

## **MANUFACTURING AND SERVICES IN HONG KONG**

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### **On a Widespread Misperception**

In the past decade, service industries have grown rapidly in Hong Kong as a result of the globalization of economic activity, rapid economic growth and integration of the Asia-Pacific region, and the opening of China.

In the decade between 1983 and 1993, the share of service sector employment in Hong Kong grew from 55 percent to 77.5 percent, while the share of manufacturing employment fell from 41 percent to 19.7 percent. The share of the service sector in the GDP grew from 62.3 percent to 78.1 percent, and the share of the manufacturing sector in the GDP fell from 23 percent to 11.2 percent. This increase in the share of service sector employment, and the corresponding decrease in the share of manufacturing employment, has led to the widespread perception that manufacturing in Hong Kong has declined.

In response, two views have emerged. Proponents of the first view believe that a change in public policy from the present laissez faire approach is necessary in order to reverse the decline. Advocates of this course of action include those who believe that Hong Kong's future economic growth and competitiveness depend on a more aggressive industrial and technology policy than the one which is currently in place. The most vocal supporters include many industrialists and some academics. For somewhat different reasons, many labor groups, whose primary concern is to create employment opportunities for manufacturing workers, are also among the chorus of supporters.

Proponents of a second view believe that the transformation into a service economy is a natural outcome of market conditions that are not unique to Hong Kong. The service sector grows in almost every economy as it matures over time. In the long run, policies designed to arrest the decline of an economy's manufacturing sector are neither desirable nor practical. Furthermore, the shift in emphasis from manufacturing to service sector jobs has not resulted in unemployment in Hong Kong, rather, it has created a higher value-added economy.

It is significant that manufacturers in Hong Kong themselves are the first to admit that their business has not declined. For most of those who have expanded their production operations across the border, business has never been better. It is estimated that in China alone, Hong Kong manufacturers employ as many as 4 million workers. Contrary to common belief, service industries have not grown at the expense of manufacturing industries. The demise of the Hong Kong manufacturer is a statistical illusion.

## **Growth of Intermediate or Producer Services in Hong Kong**

Much of the concern with the so-called decline of manufacturing in Hong Kong stems from the failure to appreciate the role of the service sector in raising productivity in the manufacturing sector. In Hong Kong, the growth of the service sector is entirely due to the growth of intermediate or producer services. These services support our manufacturing industries. This unique feature of the service economy contributes significantly to the dynamism of Hong Kong.

The most important feature of Hong Kong's service sector growth is that all of it is in the area of intermediate or producer services. An intermediate or producer service is used as an input into the production of other goods and services. It is distinguished from consumption services in that it is not directly consumed by the consumer.

We start with a simple taxonomy in Table 1 that divides output into a goods-producing sector (section I) and a service-producing sector. The service-producing sector can be divided in two different way. The production-based approach is given in section IIA and the expenditure-based approach is given in section IIB. The production-based approach includes imports and exports, wholesale, retail, restaurants, hotels, transport, storage, communications, finance, insurance, business services, real estate, community and personal services, and government services. The expenditure-based approach includes consumption, intermediate or producer, and government services.

Consumption services are all those services that are used as final consumption. In Hong Kong, the share of consumption services in the GDP declined from 29.5 percent in 1983 to 28.7 percent in 1993 (section IIB of Table 1). In contrast, during this period the share of final consumption services in Singapore, South Korea, Taiwan, Japan, and the U.S. all rose somewhat. The increase is especially pronounced in the case of Taiwan.

During the same period, the share of intermediate or producer services in Hong Kong's GDP rose spectacularly, from 32.5 percent to 46 percent (section IIB of Table 1). While the growth of services in general and of intermediate or producer services in particular is evident in all the other economies listed in the table, Hong Kong presents a striking case of rapid service sector growth that is due entirely to the existence of intermediate or producer services.

What are these intermediate or producer services which have expanded so quickly in the past decade? The rapidly expanding areas in the service producing sector are imports and exports, finance, insurance, business, and real estate services (section IIA of Table 1). The combined share of these services in the GDP rose from 28.6 percent in 1983 to 43.4 percent in 1993.

The growth of intermediate or producer services in Hong Kong is closely linked to (1) the expansion of goods-producing activities of Hong Kong manufacturing firms across the border into south China, and (2) the growing integration of trade and investment-related activities within the Pacific region. These links result in two effects.

