(Reprinted from HKCER Letters, Vol. 17, November 1992)

The Hong Kong Economy in 2001

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Editor: This is a revised version of a paper prepared for the 80th Anniversary Celebration of the University of Hong Kong.

Extrapolating from past history can sometimes yield good forecasts of the future, especially when the forecast horizon is short enough so that there is less room for surprises. Some features are easier to forecast than others because they depend more on what is known today and less on what may happen in the future. The existing comparative advantages in the Hong Kong economy will shape future developments to a large extent. The restoration of sovereignty over Hong Kong from Britain to China in the year 1997 is a known event that will define some of the key parameters of Hong Kong's economic development. The development of the world economy will also have important effects on Hong Kong's highly open economy. But predicting Hong Kong's future on the basis of forecasts of the future evolution of the world economy is more speculative.

A central feature of the Hong Kong economy is that it is a city with global reach. Developments external to Hong Kong will inevitably have a major effect on Hong Kong. Many global developments will shape the future economic environment in which Hong Kong operates. The most important is the shift towards market reforms in many state-dominated economies, for example, China, India, Indonesia, Latin America, and the ex-communist nations.

The liberation of vast amounts of labor on a global scale will inevitably alter the distribution of economic opportunities in a permanent way. These changes may not happen immediately, since it takes time for markets to be established and for capital to work effectively with labor in these economies. Nevertheless, any major realignment of global capital and trade flows as a result of the changing economic landscape will present enormous opportunities for Hong Kong in the coming decade. This is already happening. The opening of China has altered the opportunities facing Hong Kong entrepreneurs and workers alike.

Such global shifts in the comparative advantage of nations will worsen the distribution of income in these economies, as they are forced to make extensive structural adjustments.

Whether the social and political institutions in these countries will be able to accommodate such challenges without succumbing to greater protectionism is uncertain. Past history shows that the road to an open world order is a steep uphill climb, but the way down is swift. In the long run, protectionism will not be able to halt the momentous market forces that are being unleashed. But one cannot be optimistic about the interim. Politicians and governments are known to have very high discount rates.

The prospect of a fragmented world economy during this interim period has been made more likely with the emergence of a multipolar world order. Nations in the fast-growing Asia-Pacific region are acutely aware of the dangers of such developments and are likely to maintain open access to their markets for as long as possible. This would facilitate further regional integration at a time when intraregional trade is already growing faster than interregional trade. Rapid economic growth within the region may offset some of the negative effects of greater protectionism that might occur outside the region.

The next decade will witness the further transformation of Hong Kong from an export-oriented manufacturing-based economy towards a financial and services center with China as the hinterland. This is a consequence of both internal and external factors. Growing prosperity and rising wages have shifted Hong Kong's comparative advantage away from low value-added production. Increased economic integration with China presents Hong Kong with a natural solution. As China prospers and reforms successfully, the attraction of the Chinese market will grow.

Today we are only witnessing the beginning of the process of economic integration. The most important developments are in the manufacturing sector, especially of the outward processing variety. Production is essentially undertaken in China, with marketing, distribution, and financing arranged primarily in Hong Kong. This simple division of labor has allowed manufacturers in Hong Kong to expand their production capacities to a scale that could not have been imagined previously. Today local manufacturers employ at least five times as many workers in Guangdong than in Hong Kong. At the same time, about half the factory workers in the Pearl River Delta are temporary residents who were attracted there by the new economic opportunities.

In the years ahead, new economic opportunities for foreign investors will grow, not only in manufacturing of the outward processing variety, but also in production for the domestic market. Investment opportunities outside manufacturing will also grow in infrastructure projects, property development, telecommunications and transportation, retail and wholesale trade, and other services. Which developments will take place first is difficult to predict at this juncture. It will obviously depend on how quickly can China reform its economy.

Issues like renminbi convertibility and foreign exchange controls will take time to solve. As a consequence, the growth of foreign exchange earnings from exports will limit the amount and type of foreign investments that will take place. It will also constrain China's ability to import materials and equipment for domestic market-oriented production. However, foreign investments that produce for the international market will not be likewise affected and will be able to benefit from the abundance of both skilled and unskilled labor that is available.

Given the limitations of China's highly regulated banking and financial sector, and its inadequate support facilities and services, Hong Kong will play an important role in financing and servicing China trade and investment. The size of the Chinese economy also implies that regardless of the pace of her economic and financial reform, the benefits to Hong Kong, as a service and financial center acting as an intermediary between China and the rest of the world, will be substantial. A faster pace of development will simply make these opportunities available to more investors.

