HONG KONG IN TRANSITION

ECONOMIC TRANSFORMATION IN THE EIGHTIES

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HONG KONG IN TRANSITION

Economic Transformation in the Eighties

OVERVIEW

The Hong Kong economy has demonstrated a remarkable capacity to adapt to external change during the past 50 years. The economy evolved from being an entrepot trading centre for China during the immediate postwar period into an export oriented light manufacturing industrial city during the 1950s and 1960s. In the 1970s, the Hong Kong financial sector started as a local commercial banking community only to emerge as one of the largest financial centres in the world. In addition, during the 1970s Hong Kong became a leading tourist destination in the Asia-Pacific region. Most recently, with the advent of China's open door policy, Hong Kong has reemerged as the premier entrepot trading centre serving not only China but the entire Asia Pacific region. At each stage of its economy's evolution, Hong Kong has risen to the challenges of changing global conditions and succeeded in making the economy work.

The economy now stands at a new turning point in its evolution. Since the industrialization of Hong Kong during the 1950s and 1960s, manufacturing has been the main driver of the economy. Faced with rising local labour costs and stiffening world competition in consumer goods, manufacturing industries in Hong Kong have been under pressure to shift production operations offshore and to move to higher-value-added activities. Since the mid-1980s, the shift of Hong Kong manufacturing investment out of Hong Kong, particularly to the Pearl River Delta area in Guangdong Province of China, has been substantial. Meanwhile, some Hong Kong manufactures have moved up-scale to higher-value-added processing and product development.

During the past 5 years the Hong Kong economy has begun evolving in an entirely new way because of new economic links with China. The most remarkable change about Hong Kong is that, as a functional economic region, it now extends well into South China. No longer is Hong Kong simply a city-nation economy. With the extensive investment by Hong Kong manufacturers and other entrepreneurs in South China, the Hong Kong economy is now functionally articulated with South China.

Starting in 1982, the Hong Kong economy experienced an unprecedented downturn - one that was not experienced by the other three newly industrialized economies. In contrast to the high growth rates achieved in earlier periods, Hong Kong's average annual rate of growth in real terms was only 5.7% between 1981 and 1985. These declines resulted from the world economic recession, and to some degree reflected a decline in confidence about post-1997 Hong Kong.

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As Hong Kong faced difficult conditions with respect to its largest markets, the United States and the EEC countries, a completely new set of external forces was emerging with the adoption of China's new open-door policy. In particular, not only did China's new policies enable Hong Kong to serve as an entrepot for trading goods and services in and out of China, but it gave new impetus to Hong Kong manufacturing by encouraging joint-venturing and out-processing activities in China with the creation of special economic zones (SEZs).

Hong Kong today is China's foremost partner in commodity trade, tourist trade, direct foreign investment, and loan syndication. Since 1979, Hong Kong has contributed over 60 percent of all direct foreign investment to China and as well as over 60 percent of China's tourist earnings. In 1990, China's exports to (imports from) Hong Kong was 48 percent (38 percent) of total Chinese exports (imports). Hong Kong also plays an important role in transhipment. Besides trade and investment, Hong Kong facilitates China's open door policy in many indirect ways. Hong Kong serves as a contact point, a conduit of information and technology transfer, and a market and production training ground. This new dimension of the Hong Kong economy represents both opportunities and difficult challenges for Hong Kong in the next evolutionary phase of its economy.

THE CHANGING STRUCTURE OF THE ECONOMY

The changing structure of Hong Kong's economy as reflected by the relative shares of major industrial sectors in total GDP for the 1980s is shown in Table 1. Manufacturing growth has been contracting in relative terms. Its share in total GDP declined from about 24 per cent in 1980 to some 18 per cent in 1989. At its height in 1970, manufacturing had accounted for 31 per cent of Hong Kong's GDP.

In terms of employment, the share of manufacturing employment fell from about 42 per cent of the total work force in 1980 to less than 30 per cent of the employed total in 1989. In other words, over this period employment in the manufacturing sector saw a relative drop of 12 percentage points, which is even more pronounced that the decline in its contribution to total GDP over the same period. In fact, since the turn of the 1980s manufacturing employment has not only continued to edge downward in relative terms but also in absolute numbers.

The rapid growth of the service sector testifies not only to the continual expansion of Hong Kong as a major financial centre in the Asia-Pacific region, but also the re-emergence of Hong Kong as an entrepot for China trade and as a service centre for export orientated production in South China's vast hinterland.

Today, Hong Kong's service sector already accounts for nearly 74 per cent of total domestic output, but as the world's gateway to the Chinese market and China's gateway to overseas markets, Hong Kong's service sector is likely to grow further in the years to come.

