

**CENTRAL POLICY UNIT
HONG KONG SPECIAL ADMINISTRATIVE REGION**

**CONSULTANCY STUDY ON
SOCIAL, ECONOMIC AND POLITICAL
DEVELOPMENTS
IN THE MAINLAND,
WITH PARTICULAR EMPHASIS ON
REGIONAL DEVELOPMENTS AND
THE GUANGDONG PROVINCE**

SECOND BI-MONTHLY REPORT

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EXECUTIVE SUMMARY

1. The impact of US's subprime crisis on the Mainland's economy and lessons to be learned

The onset of the US subprime mortgage turmoil in July 2007 has spread rapidly to the rest of the world, setting off a series of financial crisis among US and European banks. It also led to a global tightening of credit and triggered substantial corrections in stock markets worldwide. Although strict capital control in the Mainland has shielded its banks from suffering serious loss during this round of financial crisis, the Mainland economy remains vulnerable. The resulting slow down -- if not recession -- of the US and UK economies would affect the performance of its foreign direct investment as well as exports; Hong Kong would inevitably be dragged. With the US aggressively cutting interest rates in attempts to prevent recession, the opposing trends of US and Mainland interest rates would become increasingly evident. This, in turn, has left the Mainland with less room to introduce macroeconomic control via interest rate hikes. Meanwhile, the US's subprime crisis also showed that structured instruments such as credit derivatives can exert tremendous impact on the order of global financial markets and cause huge losses. The crisis carries an important message for the development of the Mainland's financial markets, particularly in the areas of credit risk management, financial liberalisation and innovation.

2. The impact of policy adjustments introduced by the Central Government on HK enterprises in the Mainland

Mainland policies on processing trade have undergone several rounds of revisions and fine-tuning over the past year or so. On January 1, 2008, a new "Labour Contract Law" and a new "Enterprise Income Tax Law" were further launched. The series of policy adjustments have brought about unprecedented challenges for Hong Kong enterprises operating in the Mainland. These challenges are mainly reflected in their higher costs of operation and rising concerns on hiring risks. From the perspective of the country's long-term development, however, the new policies are necessary as China needs to restructure its economy to achieve sustainable development. Of the policy changes, the new "Labour Contract Law" would help stabilize and foster harmonious labour relations, as well as promote the perfection of a comprehensive system of labour regulations. The introduction of the "Enterprise Income Tax Law", meanwhile, synchronizes the tax treatment of both

domestic and foreign enterprises, helping to create a tax regime that provides a level playing field for all enterprise types, support a new model for the growth of the economy and upgrading of industries, promote the coordinated development of economies across different regions and improve the quality and standards of foreign capital utilization. Although HK enterprises will have to deal with higher costs in the short term, the positive effects that would result from these policy changes would improve the Mainland's business environment in the long-term, the benefits from which should outweigh the costs.

3. New ideas for the development of Shanghai as a financial centre and strengthening cooperation with Hong Kong

Turning Shanghai into an international financial centre is a significant part of the Mainland's overall development strategy. As such, the plan needs to be executed from a national perspective, relying on the competitive advantages of Shanghai and at the same time leveraging on the strengths of other regions. Within China, Hong Kong's financial industry enjoys a relatively advanced stage of development, and is best positioned to cooperate with Shanghai to explore the vast potentials for development. Compared to Hong Kong, Shanghai still lags behind in terms of its pool of financial industry professionals, quality of financial services, ability to regulate and supervise the financial markets, as well as financial innovativeness. While Hong Kong's financial industry boasts of comprehensive infrastructure support, its market is relatively small in scale and room for development is limited. Given the huge demand for financial services in the Mainland, cooperation between Hong Kong and Shanghai could uncover vast market potentials. On one hand, Shanghai should encourage more Hong Kong financial institutions to set up in Shanghai; support closer cooperation between the securities and futures exchanges of both sides; introduce and cultivate influential financial intermediaries such as professional credit rating agencies, law firms, information technology service companies and consulting firms. On the other hand, Shanghai should also encourage and support local financial institutions to set up their own operations in Hong Kong, e.g., offshore branches, subsidiaries, financial companies, fund management arms or jointly-owned banks.

4. Wuhan's National Pilot Zone for Overall Reform provides new development opportunities for Hong Kong

Following Shanghai's Pudong New Area, Tianjin's Binhai New Area and Chengyu New Area, Wuhan has been named one of the Mainland's four National Pilot Zones

for Overall Reform. The city is set out to resolve the fundamental contradictions between resources and environment, and economic development. By constructing a “resource preserving” and “environmentally friendly” society, Wuhan would be exploring various means for the country to achieve sustainable development. Following the designation of a cluster of cities in Hubei’s Wuhan and Hunan’s Changsha, Zhuzhou and Xiangtan as the country’s fourth National Pilot Zone for Overall Reform, China’s Central Region is likely to emerge as the next economic miracle. This not only provides new opportunities for development but also additional business opportunities for Hong Kong entrepreneurs. In the past, Hong Kong investors engaged mainly in property development, community infrastructure and construction in Wuhan. As the Wuhan city cluster moves towards a new mode of industrialization and urbanization, the focus of Hong Kong investors could also shift to modern manufacturing and services industries, as well as high-tech industries. Cooperation between Hong Kong and Wuhan could also expand from setting up factories to include a broader scope of activities such as restructuring of state enterprises and equity financing.

