

# Industrial Structural Changes in Hong Kong, China under One Country, Two Systems Framework

Simon Xiaobin ZHAO, Yingming CHAN, Carola B RAMÓN-BERJANO

(International Center for China Development Studies & Department of Geography, Faculty of Social Sciences,  
the University of Hong Kong, Hong Kong, China)

**Abstract:** Hong Kong has undergone substantial economic transformations and developed into a sophisticated business and financial center in the Asia-Pacific region, since the return of sovereignty to China as a Special Administrative Region under the One Country Two Systems (OCTS) in 1997. This paper discusses and analyzes the industrial structural changes of Hong Kong in recent decades as well as its future challenges and opportunities. The data and finding reveal that even though Hong Kong will face fierce competition from the Mainland's cities as the rise of China, the important role as a bridge between China and the rest of the world will brace Hong Kong itself under the OCTS for developing into a service hub for business and trade in the Asia-Pacific region.

**Keywords:** economic transformation; Hong Kong; industrial structural changes; One Country Two Systems

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## 1 Introduction

Hong Kong experienced significant political, economic and social transformations, from its origins as a small fishing village at the beginning of the twentieth century to becoming a major trading centre within Asia. Hong Kong's industrialization began with textiles and clothing manufacturing in the 1960s, with these two industries accounting for half of the value of domestic exports. Even today, these two account for 40% of total exports. In the late 1970s, as a result of the open and reform policy in the mainland of China, several cities in Guangdong Province were the first designated open areas for attracting foreign investment and trade. Hong Kong industrialists took this opportunity to relocate their manufacturing bases across the border, thus profiting from the abundant supply of land and labour in the Pearl (Zhujiang) River Delta (PRD), while retaining their headquarters in Hong Kong. This kind of fragmentation between

manufacturing and management was referred to as the 'front shop, back factory' model, and facilitated the transformation of Hong Kong into a service-based economy. From the early 1980s, Hong Kong's service industry experienced prosperity, with the proportion of service-based activities in GDP rising from 68% in 1980 to over 85% in the late 1990s. At the same time, thanks to the market-based economic reforms implemented post-1978, China's economy experienced rapid growth and benefited from flourishing international trade and Foreign Direct Investment (FDI), with an average annual GDP that reached 15% during the 1980s and 1990s (Yao and Zhang, 2001; National Bureau of Statistics of China, 2002).

It was a turning point for Hong Kong's economy in 1997. Hong Kong Special Administrative Region (HKSAR) was established under the principle of 'One Country, Two Systems' (OCTS) in order to maintain the prosperity and stability of Hong Kong's economy. Hong

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Corresponding author: Simon Xiaobin ZHAO. E-mail: sxzhao@hku.hk

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Kong experienced several crises—the Asian financial crisis, economic recession, the outbreak of SARS and the Global Financial Crisis. The rapid economic recovery in Hong Kong partly thanks to the support of the central government and the strong growth in China's economy. During this period, China's economy showed one of the strongest growths in the world and was ranked as second largest economy in the world in 2009 with GDP growing between 8.5% and 10% annually in the period 1997–2010 (National Bureau of Statistics of China, 2000–2011). This rapid and successful development in China provided Hong Kong with both opportunities and challenges. Before the global financial crisis, Hong Kong's people believed that the financial sector alone could boost domestic economic growth. However, with China's increasingly internationalization, there were concerns in Hong Kong that rapid development in the mainland of China ('the Mainland' for short hereafter) would threaten Hong Kong's competitiveness.

The major aim of this paper is to provide a comprehensive review of the OCTS as a means of maintaining and ensuring the uniqueness, advantages and competitiveness of Hong Kong in attracting FDI and Multinational Corporations (MNC) among the competitors in the region. In addition to analysis of Hong Kong's competitiveness, we will discuss Hong Kong's structural transformation post 1997. In terms of theoretical contribution, this paper attempts to fill the gap regarding the link between the OCTS and Hong Kong's economic development by focusing on both external and internal dynamics and empirically-derived factors. This paper will be organized as follows. Firstly, it will review the development of service hubs in the world, focusing on the world cities. Secondly, it will briefly depict recent trends in Hong Kong's industrial structure. Finally, this paper will discuss the factors behind the economic transformation and industrial restructuring experienced since 1997 in Hong Kong as well as the role of the OCTS.

## 2 Theoretical Background

OCTS is a unique idea implemented through the Basic Law for ensuring Hong Kong as a Special Administration Region (SAR) of China, whereby Hong Kong continues to have a high degree of autonomy and capitalist economic system. Under the Basic Law, Hong Kong

enjoys executive, legislative and independent judicial powers, with its own monetary and financial policies, while maintaining its own currency. Many studies focus the impact of OCTS on Hong Kong from a political and legal point of view, but only a few have studied the links between the OCTS and the economic development in Hong Kong. Undoubtedly, the impact of OCTS on the economic interactions between Hong Kong and other economies is very difficult to quantify. However, there has been a clear effect on the industrial restructuring of Hong Kong as 'the framework of OCTS was not supposed to be only political, but also economic in nature' (Tsang, 2008). Some argues claim that the OCTS was designed primarily for maintaining Hong Kong's prosperity and stability under a separate system from the Mainland for a period of 50 years; the OCTS would slow down Hong Kong's industrial development as the Mainland further liberalises its markets (Yang, 2006; Tsang, 2008). However, this paper argues that the OCTS helps maintaining Hong Kong's role as a gateway for foreigners and overseas investment to China; and vice versa for Chinese investment into overseas markets (Zhao and Chan, 2011). Furthermore, Hong Kong is expected not only to be able to play a key role in sharing its skills and experience on services sectors (Chan and Zhao, 2011) and fostering the development of the Mainland's economy, politics, and society in the next thirty years (Meyer, 2008; Zhao, 2009b); but also has the potential for becoming the only authentic world city in China despite the increasing competition from other mainland cities (Zhao, 2009a).

Hong Kong has transformed itself from a light industrial hub into a finance, logistics, trade, tourism and information technology centre in Asia, showing a potential to become a world city in the region. An overview of the development of world cities over the past centuries shows that most of today's world cities started off as trading hubs with a manufacturing base and logistics centre support (Kennedy, 1988) and later becoming financial centres in their regions (Zhao *et al.*, 2011). As urban development models were transformed due to the acceleration of international trade and globalization after the 1980s, many scholars tried to summarise the common features and definition of world cities. Friedmann and Wolff (1982) provided the first systematic research on the subject and popularized the world city concept. He gave a detailed analysis and proposed seven hy-

potheses to illustrate that the basic driving force behind the formation of world cities was the new international division of labour (Friedmann, 1986). To present, these hypotheses, are still a crucial reference to the study of modern world cities. In addition, Hall (1984) selected New York, London, Paris, Tokyo, and Moscow as examples of world cities that included 'the major centre of political power, the seats of the most powerful governments, international authorise, of trade, *etc.*'. However, globalization resulted in transformations of the economic structure and spatial distribution in the world cities. Thus, Sassen (1991) further extended the world city concept with the emergence of an international urban hierarchy notably in financial and related producer services. From the 1980s, some cities became global key cities, where service production became the key element. Rather than manufacturing centres, these world cities became 'basing points' for the accumulation and diffusion of world capital, managing, coordinating and articulating world production, marketing and distribution through a complex network of global hierarchy. Sassen claimed that modern world cities had become 'post-industrial production sites' for a variety of command and control functions that 'integrate the global economy in the post Bretton-Woods era' (Sassen, 1991).

