland is nevertheless home to approximately two-thirds of such manufacturing activity that has been relocated from Hong Kong. It is important to note that such relocation is often accompanied by a manifold increase in the scale of operation, hence stimulating the growth of producer services (Sung, 1998).

Estimating Hong Kong's Producer Services

Measuring producer services is a challenging problem, because the classification of a service as a producer service or a consumer service is a function not of the service's physical attributes but of its economic purpose. For example, restaurant service is considered a producer service when used by a business executive on assignment. But it is considered a consumer service when used by a tourist on vacation. Thus, only the share of services bought by producers can properly be considered producer services.

We measure the level and growth of Hong Kong's producer services, using a technique first developed by Grubel and Walker (1989). Detailed descriptions of our method are available in Tao and Wong (2001). It is sufficient to provide a general description of the methodology adopted here with reference to Table 3.3, which applies the expenditure-based method for estimating GDP to the service sector. Note that the entries in the consumer services and producer services categories are identical in this classification scheme. This reflects the idea that the same type of service can be used either for final consumption or as embodied service in the production of other goods.

Table 3.3: A Goods and Service Industry Taxonomy with Service Sector Classified by Use of Expenditure

I. Goods-Producing Sector
Agriculture and Fisheries
Mining and Quarrying
Manufacturing
Construction
Utilities
II. Service-Producing Sector
1. Consumer Services Output
Imports/Exports
Wholesale and Retail Trade
Transport, Storage, and Communications
Restaurants and Hotels
Community and Personal Services
Finance, Insurance, Business Services, and Real Estate
2. Producer Services Output
Imports/Exports
Wholesale and Retail Trade
Transport, Storage, and Communications
Restaurants and Hotels
Community and Personal Services
Finance, Insurance, Business Services, and Real Estate
3. Government Services Output
Government Services

Comment [rb1]: Page: 7
Can this heading be eliminated, since there is nothing under it? Alternatively, you could add a category such as "none" under this heading.

The GDP accounts of Hong Kong contain a consistent time series on the total size of the service-producing sector of the economy, as measured by its value added or GDP. *Consumer services output* refers to all those services used in final consumption. Data on the purchase of consumer services are available from consumer expenditure surveys. These data are reliable and consistent, since they serve as the raw data for the calculation of consumer price and expenditure statistics and contain very detailed records on hundreds of goods and services bought by consumers. Data on g*overnment services output* are Census and Statistics Department estimates and are available from published GDP estimates.

We estimate *producer services output* by subtracting consumer and government services output from total service sector output. Producer services therefore contain the output of the industries producing intermediate inputs (e.g., "business services," "wholesale services"). It is important to be aware that they also include as a residual the output of all those industries widely viewed as serving mainly consumers (e.g., restaurants, hotels, transportation). A large fraction of the output of these industries is used by business and government as input into the production of additional goods and services.

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Shouldn't these items be in the same order as they are in the table (i.e., producer services, then produ services, and then govt. services)?

Note that many of the services produced by the government serve both consumers and business. Unfortunately, it is not possible to determine the relative magnitude of the two. By not allocating any of the government service output to the category of producer services, our procedure biases downward the estimate of the latter.

To assess the contribution of producer services to the economy, we further have to derive the real values of producer services. We first calculate the real value added of all economic activities (i.e., real GDP) and of the goods-producing sectors—agriculture and fisheries, mining and quarrying, manufacturing, construction, and utilities. We then calculate the real value added of total services by subtracting the real value added of the goods-producing sectors from the real value added of all economic activities. Finally, we obtain the real value of producer services by subtracting the real values of government services and consumer services from the real value added of total services. The price deflator of producer services is the ratio between the nominal value and real value of producer services.

Changing Patterns of Producer, Consumer, and Government Services

Figure 3.1 illustrates the size of the total service sector and its three components as percentages of real GDP for the years 1980–97. The top line shows the clear upward trend in the basic series. The figure indicates that in 1980 consumer and government services represented 26.8% and 4.7%, respectively, of GDP, while producer services held the largest share at 42.7%. Since then, the share of government services increased to 5.8% in 1997. Producer services trended upward, and by the end of the period had reached 50.0%. Consumer services increased very modestly, to 27.8% by 1997.

Figure 3.1: Types of Services as a Share of Real GDP (%)