THE TRANSFORMING MANUFACTURING SECTOR

Unlike other places, Hong Kong's manufacturing industry was export-orientated from the very beginning and continued to be so. It is officially estimated that around 80 per cent of Hong Kong's manufacturing output is eventually exported. Manufactured products accounted for almost all domestic exports of Hong Kong.

Today, major manufacturing industry groups include textiles, clothing, electronics, watches and clocks, plastics and electrical appliance. These six major export-orientated industries together accounted for about 73 per cent of Hong Kong's total domestic exports and 67 per cent of its total manufacturing employment in 1990.

Hong Kong's manufacturing sector, which is characterised by the continued preponderance of a large number of small and medium-sized establishments that can operate in multi-storey, general purpose factory buildings, is well known for its flexibility and ability to adapt to incessant changes in external demand for light consumer goods. As in the case of Japan's early industrial development, these small scale businesses are well integrated into the economy of Hong Kong. A large number of them act as subcontractors for large manufacturing concerns and export houses, producing parts or complete products. Others occupy a supportive role and provide intermediate goods and services for the export sector and the economy as a whole. Without doubt, this network of subcontracting has facilitated the flexibility that Hong Kong requires to cope with frequently changing market conditions.

In the 1970s, the average size of Hong Kong's manufacturing sector was already getting smaller. During this period of full employment and rising wages, the small factories did quite well. They competed successfully for more labour and they also made considerable fixed capital investments. The 1970s was a time when Hong Kong started industrial restructuring under the pressure of protectionism from its markets in the advanced countries and tough competition from the other NIEs. The smaller factories probably had a hard time but they were not left behind.

But the opening up of China added a new dimension to the adjustment. Hong Kong's industrialists, large and small, were quick to take advantage of the lower labour and land costs north of the border with far reaching effects on Hong Kong's manufacturing sector in the 1980s.

Table 3 outlines the number of manufacturing establishments and the average firm size, measured by the average number of workers per establishment during the past decade. What is of interest to note is that the average size of Hong Kong's industrial undertaking, which was small by

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most international standards at the beginning, has actually become smaller over time. As shown in the table, the average number of workers per establishment fell from about 20 in 1980 to an all time low of less than 15 in 1990.

To facilitate discussion we shall define various categories of firms by their size in terms of the number of persons that are engaged:

small	-- 1 to 19
medium-small	-- 20 to 99
medium-large	-- 100 to 499
large	-- 500 and above

In Table 4 we find from figures on the shares of establishments and persons engaged that small firms had increased over time while those of all other groups had decreased. The shares in output and value-added of small firms also increased and mainly at the expense of the large firms. By 1987, the shares of small and medium-small firms in gross output and value-added had surpassed those of large and medium-large firms, while the shares of small firms had become comparable to those of large firms. The shares of small firms in gross addition to fixed assets also surpassed those of large firms.

On a per person basis, we see in Table 5 that labour cost and output was lower in small firms. But the reverse was true for gross addition to fixed assets towards the end of period. It seems that the high rates of investment in fixed assets in the small firms had contributed to their relatively high rates of increase in labour productivity (gross output per person), but as far as wages (labour cost per person) were concerned, rates of increase were approximately the same for all firms. These factors also led to a decline of the labour cost per unit of output and value-added per unit of output in small firms.

This development is also seen in the labour cost indexes in Table 6. In 1981, labour cost per person in small firms was below the sectoral average. It declined further by 1987 causing wage disparities between small firms and other firms to widen. It should also be noted here that in the process the largest firms, those with 1,000 and above persons engaged, had ceased to pay the highest wages when compared with other firms.

With regard to labour productivity, as seen in Table 7, there were significant differences between the larger and smaller firms in 1981. Developments over the years seemed to have evened out the differences among firms of various sizes except the very small firms with 1-9 persons engaged, which had fallen further below the sectoral average. The large firms had moved much closer to the average, especially the largest ones with 1,000 and above persons engaged, which have also ceased to be the high labour productivity firms within the manufacturing sector.

These developments suggest that in the 1980s there had been a process of labour substitution because a large reservoir of low-cost labour was available north across the border. Many factories had simply relocated there. For those which remained they could still take advantage of the low-cost labour by moving the labour-intensive parts of their manufacturing processes to China. As a result, the factory size measured in number of persons engaged decreased. If we had included the estimated 2 million workers across the border, the story would have been differently.

As manufacturing still had to compete with other sectors for labour in this full employment economy, the more labour intensive small factories would try to minimize their scale and modernize themselves by investing heavily in fixed capital assets to work with their local work-force. For these factories, there was a natural limit to the smallness of their size. But the large ones could reduce substantially by moving, especially those in simple processing and assembly-line operations. This would result in over-capacity of their existing capital, which may well explain why the large factories were lagging behind in fixed capital investments.

