

**CENTRAL POLICY UNIT
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**A FURTHER STUDY ON THE FUTURE
DEVELOPMENT OF THE HONG KONG ECONOMY,
CONSOLIDATION AND ENHANCEMENT OF
EXISTING CORE INDUSTRIES AND
DEVELOPMENT OF ECONOMIC AREAS WITH
HIGH POTENTIAL IN HONG KONG**

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A Further Study on the Future Development of the Hong Kong
Economy, Consolidation and Enhancement of Existing Core
Industries and Development of Economic Areas with High Potential
in Hong Kong

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Abstract

The study finds that the economic integration between Hong Kong and Mainland China is an important factor that has sustained the growth of the Hong Kong economy. In 2007, the bilateral trade between Hong Kong and the Mainland accounted for 47.5% of the total trade of Hong Kong, and the position of outward direct investment of Hong Kong in the Mainland accounted for 43.4% of the total position of outward direct investment of Hong Kong. The economic relationship between Guangdong and Hong Kong has played an important role in the integration between the Mainland and Hong Kong. In 2007, Guangdong accounted for 12.3% of China's GDP. From 1985 to 2007, the bilateral trade between Hong Kong and Guangdong accounted for 30.9% of the total trade between Hong Kong and the Mainland, and Guangdong's utilized Foreign Direct Investment (FDI) from Hong Kong accounted for 15.7% of the total utilized global FDI in Mainland China.

Hong Kong's economic integration with the Mainland, especially with the Pearl River Delta, has made positive contribution to the development of the Hong Kong economy through three effects, namely, (1) Economies of Scale (Market Expansion), (2) Resource Re-allocation, and (3) Internalization of Externalities. Our empirical analysis shows that 1 percentage point increase of the Mainland factor (represented by the growth of Hong Kong's re-export from the Mainland) and the Guangdong factor (represented by the growth of the total trade between Hong Kong and Guangdong) will result in 0.322 and 0.047 percentage point increases of real per capita GDP in Hong Kong, respectively. Besides, if Hong Kong's manufacturing industry share in GDP decreases by 1 percentage point (through cross-border resource re-allocation), Hong Kong's real GDP per capita will rise by 0.618 percentage point.

Based on our Unit Labor Cost (ULC) analysis, defined as the average labor compensation adjusted by labor productivity, for the four existing pillar industries as well as the whole service sector, we find that the ULC of traditional service industries experienced dramatic decline during the period 1997-2002, mainly attributed to the growth of labor productivity that significantly exceeded the growth of the average labor compensation. It implies that the economic integration between Hong Kong and Mainland China had notably improved the economic efficiency while slowing down the growth of labor cost. However, after 2003, the average labor compensation of traditional service industries began to surge and gradually exceeded the growth of labor productivity. Therefore, the decline of ULC has significantly slowed down and the increasing labor cost has become a severe challenge to the traditional service industries. We argue that this suggests that a further integration with the Mainland economy is the key to sustain the growth of the Hong Kong economy since the narrow local market and high factor cost are the major challenges to the traditional service industries. Furthermore, both the free economic system and export-oriented industrial structure make the Hong Kong economy vulnerable to external shocks and hence enhancing the integration may better support the Hong Kong economy when it suffers external shocks.

The future economic integration of Hong Kong with the Mainland will be a complicated dynamics that will bring both opportunities and challenges to the development of the Hong Kong economy. There will be both winners and losers during this integration process. However, to clearly understand the process and its impacts on different industries and groups of people in different time range, separate studies would be needed. The impact of such a further economic

integration on the Hong Kong economy depends on the degree and the way of further institutional adjustment and innovation that require political wisdom and administrative efforts of the Hong Kong government, Shenzhen government and Guangdong government as well as the support of the central government. However, initiatives from local governments are more important than the Central Government's policy push.

In the short run, Hong Kong will still benefit from the “*One Country, Two Systems*” framework due to its institutional guarantee and policy flexibility. Measures and arrangements under this framework, such as the *Closer Economic Partnership Arrangement* (CEPA) and the *Central Government's 14 Measures*, allow Hong Kong to further selectively relax restrictions on factor mobility to improve the efficiency of the Hong Kong economy.

In the medium and long run, both opportunities and challenges will appear which could be attributed to the following aspects: (1) Removal of the restrictions on factor mobility and boundary control resulting in supply shocks for low-cost factors, an increase of the unemployment rate, a decrease of wages and the price of real estate and an increase of residents' purchasing power, (2) The increasing openness and catch-up of the Pearl River Delta, especially the development of high quality service industries in that area, (3) The support of the central government for Shanghai in building an international finance center, as well as a trade and logistics center, (4) The *PRD Plan* which promotes the cooperation between Hong Kong and the Pearl River Delta, and (5) The *Shenzhen Reform Plan* which particularly proposes to develop Shenzhen-Hong Kong as an international financial, logistics, trade, cultural, and creative industry center.

Therefore, in the short run it is necessary for Hong Kong to fully utilize the institutional guarantees and policy flexibilities under the “*One country, Two systems*” framework to enhance the economic collaborations and integration with the Mainland especially with the Pearl River Delta. Meanwhile, Hong Kong should make appropriate strategies with supportive plans to deal with the long-term challenges and opportunities.

