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HONG KONG
CHINA'S TWO-WAY MIRROR TO THE WORLD

Hong Kong's Victor Fung, Henry Tang and K S Lo

22nd year of publication

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The wheel is turning. Corporate China now recognises that Hong Kong offers the best route through which to establish a global presence - and can be the best source of funding for expansion needs. Not for the first time, Hong Kong is reinventing itself. The transformation from 'gateway to China' to China's window on the world is almost complete. Having provided the impetus for Hong Kong's economy to kick-start again, China has given a huge psychological boost to Hong Kong traders, financiers and service providers. The Closer Economic Partnership Agreement between the Mainland and the HKSAR provides Hong Kong with some distinct advantages. Limited renminbi financial transactions have been allowed in Hong Kong. And tourism is booming (21.8 million tourists last year), thanks largely to a flood of visitors from the Mainland. Hong Kong has become the de-facto financial and services capital of the Greater Pearl River Delta, a region which accounts for by far the largest slice of China's economy. Our extended report in this issue on the repositioning of Hong Kong examines the strength of the business partnership as Hong Kong merges its economy more deeply into that of the Pearl River Delta.

We speak with Victor Fung (**7-9**), leading Hong Kong businessman, Chairman of the Airport Authority of Hong Kong and Chairman of the Pearl River Business Council, on the key issues of ongoing business discussions with China; with Henry Tang (**11-13**), Hong Kong's Financial Secretary, who spells out his renminbi strategy to strengthen the HKSAR's financial capabilities; and with K S Lo (**15-17**), Chairman and CEO of Great Eagle Holdings and a Director of HSBC (among other roles), who tips an eventual merger between the Stock Exchanges of Hong Kong, Shenzhen and Shanghai.

Also in this report – Talks open on CEPA III (**11**); At the epicentre of a powerhouse (**13-15**); High liquidity cushions Hong Kong dollar (**19**); China 'at the cusp' of consolidation (**19-20**); Hong Kong recruiting Mainland investors (**20**); Selling to China not as simple as it seems (**21**); Turning Macau into the Las Vegas of Asia (**21-22**); Singapore steals Hong Kong's shipping crown (**22**).

CHINA'S TWO WAY MIRROR: Cover design – Petar Belic. Hong Kong skyline – Graham Uden/HKTDC; Victor Fung, Henry Tsang – Hilda Hsu/*ATI*.

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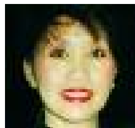

COMMENT

Florence Chong

DENG XIAOPING, who is credited with the reform of modern China, came to power in 1978 and decided then to open China's economy.

In the following year, Deng selected four sleepy backwaters for his experiment with industrial reform. He opened Zuhai, Shenzhen, Xiamen and Shatou as four Special Economic Zones for foreign investment.

Thirteen years later, on a tour of the already prosperous Southern China, Deng uttered his immortal words: "To get rich is glorious".

Some would say his message unleashed China's millions of budding entrepreneurs, encouraging them to build up private wealth. Many of them would reside in the south.

Deng's message became the touchstone for the economic development of China.

Authors of a newly-published book *The Greater Pearl River Delta and the Rise of China* (see page 13) argue that the Pearl River Delta region benefitted from Hong Kong's advanced economy. It was a partnership, they say, that has not occurred anywhere else in the world — a "unique" recipe for the region's fabulous success. Hong Kong is the epicentre of the PRD region — and its significance to the region has not diminished even as China's economic importance grows.

The authors say the Greater Pearl River Delta (GPRD) alone — through Hong Kong — is responsible for the globalisation of China. It drove China's integration with the world through its huge and growing export engine.

The PRD is now the largest economic region in China, and apparently forging unstoppably forward. While at times overshadowed by the excitement of Shanghai, the PRD is seen as the world's most vibrant economy, with combined gross domestic product calculated at US$280 billion — bigger than the economies of Thailand or Indonesia combined.

The growing affluence of the PRD is behind the success of the world's largest retail Wal-Mart. Its store in Shenzhen has one of the highest turnovers of a Wal-mart operation anywhere in the world. Wal-mart alone expects to spend US$18 billion to procure merchandise goods in China, mainly from the PRD region, this year.

Now, capital-intensive investment is beginning to take place in the PRD. And much of that funding is being sourced from and through Hong Kong.