At the end of the twentieth century, knowledge became regarded as one of the main factors in competitiveness (Negroponte, 1995). To study the transformation of Hong Kong's economy, we must compare it with other economies that underwent significant changes from raw material and labour-based industrial economies to knowledge-based economies (KBE). Globalization and the incorporation of information and knowledge into economic activities derived in an economic model where the production, distribution and use of knowledge were the main engines of growth, wealth creation and employment. The transition of key cities from economic, commercial and political geographical centres to networks of production-related services for peripheral areas and the global market constitutes our theoretical base to analyse the structural changes of Hong Kong industries under the OCTS after 1997.

Currently, the world economy is borderless given the lack of physical barriers in cyberspace. For Sassen (2001), the concept of global city has emerged because of two inter-related factors: the globalization of economic activity and the organizational structure of the

service and financial industries. Some cities stand out as global key cities because they are a nexus of decision-marking within a sophisticated global economic network and can provide goods and services for the world market rather than for domestic consumption. Thrift (1987) claims that world cities are sites for accumulation and concentration of capital where distribution and circulation are organized and controlled. Knox and Taylor (1995) found that London, New York and Tokyo, frequently grouped together as dominant world cities, only differ from each other in their cultural and political importance and their linkages to their domestic economies. In particular, the internationalization of the producer service sector and financial system has made cities vital centres for the 'management and coordination' of economic power in the global economy (Sassen, 2001).

The locational preferences of producer service activities are vitally helpful in conceptualizing the agglomeration and centralization of management functions in global cities. 'A Roster of World Cities' classified and graded cities on their ability to provide four key services: accountancy, advertising, banking/financing and law (Beaverstock *et al.*, 2000). Sassen (1991) suggests that rapid growth, specialization and agglomeration of producer service firms as well as the organization of the financial industry are all related to the formation of global cities. Thus, producer service firms 'obtain agglomeration economies when they locate close to others that are sellers of key inputs or are necessary for joint production of certain service offerings'. World city and global service centres can only emerge in the last stages of an economy, and only few places have the possibility of becoming world cities. According to Elliott Michael (2008), the Editor of TIME Asia, there are three major international financial centres, referred to as 'Nylon-kong'—New York, London and Hong Kong.

However, the global financial crisis challenged this view of major financial centres. A professor of Yale University, Garten (2009), expected that 'amid economic rubble, Shangkong (Shanghai-Hong Kong) will rise', with Hong Kong and Shanghai City becoming the most promising IFC in China. A decline of the dollar would then be mirrored by a rise in the use of the Renminbi (RMB), guaranteeing the prominence of 'Shang-kong'.

'Social and spatial polarization' is another characteris-

tic present in most world or global cities. Sassen (2001) views globalization as increasingly valuing top level professional class workers and devaluing of other types of economic activities and workers. Therefore, producer service industries led to a social polarisation. Hamnett (2003) found that these cities are characterized by an increase in the number of highly skilled/highly paid professional jobs concurrent with a decline in those less skilled. Competition among cities to evolve into world cities is intense, and in order to increase national competitiveness the role of entrepreneurial and managerial skills were underlined as key factors for innovation and technological improvement (Schumpeter, 1942; Drucker, 1957; Sloan, 1963).

### 3 Road to Industrial Polarization

Globalization and the rise of China has accelerated urban development and modernization in the Mainland's cities like Beijing, Shanghai and Shenzhen, and, as a result, Hong Kong is facing intense competition. To study the economic transformation in Hong Kong, it is essential to understand the development and distinctive composition of its economy as a unique trading hub between China and the world. Hong Kong and Shanghai share a similar history and business environments as major trading ports in China under foreign occupation. This is why a large number of businessmen, capitalists, and foreign firms relocated their businesses, assets, capital and offices from Shanghai to Hong Kong after the 1950s. That relocation, together with cheap migrant labour from the Mainland explains Hong Kong's economic miracle in the second half of the 20th century. From the 1950s to 1990s, Hong Kong's economy transformed and re-adapted itself. Before the British government handed over the sovereignty back to China in 1997, it had been regarded mainly as a service-based economy. Under the OCTS framework, Hong Kong maintained its position as the most attractive investment city in Asia because its connections with the Mainland, totalling around  $5.9899 \times 10^{10}$  U. S. dollars of inward investment in 2007 (UNCTD, 2008) and the largest Foreign Direct Investment (FDI) source in China over the past decade (Zhao *et al.*, 2012). Multinational Corporations (MNC) and FDI are both crucial elements in a world city's economy such as Hong Kong. FDI rose remarkably in Hong Kong and the PRD over the past two decades since under the presence of regional disparities

this is the most common type of capital flowing across borders between developed and developing economies.

However, the pattern of Hong Kong's FDI in China, particularly in the PRD, is different from other foreign FDI in China, and is mainly driven by local Small and Medium Enterprises (SME) (Ramón-Berjano *et al.*, 2011; Zhao *et al.*, 2012). From the 1980s, many Hong Kong manufacturers have been relocating to the Mainland, with many import and export firms in Hong Kong operating factories in the Mainland. By subcontracting production in the Mainland, these Hong Kong enterprises benefited from reduced manufacturing costs derived from abundant labour and land supply in the Mainland and thus shifted their operations from manufacturing to trading, thus becoming service providers. This operation model not only facilitated imports and subsequent re-exports of goods produced in the Mainland to foreign markets but also significantly boosted the development of related service-based businesses such as finance, transport, communications and other advanced producer services in Hong Kong. Whether a major trading centre or a worldwide financial centre in Asia, Hong Kong's favourable business environment originated during the colonial government and has been maintained by the SAR government. It is therefore important to study the driving force behind this economic transformation.

According to the Hong Kong Census and Statistics Department, two main features can be identified since the 1990s. Firstly, the proportion of manufacturing in GDP continued to fall from 6.0% in 1997 to 1.8% in 2010. During the same period, the proportion of service industries rose from 85.8% to 93% and annual GDP growth rate at current market prices averaged 2.67% between 1997 and 2010. Hong Kong's industrial structure, thus, became more service oriented with financial, insurance, real estate and business services underpinning economic development (Table 1 and Table 2). A few patterns can be mentioned, firstly, the majority of Hong Kong manufacturers relocating to the PRD in the past two decades, unlike the Taiwanese and other foreign manufacturers, e.g. Japanese, were small and medium sized, and comprised mostly low-value added businesses (Zhao *et al.*, 2012). Secondly, the relocations among Hong Kong's manufacturers were not connected or organized, so they were in dispersed locations and therefore unable to form a Hong Kong 'industrial cluster' in the PRD to promote regional competitiveness.