In general, three strategies for Hong Kong government need to be considered, namely, seeking central government support, establishing a regional inter-governmental cooperation, and developing multi-partner relationships. While Hong Kong's future economic development should still be market-driven under a free enterprise system, the government policy support for foreseeable impacts of institutional adjustment and innovation for promoting the further integration is necessary. Therefore, it requires a good understanding of not only the strengths and weaknesses of the four existing pillar industries, but also the opportunities and challenges of new industries with high growth potential for risk sharing in the medium and long run.

For the Hong Kong SAR government, three strategies should be considered:

(1) Actively seek the central government's support. Under the CEPA framework, participate actively in the *12th Five-Year Plan* and in the China-ASEAN Free Trade Area, and strive for setting up an operation base of the *China-ASEAN Fund on Investment Cooperation* in Hong Kong.

(2) Establish a regional inter-governmental cooperation relationship. Investigate the content, possibility, and timetable of establishing the Hong Kong-Shenzhen Metropolis. Improve the Guangdong-Hong Kong development coordination mechanism in the context of the *PRD Plan*. Expand the cooperation between Hong Kong and the Pan Pearl River Delta.

(3) Develop a multi-partner relationship among the governments, industry associations, enterprises, and academia. The government should provide public services such as consulting,

construct the platform of communication with the Mainland, promote coordination between different associations and organizations, and conduct research projects on economic development.

Among the four existing pillar industries, Financing Services and Trade and Logistics are facing increasing competition from emerging Mainland cities such as Shanghai. The development space of Tourism Industry is narrow. The Professional Services have relatively significant advantages. Thus, we have formulated the following suggestions.

(1) Financial Services: Take the opportunity of RMB's internationalization. Carry out the implementation of the Mainland enterprises utilizing the Hong Kong financial platform to undertake international business. Attract the Mainland capital to use the wealth management service. Strive for expanding the scale of the central government bonds issuance.

(2) Trade and Logistics: Act jointly with the Pearl River Delta to establish the pattern of Cooperative Development and Differentiated Development. Establish the Pearl River Delta Ports Development Council. Develop the Fourth Party Logistics actively. Invest in the Mainland trade and logistics industries under the CEPA.

(3) Tourism: Improve the quality of tourism products and expand tourism resource contents, including the expansion of Disneyland, medical tourism, and cultural tourism. Further simplify the Hong Kong visa application procedures for residents of the Pearl River Delta. Expand the coverage of the *Individual Visit Scheme* to more Mainland cities.

(4) Professional Services: Promote the further opening of Mainland professional qualification examinations to Hong Kong permanent residents. Accelerate the process of mutual recognition of professional qualifications. Incorporate Mainland contents in professional education by adding Mainland-related laws, and commercial and institutional courses in college teaching.

Among the six industries considered with high growth potentials, Educational Services, Cultural and Creative Industry, and Inspection and Certification Industries are more promising while the potentials of the other three are relatively limited. These are based on the preliminary analysis of the advantages, disadvantages, opportunities, and challenges of each industry. All of the considered industries are facing the problems of a limited local market, high factor cost, and immature development. Hence, the government policy should be directed to how to expand the market and reduce the factor costs through promoting the further integration with the Mainland, especially with the Pearl River Delta, rather than relying on subsidies, although some government start-up funds are important and necessary.

(1) Educational Services: Position Hong Kong as a Regional Center for Higher Education and for Qualification Training and Examination which provides "Exporting Education" services. Expand the development space in Hong Kong by developing the Lok Ma Chau Loop areas. Expand the development space in the Mainland, coordinate the cooperation among Hong Kong universities and the Mainland universities, and explore the possibility of establishing the Guangdong-Hong Kong University in the Pearl River Delta.

(2) Cultural and Creative Industry: Position cultural and creative development as one of the key long-term economic growth strategies. Accelerate the West Kowloon cultural zone project. Set up training for creative industry skills, provide government support, and cultivate creative talents. The Hong Kong government could provide some start-up funds. Enhance the cooperation with Shenzhen in this industry.

(3) Inspection and Certification: Perfect the public-private partnership. Strengthen the communications with the State Certification and Accreditation Administration and set up an

information sharing system. Build a closer cooperation in inspection and certification industries with the central government in future CEPA Supplements.

(4) Medical Services: Encourage local physicians to set up clinics in the Mainland, and encourage joint hospital establishments. Develop some superior service programs as the content for medical tourism. Implement “cooperation of Chinese medicine industry” in the CEPA Supplement III. Develop the public-private partnership.

(5) Environmental Protection Industry: Set up the Commission on Environmental Protection Industry and Policy Consulting. Pay attention to the environmental protection policies for the Pearl River Delta.

(6) Innovative Science and Technology: Universities could set up post-doctoral work stations in Hong Kong Science Park. Cooperate with the Pearl River Delta, and build a Shenzhen-Hong Kong innovation cluster and a Guangzhou-Shenzhen-Hong Kong innovation axis.

Chapter 1: Research Background

Since the handover in 1997, Hong Kong has accomplished amazing economic achievements despite the ups and downs during the last 11 years. The services industries have become more dominant in the economic and employment structure, while the share of the manufacturing industries in the economy has declined further (see Appendix 1.1).