Having recovered from an economic slump, Hong Kong is moving to reinforce its leading position in the Pearl River Delta and beyond — with Beijing's help. Emboldened by its success in negotiating a Closer Economic Partnership Arrangement (CEPA) with the mainland, and the partial deregulation of renminbi trading in Hong Kong, the HKSAR is eyeing more.

As Victor Fung, businessman and Chairman of the Pearl River Business Council, says in our lead report (see page 7), one cannot appreciate the importance of CEPA until one sees the tangible benefits. As a trading firm, CEPA has allowed Fung's personal family company to open its own offices in China and do away with the web of grey, black and white agreements that used to govern its business relationships with Chinese distributors.

Hong Kong now wants more preferential treatment from China. It also seeks to embrace a broader business in the handling of renminbi. If Financial Secretary Henry Tang achieves his ambition, Hong Kong banks will be able to clear renminbi deposits, handle renminbi-dominated trade finance, and issue renminbi-denominated bonds (see page 11).

Observers are sceptical that Hong Kong will get this far. One analyst points out that, to allow Hong Kong to do what it wants with the RMB, China will need to virtually lift controls on its currency and float the renminbi. Hong Kong is an international financial centre, and the implication is that Beijing may lose control of its own currency. No matter, Hong Kong is pushing ahead with its "renminbi strategy". It is also seeking to persuade the Chinese to lift tax and other regulations that separate production for local consumption and exports.

Through the Pearl River Delta Business Council, Hong Kong business leaders are asking China to lift restrictions that currently prevent the majority of foreign-owned ventures or joint ventures from selling into the Chinese domestic market. It will be a hard slog. But Victor Fung is not ruling out that it may be achievable before the end of the decade.

Renewed buoyancy has returned to Hong Kong, seeming to have stemmed from Hong Kong's own acceptance that its future is so intricately tied in with the PRD region.

Ratings upgrade

AS THIS ISSUE went to press, Standard & Poor's revised its A+ long-term foreign currency rating on Hong Kong to 'positive' from 'stable'. The new outlook is aligned with that of mainland China (BBB+/Positive/A-2) and, with the consolidation of Hong Kong's public finances, is a reflection that the principle risk to Hong Kong's foreign currency credit rating relates to challenges that may potentially arise from its increasing economic integration with the lower-rated mainland, S&P said.

At the same time, it affirmed all sovereign ratings on Hong Kong. "The economic upturn, renewed buoyancy in the property market and return to inflation are boosting fiscal prospects for the government, said S&P credit analyst Philippe Sachs. Hong Kong's general government deficit improved significantly to an estimated 0.8% of GDP for the fiscal year ended March 31, compared with the 6% forecast.

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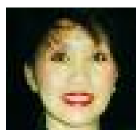
CONSOLIDATING HK'S ROLE IN THE PRD

INTEGRATION of the Hong Kong economy into the Mainland China powerhouses making up the Pearl River Delta continues apace. A combination of World Trade Organisation commitments and tariff concessions granted under CEPA (the Closer Economic Partnership Arrangement between China and Hong Kong) is expected ultimately to fully open China's domestic markets to some 70,000 Hong Kong-owned factories already manufacturing in the PRD. One of Hong Kong's most respected business leaders, Victor Fung, who Chairs the Pearl River Business Council, details Hong Kong's strategy in ongoing discussions with authorities in China . . .



Florence Chong
Editor, ASIA TODAY INTERNATIONAL

HONG KONG — Victor Fung imagines the day when any factory in Southern China will be able to legally offer its merchandise to a billion-plus Chinese consumers.

Until now, foreign ventures have gone to China primarily to manufacture for export. Beijing tightly controls the separation of domestic and export-oriented factories (see page 8).

If these restrictions were lifted, there would be an incredible bonanza for thousands of foreign joint-venture enterprises located in the Pearl River Delta.

This is no pipe-dream.

It is a key priority of the Pearl River Business Council, a business body founded last year to offer private sector input into a government-to-government initiative to forge closer integration in the Pearl River Delta (PRD) region.

"This is of special interest to Hong Kong. Our companies own nearly 70,000 factories and employ 11 million workers in the PRD region, producing goods only for export," says Council Chairman Victor Fung.

"We would like to create more opportunities for our factories. The Chinese market is so attractive. If you are allowed to sell into the local market, it opens a whole new vista for Hong Kong people. It will also appeal to other joint venture operations, whether they are from Australia or Japan."