First, the increase in demand for intermediate or producer services is derived from the growing demand for goods that are either exported, re-exported, or imported through Hong Kong. These autonomous changes propel the service economy forward. There are, of course, further interactions whereby increases in the demand for some services will generate increases in the demand for intermediate or producer goods, and the process feeds on itself.

The second effect stems from the role of intermediate or producer service inputs as a dynamic force driving the production of goods. According to this view, intermediate or producer service industries are the vehicle by which new technology is introduced into the goods-production process. This new technology can lead to the lowering of production costs, the development of improved and new products, and new and more efficient methods for the distribution of goods. These are service inputs that respond to an increased demand for goods, and in turn contribute to and change the mix of the demand for goods.

A large proportion of all services is produced by bankers, accountants, engineers, and scientists whose output is used by firms in producing goods. In addition, there are the transportation and distribution services without which there could only be self-sufficiency in production and consumption. Finally, it is possible to interpret the production of education and medical services as inputs into the creation and maintenance of society's stock of human and health capital. Without this expenditure, the productivity of any population would fall quickly.

### **Intermediate or Producer Services and Economic Growth**

In free market economies, consumer satisfaction is continuously increased through the introduction of better and cheaper products. Entrepreneurial firms draw heavily on highly educated workers. They also develop and apply new technological and scientific knowledge. They sell advice and deliver innovative services to other firms. These firms in the service industries are the main vehicles through which the human and knowledge capital of society is produced, and through which it is introduced into the production process. Evidence of the greater educational attainment of service sector workers when compared with workers in the goods-producing sector supports this view.

Human capital is enhanced not only through investments in education and on-the-job training, but also through investments in health care, nutrition, and even the kind of moral and ethical standards which make for honest and reliable workers, and which create a willingness to work hard. Knowledge capital is all the scientific and engineering knowledge which permits the design of more efficient machinery and products. It also includes the knowledge which makes for the efficient organization of firms and society in general. Therefore, even if the measured rates of productivity growth of these intermediate or producer services are rather low, their existence is the reason that firms in the goods-producing sector can enjoy high rates of productivity growth.

Economists have long recognized that labor productivity is enhanced when the production process is reorganized and becomes more "roundabout," that is, when it

includes more stages of production and employs an increasing number of intermediate or producer inputs. Labor and capital become more specialized as a result of “roundaboutness.”

The growth of the service sector goes hand in hand with the appearance of more specialized firms producing a greater diversity of intermediate or producer services. In Hong Kong, the average number of persons engaged per establishment decreased by about 16.6 percent between 1983 and 1993. Decreasing firm size is consistent with greater specialization and increasing “roundaboutness”. The decline is even more pronounced in the finance, insurance, business, and real estate services sectors, where the number of persons engaged per establishment decreased by almost 30 percent during this period. The greater decline of the average establishment size in these sectors is a sign of enhanced economic efficiency and dynamism.

Specialization through the market has variously been called the process of “dehiving,” “unbundling,” “vertical disintegration,” and “contracting out.” The process is facilitated when the size of the market grows and the transactions costs of doing business through the market is reduced. The increasing complexity of business operations, the rising cost of monitoring the performance of employees in large organizations, the rapid rates of technological change in increasingly specialized activities, and the falling cost of information and communication in the marketplace have all contributed to this process.

Any close examination of the service sector in Hong Kong reveals that it is a highly heterogeneous industry with many firms working in different market niches. The rapid expansion of the service sector reflects a positive dynamic market process at work. Fear of low productivity following de-industrialization does not appear to be justified, especially in Hong Kong, because the expansion of our service sector has served to support the growth of our goods-producing industries. Hong Kong’s service economy developed, in response to market demands, to service the requirements of firms wishing to operate across borders, in different nations, and under different jurisdictions, in what is an increasingly integrated regional and global economy.

### **Hong Kong as an International Financial Center**

The growth of manufacturing and services in Hong Kong has provided an important background for the rise of Hong Kong as Asia’s premier international financial center in the next century. As may be seen from Table 2, Hong Kong is the second largest IFC in Asia-Pacific, behind Tokyo but ahead of Singapore. At the world level, Hong Kong is very strong in international banking, and probably ranks 4th as an international banking center (IBC). But an IBC is not the equivalent of an IFC. When other financial markets are taken into consideration, Hong Kong's ranking becomes less impressive. Nevertheless, Hong Kong probably still ranks as the 6th or 7th largest IFC of the world. Hong Kong is not just a financial center: it is also a leading business center. In 1995, there were no less than 793 multinational corporations using Hong Kong as their regional headquarters, the largest number in Asia-Pacific. In 1994, Hong Kong was the 8th largest exporter of the world. During 1992-95, Hong Kong was for four consecutive years the busiest container port. Its airport in 1995 was the 4th busiest in the world.