Thirdly, while manufacturers traded in Hong Kong they were proprietors or partners of factories in the Mainland, with their general headquarters in Hong Kong where planning, management, human resources and other professional services were based; while the factories in the PRD were in charge of downstream services such as product design, sample and mould making. This phenomenon is reflected in Hong Kong's exports and imports of services (Table 3 and Table 4). Processed goods

are then imported into Hong Kong for being exported to the rest of the world or re-exported to the Mainland. The effect of Closer Economic Partnership Agreement (CEPA)<sup>①</sup> in reviving the manufacturing sector in Hong Kong and promoting the service sector into the PRD was not remarkable even after eight supplements<sup>②</sup>. Hong Kong's domestic products export still continues to gradually decline while there were eight supplements to the CEPA (Fig. 1). Therefore, as a result of trading pattern

Table 1 Proportion of industrial output values in GDP in Hong Kong (%)

Industry classification based on international standard	1970	1975	1980	1985	1990	1997	2002	2007	2010
Agriculture and fisheries	2.0	1.4	0.8	0.5	0.2	0.1	0.1	0.1	0.1
Mining and quarrying	0.2	0.1	0.2	0.1	0.0	0.0	0.0	0.0	0.0
Manufacturing	30.9	26.9	22.8	21.3	16.7	6.0	4.2	2.5	1.8
Electricity, gas and water	2.0	1.8	1.5	2.8	2.4	2.4	3.2	2.6	2.0
Construction	4.2	5.7	6.5	4.8	5.2	5.5	4.2	2.6	3.3
Wholesale, retail, import and export, catering and hotel	19.6	20.7	19.4	21.5	23.7	24.1	25.4	26.9	27.2
Transportation, warehouse and communication	7.6	7.2	6.9	7.7	9.0	8.6	10.0	9.1	11.1
Financial, insurance, real estate and business services	14.9	17.0	21.7	15.1	18.9	24.4	20.2	29.1	26.6
Community, social and personal services	18.0	18.7	11.9	16.3	14.1	17.0	21.2	17.1	16.9
Ownership of premises	0.6	0.5	8.4	9.9	9.7	11.7	11.5	10.1	11.1
Total GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: The percentage may not add up to 100% due to rounding up

Sources: Census and Statistics Department, the Government of the Hong Kong Special Administrative Region (1998; 2011)

Table 2 Hong Kong main expenditure components (% of GDP)

Main expenditure component	1970	1975	1980	1985	1990	1997	2002	2007	2010
Private consumption (C)	64.83	64.40	59.56	61.19	57.13	61.09	58.59	60.17	62.23
Government consumption (G)	7.06	7.05	6.07	7.13	7.20	8.26	10.28	8.07	8.44
Gross domestic fixed capital formation (I)	19.67	21.48	32.24	20.98	26.07	33.10	22.39	20.14	21.48
Changes in inventories (V)	0.74	1.47	2.61	0.53	0.96	0.90	0.44	0.79	2.23
Exports of goods (f.o.b.) (Xg)	65.97	60.19	68.51	84.95	106.83	106.66	122.30	167.05	175.54
Exports of services (Xs)	27.25	23.25	20.39	22.60	23.79	21.00	27.23	40.90	47.42
Imports of goods (f.o.b.) (Mg)	73.15	65.13	75.40	81.65	105.16	116.47	125.38	176.56	194.69
Imports of service (Ms)	12.36	12.72	13.98	15.73	16.83	14.54	15.85	20.56	22.66
Total (10 <sup>6</sup> Hong Kong dollars)	23100	49567	143402	276823	598950	1365024	1277314	1615574	1743858

Notes:  $GDP = C + I + G + V + ((Xg + Xs) - (Mg + Ms))$ ; the results are based on current market price; exports and imports are f.o.b. (free-on-board) valued. The percentage may not add up to 100% due to rounding up

Sources: Census and Statistics Department, the Government of the Hong Kong Special Administrative Region (1998; 2011)

① CEPA is an economic agreement between the Government of the HKSAR and the Central People's Government of the People's Republic of China, signed in June 2003 to strengthen trade and investment cooperation between Mainland China and Hong Kong and promote joint development of the two sides, through the implementation of reducing or eliminating tariff and non-tariff barriers on substantially all trade in goods between the two sides, achieving liberalization of trade in services through reduction or elimination of substantially all discriminatory measures, and promoting trade and investment facilitation. Under the CEPA framework, goods of Hong Kong origin enjoy tariff free treatment when being imported into the Mainland, and thus Hong Kong service suppliers enjoy preferential treatment in entering into the Mainland market in various service areas

② After eight supplements to CEPA, the total number of liberalised service sectors covers 47 sections, involving a total of 301 measures and the value of raw materials and component parts from the Mainland which are allowed into the 'value-added content' requirement, can be up to half of the requirement in order to further benefit from the zero tariff arrangement offered to Hong Kong's goods under CEPA (Hong Kong Trade and Industry Department, 2011b)

Table 3 Exports of services by major service group (%)

	1980	1985	1990	1997	2002	2007	2010
Transportation service	42.2	36.7	35.6	30.5	29.8	30.2	28.4
Travel service	22.3	24.0	25.6	20.8	16.7	16.2	20.8
Insurance service	2.0	1.4	0.9	0.9	1.0	0.6	0.5
Financial service	4.4	8.9	9.6	11.4	9.4	14.7	11.8
Merchanting and other trade-related service	19.2	19.1	18.5	25.6	33.3	30.1	30.0
Other service	10.0	10.0	9.7	10.7	9.7	8.2	8.4
All services (10 <sup>6</sup> Hong Kong dollars)	29239	62564	142505	286595	347836	660728	826856

Note: The sum of individual items may not tally with the corresponding total shown in table because of rounding

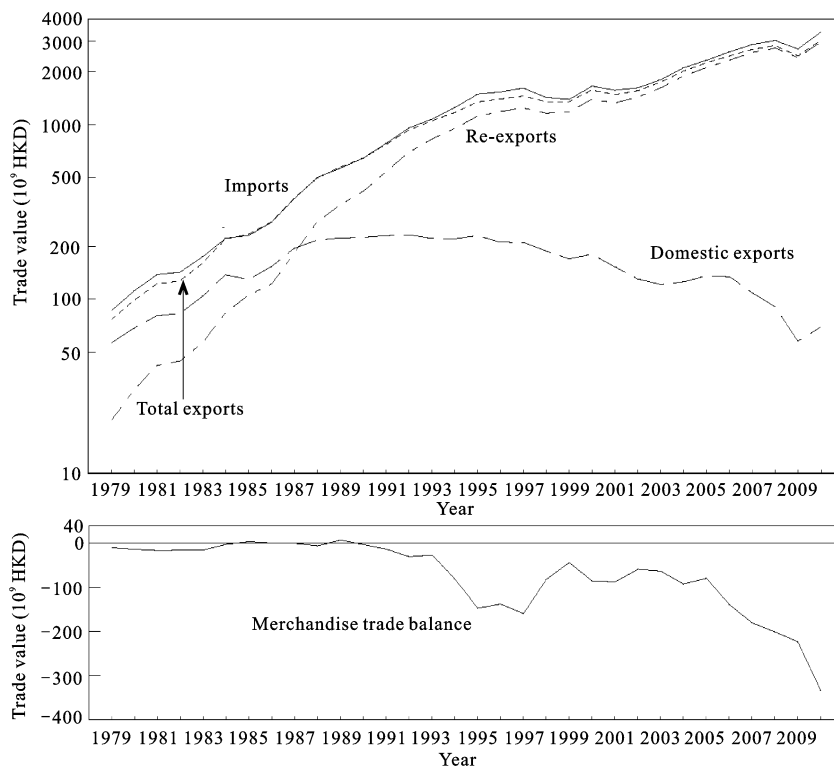
Source: Census and Statistics Department, the Government of the Hong Kong Special Administrative Region (2011f)