Fung told *ATI*: "There are two separate worlds in manufacturing in China today – one for export, the other for domestic consumption. The two don't mix. This is because China has traditionally built up the export side through joint venture factories, mostly located in the Pearl River and Yangtze River deltas. These companies export 100 per cent of their goods. They pay duty on all the imported raw materials, and when they export, they get a duty drawback."

Fung is to first to admit that it will be "very complex" to bring them together. To do so, China will have to completely overhaul its tariff system, something it is addressing as part of its undertakings to the World Trade Organisation (WTO). Fung says Beijing will have to find a "revenue-neutral" solution without prejudicing its exporters. It will be a massive change, and he expects opposition from sections of the Chinese bureaucracy, such as Customs.

"Now, if I make a product and import 100 sets of raw materials to make it, and I sell 20 of the finished products into the domestic market, I will be audited by tax authorities to make sure that I only sell 20, because I pay duty on domestic sales. This is exactly the problem we are working on. It is going to take several years at least. Very optimistically, it could be resolved within three years.

"At the leadership level, (China) is attracted to these concepts. It is part of national policy to do away with anachronistic policy geared towards exports." Philosophically, Chinese leaders also agree that manufacturing for domestic and export markets should not be kept separate.

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They, too, want the Chinese consumer to have more choice. "There are a lot of good-quality manufactures that are exported which Chinese consumers never see."

Contrary to popular belief, Fung says Chinese competitiveness has not come from leveraging on its domestic market. Fung, who is also Chairman of the Airport Authority of Hong Kong, says that behind-the-scenes co-ordination between Hong Kong and the PRD provinces is better than is generally known. An example is the so-called "A-Five" – a committee of the five international airports in the region.

"We are not naive enough to think there is no competition," says Fung. "However, we should also recognise that it is not a zero-sum game. We must look at areas where there is win-win and opportunity to co-operate." In the short run, he says, every airport jockeys for position. But if people understand the concept of hubs – the strong hubs get stronger because once a momentum gets going it is hard to stop.

Hong Kong is the dominant airport. "Over time our share might change, but I don't see how one can lose dominant status. Our international flights outnumber those going to Shenzhen and Guangzhou by 10 to one. They have good access to China. That is exactly

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Two worlds of manufacturing

IN CHINA, there is a world of export processing companies, mainly in the economic zones, that manufacture purely for export. Another world manufactures for domestic consumption. There is very little overlapping between the two.

Factories set up by Hong Kong-funded enterprises in Guangdong now stand at nearly 70,000, and about 50 per cent of them are Outward Processing Operations (OPOs). OPOs can import all equipment and machinery, all or part of the raw materials, and parts and packaging materials free from import tax and value-added tax, but are required to export finished products to overseas countries.

There are broadly three options for OPOs to sell into the domestic market — (1) by setting up a separate Foreign Investment Enterprise (FIE); (2) turning the existing OPO into on FIE; or (3) following requirements to re-pay taxes before selling into the domestic market.

For OPOs intending to market their products in the Mainland, setting up a separate FIE or turning the existing OPOs into FIEs is a more direct and simple option.

However, this may pose some difficulties for certain OPOs (especially those set up by SMEs) as the options involve further investment and a departure from their original export business.

Major problems faced by OPOs in selling products in the domestic market through tax repayment are the difficulties arising from the different business environment in the Mainland – in trade law, approval procedures for investment, import/export administration, and the tax and financial regimes.

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Victor Fung: 'We have 22 offices in China today. (CEPA) has totally changed our business there. To a trader, this is nirvana'

what you to want happen. If you are somewhere in the interior of China and you want to go to London, you might, in fact, fly to Shenzhen, train to Chep Lep Kok, and get on a flight to London – all without having to clear customs. That is what is happening on the ferries already. We are linking high-speed ferries. In future we will be linked by high-speed rail, and Shenzhen airport will be less than an hour away."

The Council also wants to improve on trade facilitation. "Traditionally, Hong Kong's role has been as the jumping-off point for multinational companies going into China. That is why we've got over 2,000 Asian headquarters in Hong Kong. We are continuing with that role, although (it is) slightly diluted since some companies are going direct to Shanghai.