In this process of adjustment, it should be pointed out, not all parties were so successful. It seems that the sector of very small factories had been less able to catch up with the change of events and found lagging further behind. Wages in manufacturing had also been depressed.

An even more important consequence of the opening of China is that it created vast opportunities for industrialists in Hong Kong to not only relocate existing production, but to make new investments. The boom in outward processing trade included exports (both domestic exports and re-exports) of raw materials and semi-manufactures, including near-finished goods, from or through Hong Kong to China for processing with a contractual agreement for subsequent reshipment of the processed goods to Hong Kong for final finishing or packaging before shipment to third countries; and imports from China of which all or part of their raw materials and semi-manufactures, also including near-finished goods, were under contractual arrangement previously exported from or through Hong Kong to China for processing.

In 1990, the respective values for domestic exports and re-exports to China related to outward processing increased by 14 per cent and 24 per cent over 1989 to over $35 billion and $55 billion, while the import equivalent grew by 28 per cent to $145 billion. Approximately 62 per cent of Hong Kong's imports from China were related to outward processing in 1990, compared to some 58 per cent in 1989. The corresponding proportions in 1990 were 79 per cent for domestic exports and 50 per cent for re-exports, compared with the respective ratios of 76 per cent and 44 per cent in 1989. Taken together, in 1990 nearly 59 per cent of Hong Kong's total exports were related to outwards processing arrangements commissioned by Hong Kong manufacturers.

Through the aggressive outward processing activities of Hong Kong industrialists, the city economy of Hong Kong has entered into a process of economic integration with South China centred around the Pearl River Delta region.

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THE EMERGING SERVICE ECONOMY

The role of Hong Kong in servicing China's open door policy can be summarized under four main functions: Hong Kong as financier, trading partner, middleman, and facilitator.

<u>Hong Kong as financier</u> Hong Kong accounted for 61 percent of contracted direct foreign investment in China in the period from 1979 to 1990. The share of Hong Kong in China's external loans was smaller because Hong Kong did not extend soft loans to China. But, the Hong Kong share had risen from 0.6 percent in 1983 to 9.4 percent in 1989. Hong Kong is also the centre for raising 80 percent of China's syndicated loans. In recent years, loans from Hong Kong and loans syndicated in Hong Kong accounted for over 20 percent of total external loans to China.

<u>Hong Kong as trading partner</u>

In the pre-1979 era, China had a large trade surplus with Hong Kong and most of China's exports were consumed in Hong Kong. China's imports from Hong Kong were negligible. China's entrepot trade with Hong Kong was relatively small at that time. China-Hong Kong trade was transformed in the reform era. The share of Chinese exports re-exported via Hong Kong rose from 6 percent in 1977 to 40 percent in 1990. Between 1977-90, China's imports via Hong Kong grew 374 times and imports of Hong Kong origin grew 869 times. The share of indirect imports in China's total imports rose from 0.5 percent in 1977 to 27 percent in 1990. Hong Kong had reemerged as a major entrepot for China, and China also become a major market for Hong Kong products.

Hong Kong was the largest final market (i.e. excluding Chinese exports via Hong Kong) for Chinese exports in the late 1960s and early 1970s, but the Hong Kong market was overtaken by the Japanese market in 1973 and by the US market in 1987. Even so the Hong Kong market still accounted for 8 percent of China's exports in 1990. Domestic exports of Hong Kong to China has grown from negligible amounts to US$6086 million in 1990. In 1984, Hong Kong became the third largest supplier of goods to China after Japan and the US. Part of the reason for the rapid growth of Hong Kong's domestic export is due to Hong Kong investment in processing and assembling operations in China. Hong Kong firms supply such operations with the required raw materials and components, part of which are made in Hong Kong.

<u>Hong Kong as middleman</u>. Hong Kong plays the role of middleman both in commodity trade and services trade, including tourism, financial services, and business consultancy. A middleman creates opportunities for trade and investment by lowering transaction costs.

In commodity trade, Hong Kong is an important entrepot as well as centre of trans-shipment for China. Hong Kong trading firms also appear to perform an important brokerage role for China's direct trade, amounting to US$15 billion or 7 per cent of China's total trade in 1988. The value of trans-shipped goods is not available as they do not go through customs, but their weight is

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known. Between 1983-89, trans-shipment of goods to (from) China via Hong Kong have increased 13.2 (2.7) times. But, in 1990, transhipment of goods from China grew by a meagre 3 percent and transhipment of goods to China dropped by 32 percent. This may be an indication that China is starting to overcome its bottlenecks in port facilities.

Since the inauguration of the open door policy, China has established numerous direct links with the rest of the world, including diplomatic, commercial, and transportation links. Paradoxically, the middleman role of Hong Kong is becoming even more important, and an increasing share of China's commodity trade, tourist trade and loan syndication is handled through Hong Kong. One indication is that the share of China's exports re-exported through Hong Kong rose from 7 percent in 1979 to 40 percent in 1990, and the share of Hong Kong re-exports in China's imports rose from 2 percent to 27 percent in the same period.

