An inseparable partnership *SCMP June 20, 2003*

Amajor part of Hong Kong's economy is tied to manufacturing production across the border. Almost 500,000 workers in Hong Kong are employed in manufacturing and import-export companies that have production operations on the mainland. Another one million work in service companies that support cross-border manufacturing operations.

The delta partnership has industrialised Guangdong and transformed Hong Kong into a service economy - one that supports the enormous manufacturing zones across the border by providing services ranging from finance to logistics and packaging. The rapid growth of such services in Hong Kong is an exact mirror of the rapid industrialisation across the border. Hong Kong's service industry thrive on cross-border manufacturing operations and serve to enhance their overall productivity. Together, Hong Kong and the delta form an inseparable partnership - one cannot do without the other.

The Greater Pearl River Delta, which covers Guangdong, Hong Kong and Macau, is the world's fastest growing export-oriented manufacturing region. In 2001, the value of exports from the region was US$289 billion, or 4.69 per cent of the world's merchandise trade. The value of domestic exports (excluding re-exports, but including earnings from re-exports) was US$152 billion - 2.56 per cent of the total merchandise trade.

In recent years, the region has received more foreign direct investment (FDI) than any other East Asian economy. Hong Kong is the largest investor in Guangdong, with total investments amounting to US$79 billion at the end of 2001, which accounted for 71 per cent of cumulative FDI.

Hong Kong's manufacturing investments have helped Guangdong become one of China's leading industrialised provinces. Guangdong's relative share of industry, value-added by industrial production on the mainland, rose from 4.7 per cent in 1978 to 11.4 per cent last year.

To gain a better understanding of the vast and growing dimensions of Hong Kong's role in the delta miracle, the Hong Kong Centre for Economic Research conducted a survey of the cross-border production activities of Hong Kong-based companies. The results reflect a level of integration wider and deeper than we expected. The survey also captures the reasons why Hong Kong has become, and is likely to remain, the financial and logistics hub for the delta.

We found that last year, an estimated 63,000 companies, which comprise 52 per cent of all Hong Kong-based manufacturers and import-exporters, were engaged in manufacturing activities on the mainland. Seven thousand of these are registered as manufacturers and 56,000 are import-exporters. About 27,000 have invested in factory facilities, 32,000 have management and operation controls of factory facilities on the mainland and 28,000 are involved in sub-contract processing arrangements with mainland factories. The 63,000 Hong Kong-based companies with manufacturing operations on the mainland employed 477,000 workers in Hong Kong. For every employee in Hong Kong, 23.5 were employed on the mainland.

In Guangdong, Hong Kong-based companies operate an estimated 53,300 factories. Of these, 21,300 are foreign-funded enterprises - companies with foreign equity or joint ventures - and 32,000 fall under the category of other contractual forms. The latter are predominantly engaged in processing and assembly operations, as well as consignment business. Together, these factories employ more than 10 million workers in Guangdong, with 4.75 million in foreign-funded enterprises and 5.59 million in firms engaging in processing, assembly and consignment work for Hong Kong companies.

An estimated 80 per cent of the value of the companies' exports and 50 per cent of the value of the imported materials was transported through Hong Kong. Its logistics industry thrives on the massive movement of goods in the region. The Hong Kong ports and airport play a critical role in moving goods.

Looking ahead, some 37 per cent of the companies said they are likely to rely more on mainland ports. But for most, the movement of goods in the region is still beset with difficulties. About two-thirds said they had suffered financial losses due to traffic congestion and customs delays while transporting goods across the border. Three-quarters said they had experienced between one and five incidents in 2001, while the rest reported six or more incidents. The median value of the financial loss incurred from such incidents was estimated at HK$100,000. This means that billions of dollars are lost each year.

Sixty-three per cent of the companies said the most important reason for moving operations and production to Guangdong was to reduce labour costs. Other reasons cited were to take advantage of the lower cost of land, and office or commercial space, to increase the volume of production, move closer to their customer and business base, and to exploit sales opportunities in the mainland market. The vast majority said their Hong Kong offices were serving as regional headquarters and were performing financial management functions. Hong Kong is still the management centre of these global supply chains and Guangdong is where most of their manufacturing operations are located.

The division of labour between Hong Kong and Guangdong is changing. At least half the companies said the functions they are performing in Hong Kong would not change in the next two to three years. But more than half said they would increase their activities in Guangdong, while headquarters and financial management functions would remain in Hong Kong.

Sixty-four per cent of the companies said they would start or increase their domestic sales activities on the mainland. As mainland domestic markets expand, the centre of gravity of the Hong Kong-Guangdong partnership will shift further north.

The companies cited Hong Kong's simple tax system, low taxes, free-port status, its absence of foreign exchange controls, the rule of law, independent judiciary, political stability and good security as the major reasons for maintaining operations here. This underscores the importance of preserving the favourable business environment, and political and legal frameworks.

The companies felt that Guangdong's business environment had improved significantly in the past three years. The biggest improvements were in infrastructure and support services, especially in areas like electricity and water supply, telecoms services and transport infrastructure. There was also a significant improvement in production operations, especially in the supply of raw materials and the availability of quality workers.

The companies were less satisfied with government policies and rules in Guangdong, like customs regulations, labour laws, tax, foreign exchange and investment policies. Nevertheless, more than half said access to information on policies and regulations had improved. They were less satisfied in areas relating to legal protection, especially the protection of intellectual property rights, although some companies said there had been improvements.

Regarding dispute resolution, the majority felt the situation in Guangdong had improved. They also said the most effective way of handling disputes was through private channels.

The knowledge and experience accumulated by Hong Kong entrepreneurs are invaluable assets that can be tapped to help foreign investors with an interest in starting manufacturing operations in Guangdong, especially small to medium-sized firms.

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