As a typical small open economy, Hong Kong is the staunch advocate of the free market economy. The export-oriented Trade and Logistics industry and Finance Service industry led by mobile capital are the major components of Hong Kong's economy. As a result, Hong Kong's economy is highly vulnerable to external shocks due to these economic institutions and industrial structure. The financial tsunami after 2008 swept the world, and it affected Hong Kong. Growth rates of GDP, Gross Domestic Fixed Capital Formation, and Private Consumption declined sharply in 2008. Moreover, Trading and Logistics industries were struck much more severely. Under the circumstances of negative external shocks, unemployment and underemployment issues emerged while their changes fell a little behind the macroeconomic dynamics. Although the macroeconomic indicators showed certain signs of improvements, the unemployment rate is predicted to grow much higher in the near future (see Appendix 1.2).

Compared with the USA and European countries, Mainland China suffered much less in this financial tsunami. However, China is also facing the challenges of a worsening economic performance. The quarterly growth rate of GDP declined sharply from 13% in the fourth quarter of 2007 to 6.1% in the first quarter of 2009. The growth of household consumption dropped significantly, although a little later than the GDP changes due to consumption smoothing, from 23% in October 2008 to the lowest at 11.6% in January 2009. Nevertheless, it rebounded in recent months. Aside from these, the macro economy is facing a deflation rather than an inflation environment, a trend which used to be a serious challenge to the Chinese government in 2007 and early 2008. Facing the declining economic trends, the Chinese government approved 10 measures and policies to enlarge the internal demands and stimulate economic growth. The investment of 4000 billion RMB in two years will focus on the infrastructure constructions and investment stimulations (see Appendix 1.2). However, the effectiveness of this inspiring policy package requires more time to be verified.

It should be noted that the longer period it takes for the recovery of the world economy, the more challenges the Mainland China will face. According to the trade data recently published by National Bureau of Statistics, the export volume in the first quarter of 2009 decreased by 20% compared with the same period of last year, while the import volume decreased by 31%. Aside from these, the public finance revenue in the first quarter of 2009 also decreased by 8% so that the period, as long as 10 years in which the public finance revenue increased by at least 10%, ended. The contraction of trade and public finance intensifies the difficulties of expanding domestic consumption demands. Although the economic situation in the first quarter of 2009 is considered as a positive change of the Chinese economy, however, this "positive change" can be attributed to the credit expansion and the 4000 billion RMB stimulation plan in the end of 2008. Currently, there is a limited possibility of further credit expansion and also the fiscal policies will be restricted by the declining public finance revenue. Compared with the financial crisis in 1997, China is suffering more severely in the current financial tsunami. In the context of continuing low

external demands and arduous stimulation of internal demands, the radical credit expansion and fiscal stimulation would only have a short-run effect, but may bring a long-term negative influence on the adjustment of China's economic structure.

It is under the severe circumstances of external shocks and declining economic growth that the adjustment cost of economic development will be relatively smaller.¹ As such, it is beneficial to adjust the industrial structure and cultivate the high potential industries. Hong Kong should calmly consider and seriously discuss the sustainability of economic growth and the medium and long-term forces of economic development. In the last 11 years after the handover, the central government, the Mainland economy, and the Pearl River Delta provided a wider space and more favorable policy support. In view of all these, the major concerns of this study are the following: how to take the opportunity brought about by the rise of the Mainland economy, how to develop the new forces of medium and long-term economic growth of Hong Kong, how to reduce the vulnerability of the macro-economy, and how to realize the sustainability of economic growth.

Under the framework of “*One Country, Two Systems*”, the mechanism of direct communication and negotiation between Hong Kong and Mainland China has been established. The central government and Hong Kong issued the “*Closer Economic Partnership Arrangement*” (CEPA) in 2003. During the following six years, six other Supplements have also been issued. Hong Kong has gained leading advantages from expanding the Mainland market and promoting closer integration with the Mainland through these arrangements. In addition, the *11th Five-Year Plan* includes Hong Kong as a part of the national plan for the first time. The plan also supports the position of Hong Kong as an international financial center, shipping center, and trade center. Recently, the central government has approved two important policies and plans involving Hong Kong's development, namely, the *Central Government's 14 Measures to Boost and Support Hong Kong Economy (Central 14 Measures)* in late 2008 and the “*Outline of Reform and Development Plan for Pearl River Delta Region (2008-2020)*” (*PRD Plan*) in early 2009.² They provide important policy support and guarantee for Hong Kong's economic growth and its integration with the Pearl River Delta. Furthermore, these are also great opportunities for the long-run development of the Hong Kong economy.

This study is based on the analysis and results of the Research Report titled “*Study on Hong Kong's Economy: Transformation, Competitiveness and Sustainability*” (“*Research Report*”), and will discuss the challenges and opportunities faced by Hong Kong in the context of the financial tsunami and the latest policy environment, including the *Central 14 Measures* and the *PRD Plan*. This study will discuss the importance of the economic integration between Hong Kong and Mainland China (particularly with the Pearl River Delta) to Hong Kong's economic development. Moreover, the study will discuss how to consolidate and enhance the existing pillar industries, and how to develop and cultivate the high potential industries which are beneficial to the medium and long-term economic development of Hong Kong.

It should be noted that the research time of this study is limited. Moreover, this study covers a wide range of economic issues (e.g., economic integration, development of existing pillar industries and high potential industries, and similar issues) which should be investigated in

¹ During a recession period, the payment to physical capital and human capital are relatively low, such that the cost of research and development, market expansion, and industrial structure adjustment are relatively low as well.