To understand this phenomenon on must look beyond the usual explanation of entrepot trade in terms of transportation costs to the examine the importance of transaction costs. Since China's adoption of an open-door policy in 1979, it is easier to trade directly with China. The transaction cost of establishing a direct trade link has been reduced and this should lead to a rise in direct trade relative to indirect trade. China, however, started to decentralize its foreign trade system in 1979, replacing vertical channels of command by horizontal links. The number of trading partners and trade links multiplied exponentially. Intermediation activities became necessary and this demand for intermediation was channelled to Hong Kong due to its comparative advantage in trading. China's foreign trade decentralization came in three waves: 1979, 1984 and 1988, and each time the share of China's trade through Hong Kong jumped.

Intermediation also explain China's increasing dependence on Hong Kong for loan syndication. China's financial system was decentralized in 1986 and selected provincial governments and enterprises were allowed to raise foreign loans without central approval. The share of loans syndicated in Hong Kong in China's total external loans jumped from 15 percent in 1985 to 31 percent in 1987. Since the fall of 1988, China drastically recentralized the power to borrow foreign loans as part of its retrenchment programme to combat inflation. As expected, the share of China's foreign loans syndicated in Hong Kong fell from the 1987 record of 31 percent to 14 percent in 1989. In the past 3 years, 80% of China's syndicated loans (excluding soft loans and non-syndicated loans) was undertaken in Hong Kong.

Intermediation also explains why Hong Kong is the foremost gateway for foreigners touring China. Though China has established more and more direct air links with other countries since 1979, the percentage of foreign tourists leaving (visiting) China via Hong Kong has been increasing since 1982, rising to 55 (44) percent in 1987. This paradox is explained by the need for intermediation as China decentralized part of the authority to organize China tours from the China Travel Service to provincial and local authorities in the early 1980s.

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China's decentralization measures in trade and other areas explain why the middleman role of Hong Kong continues to thrive despite growing direct diplomatic and trade links between China and other countries, improving transportation systems in China, and lessening of red tape within the Chinese bureaucracy.

Hong Kong as facilitator

Hong Kong facilitates the open door policy in many intangible ways. Hong Kong serves as a contact point, being the foremost base for China's trade and investment for both foreign companies and Chinese companies. Hong Kong is an important conduit of market information and technology transfer. Hong Kong also provides a market and production training ground for China: some skills can only be learned through practice in a free-market environment, and Hong Kong provides a dynamic and convenient training ground. To utilize Hong Kong as a market and production training ground, China has invested close to US$ 10 billion in Hong Kong by 1990.

The Prospect of Hong Kong as a Middleman for the Mainland

The role of Hong Kong as a middleman for the mainland is important both in commodity trade and services trade, including tourist services, and financial services. Hong Kong's 61 percent share of contracted foreign investment in China also conceals a middleman role. According to Chinese statistics, Hong Kong investment includes the investment of any company incorporated in Hong Kong. The company may well be the subsidiary of a multinational company. Multinational companies in fact like to test the investment environment in China through their Hong Kong subsidiaries because Hong Kong has the expertise for China-related business. A middleman creates opportunities for trade and investment by lowering transaction costs. An efficient middleman thus increases the volume of trade and investment.

Since China plans to further decentralize its exports in 1991, the prospect of Hong Kong as an entrepot is very bright. There are significant economies of scale and economies of agglomeration in trading activity and it is very difficult for other cities such as Singapore or Shanghai to compete with Hong Kong because Hong Kong is the established centre for China's trade. Once a city acquires a comparative advantage in trade, the advantage feeds upon itself, and more trading firms will come to the city, making the city even more efficient in trade.

Though the greater part of Hong Kong's entrepot trade is China-related trade, the non-China component of Hong Kong's entrepot trade is also thriving, growing faster than world trade. This implies that an increasing share of the trade among market economies is handled through Hong Kong in the form of entrepot trade.

Empirical analysis also indicates that Hong Kong's entrepot trade is much more capital and skill-intensive than Hong Kong's wholesale trade, retail trade, and manufacturing exports. The skills required for international trade include a good knowledge of English, familiarity with modern business practices, the ability to work in different cultural and legal environments, and proficiency with complex contractual forms. The supporting industries of international trade, namely, shipping, air transport, communications, finance, insurance and business services, are also capital or skill-intensive.

Trading, business services and financial services will be least affected by rising land prices and wages because such activities are neither land-intensive nor labour-intensive. It should be noted that New York and London have long lost their comparative advantage in manufacturing, but their positions in trading, business and financial centres remain formidable.