Table 4 Imports of services by major service group (%)

	1980	1985	1990	1997	2002	2007	2010
Transportation service	45.1	37.2	33.8	25.3	24.0	32.7	28.6
Travel service	26.8	33.1	36.8	49.5	47.8	35.3	34.3
Insurance service	4.1	3.7	3.2	2.3	2.3	1.7	1.6
Financial service	1.4	3.4	3.0	4.0	3.8	6.6	6.9
Merchanting and other trade-related service	6.6	6.4	7.0	5.0	7.2	7.3	8.4
Other service	16.0	16.2	16.2	14.0	14.9	16.4	20.1
All services (10 <sup>6</sup> Hong Kong dollars)	20047	43536	100778	198424	202494	332240	395201

Note: The sum of individual items may not tally with the corresponding total shown in table because of rounding

Source: Census and Statistics Department, the Government of the Hong Kong Special Administrative Region (2011f)



Source: Census and Statistics Department, the Government of the Hong Kong Special Administrative Region (2011e)

Fig. 1 Hong Kong's movement of aggregate trade values in 1979–2010

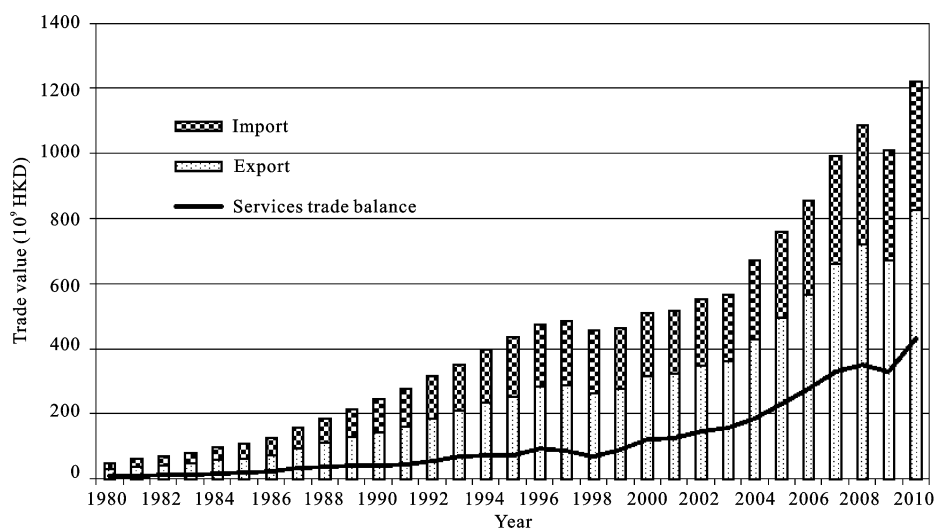
moving from goods to services trading, many high-value-added and service-oriented businesses were forced to apply new technology and business models, which could enhance their performance in the Mainland's markets and promote the services trade (Fig. 2).

#### 4 Determinants and Driving Forces of Hong Kong's Development into A Regional Service Hub

As already mentioned, the Mainland's growth, particularly in the PRD, had a complementary effect in Hong Kong, whereby Hong Kong provided producer services such as management, accounting and global supply chains while the PRD supplied land and labour (Yang, 2005). This 'front shop, back factory' model not only facilitated Hong Kong's economic transformation into a service-based economy and a world major trading centre, but also contributed to the Mainland's manufacturing industrialization. Since then, Hong Kong has developed four key industries as the driving force of economic growth, which had spillovers into other sectors in the economy. These four key industries are financial services; trading and logistics; tourism; and professional services. 1) Financial services. Financial services includes banking, insurance, stock brokerage, fund management, and other financial services. 2) Trading and logistics. Logistics refers to freight transport, freight forwarding, storage, postal and courier services. 3) Tourism. Tourism covers inbound tourism and out-

bound tourism. Inbound tourism covers retail trade, hotels and boarding houses, restaurants, other personal services, travel and airline ticket agents, and passenger transport services; Outbound tourism covers travel and airline ticket agents as well as cross-boundary passenger transport services 4) Professional services. Professional services cover legal, accounting, auditing, information technology related services, advertising and related services, engineering and related technical services, and architectural design and surveying services. Producer services refer to services for use by other companies in the local economy, as well as exports of services to companies and individuals. These four key industries together generated 58% of GDP and provided 48.2% of total jobs in 2010 (Census and Statistics Department, the Government of the Hong Kong Special Administrative Region, 2011c). However, with the Mainland's increasing integration to the international economy and further opening up of the domestic markets, the HK-PRD region lost advantages. The financial crisis exposed Hong Kong over-reliance on its financial sector and lack of diversification of its financial and economic structure. Therefore, it is important to understand Hong Kong's advantages and competitiveness as a service-based city and regional service hub under the OCTS.

The successful implementation of OCTS plays a vital role, as public confidence relies on continuing and improving both stability and prosperity. According to the Basic Law, Hong Kong has a high degree of autonomy except for national defence and diplomacy, and enjoys



Source: Census and Statistics Department, the Government of the Hong Kong Special Administrative Region (2011f)

Fig. 2 Hong Kong's movement of aggregate trade values (services) in 1980–2010

independent executive, legislative and judicial powers. The Basic Law also ensures the free port status, whereby the HKSAR remains a separate customs territory and no tariffs or policies against the safeguard of free trade and flow of goods, intangible assets and capital can be imposed. In addition, HKSAR has independent taxation, monetary and financial systems and its financial revenues are not handed over to the central government, while the Hong Kong dollar remains as legal tender in the HKSAR. These factors contributed to Hong Kong maintaining its advantages and competitiveness for attracting FDI and serving as a business base for MNC in the region and the development of service industries.

Several factors contribute to Hong Kong's unique position for attracting foreign companies and MNC in the region. These factors are low tax, being a gateway to China, location, clean government, human resource development, innovation and free economy.

#### 4.1 Low and simple tax system

Hong Kong's low and simple tax system, one of the lowest in the world, was ranked as the most important factor for investing and setting up regional headquarters/offices/local offices in Hong Kong (Census and Statistics Department, the Government of the Hong Kong Special Administrative Region, 2011a; 2011b). Profit tax is charged only on net profits generated through trade, profession or business carried on in Hong Kong, with salaries tax being calculated in a similar way but on net income. For the assessment year 2008/2009 profit tax was 16.5% while salaries tax was calculated on a scale from 2%, 7% and 12% for the first, second and third segments (40 000 Hong Kong dollars per segment since 2010/2011 onwards), and 17% thereafter (Inland Revenue Department, the Government of the Hong Kong Special Administrative Region, 2012). Further, there are no capital gains tax, Value Added Tax (VAT) or Goods and Services Tax (GST) levied in Hong Kong.