² Another important plan, the “*Shenzhen Overall Comprehensive Reform Plan*” (*Shenzhen Reform Plan*), was approved by the central government in May 2009.

separate research projects. As a result, we can only conduct this study based on the “*Research Report*” and try our best to analyze the follow-up questions in light of recent policy developments.

The remainder of this study is divided into four parts and is organized as follows. First, from the principal theory of economic integration, we discuss the effectiveness and implications of the economic integration between Hong Kong and Mainland China (particularly with the Pearl River Delta). Second, the challenges and opportunities faced by the existing pillar industries are investigated in the context of the latest policy and economic environment. Third, we discuss how to develop and cultivate the high potential industries in the same context. Lastly, policy suggestions and implications are made based on the analysis from the above sections. The four parts correspond to Chapter 2 to Chapter 5 of this report.

Chapter 2: Integration with the Mainland Economy and Hong Kong's Economic Development

In the “*Research Report*” we have already implemented several specific methods of quantitative analysis to examine the significant influence of the integration of Hong Kong with the Mainland. Based on the results of the “*Research Report*”, this chapter will further explore the impact of Hong Kong's integration with the Pearl River Delta on Hong Kong's economic growth.

2.1 Economic Integration of Hong Kong with the Mainland

Since the introduction of China's open door policy in 1979, Hong Kong has integrated continuously with the Mainland's economies, especially with the Pearl River Delta. Such integration has become faster and has deepened over time, resulting in noteworthy contributions to Hong Kong's economic development. Among Hong Kong's total trade volume, its proportion of trade with the Mainland dramatically increased from 9.3% in 1978 to 47.5% in 2007. In the same year, the position of Hong Kong's direct investment to the Mainland was 43.4% of its total outward direct investment, while the Mainland's utilized Foreign Direct Investment (FDI) from Hong Kong was 37.0% of the Mainland's utilized FDI from the world.

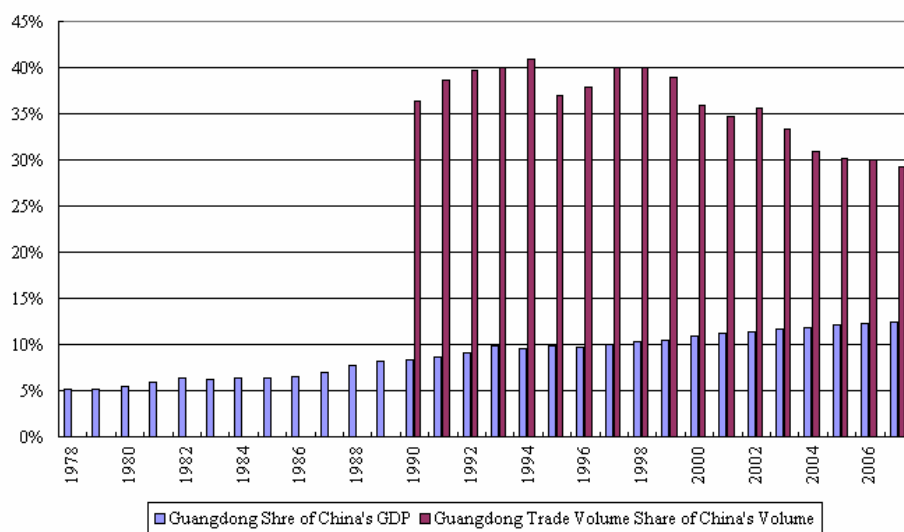


Figure 1: Guangdong's Share of China's GDP and Trade Volume (1978–2007)

Source: China Statistical Year Book 2008 and Guangdong Statistical Year Book 2008

Guangdong Province, particularly the Pearl River Delta, makes use of the geographical advantage of being near Hong Kong and Macau to become the first to respond to the reform and opening-up policies. It has built an open economy and has become an important window to China's external trade. Hence, it was able to reap the benefits from international industrial transfer and mobility of production factors. At present, Guangdong has a 12.3% share of China's GDP, exceeding the GDP of each of the Four Asian Tigers (except South Korea). Moreover, the share of Guangdong Province accounts for nearly 30% of China's external trade; at its highest, the province's share reached 40% of this external trade (see Figure 1). In addition, Guangdong still

takes the most important position among the economic and trading linkages between Hong Kong and the Mainland. Between 1985 and 2007, the trade between Guangdong Province and Hong Kong accounted for 30.9% of the total trade between China and Hong Kong, reaching 40.3% in 2007. Within this period, Guangdong Province's total utilized FDI from Hong Kong was 119.4 US\$ billion, or 15.7% of Mainland China's total utilized FDI from the world.

The Pearl River Delta consists of nine regions of Guangdong Province, namely, Guangzhou, Shenzhen, Zhuhai, Foshan, Jiangmen, Dongguan, Zhongshan, Huizhou, and Zhaoqing. It accounts for 50% of the registered household population (*hukou*) of Guangdong and 82% of its GDP. Hence, for simplicity, we will use the data of Guangdong as the proxy for the Pearl River Delta data throughout this study.