"We notice Chinese companies are beginning to go abroad. Hong Kong should be a platform for those thinking about tackling the world market. We are now working on reverse-flow. It is an exciting development for Hong Kong. Chinese companies have a language issue. The bigger companies may be able to go offshore, but the mass of small to medium-sized companies will have difficulties."

Hong Kong's drawcard is the strength of its services, which now contribute 87 per cent of its GDP, against 34 per cent for the whole of the Mainland. Beijing, he says, is the most serviced-intensive city, but services still make up only 65 per cent of GDP.

"There is still a big gap between Hong Kong and Beijing. It takes a whole generation to transform an economy to services," he says, adding that, in 1980, about 66 per cent of Hong Kong's economy came from services."China is not going to change so fast. So the role for Hong Kong is to act as the main service hub for China and especially the greater PRD region."

Hong Kong is a big economy of US$180 billion, compared to US$330 billion for the whole of the PRD. It accounts for 10 per cent of China's entire economy of around US$1.3 trillion.

The rise of Shanghai has characterised China's development over the past 10 years. Three regions, the biggest of which is the PRD, will drive China's economy in future. "In the next decade of Chinese development, Shanghai obviously will continue to be important, but it will not be the only story. I don't think Shanghai will ever be the dominant story because Hong Kong and the Pearl River Delta is the most vibrant region in the world."

Beijing, he adds, will be important. It must be looked at within the context of a "Washington, DC sitting on top of Los Angeles", meaning the political centre, overlaying a burgeoning commercial centre, especially with its "Silicon Valley" — Zhongguancun Science and Technology Park. "This combination of Hong Kong in the Pearl River Delta was not fully realised before 1997. The reason is very simple. Hong Kong was a colony and, in fact, ran as an enclave. Although Hong Kong entrepreneurs had already relocated manufacturing across the border, interaction across the boundary was really very much stifled."

The concept of creating, in a sense, a common market in the southern part of China among the nine provinces south of the Yangtze River and the two SARs (Hong Kong and Macau), has just started to take shape. The entire region is starting to be connected with a network of rail, roads and air links. "Before 1997 you had the hub separated from the hinterland — it was like Manhattan disconnected from Long Island."

Fung says few people understood the true significance of the Closer Economic Partnership Arrangement (CEPA) – a free trade agreement in other countries. "Why is CEPA so crucial? CEPA allows our service industry the right to establish in China. Now that is a very big statement. In the past, Li & Fung (Fung's family business) which has distributed products for almost 100 years in China, has relied on a web of side agreements to do business. CEPA has allowed us to obtain a nationwide licence for importing and wholesaling.

"We have 22 offices in China today. It has totally changed our business there. To a trader this is nirvana. Three years ago, I would have thought this impossible in my lifetime because the wholesale sector was tightly controlled. But CEPA has opened it to us.

"We are just one example of how one company has benefitted in one sector. Can you imagine the situation for financial services, telecoms, lawyers, accountants. Right now, many are trying to establish a company in China. This really is a huge change for us." A change, adds Fung, that will help enshrine Hong Kong's unique position in the PRD and within China. a

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Talks open on CEPA III

HONG KONG — The HKSAR Government is due to start negotiations with Beijing on the third phase of the Closer Economic Partnership Arrangement (CEPA), to further open their respective markets.

Raymond Young, Hong Kong's Director-General of Trade and Industry, is hopeful some kind of agreement can be reached by the middle of the year on CEPA III.

"We have invited manufacturers to suggest what should be covered by CEPA —products not yet manufactured in Hong Kong, but which they are interested in manufacturing in future and for which they would therefore be interested in getting zero tariff coverage. When we have the suggestions — for example, if they want 10 new items to go into CEPA — we will take them to the negotiating table."

Hopefully, Young adds, Hong Kong will be able to obtain "very liberal rules of origin" for these products. He hopes that additional liberalisation negotiated under CEPA III will kick in from January next year.

CEPA I came into force in 2004 and was soon followed by CEPA II, which was implemented this year. Some 1,100 items are now eligible for zero tariff under CEPA. "Although 1,100 does not seem a lot, it represents over 95 per cent of our exports to the Mainland," Young told *ATI*.

"In the second phase of CEPA, we deepened market access measures in the number of serviced areas. We also added eight more service sectors – like estate agencies, with some agreements to allow Hong Kong professionals to sit for Mainland examinations." Altogether, 26 service sectors are now covered by CEPA.