In the long run, China is likely to overcome its transportation bottlenecks and acquire modern trading skills. China may even clean up its bureaucracy. However, China will still rely on Hong Kong for trade and financial and business services because of economies of scale and of agglomeration.

Even in the very long run, Shanghai is likely to be the only Chinese city capable of challenging the position of Hong Kong in intermediation, but Shanghai's transport and communication facilities lag considerably behind Hong Kong and her services industries are rudimentary. China's commodity trade will shift towards less bulky and more heterogeneous goods and this will enhance the demand for intermediation. The open door policy led to the development of services trade and investment besides the traditional commodity trade, and this will enhance the need for intermediation as the 'products' of services tend to be more heterogeneous. Moreover, the secular decline in travel costs and transportation costs will imply that the locational advantage of Shanghai will be less important, while proficiency in trading skills will be more important.

The Chinese themselves are establishing many trading companies in Hong Kong, showing that they recognize the established efficiency of Hong Kong in trading. Some Hong Kong traders fear competition from Chinese trading companies in Hong Kong. However, the situation is not a zero-sum game because of economies of agglomeration; the arrival of Chinese trading companies further enhances the position of Hong Kong as a trading centre.

It is often alleged that if South Korea and Taiwan were to establish direct commercial links with the mainland, the role of Hong Kong as a middleman in China's trade would decline. This view is mistaken as it is supported by neither theory nor empirical evidence.

The combined indirect trade of Taiwan and South Korea with the mainland via Hong Kong was only 13 percent of China's indirect trade via Hong Kong in 1990. As mentioned before, though most countries have direct commercial and diplomatic relations with China, they have became more dependent on Hong Kong for their trade with China since 1979.

Canada, the US, Indonesia, and South Korea only established direct commercial or diplomatic relations with China in the 1970s or 1980s, and their experiences again confirm the efficiency of Hong Kong in intermediation. In these four countries, the establishment of direct commercial or diplomatic relations led to a sharp and once-for-all decline in the dependence on Hong Kong, but their dependence on Hong Kong rose again as China decentralized its trading system. For example, in the case of China's exports to the US, the share of indirect exports via Hong Kong fell sharply from 100 percent in 1970 to 16 percent in 1975. However, the share rose in 1979 with the decentralization of China's trade, and it increased to over 62 percent in 1990. In the case of China's exports to Canada, the share of indirect exports via Hong Kong also fell sharply to as low as 7 percent in 1975, but it also rose in 1979, and it increased to over 59 percent in 1990. In the case of China's exports to Indonesia, the share of indirect exports via Hong Kong fell to a low of 50 percent in 1988, but rose slowly thereafter. In the case of South Korea's imports from China, the share of indirect imports via Hong Kong fell from a high of 75 percent in 1987 to a low of 45 percent in 1990. However, the share of Korea's indirect exports via Hong Kong appears to be rising sharply in 1991.

The dramatic increase in China-related entrepot trade, trans-shipment and tourism has strained the port and airport facilities in Hong Kong. Hong Kong became the world's busiest container port in 1987, surpassing New York and Rotterdam in 1986 and 1987 respectively. The Tiananmen Incident slowed the growth of container traffic in Hong Kong, and Singapore surpassed Hong Kong in container business in 1990. However, with the revival of economic growth and economic reforms in China, Hong Kong is forecasted to regain the number one place in container traffic in 1991. All indications are that China-related traffic will continue to rise, and the Kai Tak airport is forecasted to be saturated by 1994.

From the above discussion on economies of agglomeration and economies of scale in trading activities, it is clear that a big and modern airport will benefit both Hong Kong and China. An over-crowded airport will turn away the business traveller and jeopardize Hong Kong's position as the gateway to China. The Agreement with China over the new airport is thus a tremendous boost to Hong Kong's position as China's window to the outside world.

STRUCTURAL TRANSFORMATION AND ITS ECONOMIC CONSEQUENCES

Structural change has been going on since the mid-1970s, but the rapid economic integration of Hong Kong and South China began to have a major impact on this process. First, the opening of China precipitated a massive transfer of low-end manufacturing processes and plants into South China. The manufacturing processes that remained in Hong Kong concentrated on producing high valued added products. The outcome for Hong Kong is that large productivity increases were obtained in manufacturing. According to a study conducted by Sung (1991), Hong Kong's manufacturing labour productivity and its growth rate have exceeded that in all the other new industrialized economies of South Korea, Taiwan and Singapore since 1985.[1]

Second, the opening of China also created enormous new opportunities for foreign direct investment, especially for export-oriented industries. Manufacturing firms in Hong Kong began to increase their investments rapidly in South China after 1985. It has been reported that Hong Kong manufacturing firms currently employ an estimated 2 million workers in South China as compared with 0.73 million in Hong Kong. The expansion of manufacturing activities generated an enormous demand for services in Hong Kong that support and complement manufacturing activities, for example, trading, merchandising, transportation, banking, insurance, financial services, and others.

