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Sustaining Hong Kong's Services amid the Changing Dynamics of China's Economy

CHIANG MIN-HUA

ABSTRACT: Hong Kong's greater economic integration with China has continued to underpin its service-oriented economy following the manufacturing sectors' hollowing out since the 1990s. Hong Kong is an important transit hub for China's external trade, especially for the Pearl River Delta Region. China's deregulation of mainland visitors to Hong Kong under the Individual Visit Scheme since 2003 has contributed to Hong Kong's bulging trade surplus in travel. Nonetheless, the tremendous business opportunities from China's financial reform won't unseat the US and the UK as Hong Kong's top trade partners in financial services. Overall, Hong Kong's service economy will continue to prosper in the near term with China's continuous granting of special treatment. In the long run, strengthening Hong Kong's bridging role between mainland China and the global market will be crucial for the viability of its services.

KEYWORDS: Hong Kong's economy, Hong Kong's service sectors, Mainland-Hong Kong Closer Economic Partnership Arrangement (CEPA), China's economy, trade in services.

Introduction

Hong Kong has played an important role in connecting China's economy with the rest of the world since the nineteenth century. Before World War II (WWII), Hong Kong mainly served as an entrepot between China and Western countries in merchandise trade. Hong Kong's economic ties with mainland China continued to grow despite the latter's shift to a socialist economy since 1949. When the United Nations began to put a trade embargo on China during the Korean War (1950-1953), Hong Kong's transit trade business fell sharply. The development of the manufacturing sector since the 1950s saved Hong Kong's economy from a major depression. Nonetheless, the export-led economic growth pattern did not last long. In the 1970s, Hong Kong manufacturers encountered fierce competition from other developing countries as well as advanced countries' growing protectionism. The launch of China's open-door policy at the end of 1978 came just in time to alleviate the difficulties of Hong Kong's manufacturing economy.

Since 1979, when China began to set out a series of preferential policies for foreign investors aimed at exports, Hong Kong entrepreneurs quickly caught these opportunities. From 1979 to 1995, around half to two-thirds of foreign direct investment (FDI) in China came from Hong Kong. However, it was often argued that Hong Kong's significant share in China's total FDI was exaggerated, as it included not only Hong Kong's investment but also substantial amounts of capital intermediated through Hong Kong. In addition, a substantial portion of the mainland's exports to other countries was also channelled through Hong Kong. While Hong Kong accounted for a major share of China's total exports, China's imports from the territory were relatively less noteworthy.

Hong Kong's unique geographic location as a gateway between mainland China and other countries allowed the territory to benefit from China's relatively closed economy. However, China's economy today is much more open than it was several decades ago. From 1985, the Special Economic Zones (SEZs) extended more widely from coastal cities in Guangdong and Fujian to the Yangtze River Delta, Pearl River Delta, Shandong Peninsula, Liaodong Peninsula, Hebei, and Guangxi. Deng Xiaoping's speech during his southern tour in China in 1992 accelerated the country's economic reform. China's trade and investment measures opened a step further after its accession into the World Trade Organisation (WTO) in 2001. Up to November 2015, China had already signed bilateral free trade agreements (FTAs) or quasi-FTAs with major economies (e.g. South Korea, Australia, Singapore, Taiwan, Hong Kong, and New Zealand) in the region. At the multilateral level, the China-ASEAN Free Trade Area has been in effect since 1 January 2010. China is also actively involved in the China-Japan-South Korea trilateral FTA and the Regional Comprehensive Economic Partnership (RCEP) negotiations. With effect from 1 October 2016, the Chinese *yuan* will be included in the International Monetary Fund's reserve currency basket, a significant step in internationalising China's financial market and its currency.

China's greater involvement in the global economy occurred as Hong Kong's economy was becoming closer to China's. The quick catching up of other mainland cities further raised concerns about the sustainability of Hong Kong's unique position as a bridge between China and other countries. How has Hong Kong's service-oriented economy been impacted by China's growing linkage with the world over the last decade? It is often argued that the implementation of the Closer Economic Partnership Arrangement

Table 1 – Hong Kong's GDP by sector 2000-2014

(As % of total GDP)

| | 2000 | 2004 (Implementation of CEPA) | 2008 | 2014 |
|--|-----------|-------------------------------------|-----------|-----------|
| • Import/export trade, wholesale retail, accommodation and food services | 24 | 28 | 28 | 28 |
| • Financial, insurance, real estate, and professional business services | 22 | 22 | 28 | 27 |
| • Transportation, storage and postal services, information and communication | 11 | 12 | 9 | 10 |
| • Public administration, social, and personal services | 19 | 19 | 17 | 17 |
| • Ownership of premises | 11 | 10 | 11 | 11 |
| Subtotal in services | 87 | 91 | 93 | 93 |
| • Manufacturing | 5 | 3 | 2 | 1 |
| • Construction | 5 | 3 | 3 | 4 |
| • Electricity, natural gas and water supply, and waste management | 3 | 3 | 2 | 2 |
| Economic growth rate | 7.7 | 8.7 | 2.1 | 2.9 |

Source: Census and Statistics Department, Hong Kong SAR, *Gross Domestic Product 2014*, February 2015, pp. 82-84; Census and Statistics Department, Hong Kong SAR, "National Income," www.censtatd.gov.hk/hkstat/sub/sp250.jsp?tableID=035&ID=0&productType=8 (accessed on 7 December 2015).

(CEPA) was a "helping hand" to Hong Kong's economy. Nonetheless, as China gradually opens up its market in order to fulfil its obligations under the WTO and other FTAs, the special treatments given to Hong Kong through CEPA is expected to dissipate. In this regard, how can Hong Kong sustain its economic development in the future?