2.2 Economics Theory of Economic Integration

The economic integration of Hong Kong with the Mainland (especially with the Pearl River Delta) has brought significant positive influences on Hong Kong's economic development and Total Factor Productivity (TFP). It should be noted that such an economic integration fully satisfies the essential principles of economic growth. The combination and cooperation of Hong Kong and the Mainland's economy imply two distinct economies with different resource endowments and comparative advantages eventually removing the barrier. This not only expands each economy's own resource boundary, but also integrates the resources of two separate economies, thus resulting in far-reaching implications.

First, the integration between Hong Kong and the Mainland expands each resource boundary and results in the improvement of the economies of scale directly. It is particularly important to Hong Kong, being a small economy with limited resource endowments. Economic integration broadens the market size of Hong Kong enterprises, commercial products, and services. It creates more job opportunities in Hong Kong and leads to a higher per capita GDP. This can be regarded as the "Market Scale Effect" from the Hong Kong–Mainland economic integration.

Second, the expanding resource boundary from the Hong Kong–Mainland economic integration results to a reallocation of resources and improves the efficiency of resource allocation. Such integration allows resources to be used more effectively when the market expands, and speeds up the adjustment of Hong Kong's industrial structure. The opening of the Mainland market stimulates Hong Kong's transformation toward a more service-specialized economy and an international financial center. It can be viewed as the "Resource Allocation Effect" of the economic integration of Hong Kong and the Mainland.

Third, the expanding resource boundary from the economic integration transforms the original "external problems" of Hong Kong and the Mainland into "internal problems". Economic integration aids originally overlooked external production costs such as pollution control and food safety. These are transformed to become internal production costs. Such transformation changes the motive of interested parties and stimulates the incentive to lower the production cost in the Mainland. On the other hand, when the external benefit previously neglected changes to an internal benefit, such as infrastructure links, it produces the incentives to stimulate more investments and obtain more mutual benefits.

2.3 Empirical Results

According to the results of production function analysis in the "*Research Report*", we find

that the growth of Hong Kong's labor productivity and its successful structural upgrading from the re-export trade and labor-intensive manufacturing industries to the financial, business, and service industries are not only owed to the absorption of the Hong Kong's labor-intensive manufacturing industries by the Mainland (especially by the Pearl River Delta). The results likewise reveal that after the Hong Kong factories moved to the Mainland, the full use of Hong Kong's specific ability in international trade and market sales to promote its products entering in the Mainland and overseas markets also contributes to these positive changes as well.

The quick capital deepening³ reflects the resource reallocation resulting from the Hong Kong–Pearl River Delta integration. From 1960 to 2007, a period of 47 years, the average growth rate of Hong Kong's labor productivity was 4.28%, in which the capital deepening contributed about 60% while the Total Factor Productivity (TFP) accounted for the remaining 40%. It indicates that both the capital deepening and TFP played an important role in Hong Kong's economic growth over the last half century. In particular, the capital deepening provides a relatively important effect. We also find that Hong Kong's capital deepening has not stopped, but has speeded up with the transfer of the manufacturing industries to the Pearl River Delta. This is mainly due to the expansion of the local resource boundary after being integrated with the Mainland, particularly with the Pearl River Delta. Low labor costs and land costs in the Mainland not only stimulated the FDI from Hong Kong but also speeded up the transformation of the Hong Kong economic structure toward a high value-added service hub, which brought about stimulation for more local investment as well.

In the “*Research Report*”, we built a multivariate regression model to analyze the impact of the Mainland factor on Hong Kong's economic growth and TFP. We used the growth rate of re-export trade from the Mainland as the proxy for the Hong Kong–Mainland Integration (Mainland factor). We find that the Mainland factor has a significant positive correlation with Hong Kong's real per capita GDP growth and TFP growth. Such a positive significant relationship is retained even though the variables, including the manufacturing share of GDP and dummy for institutional change after 1997, are added into the model.

This study will further investigate the influence of the Hong Kong–Pearl River Delta integration on the Hong Kong economy. We choose the growth rate of the bilateral trade (both import and export) between Hong Kong and Guangdong as a variable to measure the economic integration of Hong Kong and the Pearl River Delta (Guangdong factor). In addition, we choose the growth rate of re-export from the Mainland to Hong Kong as a proxy of the Hong Kong–Mainland economic integration (Mainland factor). Other control variables are the same as the ones used in the “*Research Report*”.

We first examine the impact of the Mainland factor and the Guangdong factor on Hong Kong's real per capita GDP growth.

After separately adding the Mainland factor and the Guangdong factor into the model, we find that both the factors have a positive significant relationship with Hong Kong's real per capita GDP growth rate (shown in Models 1 and 2 of Table 1). We then put these two factors simultaneously in the same model, after which the explanatory power of the model increases (adjusted R^2 increased from 0.43 to 0.53) while the estimated coefficients of these two factors fall but are still significant. The Guangdong factor accounts for this because it captures part of the effect of the Mainland factor. We further add the share of manufacturing industry in GDP in Model

³ Capital deepening refers to a phenomenon wherein per capita capital increases in an economy.

