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Does China Still Need Hong Kong?

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As the Hong Kong Special Administrative Region (HKSAR) reaches the 10th anniversary of the territory's re-union with its sovereign in China in July this year, government and business leaders in the SAR will no doubt engage in many complacent self-congratulations to celebrate that, after all, their capitalist haven has not, as the *Fortune* magazine prematurely predicted in 1995, submerged into a "global backwater" under the weight of its communist motherland. On the contrary, according to the SAR government's latest marketing hype, Hong Kong is destined to emerge as "Asia's World City" which will continue to occupy the "unrivalled role as the gateway to China and the rest of the region." While the bravado may serve as a morale booster for an economy that has recently recovered from some hard times during the first half of this decade, unwittingly it is also a reflection of the ostrich mentality of the HKSAR's business and political elite, many of whom seem to be oblivious of the looming competitive threats that their territory must confront going forward. Recently unfolding trends indicate that, in the coming decade, Hong Kong's self-proclaimed role may face the real and imminent danger of being usurped by its ambitious and aggressive "sister" cities in the mainland.

Seizing Back the Trans-Shipment Business

Take entrepot trade and the logistic business for example. For several decades since China's opening-up in 1979, Hong Kong has had a stranglehold on this sector which has allowed the territory to develop into the premier trans-shipment center for exporters and importers in the mainland. According to the Hong Kong Trade Development Council, about a quarter of China's US\$1.8 trillion foreign trade goes through the territory's port, while more than 60% of the SAR's re-exports—which account for 96% of Hong Kong's total exports—are either originated from or destined for the mainland. In the past few years, however, stubbornly high cost and energetic expansion of mainland ports have combined to erode Hong Kong's hitherto preeminent position. Container terminal operators in the territory typically charge as much as 50% more than their counterparts in Shenzhen. Quoting by the *Financial Times*, the Hong Kong Container Terminal Operators' Association has recently candidly admitted that "[t]he cost differential is making Hong Kong really not competitive." It further warns that in the absence of remedial action to slash cost, "[throughput] growth in Hong Kong in the near future will be slow or zero."

Meanwhile, ports in the mainland, especially in Shanghai and Shenzhen, have embarked on explosive enlargement plans with the undisguised aspiration to become China's hubs for cargo-container traffic of ships heading to and from other countries. At the mouth of the

Yangtze River Delta, a turbo-charged economic growth zone, the Shanghai municipal government has pressed hard to build its port into the largest in the world, let alone China, by constructing the gargantuan Yanshan Port. So impressive is the frenetic growth of the Shanghai port that in the first quarter of 2007, it established a milestone by displacing Hong Kong as the world's second-busiest port behind Singapore. After having surged 28.0% to handle 5.88 million twenty-foot equivalent units (TEUs) against Hong Kong's 2.3% rise to 5.5 million TEUs in the same period, industry analysts forecast that Shanghai will "remain ahead at the end of the year." Likewise, with the unabashed aim to grab a slice of the international trans-shipment business in the Pearl River Delta, Shenzhen has launched its own major container-port expansion programs in Shekou, Chiwan and Da Chan Bay. With its combined throughput leaping by 8.2% to 4.26 million TEUs in the first quarter, the Hong Kong Shippers' Council has pessimistically predicted that "Shenzhen will outstrip Hong Kong as the [world's] third-largest port next year."

Fund-Raising Goes to Shanghai and Shenzhen

In financial services, the Hong Kong Monetary Authority has tirelessly bragged about the SAR's irreplaceable role as the paramount fund-raising center for mainland Chinese companies. This is by and large true until recently, even though in the past years Chinese enterprises have also increasingly fanned out to raise capital in other overseas stock exchanges such as New York, London and Singapore. Lately, however, with the resuscitation of the Shanghai and Shenzhen bourses after years in the doldrums and a deluge of liquidity gushing from household savings, the appeal of domestic markets for Chinese companies has shot up significantly. As a demonstration of the breakneck pace of their revival, on April 11, China's twin stock markets notched up a significant milestone when the combined market capitalization of the Shanghai and Shenzhen exchanges, at US\$1.81 trillion, surged to surpass Hong Kong's US\$1.79 trillion (hitherto the world's sixth largest stock exchange) for the first time ever.