The purpose of this article is to investigate the structural changes in Hong Kong's service economy and the development of its economic relations with China over the last decade. In the face of China's dynamic development, this article also addresses concerns and prospects for Hong Kong's economy in the future. Macro-economic data is assessed to explore Hong Kong's service-oriented economic profile. Hong Kong's official statistics in the service industry are extensively employed as a major indicator of the territory's connection with China in services. Service trade statistics incorporate a total of 12 service items as indicated in Annex 1. Owing to the large presence of transport, travel, and financial services in Hong Kong's service trade, statistics for these three service items will be the main focus when analysing Hong Kong's service trade relations with China. The implementation of CEPA is considered a turning point in Hong Kong's economic transformation. Hence, the opening up measures between Hong Kong and the mainland through CEPA, particularly in transport services, financial services, and travel services, will also be reviewed.

The article is structured as follows. First, the development of Hong Kong's structural changes in terms of gross domestic product (GDP) and employment by sector is analysed. From the second to the fourth parts, China's importance in promoting Hong Kong's transport services, financial services, and travel services is elucidated. In spite of closer economic ties, there has been growing discontent in Hong Kong society against the mainland government. Whether social disintegration with China would cause an economic setback for Hong Kong deserves attention. Finally, this article concludes with some reflections on how Hong Kong and mainland China can cooperate in order to best serve each other's economic interests in the future.

CEPA accelerated Hong Kong's shift towards services

China and Hong Kong signed "The Mainland and Hong Kong Closer Economic Partnership Arrangement," or "Closer Economic Partnership Arrangement" (CEPA) on 29 June 2003. Initiated by the territory's business community, CEPA provides Hong Kong with priority entry into China's market. Under CEPA, some 273 goods produced in Hong Kong, which comprise two-thirds of Hong Kong's domestic exports to China, have enjoyed zero tariffs since January 2004. All imports from Hong Kong to mainland China were exempted from tariffs as of 2006. This special treatment extends to products with 30% value-added, more advantageous than the conventional requirement of 40%-50% domestic content. In terms of investment, China agreed to open 18 service sectors for Hong Kong companies to invest in, which is more favourable than the measures based on WTO rules. CEPA also eases requirements for professionals (e.g. accountants, surveyors, and lawyers) from Hong Kong to operate their business in the mainland,⁽¹⁾ thus allowing Hong Kong professionals to explore this emerging market.

Between 2004 and 2013, Hong Kong and China broadened the scope of CEPA with an additional 10 supplements. Under CEPA and previous supplements, 28 sectors⁽²⁾ were already partially liberalised for Hong Kong. Since 1 January 2014, conditions for market access for the 28 sectors have been further relaxed under Supplement X. Supplement X to CEPA also included various CEPA-plus liberalisation measures covered in the services agreement signed by China and Taiwan in June 2013 under the Economic Cooperation

1. John Wong, "CEPA: A Gift from Beijing?", in Zheng Yongnian and Yew Chiew Ping (eds), *Hong Kong under Chinese Rule: Economic Integration and Political Gridlock*, Singapore, World Scientific, 2012, pp. 23-24.

2. The 28 sectors include legal; construction; computer and related services; real estate; market research; technical testing and analysis services; placement and supply services of personnel; building-cleaning; photographic; printing; convention and exhibition; translation and interpretation; telecommunications; audiovisual; distribution; environment; banking; securities; hospital services; social services; tourism; cultural; sporting; maritime transport; air transport; road transport; freight forwarding agency, and trade mark agency.

Table 2 – Hong Kong's employment by sector, 2000-2014

(1,000 people)

| | 2000 | 2004 (Implementation of CEPA) | 2008 | 2014 | Difference between 2000 and 2014 | As % of total employment in 2014 |
|---|--------------|-------------------------------------|--------------|--------------|--|--|
| • Import/export trade, wholesale and retail, restaurants and hotels | 1,090 | 1,136 | 1,177 | 1,185 | 95 | 31 |
| • Financial, insurance, real estate, and business services | 453 | 484 | 635 | 737 | 284 | 20 |
| • Transport, storage, and communication | 349 | 351 | 420 | 424 | 75 | 8 |
| • Community, social, and personal services | 763 | 867 | 857 | 970 | 207 | 26 |
| Subtotal in services | 2,655 | 2,838 | 3,090 | 3,316 | 661 | 88 |
| • Manufacturing | 227 | 179 | 142 | 105 | -122 | 3 |
| • Construction | 302 | 269 | 268 | 310 | 8 | 8 |
| • Others | 28 | 26 | 21 | 19 | -9 | 1 |
| Unemployment rate (%) | 5 | 7 | 4 | 3 | n/a | n/a |

Source: Census and Statistics Department, Hong Kong SAR, "Quarterly Report of Employment and Vacancies Statistics," various issues: fourth quarter 2001, fourth quarter 2005, fourth quarter 2009, and fourth quarter 2015, www.censtatd.gov.hk/hkstat/sub/sp452.jsp?productCode=B1050003 (accessed on 13 May 2016).

Framework Agreement (ECFA).⁽³⁾ To minimise the impact of ECFA on Hong Kong, the tariff concession under ECFA is applicable to goods shipped through Hong Kong. To retain cargo flow between Taiwan and China through Hong Kong, the "Hong Kong Facilitation Scheme for Cross-Strait Transshipment Cargos" was launched in January 2011.⁽⁴⁾

CEPA came at a time when Hong Kong's economy was struggling after the massive hollowing out of manufacturing production from the 1990s onward. Like Taiwan and South Korea, Hong Kong was once an important export platform for electronic products during the 1960s and 1970s. While Taiwanese and Korean manufacturers advanced their technology at home following the relocation of labour-intensive sectors to overseas countries, Hong Kong manufacturers chose to transform themselves into traders by making use of their business contacts with local subcontractors based in mainland China. Consequently, services aimed at supporting manufacturing activities on the mainland, such as transport and financial services, gradually developed in Hong Kong. This explains why Hong Kong's manufacturing industry experienced a more significant hollowing out than other Asian tigers.