In a preliminary study on the impact of CEPA on Hong Kong's economy in the first nine to 12 months of its implementation, some HK$1.15 billion worth of Hong Kong domestic exports to the Mainland qualified for zero tariff.

Manufacturers of pharmaceutical products, textiles and clothing, plastic articles, colouring matter, chemical products and electrical and electronics products were the main groups to apply for zero tariff concessions under CEPA.

In the random sampling survey, involving 250 enterprises, 93 per cent of respondents believed that CEPA is beneficial to the Hong Kong economy and 89 per cent considered CEPA beneficial to Hong Kong's manufacturing sector – 53 per cent indicated that CEPA was beneficial to their company's Mainland-related business.

Raymond Young: Wants very liberal rules of origin.

CEPA also liberalises visits by Mainland residents to Hong Kong. Progressive liberalisation between July 2003 and July 2004 has meant that some 148.3 million Chinese are now able to visit Hong Kong on individual visits. In 2004, Mainland residents made 4.26 million trips to Hong Kong under the scheme.

HENRY TANG, Hong Kong's Financial Secretary, wants a bigger slice of renminbi business for Hong Kong banks and is hoping current discussions with Beijing authorities will allow him to succeed in time for his March 2006 Budget. Tang wants local Hong Kong banks to clear renminbi transactions instead of having to send funds back to Shenzhen for clearance . . .

Spelling out the renminbi strategy

HONG KONG — Henry Tang is pursuing what he terms his "Renminbi Strategy", which, if it comes to pass, will significantly broaden Hong Kong's role as Greater China's financial services centre. In simple terms, Tang wants Hong Kong banks to have a bigger slice of renminbi (RMB) business.

Tang, Hong Kong's Financial Secretary, first raised the prospect in his Budget, handed down in March. In an exclusive interview with *ATI*, Tang said: "We are in discussion with the Central Government. I hope I will be able to claim success by the time of the next Budget. But, of course, all of this will have to be consistent with China's policy on the RMB.

"Last year, we made a tremendous breakthrough. We convinced Beijing to allow us to conduct RMB banking businesses. We are the first place outside the Mainland to conduct this business — exchange remittance, deposits and also RMB-denominated credit cards. For a bank, this is small business. But it is a breakthrough nevertheless. The question now, what is next?

"In my job I have to think of the other strategic directions in which we want to go. I would say that, within financial services, the renminbi would be a key that we should pursue in three strategic directions.

"The first is to expand RMB business so that institutional business can be conducted in RMB accounts – to diversify the account base.

"The second is to allow Hong Kong banks to clear RMB instead of having to send funds back to banks in Shenzhen for clearance."

The third direction, he says is to expand to issuing RMB-denominated commercial paper, such as bonds.

Tang wants Hong Kong banks to eventually be able to issue letters of credit and other trade-related business such as factoring or discounting of L/Cs denominated in RMB. This will allow RMB deposits to be recirculated within Hong Kong's banking system. He says Hong Kong has the systems to act as a clearance house for RMB in real time. "I believe this is one of the key strategic directions to further strengthen our financial services sector."

Tang says the pool of yuan in Hong Kong is growing by HK$100 million a day. Some 31 banks are authorised to do RMB business, and collectively they hold total deposits of HK$13.1 billion. "In view of the large amount of business done between Hong Kong and the Mainland — manufacturing, offshore trading and re-export business — all are currently denominated either in HK$ or US$, but mostly in US$ — there is exchange risk as well as the additional cost of currency conversion. If we can conduct this business in RMB, it will save costs and reduce minimise risks."

Tang's strategy will come undone if China allows the full convertibility of its currency —

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something which Tang believes is unlikely to happen in the immediate future. "That is a big question. I don't think I will have to cross that bridge so soon," he told *ATI*.

Hong Kong has already established a pivotal role as a capitals market for Chinese companies. In time, Tang hopes they will move their treasury services to Hong Kong. In fact, he says "an increasing amount" of Chinese corporate treasury services are now placed in Hong Kong.

"With our mature settlement and clearance infrastructure in place, this will become an ideal place for them to do all their treasury operations," he says. "I very much believe that we have all the ingredients and the right conditions for us to be a major financial centre for not just China but beyond."