5. New development ideas for Guangdong and their implications on Guangdong-Hong Kong cooperation

At the second session of the 10th Guangdong People's Congress Committee, Guangdong Party Secretary Wang Yang called for the fostering of a harmonious society via “liberalization of thoughts”, “change in mindset”, “adoption of a global vision”, and “implementation of the scientific development tenet”. To achieve these, Wang Yang indicated that Guangdong needs to divert away from the current extensive mode of development, which is heavily reliant on cheap labour and resources, and move toward an intensive mode of development, which would require greater innovative capability, promoting conservation, minimizing emission of pollutants, as well as constructing an ecological environment, so that the coordinated development of both the economy and the environment would be promoted. Moreover, there is a need to speed up the development of social enterprises, the development of which has lagged behind; improve residents’ quality of life, resolve outstanding social issues, and foster a harmonious society. As Guangdong strives to implement the scientific concept of development, the traditional “shop in the front and factory at the back” mode of cooperation between Guangdong and Hong Kong, which basically relies on cheap resources and labour, would face increasing challenges and would soon be outdated. Instead, cooperation between the two sides would diversify into developing high-tech industries and upgrading or transforming the traditional ones. During the transition,

huge demand for services would emerge and further spur the cooperation between Guangdong and Hong Kong in the areas of finance, modern logistics, professional services, and conventions and exhibitions.

6. The impact of tightened regulatory measures by the Central Government on Guangdong's property market and Hong Kong's real estate industry.

Last year, the Central Government launched a series of macroeconomic control measures to regulate the property market. These measures, which were aimed at cooling the property market, included collection of Land Appreciation Tax (LAT), ensuring that idle lots are put to use, and a new set of mortgage policies. Dragged by these measures, property prices in some core cities of Guangdong have started to decline, after having risen sharply in the first half of 2007. With policies directed at curbing speculative activities, Guangdong's property market will gradually transform from being "investor-driven" to become "end-user driven", giving it more room for steady and reasonable development. This, in turn, would provide Hong Kong property developers in the Mainland with opportunities for long-term investment and development. Currently, quite a number of Hong Kong developers have already snatched opportunities to purchase lots and build their land banks in the Mainland. Some smaller-scale Mainland developers with limited capital even had their shares in the company acquired by larger Hong Kong developers, and their operations merged into the larger company. Meanwhile, the tightened measures also led some Mainland investors to reconsider their options. After carefully assessing the prospects of the Mainland property market, some of them have decided to invest in Hong Kong instead, rendering support to the continued prosperity of Hong Kong's property market.

7. Shenzhen challenges world's advanced cities – room for Shenzhen-Hong Kong cooperation in developing innovation industries

According to Guangdong Party Secretary Wang Yang, "Going forward, Shenzhen, which serves as the window and image city of China, would be benchmarking itself against the world, instead of just comparing itself with other Mainland cities." From the perspective of challenging the world's advanced cities, future Shenzhen-Hong Kong cooperation should seek to make a breakthrough in the international market. To achieve this, cooperation in the innovation industries could be a strategically viable solution. Shenzhen's comparative advantage lies in the solid foundation of its high-tech industry, which is where Hong Kong lags behind. Hong Kong's comparative strengths, meanwhile, include quality

professionals and extensive international exposure, which Shenzhen lacks. The two cities can well complement each other and there is huge potential for future cooperation. Following the formal signing of the Agreement on "Shenzhen/Hong Kong Innovation Circle" in May 2007, Shenzhen and Hong Kong are set to promote, strengthen and extend cooperation in technology, economy, human resource development, business and trade, etc. These efforts would give rise to a modern hub for new resources and innovation-related activities. Facilitating the two cities to complement each other, the Shenzhen-Hong Kong partnership has the potential to rise to the ranks of the world's top-class research and development bases.

8. From Heyuan's comparative advantage and industrial development to its cooperation with Hong Kong

Hong Kong businesses' investments in Guangdong traditionally focused in the Pearl River Delta (PRD) region. As economic and trade development matured in the PRD, Hong Kong businesses have begun moving their investments toward other Guangdong regions. Among these alternatives is the city of Heyuan, which ranked 14th on the list of China's 200 most competitive cities and has promising potential for development. Endowed with abundant resources, Heyuan's comparative advantages are rather obvious. Electricity, water and land in Heyuan are all cheaper than those of Guangzhou, Shenzhen and Dongguan. Leveraging on such an amicable investment environment, and having undergone 20 years of construction and development, Heyuan is well prepared to accelerate the pace of its development. Currently, the manufacturing industries of mobile phones, molds, watches & eyeglasses, as well as tourism industries in Heyuan are already well-developed. To meet the challenges ushered in with Guangdong's economic transition, Hong Kong businesses in the PRD region may consider upgrading or transforming their existing set ups, and cooperate with Heyuan to achieve further development. Entering a new era of socio-economic development, Heyuan provides opportunities for Hong Kong industries seeking to relocate their labour-intensive and environmental-friendly set ups. There are also tremendous opportunities for Hong Kong to cooperate with Heyuan in developing the city's tourism industry.