The implementation of CEPA has accelerated this industrial hollowing out process. As indicated in Table 1, the significance of services in Hong Kong's GDP progressed from 87% in 2000 to 93% in 2014. The share of trade, wholesale, retail, accommodation, and food services has shown particularly clear growth from 24% of GDP in 2000 to 28% in 2014. During the same period, financial services in Hong Kong's economy also expanded noticeably from 22% to 27%, whereas the weight of the manufacturing sector in GDP became trivial. Unlike other countries, the growing service share in GDP did not lead to Hong Kong's economic stagnation. Over the last decade, Hong Kong's economy has continued to expand moderately even with the enhancement of services in GDP. Hong Kong maintained relatively high economic growth, between 6.5% and 8.7%, from 2004 to 2007. After 2010, the economy showed a clear deceleration and declined to 2.9% in 2014. The slowdown was due to the contraction in international trade that indirectly impacted Hong Kong's services for international manufacturers.

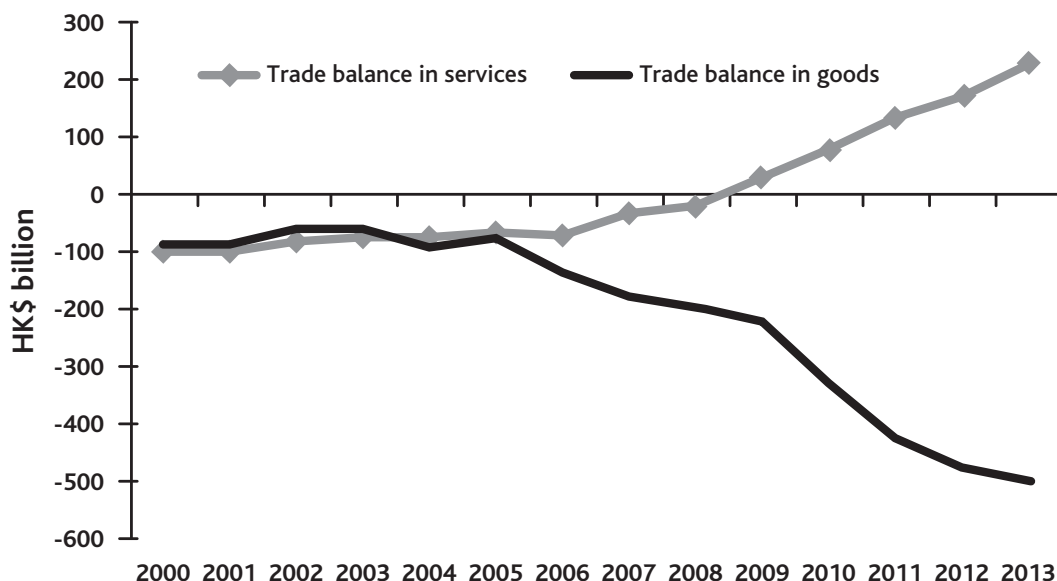
Similar to the structural changes in GDP, the quick hollowing out of the manufacturing sector resulted in an employment dip from 227,000 in 2000

to 105,000 in 2014 (see Table 2). Meanwhile, Hong Kong's overall unemployment rate declined rapidly from 7.9% in 2003 to 3.5% in 2008 and 3.2% in 2014. The quick drop in unemployment rates implied that the labour force had successfully shifted to the service sectors at the time when manufacturing production was diminishing. As shown in Table 2, the employment increase was especially obvious in financial, insurance, real estate, and business services (an increase of 284,000 people from the years 2000 to 2014), followed by community, social, and personal services (an increase of 207,000 persons during the same period). Overall, employment in services increased by 661,000 persons, much greater than the loss of employment in the manufacturing sector (122,000 persons).

Hong Kong's service trade expansion

Compared with other Asian peers, Hong Kong's economic growth and unemployment rates have remained relatively moderate over the years 2010-2014. Hong Kong has not experienced the prolonged economic recession that many Western countries experienced after transforming from a manufacturing to service-oriented economy. How have services successfully underpinned Hong Kong's economy and employment? Given Hong Kong's limited market size, the small economy cannot be prosperous without trading with other countries. Net exports (exports minus imports) are important components in promoting a country's economic growth. However, unlike other Asian economies that rely mostly on exporting manufacturing goods, Hong Kong has depended on exporting services for its economic survival. Official statistics show that since 2009, Hong Kong's service trade balance has turned from deficit to surplus. While the service trade surplus has continued to grow over the last few years, its trade balance in goods has been in deficit (see Figure 1).

3. "Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA)," Trade and Industry Department, Hong Kong SAR, www.tid.gov.hk/english/cepa/further_liberal.html (accessed on 27 July 2014).
4. "Legislative Council Panel on Commerce and Industry-Trade Relations between Hong Kong and Taiwan," The Legislative Council Commission, Hong Kong Special Administrative Region of PRC, LC Paper No. CB (1) 57/12-13(04), www.legco.gov.hk/yr12-13/english/panels/ci/papers/ci1029cb1-57-4-e.pdf (accessed on 7 June 2013).

Figure 1 – Hong Kong's trade balance in goods and services 2000-2013

Source: CEIC Data, 2015, www.ceicdata.com (accessed on 13 May 2016).