#### 4.2 Gateway to China

Hong Kong, being strategically located on the doorstep of the Mainland, is the second most preferred destination for inward direct investment in Asia, after the

Mainland's. It is also a springboard for Mainland enterprises expanding their businesses to the global market. Since the introduction of the open door policy in China in 1978, market-oriented state-owned and private enterprises became the most vibrant part of China's economy. However, and as a result of further opening after entering the WTO, international competition became tougher with the Chinese government encouraging domestic enterprises to 'go global'. These enterprises can open overseas markets, and can also take their experiences of foreign markets back to China and therefore contribute to enhancing local enterprises' competitiveness against foreign companies. Hong Kong's favourable business environment, such as first-class business infrastructure and service industry, well-established legal system, free flow of goods, information and capital constitute an ideal platform for Mainland enterprises seeking to expand their businesses into the global market. According to Census and Statistics Department, the Government of the Hong Kong Special Administrative Region (HKCSD),  $2.763 \times 10^{11}$  Hong Kong dollars from the Mainland had been invested in Hong Kong in 2010, equivalent to 69% of total inward foreign direct investment in Hong Kong (Census and Statistics Department, the Government of the Hong Kong Special Administrative Region, 2011a). Moreover, as at the end of 2011, 97 regional headquarters and 151 regional offices in Hong Kong belonged to the Mainland's enterprises (Census and Statistics Department, the Government of the Hong Kong Special Administrative Region, 2011b). According to the Ministry of Commerce of the PRC, at the end of December 2008, over 3800 Mainland enterprises from different business sectors had set up their operations in Hong Kong, with an accumulated investment of over  $2.07 \times 10^{10}$  U. S. dollars<sup>①</sup>. Thus, the rapidly expanding Mainland market and increasing trade and investment flows between the Mainland and the rest of the world have raised demand for a wide range of Hong Kong's financial services and advanced producer services.

#### 4.3 Excellent location

Owing to its prime geographic location within Asia, Hong Kong is a major international and regional avia-

<sup>①</sup> Hong Kong is also a premier fund-raising centre providing excellent services to Mainland enterprises seeking international capital, with 167 H-shares and 107 'Red chip' shares being traded in the Hong Kong Stock Exchange. The Mainland-related shares comprised 46% of total market capitalization and 53% of total equity turnover in the Hong Kong stock market at the end of 2011 (Hong Kong Exchanges and Clearing Limited, 2012)



tion centre. Hong Kong International Airport (HKIA) is one of the busiest and state-of-the-art airports in the world, and one of the most important gateway hubs for China. Most metropolises in Southeast Asia can be reached within five hours from Hong Kong. Under the OCTS, Hong Kong can continue to negotiate bilateral air service agreements for scheduled air service. By the end of 2010, 90 airlines provided flight services between Hong Kong and over 150 cities worldwide (Information Services Department, the Government of the Hong Kong Special Administrative Region, 2011). The demand for flight services between the Mainland cities and international destinations is expected to grow strongly in the future. As a result of the increase in the demand for international flight services, particularly within the PRD area, the Airport Authority provides cross-boundary ferry services between the airport and six PRD ports facilitating passengers' customs and immigration formalities in Hong Kong before boarding international flights. In addition, there are cross-boundary coach services between HKIA and 90 destinations in the PRD. Thus, Hong Kong is not only one of the most important gateway hubs for China, but also the busiest regional aviation centre with international flight service in the PRD. According to the Airports Council International (ACI), HKIA ranked number one and number eleven worldwide in terms of international freight and international passenger throughput in 2010 respectively (Tokyo, which was number 9 and number 5 respectively, and Singapore in 11th and 18th for freight and passenger categories (ACI, 2011).

In addition, Hong Kong is one of the world's largest maritime centres and third largest container port in the world, as per the TEU in 2010 (Hong Kong Port Development Council, the Government of Hong Kong Special Administrative Region, 2012). According to the Basic Law, in international shipping activities, and similarly to civil aviation, HKSAR can participate under the name 'Hong Kong, China' in the International Maritime Organisation and can negotiate double taxation relief arrangements with trading partners. Hong Kong's shipping took off from the 1950s, but since the opening up of the Mainland, benefited greatly from its excellent geographic position and close links to the PRD. In 2010, the port of Hong Kong handled  $2.45 \times 10^7$  TEUs<sup>①</sup>, of which

36% of laden container movements were between Hong Kong and the Mainland, and 75.6% being between Hong Kong and the ports in the PRD (Census and Statistics Department, the Government of the Hong Kong Special Administrative Region, 2011d). In recent years, the Mainland port facilities have improved. As a result, there has been a rising trend of exporters shipping their goods to overseas market directly from the Mainland, and so Hong Kong is facing growing competition from ports in Shanghai and Shenzhen as well as Singapore. Delivering high value-added service in the logistics sector is vital and therefore Hong Kong has to develop high value-added, knowledge-based and offshore services in areas such as ship management, ship financing, marine insurance, ship broking, maritime legal services and maritime and offshore engineering to remain competitive.

#### 4.4 Clean business environment

Hong Kong rates as one of the most corruption-free economies in the world. The Corruption Perceptions Index 2010 by Transparency International (2011), ranked Hong Kong as the 12th least corrupt place in the world (ahead of Japan which was number 14 and the USA at number 24). This is mostly due to the Independent Commission Against Corruption (ICAC), which maintains and promotes a strong awareness about anti-corruption in Hong Kong. In addition, the United Nations Convention Against Corruption (UNCAC) came into effect in Hong Kong in 2006. The UNCAC advances international cooperation in fighting corruption around the world through the exchange of information, surrender of fugitive offenders and asset recovery. Apart from regular contacts with overseas law enforcement agencies, the ICAC and the Mainland procuratorate authorities assist each other in corruption investigations carried out under the Mutual Case Assistance Scheme.

#### 4.5 Quality human capital

Intellectual capital is a critical asset in a knowledge-based economy, reflecting the quantity and qualities of individuals that are able to access and use knowledge and information and, in turn, generate and distribute further knowledge and information into the economy. The development of a pool of talented and skilled

① 20-foot equivalent units of containers

manpower is considered a key element for Hong Kong having competitive advantage. Post-secondary education opportunities have been increasing in the past few years. Post-secondary education graduates increased from 15.2% in 1996 to 27.3% in 2011 (Census and Statistics Department, the Government of the Hong Kong Special Administrative Region, 2012a), almost double. Accordingly, the proportion of population employed in knowledge-based positions increased in that period, and can be seen on the proportion of population engaged in professional and producer services, which increased from 9.8% in 1998 to 11.7% in 2007. Under the OCTS, Hong Kong retains autonomy over its immigration policy. In order to further improve competitiveness of its workforce and upgrade the quality of its manpower, the Immigration Department introduced the Quality Migrant Admission Scheme<sup>①</sup>, Admission Scheme for Mainland Talents and Professionals<sup>②</sup> and Arrangement for Employment of Non-local Student with Hong Kong Degree<sup>③</sup> to attract talented people and professionals from the Mainland and abroad.

#### 4.6 Innovation

Together with education, innovation is another engine to enhance competitiveness and economic growth. In the service economy, innovation is the new source of growth, with technology development and R&D underpinning productivity and wealth increases. The Government of Hong Kong provides adequate support services and infrastructure as well as encouraging innovation and technological improvements. The capacity for international telecommunications facilities (in cable) has been enhanced materially over the past few years since

2000 (Office of the Telecommunications Authority, the Government of Hong Kong Special Administrative Region, 2012). Further, Hong Kong has several government-funded universities that attract research talent from around the world, supporting R&D activities. According to the Basic Law, Hong Kong's educational institutions can retain their autonomy and enjoy academic freedom, on a par with international standards and protecting scientific and technological achievements, patents, discoveries and inventions. The proportion of total R&D expenditure in GDP increased from 0.43% in 1998 to 0.76% in 2010 (Census and Statistics Department, the Government of the Hong Kong Special Administrative Region, 2011e). Interestingly, the share of business R&D expenditure in total R&D expenditure has been higher than that of the higher education sector since 2005. In particular, wholesale, retail, import and export trades, restaurants and hotels sectors contributed 43% of the total R&D expenditure in the business sector in 2010. For these sectors, R&D activities were mainly performed by trading firms with sub-contracting processing arrangements in the Mainland.