4, and both this variable and the year 1997 dummy variable in Model 5. We find that the both the Mainland and Guangdong factors have remained significant. In particular, the influence of the Mainland factor is significant and larger. Moreover, the share of manufacturing has a negative correlation with the growth rate of Hong Kong's real GDP per capita, while the year 1997 dummy variable is insignificant. It shows that both the Mainland and Guangdong factors have a positive significant influence on Hong Kong's economic growth. The structural transformation from manufacturing to non-manufacturing industries also strengthens the growth of the Hong Kong economy. The above findings strongly support our theoretical analysis that the integration of Hong Kong with the Mainland, especially with the Pearl River Delta, can promote local income growth by enhancing the economies of scale and the efficiency of resource allocation. Using Model 4 as an example, if the Mainland factor (Hong Kong re-export growth rate from the Mainland) and the Guangdong factor (growth rate of the total trade of Hong Kong with Guangdong) increase 1 percentage point separately, then Hong Kong's real per capita GDP will increase 0.322 and 0.047 percentage point respectively. If Hong Kong's manufacturing industry share in GDP reduces 1 percentage point, then Hong Kong's real GDP per capita rises by 0.618 percentage point.

Table 1: The Mainland Factor, Guangdong Factor, and Hong Kong's Real Per Capita GDP Growth

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Mainland Factor	0.148		0.125	0.322	0.313	0.236	0.308	0.240
	(4.12)**		(3.67)**	(5.59)**	(5.30)**	(3.24)**	(4.10)**	(2.88)*
Guangdong Factor		0.080	0.055	0.047	0.048	0.039	0.047	0.039
		(2.73)*	(2.26)*	(2.55)*	(2.55)*	(2.12)+	(2.45)*	(2.06)+
Manufacturing Share				-0.618	-0.514	-0.258	-0.497	-0.274
				(3.83)**	(2.52)*	(1.04)	(1.88)+	(0.95)
D1997					1.286	-0.062	1.704	-0.511
					(0.84)	(0.04)	(0.40)	(0.12)
(Guangdong Factor)*D1997							-0.083	0.086
							(0.11)	(0.12)
(Manufacturing Share)*D1997						0.121		0.122
						(1.66)		(1.61)
Constant	1.022	2.361	0.350	2.308	0.864	-0.120	0.774	-0.036
	(1.05)	(2.45)*	(0.37)	(2.63)*	(0.45)	(0.06)	(0.36)	(0.02)
Observations	22	22	22	22	22	22	22	22
Adjusted R ²	0.43	0.24	0.53	0.73	0.72	0.75	0.70	0.73

Note:

1. The real per capita GDP growth rate is the dependent variable.
2. For independent variables, "Mainland Factor" is the growth rate of re-export from the Mainland to Hong Kong; "Guangdong Factor" refers to the growth rate of the trade volume between Hong Kong and Guangdong; "Manufacturing Share" is the share of the value-added of the manufacturing industry in the overall GDP for Hong Kong; "D1997" is a dummy variable which equals 0 for the year before 1997 and 1 for the year after 1997; "(Guangdong Factor)*D1997" and "(Manufacturing Share)*D1997" are the interaction terms of "Guangdong

Factor” and “D1997” and of “Manufacturing Share ” and “D1997”, respectively.

3. The number in parentheses is the t value.

4. “+”, “*”, and “***” represent the significance levels at 10%, 5%, and 1%, respectively.

On the other hand, we use regression analysis to examine the effects of the China and Guangdong factors on the growth of Hong Kong’s Total Factor Productivity (TFP). The variables are similar to those in the regression analysis of Hong Kong’s real per capita GDP. The results are shown in Table 2.

Adding the Mainland and Guangdong factors into the model separately, we find that each of these factors has its own positive significant relationship with the growth rate of Hong Kong’s TFP growth (shown in Models 1 and 2 of Table 2). When we add both factors into the model simultaneously (Model 3), the significant positive correlation of both factors with the TFP growth rate remained. However, the two estimates fall because the Guangdong factor captures the partial influence of the Mainland factor. Models 4 and 5 put the share of manufacturing industry and year 1997 dummy variable in the regression. The results show that both the Mainland and Guangdong factors still have a significant positive relationship; in particular, the estimated coefficient of the Mainland factor is larger. In addition, the share of manufacturing industry is negatively correlated with the TFP growth rate, while the year 1997 dummy variable is insignificant. It indicates that both the Mainland factor and the Guangdong factor have a significant effect on Hong Kong’s TFP growth rate. When other variables are unchanged, the reallocation of resource induces the TFP to grow. The above findings strongly support our theoretical analysis: the economic integration between Hong Kong and the Mainland (particularly the Pearl River Delta River) can stimulate Hong Kong’s TFP growth rate. When the Mainland factor and the Guangdong factor separately increases by 1 percentage point, the TFP of Hong Kong grows by 0.327 and 0.039 percentage point, respectively. If the share of Hong Kong’s manufacturing industry falls by 1 percentage point, then it brings about a 0.704 percentage point on Hong Kong’s TFP growth.