Transport services and financial services used to be the two major pillars in Hong Kong's service industry. Hong Kong's transport services were developed largely based on its intermediary role between China and other countries. With China's economic opening up at the end of the 1970s to the mid-1990s, Hong Kong's middleman role in China's external trade was carried out in the form of "re-export." Re-export took place when Hong Kong traders purchased goods from China, carried out simple processing in Hong Kong (e.g. packaging, marketing, etc.) and resold them elsewhere. Mainland Chinese goods were sold at a higher price to the global market than when they entered to Hong Kong. Since the mid-1990s, Hong Kong's middleman role has shifted from re-exports to offshore trade. Offshore trade refers to goods shipped from one country to another without entering Hong Kong. Companies in Hong Kong involved in offshore trade arranged services on behalf of buyers and sellers outside Hong Kong and earned service charges. In terms of financial services, Hong Kong's sound institutional framework for finance, a stable currency, and free exchange continued to consolidate its unique position as a regional financial centre. As a major international financial centre, Hong Kong has an integrated network of institutions and markets providing a variety of financial products and services with a high degree of liquidity to local and international investors. At the time when China successfully attracted massive numbers of foreign companies to invest in its manufacturing production, Hong Kong became an ideal bridgehead for expanding their business in China. Many foreign financial institutions set up offices or branches in Hong Kong to serve the demand of foreign manufacturers on the mainland.

Despite the importance of transport and financial services to Hong Kong's economy, the development of service trade in recent years is mainly attributed to the quick growth of surplus in travel services. As shown in Figure 2, Hong Kong's trade surplus in services showed clear growth, from HK\$27.6 billion in 2009 to HK\$234.7 billion in 2014. During this quick development period, the trade surplus in travel services increased most noticeably, from HK\$6.7 billion to HK\$126.7 billion. Although Hong Kong's trade surplus in transport services and financial services has developed gradually over the

past few years, the trade surplus from these two items progressed less noticeably compared to travel services.

In terms of service trade partners, the US had been Hong Kong's main source of trade surplus. China replaced the US as Hong Kong's largest source of trade surplus in services in 2013, accounting for 39% of Hong Kong's service exports and 40% of its service imports, far more than Hong Kong's other trading partners (see Annex 1).

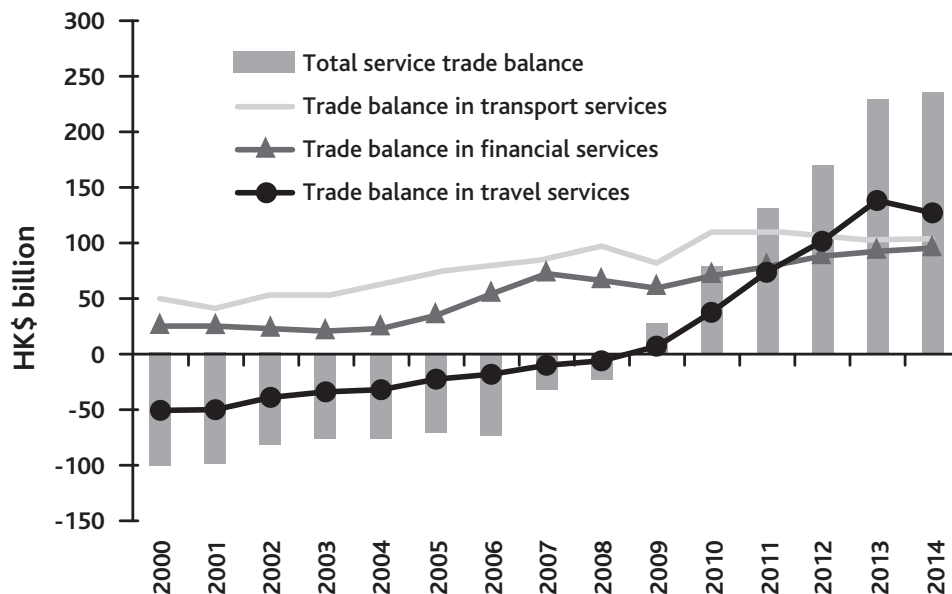
Pearl River Delta region behind Hong Kong transport services development

In transport, China is Hong Kong's largest trade partner. In 2013, China took 18% of Hong Kong's exports in transport services, the same as the percentage taken by the US, followed by Japan (9%) and Taiwan (9%). The mainland also accounted for 20% of Hong Kong's imports in transport services, followed by the US (13%) and Japan (9%) (see Annex 1).

China's merchandise trade expansion with the outside world could have resulted in its greater demand for transport services from Hong Kong. This can be seen from Hong Kong's rising re-export of goods from the rest of the world to China, from HK\$572 billion in 2002 to HK\$1,831 billion in 2012, and as origin of merchandise re-exported from China to other countries, from HK\$864 billion to HK\$2,104 billion during the same period.⁽⁵⁾ As for the goods traded, in 2012, 69% of Hong Kong's re-exported goods to China consisted of electrical machinery, electrical parts, telecommunications, sound recording apparatus, office machines, and automatic data processing machines. It included the re-export of 59% of goods originating from China.⁽⁶⁾ The substantial re-exports to China indicate that Hong Kong plays the role of a merchandiser, distributor, and provider of other logistics services in China's manufacturing production network, particularly in the

5. Census and Statistics Department, Hong Kong SAR, *Hong Kong Annual Digest of Statistics 2013*, p. 67.

6. "Trade between Hong Kong and the Mainland of China," *Hong Kong Monthly Digest of Statistics*, Feature Article, June 2013, C&SD, Hong Kong SAR, p. 8 and p. 12.

Figure 2 – Hong Kong's trade balance in services by selected service items 2000-2014

Source: CEIC Data, 2015, www.ceicdata.com (accessed on 13 May 2016).

information and communications technology industry. In addition, most of the re-exports to China are via land, accounting for 72% of total re-exports from Hong Kong to China, followed by air (17%), ocean (5%), river (5%), and other (1%) in the same year. Similarly, 75% of goods imported from China for re-export are via land, followed by air (10%), ocean (8%), river (5%), and other (2%).⁽⁷⁾ The majority of re-exports to and from China via land suggests that Hong Kong's trade with China is largely for the Pearl River Delta region.