The outward expansion of manufacturing activities to South China led to a growth in income from foreign sources for Hong Kong that is not recorded in GDP measures. This increase in wealth boosted the demand for consumption. While consumption of tradeables can be imported, consumption of non-tradeables have to be met by increased production at home.

The approach of 1997 led to considerable emigration of skilled personnel overseas. The process began to accelerate in the mid-1980s. By 1986 the number of emigrants was estimated to have jumped to 45,000 per year from a base of about 20,000 in 1980. Most of the employees who have emigrated were from the service sectors. The effect was to slow down productivity growth in the service sectors. The very rapid increase in labour productivity in the manufacturing sector contrasts sharply with the slow growth of productivity in the other sectors.

A slow growing labour force coupled with rapid growth in demand resulted in tight labour markets. Since 1986 the growth rate of the labour force has been declining. The tightness of the labour market is clearly demonstrated by the changing pattern of vacancy rates and unemployment rates during this period. Beginning in 1986 the vacancy rate began to overtake the unemployment rate and the gap continued to grow until mid-1989. Since then the gap has stabilized because of the slow down in the rate of growth of the economy.

This gap measures the tightness of the labour market and causes wages to rise, which in turn leads to increases in the price level. Wages and prices began to accelerate in 1986. Throughout the period wage growth has exceeded price growth implying that there has been real wage growth.

The tightness was much more severe in the service sectors than in the manufacturing sector because the enormous growth in the demand for services that derived from the massive amounts of Hong Kong investments in South China more than offset the labour released by the transfer of manufacturing processes into China. The relative tightness of the labour markets is reflected in the

[1] Sung, Yun-Wing (1991), "Competitiveness of Hong Kong Manufacturing versus its Major Competitors", Department of Economics, The Chinese University of Hong Kong, July 1991.

fact that unemployment and underemployment rates were somewhat higher in the manufacturing sector than in the other sectors, with the exception of the construction industry whose employment conditions are necessarily more volatile. This resulted in a slower growth of nominal wages in the manufacturing sector than in other sectors since 1986. The net effect is that production costs were pushed up faster in services than in manufacturing. Given Hong Kong's linked exchange rate system, the prices of traded manufactures are determined in world markets, their rates of inflation have to follow international levels. The prices of non-traded services are determined domestically; their rates of inflation depend on the excess of local demand over supply. This explains why the domestic rate of inflation has been higher than international levels since 1986. The rapid transformation of the economy that took place within the context of a slow growing labour force and the linked exchange rate combined to generate an accelerating inflation.

The inflationary pressure in the product market is also reflected in the inputs market. Capital which is internationally mobile is less subjected to inflationary pressure from economic restructuring. Residential land is a relatively non-traded resource. Hence its value rises significantly. Land used for commercial and industrial purposes is indirectly traded because firms and industries can be relocated over time. The value of such land is therefore less subjected to inflationary pressure. The current stagnation in the price of office space and industrial premises contrasts sharply with steep price hikes of residential premises.

Labour which is not highly mobile internationally is also a relatively non-traded resource and its value rises in the short run. If wages continue to rise as a result of economic restructuring, some of the existing firms and industries will become less competitive and will eventually be relocated elsewhere. In the long run, real wages are determined by labour productivity and not the scarcity of labour. The persistent rise in wages since 1986 is a sign of a continual process of economic restructuring that is still in progress and shows little signs of abating.

The analysis presented in this part offers an explanation for a wide array of phenomena in Hong Kong. First, we have an explanation of high inflation caused by rapid structural transformation of the Hong Kong economy that created a continuous excess demand for non-tradeable. Second, the opening of China generated an enormous boom in economic activity in Hong Kong, especially in the service sector, leading to a situation of over full employment. Third, the rapid shift into low productivity growth service industries away from high productivity growth manufacturing industries implied a slow rate of GDP growth. Fourth, the increase of wealth that accrued to Hong Kong from investments in China explains why despite slow GDP growth asset prices in Hong Kong have risen faster than inflation. Fifth, the presence of a continuous excess demand for non-tradeable imply that there is an excess supply of tradeable that can be exported, which explains why the real value of merchandise trade began to have a surplus balance after 1985 rather than the typical deficit balance that is characteristic of Hong Kong's trade position in the past.