Because of its proximity to China and cultural familiarity, Hong Kong has become the natural capital raising centre for Chinese companies. "In the last 10 years we have raised about HK$110 billion for Chinese companies in Hong Kong. Last year we raised HK$265 billion. That made us the largest capital-raising market in Asia, surpassing Tokyo. We never thought we could surpass Tokyo — it is a much larger country in its financial might as well as the size of its stock market."

Tang says: "There are three legs to a financial centre — equities; banks and debt. On debt, we have not done very well because, traditionally, Hong Kong businesses finance through equity or bank loans. We want to stimulate the debt market, and we have partially achieved that. But until we are able to issue more paper, I cannot say we have reached that goal yet."

He adds that there is strong demand for Hong Kong paper because it is perceived as a good risk. The Hong Kong Government is a creditor economy but has chosen to issue bonds only to create a market.

Tang is closing Hong Kong's deficit gap — thanks to an economy which grew 8.1 per cent last year. The Government is forecasting 4.5-5.5

> “An increasing amount of Chinese corporate treasury services are now placed Hong Kong”

per cent growth this year and four per cent each year until 2009. "Our estimates come in at around mid-range of the private sector forecasts," Tang says.

"When I did my first Budget, we set out certain financial disciplines for ourselves. We want to balance both our recurrent account and consolidated accounts, which means a balanced capital account. Revenue from land sales comes in through our capital account.

“We will balance it for the next five years. I am not worried about that. But as far as the recurrent account – which relies partially on salary tax, profits tax and stamp duties – is concerned, all of these revenues will grow only if the economy grows." Based on the Government's forecast of four per cent annual growth in the next four years subsequent to this year, Tang hopes to achieve fiscal balance on the recurrent account in 2008-09.

He agrees that the Government is behind on its asset sales programme, but adds that the urgency has passed because circumstances have changed. "When we initiated a privatisation programme, it was because we wanted to free up assets for the private sector — but also partially for fiscal reasons. Now those fiscal reasons have disappeared because property has rebounded and demand for land has increased dramatically.”

Hong Kong's budgetary weakness has long been blamed on its reliance on land tax and other property-related revenue. The property sector has picked up – one reason for the strong fiscal position. "Last year, revenue for land sales was robust, but it is not back to 1997/98 when it accounted for 2.4 per cent of GDP." Tang agrees the Government needs to reduce that dependency and broaden its tax base.

"We will launch a consultation on a GST (Goods and Services Tax), after the election of the Chief Executive. In view of the importance and the contentiousness of the issue, it is the right thing to do to make sure the new Chief Executive is fully onboard before we launch this consultation exercise."

While some would argue that Hong Kong's economy has decoupled from the Mainland's — because it was in deflation when China was growing strongly since 1998 — Tang disagrees. He says it is precisely because of its integration with the Mainland that Hong Kong's gross national savings continued to grow strongly when Hong Kong was in recession. a

At the epicentre of a powerhouse

A NEW book traces Hong Kong's role in the emergence of China's most succesful economic region – and predicts future directions for what is now seen as a unique formula . . .

HONG KONG — The Pearl River Delta region, including Hong Kong and Macau, boasts of a gross domestic product of US$280 billion – bigger than the economies of Thailand (US$143 billion) and Indonesia (US$208 billion) combined.

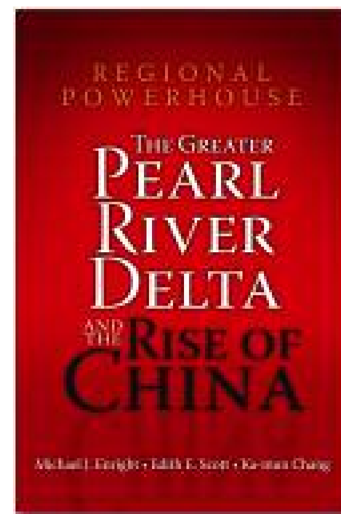
What is the singular factor that propelled the ascendancy of China's PRD region in the global economy? And it is not the PRD's enormous pool of labour or the huge domestic market.

The answer lies in the unique – and the operative word is unique – combination of Hong Kong's world class services sector and the huge hinterland that the PRD provides, according to author Edith Scott.

This unique combination has turned what was the least-developed region in China pre-1978 into what is now one of the most vibrant regions, not just within China but in the world, says Scott.