Since China's opening up to foreign investment in container terminals, shipping, and cargo forwarding after Deng Xiaoping's 1992 tour in support of further economic reforms, Hong Kong's main container handlers began to invest in Guangdong's ports and built up Guangdong's cargo handling capacity. With increasing manufacturing production capacity in Guangdong, it is no longer necessary to bring goods into Hong Kong for packaging or quality control. CEPA has further allowed Hong Kong companies to set up more transport-related firms (e.g. logistics, freight forwarding, shipping, and warehousing services) in the form of wholly-owned operations in the mainland. In spite of concerns that other mainland cities could quickly catch up with Hong Kong's transport services, the territory's growing trade surplus in transport vis-à-vis China implies that the relocation of transport services to Guangdong did not reduce China's demand for transport services from Hong Kong. On the other hand, the relocation of physical transport activities (e.g. cargo handling) to Guangdong provided Hong Kong with opportunities to upgrade other high value-added services (e.g. the transport of valuable equipment as well as serving as a centre of supply-chain management).

The better infrastructure that connects Hong Kong with other mainland cities will facilitate the division of labour between Hong Kong and China and further link Hong Kong's transport service activity more tightly with that of the mainland. Infrastructure linking Hong Kong with the mainland, such as the Hong Kong-Zhuhai-Macao Bridge (HZMB) (initially announced to be completed in 2016), will promote Hong Kong's integration with the Pearl River Delta region. The Hong Kong section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link (XRL) (initially announced to be com-

pleted in 2016) will cut journey time not only between Hong Kong and major cities in the Pearl River Delta region such as Shenzhen, Dongguan, and Guangzhou but also between Hong Kong and Beijing (10 hours) and Shanghai (8 hours). As the XRL becomes part of the 16,000 km national high-speed rail network, Hong Kong's economic ties with the mainland are expected to be boosted further. With the gradual transfer of skill and knowledge in services via Hong Kong firms' investment and quick development in infrastructure linking Hong Kong with the mainland, cities in the Pearl River Delta region are poised to take over more of the transport services in goods and passengers from Hong Kong in the future.

Hong Kong's financial services remain internationally competitive

China's contribution to Hong Kong's exports in financial services includes the expanded mainland shares listed in Hong Kong, increased turnover of mainland-related shares in the Hong Kong market, the rise of merger and acquisition (M&A) activities between Hong Kong and mainland China, and increased inward portfolio investment from mainland Chinese investors.⁽⁸⁾ In addition, over the past few years, Hong Kong has established itself as the largest offshore centre for the RMB. At the end of 2013, RMB deposits and outstanding RMB certificates of deposit in Hong Kong exceeded one trillion *yuan*, accounting for 70% of the offshore pool of RMB liquidity.⁽⁹⁾ The fast-growing RMB pool provides impetus to support financial product development in Hong Kong, such as fixed income instruments, derivative products, and publicly traded equity products in the offshore RMB market.

7. *Ibid.*, p. 4 and p. 11.

8. Frank Leung, Kevin Chow, Jessica Szeto, and Dickson Tam, "Service Exports: The Next Engine of Growth for Hong Kong?", in Hans Genberg and Dong He (eds), *Macroeconomic Linkages between Hong Kong and Mainland China*, Hong Kong, City University of Hong Kong Press, 2008, pp. 127-128.

9. "HK's RMB Deposits Exceed \$163 Bln," *China News Service*, 26 February 2014, www.ecns.cn/business/2014/02-26/102449.shtml (accessed on 26 February 2014).

Since 2004, Hong Kong banks have been allowed to enter the mainland market under CEPA.⁽¹⁰⁾ From January 2014, CEPA has further allowed Hong Kong banks on the mainland to provide RMB services to Hong Kong-owned enterprises in the country. This is expected to broaden the customer base of Hong Kong banks' operations for better penetration into the mainland market.⁽¹¹⁾ Growing global interest in trading and investing in mainland-related securities will also allow Hong Kong to promote new derivative products linked to equities of mainland enterprises. Besides, there is ample room to further develop the derivatives market following financial liberalisation in China. Mainland entities' interest in investing overseas is also providing great opportunities for Hong Kong to develop its fund management industry.

Nonetheless, serving China's financial demands is not without challenges and difficulties. First, a more developed and open stock exchange in Shanghai or Shenzhen may reduce the number of new listings and turnover of mainland-related shares in Hong Kong and further undermine the growth of service income from securities transactions, one of the key drivers of financial service exports in Hong Kong.⁽¹²⁾ From a positive point of view, as long as the Chinese government continues to grant Hong Kong preferential access to the mainland market, neither Shanghai nor Shenzhen will be able to challenge Hong Kong's unique role as an international business hub and a global platform for China's financial businesses. In the long run, Hong Kong alone cannot serve China's objective of greater economic and financial integration with the rest of the world. Hong Kong will have to cooperate and coordinate with other mainland cities so as to achieve the macro goals of China's financial reform.

Second, the competition in financial services is not coming from mainland Chinese cities alone. In 2013, China granted a renminbi qualified foreign institutional investor (RQFII) quota of RMB80 billion to London and RMB50 billion to Singapore. Although quotas granted to London and Singapore are lower than Hong Kong's RMB270 billion, China's widening channels for foreign investors buying stocks, bonds, and money market instruments from London and Singapore have reduced Hong Kong's edge as the only entry port to China's financial market.