In an attempt to add more breadth and depth to the still relatively immature twin domestic bourses, the China Securities Regulatory Commission (CSRC) has since mid-April directed all but the largest potential initial-public-offering (IPO) issuers in the mainland to list on the Shanghai or Shenzhen exchange first before they can be granted approvals to issue H-shares in Hong Kong. While the intentions of the latest CSRC stance are to raise the number of quality stocks available to mainland investors and concurrently mop up excess liquidity in the home markets, rather than to undercut Hong Kong's fund-raising clout, the policy is likely to reduce sharply the number of IPOs by mainland companies in the SAR. This is certainly bad news not just for the Hong Kong exchange, but also for the many international investment banks that rely on H-share listings for underwriting income. Last year, 59 companies raised US\$41.5 billion in Hong Kong IPOs, of which US\$38.6 billion (93%) was from 41 mainland companies. Already, CSRC's move has claimed several Hong Kong listing casualties, including a US\$600 million IPO by West Mining Co., a US\$150 million listing by Tianjin Lishen Battery, and a US\$200 million offering by Chongqing City Commercial Bank. All three are now switching to list in Shanghai instead this year. As listing casualties in Hong Kong are set to mount, PricewaterhouseCoopers has recently made the grim predictions that IPO proceeds raised in the SAR this year will fall precipitously by as much as 50% to US\$20 billion, while the correspondent numbers on the mainland exchanges will surge 50% to reach US\$25 billion. Commenting on the repercussions of this unfavorable development on Hong Kong, the *Financial Times* has pessimistically opined that "the shift in [CSRC's] bias towards approving A-share listings is expected to hasten Hong Kong's toppling as greater China's leading centre for initial public offerings."

Migration of MNC RHQs to China

Finally, but no less important, a third challenge that Hong Kong must tackle going forward is the inexorable erosion of its traditional competitive advantage as a location of choice for multinationals (MNCs) to base their regional headquarters (RHQs) to oversee their Greater China/Asia-Pacific business activities. Exorbitant operating costs which are easily more than double that in the mainland's front-running metropolises, rising air pollution that is shooting toward the levels in Beijing and Shanghai, and aggressive campaigns by "sister" cities in China which doggedly push to grab a slice of this lucrative business segment are the three main threats that are now contesting Hong Kong's hitherto hegemony as the preferred host for MNCs' RHQs. High costs of doing business in the SAR including office rentals and wages have been consistently cited by foreign companies as the major impediment to operating in the territory. To this deterrent one must now add plunging air quality. The *Financial Times* has identified the latter as "a big risk for Hong Kong" as "pollution is threatening to drive foreign investment and executives away." It further warns that as a host to MNCs' RHQs, the SAR's "advantages are being overshadowed by the haze." Not unexpectedly, Hong Kong officials have tried hard to play down this negative aspect of their city. However, as *Fortune* magazine has quipped, given much lower costs in China, "if pollution is as bad in Hong Kong as it is on the mainland, why not just move to Beijing?"

The latest annual survey by Invest Hong Kong, the SAR's official investment promotion agency, claims that there are more than 1200 foreign RHQs in the territory. The number is probably an exaggeration, as its annual surveys are based on voluntary, self-selected responses by participating companies rather than on some objective, quantitative yardsticks to measure the actual regional responsibilities of these entities. Notwithstanding the SAR's seemingly awesome statistics, MNCs are increasingly lured by Beijing, Shanghai, and even Guangzhou to (re)locate their RHQs there, as all three cities—together with the Ministry of Commerce—have promulgated attractive RHQ schemes to offer generous incentives such as tax rebates/exemptions, special distribution and export/import rights, wider market access, and so on to MNCs. Alcatel-Lucent, General Electric and Unilever were among the first MNCs to have established Greater China/Asia-Pacific RHQs in Shanghai, followed by Exxon Mobil, Kodak, Honeywell, and Johnson & Johnson. According to the authoritative *China Daily*, the past few years have witnessed several MNCs—among others, AMD, American International Insurance, Fuji Xerox, General Motors, Goodyear, and UPS—uprooting their RHQs in Hong Kong or Singapore and relocating them to mainland cities. By the end of 2006, 154 MNCs had set up RHQs in Shanghai and 181 in Beijing. While as a starting trend these are still modest figures, they are set to grow rapidly as other aspiring Chinese cities such as Guangzhou, Nanjing and Tianjin join the fray—a development that no doubt will come at the expense of Hong Kong.

No Game Plan to Reverse Decline?

Do the political and business mandarins in Hong Kong possess the adroitness and ingenuity to help them avert the relative decline of their city vis-à-vis fierce rivals in the mainland which seem to have displayed more dynamism, aggressiveness, raw energy, and in some cases, even vision? Thus far, the SAR government and the cartel operators who dominate the local economy have opt to rely on catchy public-relations slogans than on the articulation of a credible counter-measure strategy. Donald Tsang, Chief Executive of the HKSAR government, has often boasted that the mission of his administration is to elevate "Hong Kong into a New York or London of the East Asia time zone." However, our foregoing diagnosis suggests that on its current course, and in the absence of a coherent strategic roadmap to preserve Hong Kong's premier brand, the title that Tsang so covets is likely to be

out of reach. In response to past international criticisms, the SAR government has bragged that “it has always been a mistake to bet against Hong Kong.” That is just sheer hubris. On the contrary, our bet is that, between now and 2017, the usurpation of Hong Kong’s economic role as the uncontested interface between China and the rest of the world by some of mainland’s first-tier cities will be as inevitable as it is inexorable.

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