### 5 Transformation into A Service Hub: Excelling and Leading Services Integration in Pearl River Delta

The One Country Two Systems (OCTS) has safeguarded Hong Kong's position as a leading international financial centre in the region and premier capital formation centre for the Mainland market after 1997. Over the past two decades, the structure of Hong Kong's economy continued to shift away from manufacturing and into

① The Scheme was launched on June 28, 2006. It is quota-based, with an initial annual quota of 1000. Selection is done by the General Points Test or the Achievement-based Points Test. Successful applicants are not required to secure an offer of local employment before entering Hong Kong for settlement. (Immigration Department, the Government of the Hong Kong Special Administrative Region, 2008c)

② The Scheme was launched in July 2003. This scheme has no restrictions on sectors or quota and not only covers professionals in the commercial and financial fields, but also in the arts, culture, sporting and culinary professions. The selection criteria are consistent with those of the General Employment Policy. There is no automatic right of abode in Hong Kong granted to the successful applicants, but they could apply for the right of abode after having ordinarily resided in Hong Kong for a continuous period of not less than seven years (Immigration Department, the Government of the Hong Kong Special Administrative Region, 2008a)

③ The arrangement started on August 1, 2001, which allowed mainland students who graduated from University Grants Committee (UGC) funded institutions to work in Hong Kong. In July 2005, it was extended to those who were admitted to study at non-UGC-funded institutions and who subsequently graduated from full-time locally accredited degree-level or above programmes. This arrangement aims to attract outstanding Mainland students who have graduated from locally accredited academic institutions at degree or above levels to work in Hong Kong (Immigration Department, the Government of the Hong Kong Special Administrative Region, 2008b)

services and became one of the most open and external-oriented economies in the world. Apart from Hong Kong's strategic location, Hong Kong remains an ideal metropolis for conducting business and a bridge between China and the world under the OCTS. The current economic restructuring towards a knowledge-based economy, coupled with the policies outlined for Hong Kong by the central government, such as the CEPA, and Framework Agreement on Guangdong/Hong Kong Cooperation, provide Hong Kong with a unique opportunity to combine the competitiveness of Hong Kong's service industries with the scale of Guangdong's domestic market<sup>①</sup> to develop into a regional service hub in the next decade (Wang, 2003).

Under the OCTS, Hong Kong is regarded as a separate customs and monetary territory to that of the Mainland, formulating tax and monetary policies of its own, and with the privilege to sign economic cooperation agreements with the Mainland. Tourism and trading industries deserve a special mention as these have benefited significantly under the OCTS. Before 1997, Mainlanders were only able to visit relatives in Hong Kong under a quota system—'Hong Kong tour'. After 1997 this system was relaxed and in 2001 it was discontinued entirely. To facilitate the implementation of CEPA, the Individual Visit Scheme (IVS) was introduced, whereby the Mainland residents were allowed to visit Hong Kong for a period not exceeding seven days on an individual basis since July 2003. By 2007, the scheme covered 49 cities (around  $2.6 \times 10^8$  persons) and Mainland visitors soared from  $6.8 \times 10^6$  in 2002 to  $2.81 \times 10^7$  in 2011, an increase in the share of total visitors from 14.2% to 67.0% respectively (Hong Kong Tourism Commission, the Government of the Hong Kong Special Administrative Region, 2012). Thanks to the liberalization measures in CEPA, Hong Kong's travel agencies were able to setup wholly owned or joint venture travel agencies in Guangdong and offer group tours in Hong Kong. More than  $6.76 \times 10^6$  Mainlanders visited Hong Kong under the scheme in 2010, a 62.8% of arrivals from the Mainland (Hong Kong Tourism Board, 2011). Among new measures announced, Shenzhen residents are allowed to make multiple visits to Hong Kong dur-

ing a one-year period with a single IVS endorsement. Hong Kong's economy benefited greatly by the large number of the Mainland visitor arrivals and their related spending, as this facilitated the development of RMB business and enhanced the capability of Hong Kong's financial system to handle RMB transactions. A study of IVS's impact on the Hong Kong economy conducted by the Economic Analysis and Business Facilitation Unit of the Government of Hong Kong, the net contribution of IVS (including the impact of Shenzhen residents' multiple visits permit) to the Hong Kong economy in 2009 amounted to  $1.61 \times 10^{10}$  Hong Kong dollars in value-added, and 50 300 in number of jobs. Of which, the incremental multiple visits permit arrivals contributed  $1.3 \times 10^9$  Hong Kong dollars in value-added and 4200 jobs (Hong Kong Trade and Industry Department, the Government of Hong Kong Special Administrative Region, 2011a).

The prospects for the trading and logistics industries are cautiously optimistic under the OCTS framework, due to cost increases in manufacturing in the PRD. Moreover, as China's logistics infrastructure and services became more sophisticated in coastal areas, exporters can ship their goods directly to the overseas market. As the major exporting business moved north, some of Hong Kong's shipping companies have expanded their businesses to the Mainland and overseas, becoming global supply chain service-providers. For example, Hutchison Port Holdings (HPH), the Hong Kong-based operator, is the world's largest port management company but their Hong Kong container port throughput only accounts for 16.4% of their throughput worldwide (HPH, 2009). Admittedly, this is a unique example as most of Hong Kong's logistics sector is comprised by middle and small-sized services to the PRD. However, given the scale of Guangdong's economy, the market is big enough to support Hong Kong as a regional logistics services hub.

Under the CEPA all goods exported from Hong Kong to the Mainland are tariff-free. Thus, some brand names chose to relocate part of their production back to Hong Kong in order to benefit from labelling differentiation, i.e., 'Made in Hong Kong' rather than 'Made in China',

① Guangdong Province is the largest market in China in terms of its scale of economy and population, equivalent to the eighteenth largest economy by GDP (Central Intelligence Agency, 2010) and the eleventh largest population region (United Nations, 2010) in the world

despite the resulting rise in their production costs. Indeed, there has been a growing number of products benefiting from CEPA's tariff-free treatment, which increased dramatically from 374 in 2004 to 1633 in 2011 (July figures). Accordingly, the share of Hong Kong exports benefiting from CEPA in Hong Kong's overall domestic exports to the Mainland has increased from 3% to over 15% (Table 5). Since the introduction of CEPA in 2003, it has offered many opportunities for Hong Kong service suppliers across different service areas to establish an early and preferential presence in the Mainland market. The CEPA-induced business receipts obtained by the Mainland operations established by Hong Kong service suppliers amounted to  $6.87 \times 10^{10}$  Hong Kong dollars in 2009, and the business receipts received from the Mainland-related business due to CEPA by Hong Kong companies amounted to  $1.46 \times 10^{10}$  Hong Kong dollars in 2009 (Table 6 and Table 7). Hong Kong serves as a major channel for overseas importers sourcing the Mainland's products. The surplus of service trade balance has grown since the 1990s (Fig. 2), further cementing Hong Kong's role as a service hub in the region. Another key issue is access to information; which can help companies make better decisions about their production positioning, choice of skills and target customers. The Mainland enterprises sometimes lack international mind-set, management style, experience, capital

and technology. To tackle these difficulties many private enterprises make use of Hong Kong's professional expertise and international experience to enhance competitiveness, some even setting up a direct presence in Hong Kong, leveraging on Hong Kong's advantages as an international financial and business centre.