The factors for Hong Kong's success may be divided into two categories: internal and external. Among the former are political and social stability, economic freedom, the rule of law, good and responsive government, excellent record of national treatment and reciprocity, business-friendly tax regime, low regulatory costs, modern infrastructure, freedom of information, skilled human resources, and use of English. Among the latter are location and time-zone advantages, the China Factor, robust economic growth in the Asia-Pacific region, and globalization of banking and finance

The benefits of being an IFC are very substantial in terms of employment, income and balance of payments. Between 1975 and 1995, more than 110,000 jobs were created in the narrowly defined financial sector, while more than 300,000 jobs were created in the broadly defined financial sector during the same period. Between 1980 and 1994, the broadly defined financial sector added more than HK\$218 billion to the GDP. While Hong Kong still does not yet have comprehensive balance of payments accounts, available data on exports and imports of financial services show that during 1983-94, Hong Kong recorded a surplus every year, with net exports totaling HK\$31.8 billion. Another qualitative effect is that, in the presence of a large number of domestic and foreign banks, entrepreneurs can get better terms of credit than would otherwise be the case. The costs of being an IFC are mainly money laundering and the increased costs of monitoring and supervising financial institutions and markets. Our rough estimate is that these costs averaged about HK\$120 million a year at 1995 prices, a trivial amount compared to the actual benefits. Moreover, all IFCs are confronted with the same problems, and there is no evidence to show that Hong Kong's competitiveness is adversely affected.

Hong Kong's prospects as an IFC depend on the validity of six major premises: whether there will be a smooth transition from a British Crown Colony to a Special Administrative Region (SAR) of China; whether China will strictly observe its commitments under the Joint Declaration and Basic Law, and accord to Hong Kong a high degree of autonomy; whether China will continue its market-oriented economic reform and open-door policies; whether cross-strait relations can stabilize without degenerating into military showdown; whether China can maintain stable external relations with the major industrial powers, especially the United States; and whether Hong Kong itself will preserve all the favorable internal factors responsible for its past success. Our judgment is that these premises probably can hold, though not in an ideal manner. Moreover, only the last premise is within the control of Hong Kong, whereas China is involved in all the rest. China therefore must bear the major responsibility for Hong Kong's prospects as an IFC. There are also possibilities of financial crisis, and a sudden upsurge in sovereign risk and brain drain around the date of retrocession. It is our considered opinion, however, that the possibility of a reprise of the 1982-83 financial crisis is minimal, and that the problems of sovereign risk and brain drain are manageable.

Even if the six major premises mentioned above are valid, Hong Kong still has to face increasing competition from other financial centers in the Asia-Pacific region: established centers like Tokyo and Singapore, and emerging centers like Shanghai, Taipei and Sydney. Tokyo is already a global financial center (GFC), while Hong Kong is not, and to that extent the two belong to "non-competing groups". But Tokyo is actually much less external-oriented than Hong Kong: it becomes a GFC by virtue

of the sheer size of its domestic financial sector. It is inferior to Hong Kong in respect of national treatment, transactions and regulatory costs, transparency of the regulatory regime, tax regime, use of English etc. Shanghai, Taipei, and Sydney also lag behind Hong Kong in terms of liberalization and internationalization. Sydney in addition suffers from an inconvenient location: its average air travel time to other major cities in the region is 9.1 hours, as against 3.6 hours for Hong Kong and 4.1 hours for Singapore. Hence, the only center that can challenge Hong Kong is Singapore. In fact, the two have been rivals for over 30 years. We use 30 variables to compare them, and find that Hong Kong leads on 16 counts, Singapore leads on 10 counts, while the rest are more or less neutral. On balance, therefore, Hong Kong is still a larger and more important IFC than Singapore. However, the edge is so small that Singapore can quite easily overtake Hong Kong, especially if the 1997 transition is not managed well.