Despite the potential challenges from other cities and financial centres, the impact on Hong Kong's financial services has been limited so far. At the end of the third quarter of 2013, Hong Kong's external financial assets and liabilities amounted to US\$28,240.4 billion and US\$22,615.4 billion respectively, or a net external financial asset of US\$5,624.9 billion, an increase from US\$5,171.1 billion at the end of 2010.⁽¹³⁾ Apart from soaring fundraising activities by mainland Chinese enterprises in Hong Kong, continued expansion in net financial assets is fuelled by the US monetary expansion policy and Hong Kong's attractiveness (e.g. efficiency, good infrastructure, rule of law, and easier access to the China market) to international financial firms to set up branch offices or headquarters in the territory. The limited impact from other mainland cities could also be due to the fact that China accounted for a small portion of Hong Kong's trade in financial services. Despite growing opportunities from the gradual opening up of China's financial market, the US remains the largest export destination of financial services in Hong Kong, accounting for 25% of Hong Kong's total exports in financial services in 2013, followed by the UK (16%). China took only 4% of Hong Kong's exports in financial services. In terms of imports, the UK and the US accounted for a respective 15% while China accounted for 7% (see Annex 1). Hong Kong's relatively strong connection with the US and UK in terms of financial service trade and the Hong Kong dollar's peg to the US dollar also suggests that a financial crisis in the West would have a

great impact on the territory. China is therefore not only a booming market for Hong Kong to take advantage of; it could also serve as a last resort in case a crisis in the West affects the territory.

China as a major contributor to Hong Kong's rapid expansion in travel services

One of the most noticeable developments in mainland-Hong Kong relations in recent years is the growing number of mainland visitors to Hong Kong. The number of visitor arrivals in Hong Kong soared from 14 million in 2001 to 54 million in 2013, with China contributing the lion's share of the rise. The share of visitors from mainland China to Hong Kong increased from 32% in 2001 to 72% in 2013. Of particular note is the growth in mainland day visitors to Hong Kong. The number of day visitors from the mainland has exceeded overnight travellers since 2011. Among 41 million mainland visitor arrivals in 2013, 24 million (59%) were day visitors, while 17 million (41%) stayed overnight in Hong Kong.⁽¹⁴⁾

The Individual Visit Scheme (IVS) introduced in 2003 is a contributor to this huge hike in mainland visitors to Hong Kong. The scheme has allowed Chinese residents in four cities in Guangdong province to visit Hong Kong and Macao on an individual basis since 2003. The IVS has expanded gradually, and by January 2007 it covered 49 mainland cities.⁽¹⁵⁾ In April 2009, the Chinese government launched a year-round multiple entry visa arrangement for Shenzhen residents to visit Hong Kong. In December 2010, the Chinese government further expanded the IVS for non-Guangdong residents in Shenzhen.⁽¹⁶⁾ In 2012, the number of mainland visitors to Hong Kong with a year-round multiple re-entry visa reached 9.8 million, accounting for 43% of all IVS visitors.⁽¹⁷⁾

Following the rapid growth of visitor arrivals, Hong Kong's tourism receipts have grown significantly from HK\$44 billion in 2001 to HK\$359 billion in 2014. In 2014, 75% of Hong Kong's overnight tourist spending came from mainland visitors, with the remaining 25% by visitors from other regions. Although China's per capita GDP is relatively lower than that of other countries, it is surprising to find that the per capita spending of overnight Chinese tourists in 2014 (HK\$8,703) was higher than spending by tourists from other advanced countries such as the US (HK\$7,151), Europe (HK\$7,203), Australia (HK\$7,727), New Zealand (HK\$6,441), and Japan (HK\$5,196). The rapid growth in mainland visitors might explain the expansion of wholesale, retail, accommodation, and restaurants in Hong Kong's GDP and employ-

10. Zhang Yang and John Wong, "Hong Kong's CEPA with mainland China," in Zheng Yongnian and Yew Chiew Ping (eds), *Hong Kong under Chinese Rule: Economic Integration and Political Gridlock*, op. cit., p. 42.

11. "CEPA Supplement X and Hong Kong's Financial and Distribution Services Sectors," Hong Kong Trade Development Council, 23 December 2013, <http://economists-pick-research.hktdc.com/business-news/article/Research-Articles/CEPA-Supplement-X-and-Hong-Kong-s-financial-and-distribution-services-sectors/rp/en/1/1X000000/1X09VOV5.htm> (accessed on 26 February 2014).

12. Frank Leung, Kevin Chow, Jessica Szeto, and Dickson Tam, "Service Exports: The Next Engine of Growth for Hong Kong?", art. cit., pp. 139-141.

13. *Hong Kong Monthly Digest of Statistics*, C&SD, Hong Kong SAR, January 2014, p. 99.

14. Data source: CEIC.

15. Commerce and Economic Development Bureau, Hong Kong SAR, "Xianggang chengshou ji jiedai lüke nengli pinggu baogao" (Assessment report on Hong Kong's capacity to receive tourists), December 2013, pp. 3-4.

16. "Shenzhen Extends Individual Visit Scheme," CNTV, 1 May 2011, <http://english.cntv.cn/20110105/110772.shtml>, (accessed on 18 June 2014).

17. Commerce and Economic Development Bureau, Hong Kong SAR, "Xianggang chengshou ji jiedai lüke nengli pinggu baogao" (Assessment report on Hong Kong's capacity to receive tourists), op. cit., p. 4.

ment. The Hong Kong government estimated that the HK\$26 billion spent by mainland Chinese tourists under the IVS in 2012 contributed 1.3% of Hong Kong's GDP and 3% of its total employment.⁽¹⁸⁾

The upsurge in mainland visitors' spending has made China Hong Kong's largest trade partner in travel services, accounting for 79% of its exports in 2013. China is also the largest import source of travel, contributing 31% of the territory's total imports in travel and indicating that Hong Kong travellers spent more in the mainland than in other countries (see Annex 1). The real commercial benefits for Hong Kongers may be greater than reflected in service trade because of Hong Kong travel agencies' business operations in China. Since 2007, Hong Kong travel agents in Guangdong Province have been allowed to apply for the operation of group tours to Hong Kong and Macao for its residents (CEPA Supplement III). Since 2008, Hong Kong travel agents have been allowed to operate in the Guangxi Zhuang Autonomous Region and in the provinces of Hunan, Hainan, Fujian, Jiangxi, Yunnan, Guizhou, and Sichuan (CEPA Supplement IV), and in Beijing and Shanghai since 2011 (CEPA Supplement VII).⁽¹⁹⁾