Economic integration with China will shape Hong Kong's development in the coming decade. Aside from expanding Hong Kong's effective economy, it will shift Hong Kong's comparative advantage increasingly towards providing financial and entrepot services. In the process, it will alter Hong Kong's niche in the world economy and her economic relationship with other nations. The economic meaning of the border that separates Hong Kong and China will also have to undergo a radical redefinition.

The German experience has shown that for "one country and two systems" to survive in Hong Kong, the physical border between Hong Kong and China has to be maintained to prevent uncontrolled population and labor flows. Economic integration between the two, however, will generate enormous pressures to accommodate both temporary and permanent cross-border movements. A large floating population composed of cross-border commuters and visitors may well become a permanent feature in Hong Kong. This group would be comprised of both Chinese residents who come to Hong Kong, and Hong Kong residents who travel to China.

Because of rapid economic growth in the territory, permanent labor and population flows into Hong Kong will also have to be accommodated.. Labor shortage will become a permanent condition that cannot be met by the slow growth of the local labor force. Further depletion of the local labor force is likely, as more people find it attractive to work across the border. The total population in Hong Kong will probably grow rapidly because of the needs of the expanding economy, despite the depletion of the local elderly population which may find retiring in China an attractive option. Current projections of the population in the year 2001 may have to be revised upward substantially. Hong Kong will not be a city whose size will be limited by its natural population growth rate. Such a development has major implications for infrastructure provision and town development.

Cross-border capital flows will have few effective barriers given the economic integration between Hong Kong and China. While Hong Kong residents and companies will hold more assets in China to capture higher yields, Chinese residents will come to hold more assets in Hong Kong and the rest of the world because disparities in the system of legal protection for private property rights between China and the outside world will not disappear. As China prospers, Hong Kong will become a safe haven for parking that wealth, and an even more obvious center for channelling and processing those funds further.

Economic integration with China will subject the economy of Hong Kong to the vicissitudes of China's domestic politics and economic developments. While Hong Kong will become hostage to a political meltdown in China, it will also benefit most from continued stability across the border. To the extent that Chinese economic shocks do not move in phase with those in the rest of the world, economic fluctuations in Hong Kong may well become more stable. A telling example is the current boom experienced in Hong Kong while the rest of the world is in the middle of a recession.

Rapid economic transformation in Hong Kong will inevitably create pockets of hardship and resistance among those who find it costly to make the adjustment. Both labor and industry will have to adapt, and both will look to government to bear the cost of facilitating the adjustment and providing a safety net. Open special interests lobbying will become an increasingly familiar feature of the political landscape, a development that is in part a product of the uncertainty created by the impending change of sovereignty in 1997. Numerous interest groups have been seeking to institutionalize their own interests through protective measures. This will gradually erode the economic foundations of an open and competitive system in Hong Kong.

As Hong Kong becomes a more service-oriented economy, the task of keeping our markets free and open would require a pro-competition initiative from government. Unlike manufacture products, which have to compete in the international market, most services are less internationally traded. There is little point for a local manufacturer to lobby foreign governments for special favors; he is naturally inclined towards free trade. Providers of locally consumed services, however, have an incentive to lobby their own government for protection in keeping out competitors.

Debates as to what will be the best way forward for Hong Kong will continue, but there is little doubt that most people will come to realize, hopefully not the hard way, that the best strategy for Hong Kong is to continue to keep our tax rates low, our regulations simple, and our markets free, competitive, and accessible to all without discrimination. As a small and vulnerable entity in the world economy, Hong Kong has few viable alternatives.

An entrepreneurial Hong Kong will respond to emerging opportunities in a changing world with greater agility. A flexible Hong Kong will overcome adversity in an uncertain world, with greater resilience than one burdened by an overregulated state. It would be plain folly to do otherwise. Furthermore, Hong Kong cannot risk a tarnished image in the world at a time when international goodwill can make a difference.

Between 1981 and 1991, per capita real gross domestic product in Hong Kong grew at 5 percent a year and reached the level of HK$113,450 (or US$14,545) in 1991, which is 65 percent of that in the United States (US$22,450). The economic opportunities created by the opening of China in the next decade will probably outweigh any negative development in the domestic and world economy. It is reasonable, therefore, to expect that the growth rates of the last decade will be sustainable in the coming one as well. This means that per capita real GDP in the year 2001 will be HK$185,000 (or US$23,690) in 1991 dollars. If the United States maintains a 2 percent per capita real growth rate, Hong Kong's per capita real GDP will be 86.5 percent of that of the United States in 2001.

These projected growth rates imply that Hong Kong will overtake the United States in the year 2006. Most people in Hong Kong know that GDP figures will increasingly understate their level of real income because growing numbers of the local population derive their income from China and overseas. With a little more luck, Hong Kong just might achieve a standard of living comparable to that of the United States even by the year 2001.

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