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HONG KONG AND CHINA'S US MFN STATUS

The increasing economic integration of Hong Kong with South China have made Hong Kong's economic fortunes increasingly enmeshed with those of China. Today the most rapidly growing component in Hong Kong's overall external trade is the re-exports of products from Guangdong and elsewhere in China. Hong Kong and China are now each other's larger trading partner. In the long run, the growing integration of Hong Kong's manufacturing, service and trade activities with that of South China has both advantages and disadvantages. On the positive side, China has provided Hong Kong with a vast hinterland of cheap land and low-wage labour at a time when Hong Kong's external competitiveness in traditional areas was gradually eroding. This has made it possible for Hong Kong' entrepreneurs to grow beyond it wildest dreams. However, the economic integration has also made Hong Kong vulnerable to the vagaries of China' trade relations with the rest of the world.

The most damaging economic event for Hong Kong is US trade action against China, either in the form of a revocation of China's Most Favoured Nation (MFN) trade status with the US or through an enforcement of Section 301 of the US Trade Act of 1974, the so-called 'Super 301', and the Omnibus Trade and Competitiveness Act of 1988 (actually set out in Section 310). The importance of MFN status to China and its implications for Hong Kong could hardly be over emphasised.

For Hong Kong's part, the effects of a loss in China's MFN status could be enormous, if not disastrous. Revoking China's MFN status implies that US import tariffs on Hong Kong's re-exports from China would go up by as much as tenfold. Put another way, without the MFN status, some 75 per cent of China's exports to the US would be cut off, with dire consequences for Hong Kong's exporters with production based in China. According to Hong Kong Government estimates, should the status be lost, Hong Kong's overall trade would suffer a loss of $69 billion to $91 billion in the first year.

The damage to both Hong Kong and China would not be limited to one year. In terms of employment opportunities, up to 43,000 jobs could be lost. The disruption could cost up to 1.8 per cent off Hong Kong's GDP. But this is not all. Conceivably, Hong Kong's loss would significantly enlarge if China were to retaliate against the US.

For political and economic reasons, trade relations between China and the US has been at a low ebb in the past three years. During the last few months, the US Senate has joined the House of Representatives in voting to impose tough conditions on next year's renewal of China's MFN status. The annual debate over renewal of MFN status generates considerable uncertainty about making investments in China. The upcoming US presidential election in 1992 is likely to increase such uncertainties even further.

China already has one of the largest trade surpluses with the US of any country in the world. According to the US Department of Commerce, US's bilateral trade deficit with China, which has already swelled from some US$3.5 billion in 1988 to over US$7 billion in 1989, rose to US$10.4 billion in 1990, and could grow to as high as US$12 billion to US$16 billion in 1991. These figures make China the third largest surplus trading partner with the US after Japan and Taiwan. Clearly, China's burgeoning trade surplus with the US works against the continuation of its MFN status.

China's export performance in the US is to a large extent the result outward processing activities of Hong Kong manufacturers in South China. In a sense, this has enabled Hong Kong to hold down its trade surplus with the US by shifting some of the surplus onto China's trade ledgers. More recently, following the footsteps of Hong Kong, Taiwanese companies has also shifted production facilities into China, thereby reducing Taiwan's trade surplus with the US. The combined outward processing activities from these two places would make China's trade surplus with the US even larger.

Hong Kong's economic prospects are intimately tied to both economic and political developments in China as a result not only of the signing of the Sino-British Joint Declaration on 19 December 1984, but also because of the increasing economic integration with South China. This development more than anything else defines the transition of Hong Kong in the 1980s. Viewed in this perspective China has been both a realized blessing and a possible curse.

Table 1. Changes in Industrial Structure: Percentage Contribution by Major Industrial Sectors to GDP (at factor Cost), 1980-89

Sector	1980	1985	1989
Primary sector	1.0	0.7	0.3
Secondary sector	31.8	29.6	25.9
Manufacturing	23.8	21.9	18.3
Construction	6.7	5.0	5.3
Tertiary sector	67.2	69.7	73.8
Financial services	22.8	16.3	19.7

Source: Census and Statistics Department, Estimates of Gross Domestic Product 1966 to 1990 (Hong Kong: Government Printer, 1991).

Table 2. Changes in Industrial Structure: Percentage Distribution of Working Population by Major Industrial Sectors, 1980-90

Sector	1980	1985	1990
Primary sector	1.4	1.8	1.1
Secondary sector	49.8	43.8	36.8
Manufacturing	41.7	35.6	28.0
Construction	7.6	7.5	8.4
Tertiary sector	48.8	54.4	62.1
Financial services	4.9	5.8	7.3

Source: Census and Statistics Department, Quarterly Report on Household Survey: Labour Force Characteristics, relevant issues.

Table 3. Number of Manufacturing Establishments and Mean Number of Workers per Establishment, 1980-90

	1980	1985	1990
Number of establishments	45410	48070	49090
Workers per establishment	19.7	17.7	14.9

Source: Census and Statistics Department, Hong Kong Monthly Digest of Statistics (Hong Kong: Government Printer, relevant issues).