To ensure that Hong Kong can continue to function effectively as a leading IFC, both China and Hong Kong should follow policies conducive to this goal. China should observe strictly its commitments under the Joint Declaration and Basic Law, accord to Hong Kong a high degree of autonomy, devote itself to peaceful economic development, and provide a stable external environment for Hong Kong. Hong Kong, on its part, should strive to maintain all the favorable factors responsible for its success in the past already enumerated above, and improve on them whenever possible. Specifically, it should raise the ratio of the 17-20 age group receiving tertiary education from the present 18% to 30% within a decade, review the 1½ percentage point surcharge on corporation profit tax if fiscal conditions permit, examine the implications of "double taxation agreements", expedite the real time gross settlement (RTGS) and the Mandatory Provident Fund Scheme, exploit vigorously the positive aspects of the Chinese connection by maintaining not only its present position as the leading offshore center for syndication and capital-raising, but also eventually, reinsurance and trading in Renminbi, strengthen links with foreign financial markets, including linking up our payments system with those of China and the U.S. The strategy of promoting service industries, and the proposal of setting up a mortgage corporation modeled after the U.S. prototype announced in the 1996-97 Budget, are important policy measures in the right direction.

**Table 1: Value-Added by Sectors**

	Hong Kong		Singapore		South Korea		Taiwan		Japan		U.S.	
Year	1983	1993	1983	1993	1983	1992	1983	1993	1983	1993	1983	1992
I. Goods Producing Sector	32.46	18.68	40.02	36.61	54.50	53.30	51.32	42.71	43.84	42.37	29.72	29.77
Agriculture & mining	0.76	0.22	1.19	0.28	15.73	7.56	7.10	3.79	3.74	2.41	3.68	4.00
Manufacturing	22.95	11.15	25.22	27.53	28.24	33.77	36.43	31.08	29.05	26.80	18.79	18.58
Construction, electricity & gas	8.75	7.31	13.61	8.80	10.52	11.97	7.79	7.83	11.05	13.16	7.25	7.19
IIA. Service Producing Sector (production based estimates)	62.26	78.11	59.98	63.39	42.46	45.33	50.45	58.58	58.09	59.26	70.32	70.96
Imports-exports	10.95	17.54										
Wholesale, retail, restaurants & hotels	9.50	9.54	17.45	17.79	12.17	12.25	12.93	15.51	14.91	12.53	16.08	17.55

Transport, storage & communications	8.20	9.52	12.80	14.44	7.56	8.74	6.29	6.33	6.17	6.31	6.04	6.79
Finance, insurance, business services & real estate	17.65	25.84	22.99	26.86	10.77	14.89	13.48	18.98	15.43	16.17	22.49	21.43
Community & personal services	10.38	9.09	-	-	3.75	4.31	5.23	6.96	13.05	16.36	12.52	13.46
Government services	5.58	6.62	6.74	4.30	8.21	5.14	12.52	10.81	8.53	7.90	13.19	11.73
<b>IIB. Service Producing Sector</b> (expenditure based estimates)	62.26	78.11	59.98	63.39	42.46	45.33	50.45	58.58	58.09	59.26	70.32	70.96
Consumption services	29.45	28.71	21.63	23.75	20.85	21.33	23.48	31.65	29.53	29.73	36.57	37.97
Producer services	<b>27.23</b>	<b>42.78</b>	<b>31.61</b>	<b>35.34</b>	<b>13.41</b>	<b>18.86</b>	<b>14.45</b>	<b>16.13</b>	<b>20.03</b>	<b>21.63</b>	<b>20.56</b>	<b>21.26</b>
Government services	5.58	6.62	6.74	4.30	8.21	5.14	12.52	10.81	8.53	7.90	13.19	11.73
Overall Economy	100	100	100	100	100	100	100	100	100	100	100	100

Note: For Hong Kong and Japan, nominal shares were used because figures for real value-added were not available.

**Table 2: Ranking of Hong Kong as an IFC, 1995**

<u>Categories</u>	<u>Asia-Pacific Ranking</u>	<u>World Ranking</u>
<u>Banking:</u>		
No. of foreign banks	1	2
Banks' foreign assets	2	4
Banks' foreign liabilities	2	5
Cross-border interbank claims	2	6
Cross-border interbank liabilities	2	4
Cross-border credit to non-banks	1	2
Syndicated loans and note-issuing facilities (NIFs) (1994)	1	4
<u>Forex Market:</u>		
Net daily turnover	3	5
<u>Derivatives Market:</u>		
Net daily forex contract turnover	3	5
Net interest rate contract turnover	4	8
Overall	3	7
<u>Stock Market: (1994)</u>		
Market capitalization	2	9
Value traded	4	11
No. of listed domestic companies	6	14
<u>Gold Market</u>	1	4
<u>Insurance:</u>		
No. of authorized insurance companies	1	N.A.
Premium income	5	27
Qualified actuaries	1	N.A.
<u>Fund management</u>	2	N.A.

N.A. = not available