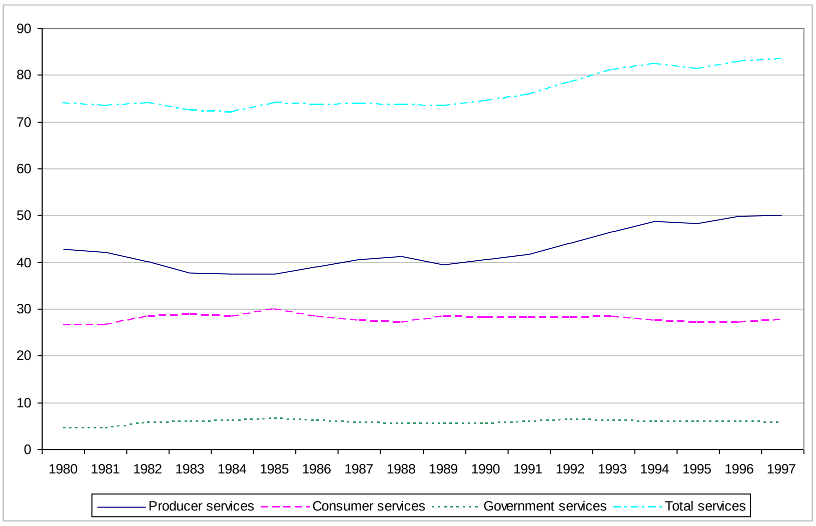

Figure 3.2: Growth of Manufacturing and Producer Services as a Share of Real GDP (1980=100)

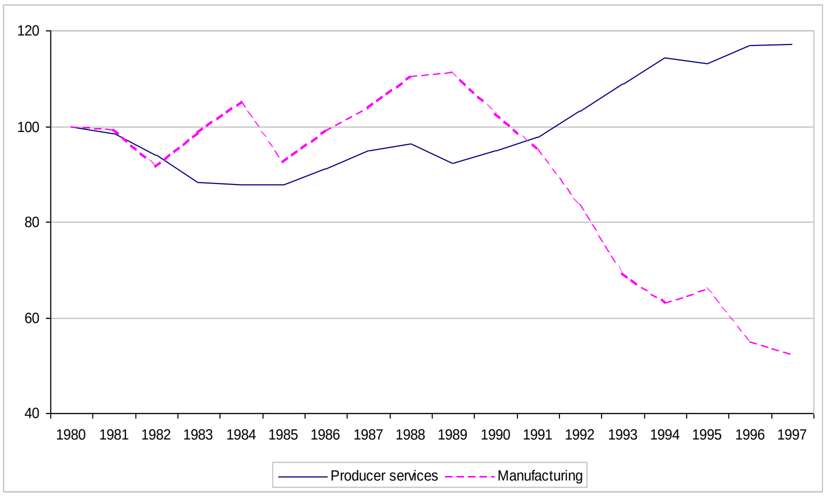

Figure 3.2 contrasts the changing pattern of producer services with that of manufacturing. According to this figure, producer services grew very robustly from the late 1980s onwards. At about the same time, we witnessed the decline of the manufacturing sector. Manufacturing expressed as a share of GDP fell by about 57.6%, while the rise in the share of producer services was about 16.9%. This is consistent with the hypothesis that the relocation of the manufacturing industries to the Chinese hinterland and the rest of Asia paved the way for the growth of producer services in Hong Kong.

Hong Kong's relocation of manufacturing industries into mainland China was associated with significant investment flows, which then created a demand for China-related trade activities in Hong Kong and gave impetus to the growth of Hong Kong's reexports. Indeed, Figure 3.3 shows the close relationship between the percentage change of real producer services and the percentage change in the value of utilized stock of foreign direct investments that Hong Kong had made in the Chinese hinterland. Figure 3.4 shows clearly how the percentage growth of real producer services is closely related to the percentage growth of real reexports from Hong Kong.

Figure 3.3: Real Producer Services and China's Foreign Direct Investment from Hong Kong (Growth Rate in Percent)

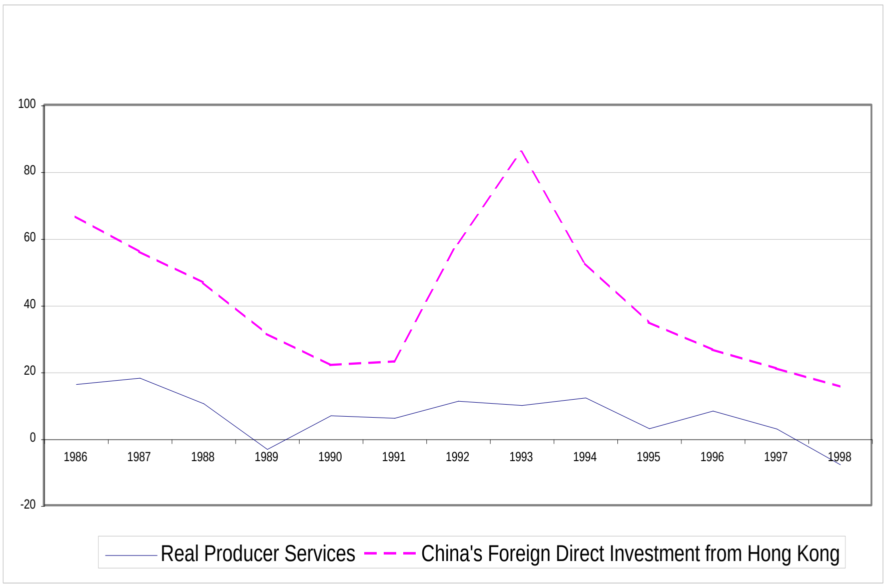

Figure 3.4: Real Producer Services and Real Reexports (Growth Rate in Percent)

Figure 3.5: Real Producer Services and Real Value of Trade with Mainland China (Growth Rate in Percent)

The other reason for the rise of producer services is the increasing role of Hong Kong as an intermediary for trade between mainland China and the world market. As shown in Figure 3.5, there is a close relation between the percentage growth of real producer services and the percentage growth of the real value of all Hong Kong trade with mainland China.