Table 2: The Mainland Factor, Guangdong Factor, and TFP Growth in Hong Kong

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Mainland Factor	0.122		0.103	0.327	0.316	0.269	0.280	0.243
	(3.40)**		(2.91)**	(6.03)**	(5.76)**	(3.79)**	(4.10)**	(3.05)**
Guangdong Factor		0.069	0.048	0.039	0.040	0.034	0.038	0.034
		(2.45)*	(1.90)+	(2.24)*	(2.27)*	(1.90)+	(2.17)*	(1.85)+
Manufacturing Share				-0.704	-0.585	-0.429	-0.451	-0.331
				(4.63)**	(3.07)**	(1.77)+	(1.88)+	(1.20)
D1997					1.475	0.653	4.711	3.518
					(1.04)	(0.40)	(1.23)	(0.87)
(Guangdong Factor)*D1997							-0.641	-0.550
							(0.91)	(0.77)
(Manufacturing Share)*D1997						0.074		0.066
						(1.04)		(0.90)

Constant	-0.905	0.160	-1.489	0.742	-0.915	-1.515	-1.614	-2.050
	(0.93)	(0.17)	(1.54)	(0.90)	(0.51)	(0.81)	(0.82)	(1.01)
Observations	22	22	22	22	22	22	22	22
Adjusted R ²	0.33	0.19	0.41	0.72	0.72	0.72	0.72	0.71

Note:

1. The growth rate of the Total Factor Productivity (TFP) is the dependent variable.
2. For independent variables, “Mainland Factor” is the growth rate of re-export from the Mainland to Hong Kong; “Guangdong Factor” refers to the growth rate of trade volume between Hong Kong and Guangdong; “Manufacturing Share” is the share of the value-added of the manufacturing industry in the overall GDP for Hong Kong; “D1997” is a dummy variable which equals 0 for the year before 1997 and 1 for the year after 1997; “(Guangdong Factor)*D1997” and “(Manufacturing Share)*D1997” are the interaction terms of the “Guangdong Factor” and “D1997”, and of the “Manufacturing Share ” and “D1997” respectively.
3. The number in parentheses is the t value.
4. “+”, “*”, and “***” represent the significance levels at 10%, 5%, and 1%, respectively.

2.4 Policy Suggestion

Our study shows that the economic integration of Hong Kong with the Mainland, especially with the Pearl River Delta, expands the resource boundary of the Hong Kong economy, enhances the speed of Hong Kong’s economic structure transformation, raises the reallocation efficiency of Hong Kong’s resources and capital, and hence brings about Hong Kong’s economic development over the last three decades. The continuous growth of the Mainland’s economic scales, continuous improvement of the completeness of the market system, and continuous increase of consumption demand all contribute to the importance of the Mainland economy to Hong Kong’s medium and long-run economic development.

The economic integration of Hong Kong with the Mainland needs to satisfy institutional requirements. For one, the Hong Kong government has to coordinate with the central government and local governments. In addition, it should issue relevant policies and sign relevant agreements so as to remove the barriers of factor and capital mobility. Moreover, physical requirements also need to be complied with. Hong Kong should actively take part in the planning of the Mainland’s regional development and strive for a more favorable position in the Mainland’s development plan, especially in relation to that of the Pearl River Delta where infrastructure projects are a focus area.

At present, among the *Central Government’s 14 Measures to Boost and Support Hong Kong Economy (Central 14 Measures)*, several policy plans and infrastructure projects are aimed to promote the economic integration between Hong Kong and the Pearl River Delta. It includes assisting the construction of the Hong Kong-Zhuhai-Macau Bridge, and bringing about the Hong Kong-Shenzhen Airport Rail Link, Guangzhou-Shenzhen-Hong Kong Express Rail Link, and innovation projects of Huanggang and Man Kam To Checkpoints. In particular, the State Council recently passed the “*Outline of Reform and Development Plan for Pearl River Delta Region (2008-2020)*” (*PRD Plan*). It is the first time that the close cooperation among the Pearl River Delta, Hong Kong, and Macau is explicitly expressed in the government plan. Likewise, the document establishes the common development and common prosperity of the Pearl River Delta and Hong Kong as two of the most important development targets.

Strategically, the major goals of the *PRD Plan* are to encourage closer cooperation between the Pearl River Delta, Hong Kong, and Macau and to integrate these three regions as “a globally

competitive” and “most vigorous” area in the Asia-Pacific region. The Pearl River Delta also aims to develop modern service industries that meet the requirements of Hong Kong, which functions as an international financial center. The Pearl River Delta will also specialize in the differentiated development with Hong Kong and Macau to jointly become an international center for shipping, logistics, trade, exhibitions, tourism, and innovation.

“Cooperative Development” and “Differentiated Development” are the strategic positions of close cooperation and common development of the Pearl River Delta, Hong Kong, and Macau in the “*PRD Plan*”. It proposes many empirical implementations to achieve strategic objectives including the connection of major infrastructure, further cooperation among industries, collaborative establishment of quality living areas, development of new cooperative mechanism, and so forth.

Hong Kong should take advantage of the opportunities generated by the “*PRD Plan*”. It should actively cooperate and coordinate with the central government and the Guangdong government, particularly on the details of the development plan and empirical events so as to acquire a more favorable and spatial position for its medium and long-run development. Relevant departments in the Hong Kong government need to investigate a set of development schedules and strategies on the basis of the “*PRD Plan*”.

“Cooperative Development” requires Hong Kong and the Pearl River Delta to cooperate and coordinate in developing a mature and effective mechanism of Chief Executive Joint Conference, an information exchange mechanism, and an urgent cooperation system in order to reduce the communication cost and institutional barriers. This way, the two regions can achieve win-win outcomes. Moreover, Hong Kong and the Pearl River Delta can make use of the linkage of infrastructure, urban plan, and transport and communication networks to eliminate the barriers for promoting the common development.