Business benefits aside, the sharp rise in mainland visitors to Hong Kong has brought about growing tension between mainlanders and Hong Kongers in recent years. The 2012 plan to facilitate non-permanent residents without household registration documents in Beijing, Shanghai, Chongqing, Guangzhou, and Shenzhen to apply for a visa to Hong Kong was cancelled only days after the policy was announced. The central government in Beijing agreed not to add to the number of trial cities for IVS until Hong Kong confirms its capability to receive more visitors.⁽²⁰⁾ The Hong Kong government's assessment report estimated that Hong Kong's tourism sector is well-equipped to handle the yearly volume of 70 million tourists in 2017, up from 54 million in 2013, although hotel vacancies may remain tight.⁽²¹⁾ The forecast was nevertheless criticised by the general public for failing to consider the impact of robust tourism on residents' daily lives. Some predicted that conflicts between locals and mainland tourists would rise if mainland visitors continue their huge influx.⁽²²⁾ In fact, given Hong Kong's limited land size but relatively mature service economy, the development of high value-added tourism services (e.g. medical services, education, and high-end shopping tourism) is far more important than promoting visitor numbers. Strengthening Hong Kong's role as a gateway to the mainland market and a springboard for mainland enterprises to venture into the global market will also attract more high-yield business visitors who spend more and stay longer.

Beyond the service trade expansion: Growing social discontent in Hong Kong

During the time when Hong Kong's services took advantage of entering China's emerging market, China also benefited from Hong Kong's greater linkage with the outside world to facilitate mainland companies' internationalisation. The number of mainland companies listed in the Hong Kong stock market increased from 214 in 2002 to 721 in 2012, leading to a surge in market capitalisation from 27% to 58% during the same period.⁽²³⁾ The economic integration between the two economies with different levels of development is supposed to be mutually beneficial. In reality, not everyone has enjoyed the benefits of greater economic integration. Among 144 countries survey by the *World Factbook*, Hong Kong's Gini index is the 12th highest.⁽²⁴⁾ Growing income inequality in Hong Kong implies that economic expansion has benefited only a small group of people in society. Without a more equalised wealth distribution, the increasing economic ties with China

promoted by both market forces and government initiatives have brought about more and more social discontent.

Since the handover, the mainland Chinese government has tried to construct a united front in support of its Hong Kong policy by incorporating local Pro-Beijing capitalists into several institutional bodies. Nonetheless, the new state-business alliance after 1997 has not consolidated Beijing's governance in Hong Kong. Instead, there has been a growing dissatisfaction towards the Beijing government in Hong Kong society. In the policy-making process, the post-colonial state has also been confronting various agents of business interests and has even been dragged into conflicts among competing business groups. Unlike during the British colonial period, the business sector has become distanced from the local community. The state-business alliance established on the government's relations with a few Chinese business tycoons was fragile and vulnerable.⁽²⁵⁾ Despite the brilliant economic figures, the mainland-Hong Kong economic integration process has not been accompanied by political and social harmony. Over the past 15 years, Hong Kong society has experienced several demonstrations against the Hong Kong government, most notably the Occupy Central Movement in 2014. Although the movement ended without any concessions to the protestors, the Hong Kong government's ability to govern the territory is widely considered to have weakened further after the movement.

In sum, the visible business benefits to the territory following intensified economic integration with China has not eased the growing tension between mainlanders and Hong Kongers. The growing social discontent with immigrants and tourists from the mainland and weak public confidence towards the Hong Kong government have raised concerns over whether the Hong Kong-mainland economic integration can proceed smoothly in the future. Mainland officials regard Hong Kong as part of China and feel that both sides should work for China's interest. On the other hand, Hong Kongers are used to embracing the entire world and positioning themselves as part of a global village. These different ideologies will continue to set Hong Kong apart from the mainland socially and politically despite closer economic ties.

Concluding remarks

Over the last decade, Hong Kong has maintained moderate economic growth rates and its unemployment rate has also remained at a relatively low level. The territory's greater integration with China through trade, fi-

18. *Ibid.*, p.34.

19. Trade and Industry Department, Hong Kong SAR, "Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA), Travel Agency and Tour Operators, Liberalization Measures under CEPA," www.tid.gov.hk/english/cepa/tradeservices/tou_liberalization.html (accessed on 14 February 2014).

20. "Commerce and Economic Development Bureau, Hong Kong SAR, "Xianggang chengshou ji jiedai like nengli pinggu baogao" (Assessment report on Hong Kong's capacity to receive tourists), *op. cit.*, p. 1.

21. *Ibid.*, pp. 34-38.

22. "Annual Tourists to Hong Kong Could Rise to 70 Million in Three Years, Commission Says," *South China Morning Post*, 17 January 2014, www.scmp.com/news/hong-kong/article/1407779/visitor-numbers-can-rise-70m-three-years-commission-says?page=all (accessed on 14 February 2014).

23. Trade Office of the Economic Affairs Department of the Liaison Office of the Central People's Government in HK SAR, "CEPA shishi cujin qiye zou chuqu" (CEPA promotes the implementation of enterprises to go), 12 September 2013, <http://big5.mofcom.gov.cn/gate/big5/hk.mofcom.gov.cn/article/ztdy/201309/20130900300766.shtml> (accessed on 27 July 2014).

24. "Country Comparison, Distribution of Family Income," *The World Factbook*, Central Intelligence Agency, <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2172rank.html> (accessed on 14 January 2015).

25. Brian C.H. Fong, *Hong Kong's Governance under Chinese Sovereignty: The Failure of the State-Business Alliance after 1997*, London, New York, Routledge, p. 121.