Since China adopted the open-door policy in late 1970s, it has become easier for foreign enterprises to trade directly with China. The transaction costs of establishing a direct trade link have gone down, which in principle should lead to a rise of direct trade between foreign enterprises and Chinese enterprises. What has happened, however, is a rise of indirect trade between foreign firms and Chinese firms via Hong Kong. This is because, along with its open-door policy, China has relaxed its foreign trade system. In late 1970s, the Chinese government deregulated foreign trade, replacing vertical channels of command with horizontal links. The number of trading companies in China has increased at an extremely high rate, reaching one thousand by 1984. The deregulation of foreign trade in China creates a challenging problem for multinationals to spot trading opportunities, find trustworthy trading partners in China, and efficiently carry out transactions in an imperfect legal environment.

Being a combination of the East and the West, Hong Kong is in a unique position to play the role of an intermediary. Hong Kong people speak the same language spoken in mainland China, and at the same time they have great ease in communication with Western people. More importantly, a significant percentage of Hong Kong people were originally from various parts of China. There are thus informal links between Hong Kong people and people in all parts of China. This network of friends and relatives allows Hong Kong people to spot trading opportunities and identify trustworthy trading partners, effectively alleviating the information problem of market transactions. In addition, the informal network has created reputation concerns for Chinese firms and their Hong Kong counterparts, and thereby served as a partial substitute for the imperfect contract enforcement in China.

The Size and Growth of Various Types of Producer Service Industries

According to government statistics, nongovernment services in Hong Kong are further classified into thirteen categories. We estimate the percentage contribution to *real producer services* made by different types of service industries (see Table 3.4). The details for estimating various types of producer services can be found in Tao and Wong (2001).

Table 3.4: Percentage Share of Various Services in Total Producer Services for Selected Years and Periods

	1980	**1997***	**1980–89**	**1990–97**
Wholesale trade	5.0	2.6	4.3	3.3
Retail trade	5.8	3.0	5.2	3.5
Import and export trade	28.1	37.7	34.1	37.9
Restaurants	1.2	0.8	1.3	1.0
Hotels	2.5	2.3	3.2	2.7
Transport, storage, and communications	8.7	8.8	10.1	9.7
Financing	15.4	19.4	15.7	18.2
Insurance	0.3	0.4	0.42	0.44
Real estate	17.9	11.6	11.7	11.7
Business services	6.0	9.2	8.2	8.6
Community, social, and personal services	1.6	1.9	2.0	1.8
Ownership of premises	10.6	13.4	12.5	12.0
Adjustment for financial intermediation services	-3.0	-10.9	-8.9	-10.7

* 1997 figures are our own preliminary estimates

The contributions of wholesale and retail trade to real producer services decreased substantially in the past two decades, falling from 4.3% in 1980–89 to 3.3% in 1990–97 and from 5.2% in 1980–89 to 3.5% in 1990–97, respectively. Restaurants and hotels also decreased their contribution to real producer services from 1.3% in 1980–89 to 1.0% in 1990–97 and from 3.2% in 1980–89 to 2.7% in 1990–97, respectively.

The community, social, and personal services and the services derived from the ownership of premises slightly decreased their contributions to real producer services, from 2.0% in 1980–89 to 1.8% in 1990–97 and from 12.5% in 1980–89 to 12.0% in 1990–97, respectively. The percentage contribution to real producer services made by real estate services was more stable, remaining at 11.7% in both periods. Similarly, the transport, storage, and communications services modestly decreased their contribution to real producer services, from 10.1% in 1980–89 to 9.7% in 1990–97.

The contributions of insurance services and business services to producer services increased from 0.42% in 1980–89 to 0.44% in 1990–97 and from 8.2% in 1980–89 to 8.6% in 1990–97, respectively. The share of real producer services contributed by import and export trade increased substantially, from 34.1% in 1980–89 to 37.9% in 1990–97. The increase in percentage contribution made by financing to real producer services is most substantial: from 15.7% in 1980–89 to 18.2% in 1990–97.

Insurance, financing, import/export trade, and business services have led the growth of total real producer services. The rise of producer services, and especially of the above components, has transformed Hong Kong from a center of manufacturing industries into a hub for managing outsourcing and financial intermediation activities.

4. Conclusion

Hong Kong's economy has been closely linked with that of mainland China. In the past fifty years, it has transformed first from entrepôt to manufacturing after the United Nations embargo on China trade, and then from manufacturing to producer services after the opening up of the mainland Chinese economy since late 1970s. At the time of writing, China has just been admitted to the World Trade Organization. The role of Hong Kong as a center of managing outsourcing and intermediation may well be challenged as a result. It remains to be seen how Hong Kong will cope with the further opening up of the mainland Chinese economy.

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