The rise of the PRD is traced in a new book, *Regional Powerhouse: The Greater Pearl River Delta and the Rise of China*, written by Scott with Michael J.Enwright and Ka-mun Chang (published by John Wiley).

The authors believe the whole PRD region is poised for dramatic growth in the next 10 to 15 years with Hong Kong as its epicentre. Hong Kong will be the single largest source of foreign investment. Scott says just about every province in China will seek to strengthen linkages to Hong Kong as they compete for the



world market. But the authors also spell out in the book a host of emerging problems that could impede growth, including environmental issues and education.

Scott says China's economy is essentially powered by three regions – Hong Kong and the PRD region; Shanghai and the Yangtze River Delta; and Beijing and the Bohai-Hubei region to the north. Shanghai and the Yangtze River

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Delta region has long been the heavily industrial workshop of China, while the Beijing/Tianjin/Bohai area has enjoyed being the capital and centre of education.

The PRD region, in contrast, was not well-endowed. This was precisely the reason then-paramount leader Deng Xiao-ping decided to use Southern China to experiment with his open-door policy. In 1978, he declared Shenzhen, adjacent to the Hong Kong border, a Special Economic Zone.

"In economic terms, China is a nation of regions with great disparity. Some of these regions are growing in double digits, others are experiencing stagnation or worse," Scott told *ATI*. The Gross Domestic Product of the PRD region is US$280 billion (in 2002), compared to US$240 billion for the Shanghai Yangtze region and US$145 billion for Beijing Bohai region.

"When people ask how it was that China became a major player in the world market within 20 short years, the answer is that China, by itself, did not. It is the distinctive and unique combination of Hong Kong capabilities and Mainland Chinese resources in the PRD that emerged to conquer the world market" says Scott. The opening of southern China occurred at a time when labour and land costs in Hong Kong were rising rapidly. "Hong Kong manufacturers needed a lower-cost hinterland in order to be able to compete successfully. Hong Kong was basically reunited with its economic hinterland, which offered a very substantial disparity in pricing."

Scott points out that, in other areas in the world, there is usually a cost differential between an economic core and its hinterland – but never at the multiples that existed between Hong Kong and the PRD in the early stages of their integration. "It was the combination of capital, management expertise and international supply chain management which came out of Hong Kong, with low-cost land and labour and other resources that in the PRD economic zone gave rise to the tremendous growth of manufacturing operations in the PRD in the 1990s," she says.

Now, as the regional PRD economy matures, industrialisation has deepened to include a componentry of capital goods. The PRD has started to shift to higher-value-added processing, in particular in IT products, and capital-intensive car-manufacturing and petrochemical plants. Scott says the IT sector has replaced textiles and leather factories, which are moving out of Shenzhen and Dongguan to the hinterland, within three hours drive of Shenzhen and Dongguan. Scott explains that "three-hour driving time" is a crucial factor. Shenzhen and Dongguan are within three hours of Hong Kong and consequently have spurted ahead economically compared with Zuhai, which is closer to Macau than Hong Kong, and consequently has not developed at the same pace as the other two cities.

Scott says: "We were able to trace the flow of investment and manufacturing activities to Shenzhen and Dongguan from Hong Kong. They have benefitted from their proximity to Hong Kong investment and advanced manufacturing operations. We found, from extensive interviews with managers, that they want their plants within three hours driving time so that they can do a day trip when visiting them."

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With plans to build a Y-shaped bridge connecting Hong Kong with Macau and Zuhai, Scott says the radius of the magical three-hour driving time from Hong Kong will be extended to many more areas, including Zuhai.

"We can now expect a rapid and immediate relocating of lower-cost, lower-value activities from Dongguan and Shenzhen into the western side of the Delta," she says. "We expect this process to be much faster than the original process (Hong Kong to Shenzhen) because the activities are already mature and present in Dongguan and Shenzhen."

She says a car-making industry has taken off in the last four to five years and car component suppliers have followed. "Within a short number of years, Guangdong will, in essence, become an export processing zone for automobiles. This is a significant advance of capability — an economy that can export-process automobiles essentially can export-process anything."

The petrochemical industry is another sector. British Petroleum and Shell have invested in the PRD. Shell and the Chinese company CNOOC are jointly involved in what is the single largest foreign investment in China, in Huaizhou, in southern China. Japan's JFE Steel has invested in a US$1 billion joint venture with Chinese partners to produce steel for car manufacturers.