The financial service is another industry which benefited greatly from the implementation of the OCTS not only reinforcing Hong Kong's position as one of the most vibrant international financial centres in the world, but also contributing to the development of the Mainland financial markets. Financial services are based on the production, distribution and use of knowledge and information. Freedom and privacy of communication are protected by the Basic Law, which is the fundamental requirement for Hong Kong as an international finance centre.

Financial services became the pillar industry in Hong Kong, with 6.3% of the labour force engaging and generating around 15.4% of Hong Kong's GDP in 2010. Hong Kong has one of the highest concentrations of banking institutions in the world. With 146 licensed banks, of which 136 are foreign-owned, Hong Kong is also home to 70 of the world's top 100 banks in terms of the figures from Hong Kong Yearbook 2010 (Information Services Department, the Government of Hong Kong Special Administrative Region, 2011). China's accession to the WTO and the CEPA's 'first mover' advantages will only further strengthen Hong Kong's position as a springboard into the Mainland. In the 11th Five-year plan, as well as in the Supplement V of the CEPA (CEPA V) package, China reinforces Hong Kong's position and development as a financial centre and supports further financial cooperation. Among other things, the thresholds of market entry have come down considerably with the Mainland being currently more open for smaller Hong Kong banks. For example, the requirement for total assets is set at  $6 \times 10^9$  U. S. dollars,

Table 5 Export value of goods benefiting from CEPA

Year	Value ( $10^6$ Hong Kong dollars)	Share in domestic exports to China (%)	Share in total domestic exports (%)
2004	1150	3.0	0.9
2005	2366	5.3	1.9
2006	3254	8.1	2.4
2007	4430	10.9	4.1
2008	4819	13.9	5.3
2009	5302	15.2	5.8

Table 6 Business receipts obtained by Mainland operations established by Hong Kong service suppliers

Year	Amount ( $10^6$ Hong Kong dollars)	% to position of outward direct investment in China	% to position of outward direct investment in service activities determined on the major activity of the enterprise group in Hong Kong
2007	54014	1.6	0.7
2008	75653	2.9	1.4
2009	68785	2.5	1.1

Table 7 Business receipts received from Mainland-related service business by Hong Kong companies

Year	Amount (10 <sup>6</sup> Hong Kong dollars)	Equivalent to % in total service exports to China	Equivalent to % in total service exports of GDP
2004	1582	1.4	0.37
2005	3323	2.6	0.67
2006	4178	3.0	0.74
2007	18288	11.3	2.77
2008	19529	11.1	2.72
2009	14689	8.3	2.19

Sources: Hong Kong Trade and Industry Department, the Government of the Hong Kong Special Administrative Region (2011b); Census and Statistics Department, the Government of Hong Kong Special Administrative Region (2012b)

significantly lower than the requirement under WTO commitments ( $2 \times 10^{10}$  U. S. dollars)<sup>①</sup>. Hong Kong banks entering the Mainland's banking sector will be subject to a minimum uniform asset requirement of  $6 \times 10^9$  U. S. dollars (which was lowered from  $1 \times 10^{10}$  U. S. dollars) to give smaller banks more flexibility. Hong Kong banks like Chong Hing Bank and Fubon Bank would thus benefit from this CEPA V provisions.

Accordingly, the Mainland banks will be supported in setting up subsidiary operations in Hong Kong. This builds on the Mainland's prior CEPA commitments in financial cooperation, which encourage the Mainland financial institutions taking active participation in Hong Kong to acquire international best practices, to relocate their international treasury and foreign exchange trading centres and to develop networks with the overseas markets via Hong Kong's establishments. Further, the Mainland financial institutions are also encouraged to seek stock listings in Hong Kong, with some mega-sized listings of top Mainland banks taking place in Hong Kong. Under CEPA V, the Mainland is committed to setting up green lanes for processing applications of Hong Kong banks opening branches in Guangdong and other areas, both urban as well as rural.

Thanks to hundreds of the Mainland's companies that

want to raise money in global markets, Hong Kong's stock market's capitalization jumped almost six-fold in the 14 years from 1997, ranking as seventh largest market in the world and third in Asia, following Japan (Tokyo) and the Mainland (Shanghai) (World Federation of Exchanges, 2012). In 2011, equity funds raised by the Mainland enterprises reached  $1.499 \times 10^{11}$  Hong Kong dollars, 30.5% of total equity funds raised through the HKSE during the year<sup>②</sup>. In 2011, total annual trading turnover of the Mainland enterprises accounted for 46.4% of the total annual equity turnover of the Hong Kong (Main Board) stock market (Hong Kong Exchange and Clearing Limited, 2012). It is expected that the Mainland issuers will continue to be major growth drivers of the stock market in the future. Under the OCTS, Hong Kong not only possesses a stable, transparent regulatory regime and less risky legal environment, but also the market maturity and diversity of funding, and more importantly, without foreign exchange controls. Therefore, Hong Kong is a favourable financial market for the Mainland enterprises 'going-global'.

Furthermore, under the Supplement IV to the CEPA (CEPA IV), the qualified Mainland fund management companies are allowed to set up subsidiaries in Hong Kong. Together with prior commitments under CEPA, the Mainland securities and futures as well as fund management companies can now participate in the Hong Kong market through their subsidiaries, thus enhancing the breadth of the financial intermediary base (Hong Kong Trade and Industry Department, the Government of Hong Kong Special Administrative Region, 2008). Nowadays, funds from non-Hong Kong investors have consistently accounted for around two-thirds of the asset management business (Hong Kong Securities and Futures Commission, 2008). Non-Hong Kong sourced funds are expected to show further growth. In addition, Hong Kong-based fund managers, have already successfully established joint-ventures with the Mainland fund managers and enabled foreign investors to seize investment opportunities on the Mainland.

① Under CEPA V, the 'Substantial business operation' requirement will also be lowered from five years or more of local incorporation

② About  $5.78 \times 10^{10}$  Hong Kong dollars were raised in new listings of Mainland enterprises in Hong Kong, accounting for 22.2% of the total equity funds raised in Initial Public Offering (IPOs) on the Hong Kong Stock Exchange (HKSE) (ibid). In 2006, the listing of the Industrial and Commercial Bank of China, which was the world's second largest IPO to date, raised  $1.249 \times 10^{11}$  Hong Kong dollars in Hong Kong. In 2010, the Agricultural Bank of China became the world's largest IPO, raised a total of  $2.21 \times 10^{10}$  U.S. dollars after both Shanghai and Hong Kong's over-allotments were fully exercised

The signing of CEPA enhances economic complementarities and acts as a springboard both for the Mainland enterprises and capital to 'go out' and for international companies and capital to go into China, generating demand for a wide range of financial services supporting these flows between the Mainland and the rest of the world. Further development of RMB business is expected to enhance the capability of Hong Kong's financial system to handle RMB transactions as the first economy outside the Mainland to be allowed to conduct RMB banking services<sup>①</sup>. In July 2007, China Development Bank (CDB) became the first Mainland financial institution to issue RMB bonds in Hong Kong. Its RMB bond issuance of RMB 5 billion to both retail and institutional investors was about three times over-subscribed. In July 2009, the state council announced the cross-trade RMB trade settlement pilot programme. Under the Pilot Scheme, cross-border trade transactions between approved areas within and outside the Mainland are eligible for settlement in RMB. The operation of the Pilot Scheme needs the provision of related RMB services by commercial banks. Non Mainland banks participating in the Pilot Scheme may provide RMB services to enterprises that choose to settle trade transactions in RMB with designated Mainland enterprises. The success of this scheme provides a foundation for the subsequent development of the RMB business in Hong Kong and its internationalization.