Annex 1 – Hong Kong's top five trade partners by service items in 2013

| | Export (HK\$ billion) | Exports by destination (%) | | | | | |
|--|------------------------------|----------------------------|-----|----|-------|--------|--------|
| | | China | USA | UK | Japan | Taiwan | Others |
| 1. Manufacturing services | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 2. Maintenance and repair services | 2.4 | 15 | 48 | 4 | 5 | 4 | 23 |
| 3. Transport | 242.4 | 18 | 18 | 6 | 9 | 9 | 40 |
| 4. Travel | 302.0 | 79 | 2 | 1 | 1 | 2 | 15 |
| 5. Construction | 3.0 | 0 | 0 | 0 | 0 | 0 | 100 |
| 6. Insurance and pension services | 7.9 | 37 | 6 | 5 | 12 | 12 | 28 |
| 7. Financial services | 127.8 | 4 | 25 | 16 | 2 | 1 | 51 |
| 8. Charges for the use of intellectual property | 4.5 | 28 | 15 | 9 | 5 | 0 | 44 |
| 9. Telecommunications, computer and information services | 20.5 | 31 | 9 | 10 | 4 | 2 | 44 |
| 10. Other business services | 99.5 | 17 | 31 | 6 | 5 | 2 | 40 |
| 11. Personal, cultural, and recreational services | 1.8 | 0 | 0 | 0 | 0 | 0 | 100 |
| 12. Government goods and services | 0.6 | 0 | 0 | 0 | 0 | 0 | 100 |
| Total exports in services | 812.4 | 39 | 14 | 6 | 4 | 4 | 32 |
| | Imports (HK\$ billion) | Imports by source (%) | | | | | |
| | | China | USA | UK | Japan | Taiwan | Others |
| 1. Manufacturing services | 116.0 | 100 | 0 | 0 | 0 | 0 | 0 |
| 2. Maintenance and repair services | 0.8 | 24 | 11 | 12 | 3 | 7 | 42 |
| 3. Transport | 140.6 | 20 | 13 | 4 | 9 | 5 | 49 |
| 4. Travel | 164.5 | 31 | 9 | 7 | 10 | 8 | 35 |
| 5. Construction | 2.7 | 0 | 0 | 0 | 0 | 0 | 100 |
| 6. Insurance and pension services | 10.4 | 29 | 27 | 4 | 4 | 2 | 34 |
| 7. Financial services | 32.7 | 7 | 15 | 15 | 7 | 3 | 54 |
| 8. Charges for the use of intellectual property | 15.7 | 5 | 37 | 9 | 15 | 1 | 32 |
| 9. Telecommunications, computer and information services | 12.8 | 32 | 14 | 15 | 4 | 2 | 32 |
| 10. Other business services | 85.0 | 36 | 16 | 7 | 6 | 3 | 33 |
| 11. Personal, cultural, and recreational services | 0.8 | 0 | 0 | 0 | 0 | 0 | 100 |
| 12. Government goods and services | 1.2 | 0 | 0 | 0 | 0 | 0 | 100 |
| Total imports in services | 583.2 | 40 | 11 | 6 | 7 | 4 | 33 |

Note: The percentages are calculated by the author.

Source: Census and Statistics Department, Hong Kong SAR, *Hong Kong Trade in Services Statistics in 2013*, February 2015.

financial links, and tourism has apparently underpinned its service-oriented economy. The manufacturing production network in the Pearl River Delta Region has offered Hong Kong a chance to develop high value-added transport services. China's gradual financial reform brings hope for advancement of Hong Kong's financial services. Hong Kong's trade surplus has shown particularly rapid growth in travel services owing to the considerable spending by large numbers of visitors from mainland China. CEPA apparently consolidated the Hong Kong-mainland division of labour in which the territory's service role is reinforced.

Looking into the future, China's continued economic expansion and greater involvement with the world economy will offer both opportunities and challenges for Hong Kong's service sectors. Meanwhile, Hong Kong-mainland economic integration will continue in spite of the mounting social discontent in Hong Kong in recent years. Enhancing Hong Kong's role as an "international city" (e.g. consolidating Hong Kong's role as a regional headquarters for multinational enterprises and maintaining its international standard in education, regulatory environment, and business services, etc.) may reduce Hong Kongers' dissatisfaction with the mainland government.

China's developing economy will also benefit from Hong Kong's greater commercial ties with the outside world. For example, Hong Kong is like a trial area for China's full economic liberalisation in the future.

As an international city, Hong Kong is set to benefit from growing regional economic integration. Hong Kong's initiative to launch FTA with the Association of Southeast Asian Nations (ASEAN) is set to reinforce its central role in providing services to East Asia's economic network. The FTA with ASEAN will also put Hong Kong in good stead to compete with Singapore, another regional financial and logistics service centre. Besides, in spite of the rapid regional economic integration in terms of trade and investment in recent years, the entire region has yet to be integrated financially. Hong Kong's strength in financial services could therefore enhance China's financial muscle in linking with regional economies. Furthermore, Hong Kong may also be an ideal bridge between China and the US-led Trans-Pacific Partnership (TPP). Its more advanced economy qualifies it for membership to the TPP. Granting Hong Kong the right to join the TPP is also a significant step for China to show its goodwill towards this cross-regional trade agreement. In fact, stable and cooperative China-US relations are critical for Hong Kong's future. Despite China's growing weight

in Hong Kong's economy, US influence in Hong Kong is as significant as before simply because most of the financial assets in Hong Kong are still in US dollars. Hence, even with the tremendous potential opportunities from the RMB's internationalisation, the stability of the US currency will remain important to facilitating the development of Hong Kong's financial sector in the foreseeable future.

Hong Kong's service economy will continue to prosper in the near term with China's continuous special treatment. In the long run, strengthening Hong Kong's bridging role between mainland China and the global market will be crucial for the viability of its services. The Hong Kong government will have to take more ambitious initiatives to strengthen the competitiveness of its service sectors, cooperate rather than compete with mainland cities, and diversify its external economic relations instead of relying on the mainland government's special treatment for its economic survival.

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