> “Hong Kong facilitates highly-sophisticated financial transactions which are simply not possible in China – and will not be in the foreseeable future”

Hong Kong is the epicentre of the supply chain and financial, trade and trade finance services. "Hong Kong performs all of these services for, to a large extent, not such Southern China, but the whole of China," says Scott. The value-adding function of Hong Kong is just as strong as it's ever been — and will continue. As China liberalises and establishes a nationwide system of highways, greater geographic expenses of the Mainland will be brought closer to ports, and Hong Kong's function is unmatched."

Scott believes Hong Kong's distinctive environment, its openness, capital and information flows and soft infrastructure – including its judicial system, government administration and regulatory regime – will continue to serve it well into the future. "Hong Kong facilitates highly-sophisticated financial transactions which are simply not possible in China and will not be in the foreseeable future" she says.

Going forward, Scott sees more services developing in Hong Kong, Shenzhen, Zuhai and Macau. Macau will become the entertainment hub (see page 17).

"When other countries like Central America and South America come to us and ask how they can compete with South China, our answer is that, in terms of basic head-to-head manufacturing strategy, you can't. This is because you are not competing against southern China — you are competing against a combination of Hong Kong, with its world-class expertise, supply chain management and South China." It is a formula that has yet to emerge elsewhere in the world."

A PAN-CHINA BOURSE?

Exchange merger in the offing

ONE of Hong Kong's leading business identities, K S Lo, is predicting a merger of the Hong Kong, Shanghai and Shenzhen stock exchanges – perhaps as the world's second-largest exchange – some time after China makes its renminbi fully-convertible. Meanwhile, the former cardiologist is looking to hotel management to boost his company coffers . . .

HONG KONG – Leading Hong Kong businessman Lo Ka Shiu believes the Hong Kong, Shanghai and Shenzhen stock exchanges could eventually merge and become a large exchange for China.

Lo, Chairman and Chief Executive of Great Eagle Holdings and a Director of HSBC and China Mobile, says such a merger will likely take place when the Chinese currency, the renminbi, becomes fully convertible.

When their market capitalisation is combined, Lo says, the three exchanges are now the sixth-largest in the world — with total market capitalisation of US$1.23 trillion. Projecting forward, he believes it is conceivable that, by 2020, the merged exchanges could become the second-largest stock exchange in the world.

Quoting figures from the World Federation of Exchanges, Lo says Hong Kong is currently ranked eighth-largest, while Shanghai is 14th and Shenzhen 18th.

Where the enlarged exchange would be based if it came to fruition, Lo told *ATI*, would depend at the time of the merger on which is the largest exchange. "If Hong Kong remains the largest, then it will be domiciled in Hong Kong," he said, adding that people are used to trading on the Hong Kong exchange.

Lo says the subject has been broached among senior executives of the exchanges. But ultimately, serious negotiations will only take place when the timing is right and the renminbi becomes a free floating currency.

As Chairman of the listing committee of the Hong Kong Stock Exchange from 1992 to 2002, Lo was instrumental in the listing of Chinese enterprises in Hong Kong. These have irretrievably changed the Hong Kong stock market. Lo says that, today, Chinese companies make up 29 per cent of market capitalisation, a figure that will rise to 80 per cent in 15 years. "Some 300 Chinese companies are waiting in a queue to raise capital in the Hong Kong market," he told *ATI*.

Lo says that just in the first 10 months of 2004, 33 Chinese enterprises represented 26 per cent of all IPOs listing in Hong Kong. The daily average trading turnover of Red Chips and H-shares is around US$1 billion.

Chinese companies raised a total of US$6.4 billion, or 72 per cent of the capital raised in that period. A further US$4.2 billion was raised in the secondary market. In total, Chinese companies raised US$10.6 billion, or 35 per cent of the capital raised in Hong Kong in the first 10 months of 2004.

K S Lo: 'The three exchanges together are now the sixth-largest in the world'

Global funds managers seeking China exposure often choose to buy Hong Kong-listed H-shares or Redchips in preference to buying "A" shares listed in Shenzhen or Shanghai. Lo says investors see Hong Kong as having more stringent listing rules and, as the eighth-largest exchange, it has deeper liquidity than the two Chinese exchanges.

He agrees that, despite more strenuous checks and balances in Hong Kong, "you still

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