So far, under the OCTS, Hong Kong's strengths, including its high market liquidity, a robust regulatory system and efficient information flow remain unchanged; and together with CEPA, Hong Kong's financial industry enjoys greater market access and flexibility for their operations on the Mainland. The use of cross-boundary links with Guangdong and Shenzhen reflected increased economic integration between the Mainland and Hong Kong, with the OCTS contributing to the development of the Mainland financial markets. In August 2009, the governments of Hong Kong and Guangdong signed a cooperation agreement whereby Hong Kong and Shenzhen will jointly develop a demonstration zone, free finance and service zone for the 'modern service industries' in Qianhai, Shenzhen's Nanshan District, covering 3.7 km<sup>2</sup>. This zone can be used to try out pilot

measures between Hong Kong and the Mainland, providing a 'smaller door' to implement early and pilot measures under the CEPA, and eventually granting Hong Kong's service industries easier access to the Guangdong market (Chan and Zhao, 2012).

It is impossible for the Mainland (which began its reform and opening-up three decades ago) to remain just the world's factory and not to develop its service industries. Shenzhen is keen on developing its service industries, and thus Hong Kong should seek opportunities while it does so. The agreement stipulates that the Qianhai modern service-industry experimental zone will most likely adopt the 'Hong Kong model' with Hong Kong rules and management systems, thus opening an opportunity for Hong Kong to excel and lead financial services integration in the PRD. It would be the first experimental zone that serves the whole country with rules and regulations different from those in force in other parts of it. It could be also regarded as a pilot scheme to fundamentally reform the Mainland law in accordance with the development of modern service industries in China (Zhao and Chan, 2011).

## 6 Conclusions

The main objective of this paper was to study the advantages and competitiveness of Hong Kong and its economic transformation under the OCTS. This paper argues that under globalisation and the rise of China, Hong Kong will reinforce its important role as a bridge between China and the rest of the world becoming a regional services hub. Although Hong Kong has a great advantage, it will still face fierce competition from other Mainland's centres such as Shanghai and Shenzhen and therefore the reinforcement towards a KBE should be continued.

The basic law, in accordance with the OCTS principle, acts not only as a constitutional law ensuring fundamental rights for the residents on a par with the colonial period, but also, and most crucially, as the foundation of Hong Kong's prosperity and stability by maintaining advantages and competitiveness in attracting FDI and serving as a business base for MNCs in the region. This paper has reviewed the literature regarding the eco-

<sup>①</sup> The central government also indicated in 2006 that, as part of Mainland-Hong Kong cooperation, it would study the scope for further expansion of RMB business in Hong Kong, allowing import settlements and financial bond issuing in RMB on a pilot basis

conomic transformation in the world cities. The literature finds that globalization has promoted international trade and division of labour, and some world cities became a nexus of decision-making in the network of the global economic system. Hong Kong's economic transformation shows a potential to become the first world city in China amidst China's rise. Hong Kong plays a key role in sharing its skills and experience and fostering the development of the Mainland's economy, politics, and society in the next 30 years. The establishment of reform and opening policy in China promoted the relocation of Hong Kong's manufacturing activities to the PRD, which is regarded as one of the main forces behind Hong Kong's economic transformation from a manufacturing-based economy to a service-based economy over the past two decades (with the service sector accounting for over ninety percent of GDP since the early 1990s). Since then, and thanks to the favourable business environment and overseas linkages, Hong Kong has become an important business services hub for other foreign investors into the PRD.

Hong Kong first developed from a transit-trade based economy in which goods were the key resource into a processing-trade based economy in which natural resources and labour were the main resources. Since the late 1990s, the relocation of Hong Kong's industries expanded to low-end value-added services, such as retailing, recreation and leisure, and business-supporting services (e.g., accounting, back office operations of banks, call centres of telecommunication companies). As a service-based economy, Hong Kong supported part of the processing-trade activities in the Mainland where the free flow in people, goods, capital and information resources were the dominant factors under the OCTS principle. Finally, it is now advancing to a knowledge-based economy (KBE) directly based on the production, distribution and use of knowledge and information as main engines for economic growth, wealth creation and employment across all industries.

Hong Kong has the potential to become a regional service hub under the OCTS. China's increasingly integration to the international economy needs a nodal city capable of matching the country's economic strength and showing direct and tangible effects on global affairs. Under the OCTS, Hong Kong enjoys high degree of autonomy which enables it to serve as a point of entry for investments and resources flowing into the Mainland.

More importantly, the OCTS principle empowered Hong Kong as an independent entity from China to formulate policies and to conduct and engage in economic negotiations with foreign countries, as well as participating as full members in various international organizations. Furthermore, Hong Kong can sign economic agreements with the central government as a separate economy in order to strengthen trade and investment cooperation with the Mainland and promote joint development for the two sides. Further, the government of Hong Kong can establish independent policies for attracting talented people and professionals from the Mainland and overseas to work in Hong Kong, which is a key factor for a KBE. Thus, Hong Kong provides a service platform and the Mainland supplies resources according to respective comparative advantages. We mentioned tourism, financial, and trading services as examples in order to highlight that Hong Kong's position has been reinforced under the OCTS framework. The Mainland's enterprises have established the largest number of local offices in Hong Kong in order to access international markets. Hong Kong is therefore well placed to provide excellent services to the Mainland's enterprises seeking listing in an international financial centre. In addition, low and simple tax system and free flow of information, people, capital and goods were regarded by the majority of the companies as favourable factors for setting up their regional headquarters or offices. The OCTS is the foundation for Hong Kong to maintain its uniqueness, to ensure that it would not be superseded by other main cities in China. Also, under the OCTS, Hong Kong can have an important role as a bridge between China and the rest of the world, as well as develop into a service hub for business and trade in the Asia-Pacific region.

Under several economic agreements signed with the central government, the progress of Hong Kong's companies 'going in' Mainland markets has been comparable with that of Mainland enterprises 'going out' via Hong Kong. We argue that a huge economy needs a metropolis to connect with the network of international trading, such as New York and London. In fact, the development of Hong Kong's infrastructures is even better than New York and London. Under the rapid growth of economic development in China, Hong Kong benefited greatly by its important role as a bridge between China and the world. Therefore, it is under the OCTS, that the core

values on which the competitiveness of Hong Kong are based and differentiated Hong Kong from other Chinese cities; constituting the key comparative advantage that Hong Kong has over other Chinese and Asian cities to become a comparable metropolis to New York and London serving the complete global economy.

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