○ Conference paper (Proceedings of the Conference on the Changing World Community : Development Consequences and Adjustments in Asia and the Pacific, Ninth General Meeting of the Association of Development Research and Training Institutes of Asia and the Pacific, October 8-11, Macau)

Table 4: Contributions by Size of Manufacturing Firms: 1980s

	Size: No. of Persons Engaged per Establishment Year				
	1-19	20-99	100-499	500 & above	Total
No. of Establishments (%)					
1981	78.6	17.8	3.2	0.4	100.00
1984	80.9	15.8	3.0	0.3	100.00
1987	81.6	15.3	2.8	0.3	100.00
No. of Persons Engaged (%)					
1981	21.8	34.2	27.8	16.2	100.00
1984	23.0	33.5	27.8	15.6	100.00
1987	24.4	33.3	27.1	15.2	100.00
Gross Output (%)					
1981	14.0	32.1	32.1	21.8	100.00
1984	15.0	33.3	32.8	18.9	100.00
1987	17.7	32.4	32.1	17.8	100.00
National Accounts Value-Added (%)					
1981	17.0	30.7	29.8	22.5	100.00
1984	16.9	31.7	30.5	20.9	100.00
1987	18.6	32.1	30.2	19.1	100.00
Gross Addition to Fixed Assets (%)					
1981	18.0	26.7	38.1	17.2	100.00
1984	20.7	36.0	24.6	18.7	100.00
1987	27.2	40.5	24.0	8.3	100.00

Source: 1981, 1984 and 1987 Survey of Industrial Production, Census and Statistics Department, Hong Kong.

Note: Taken from Victor Mok, "Size Structure of Hong Kong's Manufacturing Sector", Department of Economics, Chinese University of Hong Kong, June 1991.

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Table 5: Characteristics by Size of Manufacturing Firm: 1980s

Year	Size: No. of Persons Engaged per Establishment				
	1-19	20-99	100-499	500 & above	All Mfg.
Labour Cost per Person (thousand dollars)					
1981	20.2	24.5	25.4	25.1	23.9
1984	26.1	35.9	37.5	38.3	34.5
1987	38.5	50.6	51.7	52.6	48.3
Gross Output per Person (thousand dollars)					
1981	88.4	128.6	158.6	183.7	137.2
1984	129.4	197.7	233.4	239.0	198.4
1987	217.9	292.1	355.7	350.3	300.1
Gross Addition to Fixed Assets per Person (thousand dollars)					
1981	3.9	3.7	6.6	5.0	4.8
1984	5.0	5.9	4.9	6.6	5.5
1987	12.0	13.1	9.6	5.9	10.8
Labour Cost/Gross Output (%)					
1981	22.8	19.0	16.0	13.7	17.4
1984	20.2	18.1	16.1	16.0	17.4
1987	17.7	17.3	14.5	15.0	16.1
National Accounts Value-Added/Gross Output (%)					
1981	31.9	25.2	24.5	27.3	26.4
1984	31.2	26.5	25.9	30.8	27.8
1987	28.1	26.5	25.2	28.7	26.7

Source: 1981, 1984 and 1987 Survey of Industrial Production, Census and Statistics Department, Hong Kong.

Note: Taken from Victor Mok, "Size Structure of Hong Kong's Manufacturing Sector", Department of Economics, Chinese University of Hong Kong, June 1991.

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Table 6: Labour Cost Indexes by Size of Manufacturing Firms: 1980s

No. of Persons Engaged per Establishment	Year		
	1981	1984	1987
1 - 9	73	63	68
10 - 19	97	93	93
20 - 49	100	102	103
50 - 99	105	106	107
100 - 199	106	108	106
200 - 499	106	109	109
500 - 999	105	108	112
1,000 & above	105	114	105
All Mfg.	100	100	100

Source: 1981, 1984 and 1987 Survey of Industrial Production, Census and Statistics Department, Hong Kong.

Note: Taken from Victor Mok, "Size Structure of Hong Kong's Manufacturing Sector", Department of Economics, Chinese University of Hong Kong, June 1991.

Table 7: Labour Productivity Indexes by Size of Manufacturing Firms: 1980s

No. of Persons Engaged per Establishment	Year		
	1981	1984	1987
1 - 9	74	66	69
10 - 19	82	83	85
20 - 49	84	91	93
50 - 99	97	100	101
100 - 199	105	103	105
200 - 499	110	116	119
500 - 999	140	130	133
1,000 & above	136	137	118
All Mfg.	100	100	100

Source: 1981, 1984 and 1987 Survey of Industrial Production, Census and Statistics Department, Hong Kong.

Note: Taken from Victor Mok, "Size Structure of Hong Kong's Manufacturing Sector", Department of Economics, Chinese University of Hong Kong, June 1991.