“Differentiated Development” requires these two regions to identify their own industrial comparative advantages and disadvantages, and then enhance their industrial cooperation to enjoy the benefit of their specializations. In turn, the regions will realize the advantage complementarity, the common development, and the increased global competitiveness of Hong Kong and the Pearl River Delta. To be a high valued-added service center of finance, trading, shipping, and logistics, Hong Kong also needs to encourage more Pearl River Delta enterprises to be listed in the Hong Kong stock market, to strengthen their technological and innovative cooperation, and to obtain more mutual recognition of professional qualifications and tertiary education.

2.5 Economic Linkage between Hong Kong, Taiwan, and Southeast Asia

The economic linkage between Hong Kong and the Mainland is the most important economic relationship of Hong Kong. Moreover, Taiwan and the Southeast Asian region are also important partners of external trade for Hong Kong; thus, their economic conditions should also be Hong Kong’s concern. This section will discuss the economic relationship of Hong Kong with Taiwan and with Southeast Asian countries.

Over the last three decades, Hong Kong has played the intermediary role for the business and trade between Taiwan and the Mainland. Taiwan has been the fourth largest trading partner of Hong Kong (just behind the Mainland, the United States, and Japan) for the last three decades. In 2008, the bilateral trade between Hong Kong and Taiwan was close to 250 HK\$ billion, accounting for 4.2% of Hong Kong’s total trade volume (see Figure 2). After Taiwan and the

Mainland resumed communication, the Mainland's Association for Relations across the Taiwan Straits (ARATS) and Taiwan's Straits Exchange Foundation (SEF) had carried out three rounds of talks. Three agreements and one consensus were reached during the third round of talk at the end of April 2009. In the near future, the Mainland and Taiwan will implement "Three Direct Links" through mail, transport, and trade.

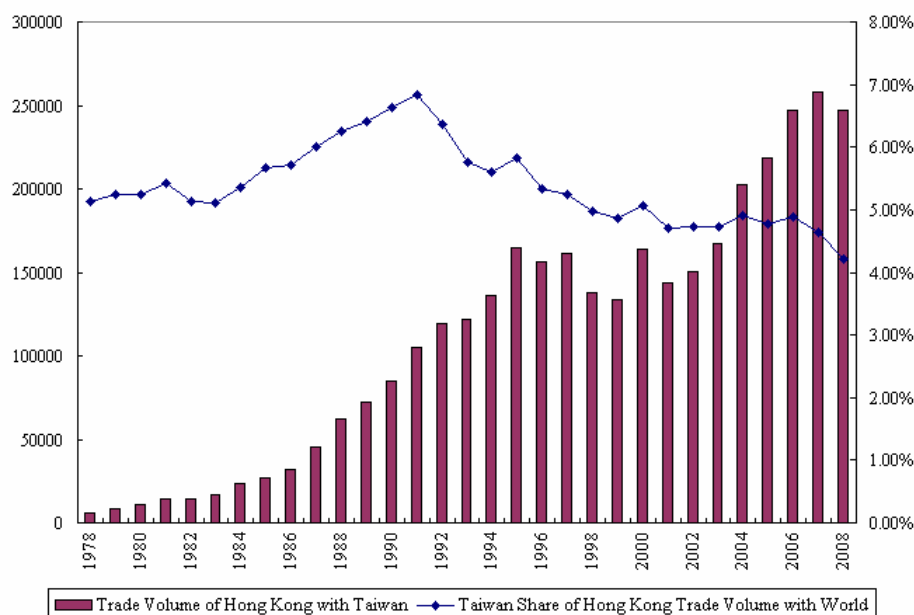


Figure 2: Trade Volume and Share of Hong Kong with Taiwan (1978-2008)

Note: Unit is HK\$ Million.

Source: Census and Statistics Department, Hong Kong SAR.

The future implementation of "Three Direct Links" between the Mainland and Taiwan will certainly weaken the role of Hong Kong as an intermediary center for visible trade (including cargos and passengers) across the straits and bring a negative short-run effect on Hong Kong's re-export trade, passenger and cargo transport services of port, airport, and tourism. However, according to the Hong Kong Trade Development Council's analysis, such an unfavorable effect is partial and limited.⁴ On the contrary, direct cross-strait shipping links between the Mainland and Taiwan must enhance the multi-directional communication and business linkage across straits and, in turn, strengthen Hong Kong's intermediary position of across straits' invisible trade (service trade). Taiwan enterprises must also enlarge their investments in the Mainland. These companies will mature and will become potential candidates for listing in the Hong Kong stock market for capital financing. Moreover, the direct transport across straits also creates two growth opportunities for Hong Kong enterprises. These are Taiwan's business investment on the Mainland's service industry and the entrance of more Mainland enterprises into Taiwan.

⁴ There are about 2.7 million Taiwanese entering or passing through the Hong Kong International Airport each year, which represents around 11% of the total tourists visiting Hong Kong. Aside from this, the air cargo weight between the two regions reaches 0.28 million tons each year, accounting for 7.4% of the overall amount. The volume of cargo between Hong Kong and Taiwan is about 0.74 million standard shipping containers, accounting for 37% of the total amount. Lastly, the total weight of postal objects is about 0.39 million kilograms, about 0.7% of the overall weight.

The amount of Taiwan's investment in the Mainland has been very significant since 1978, just less than that of Hong Kong. However, Taiwan businessmen mainly invest on the manufacturing industry in the Mainland while the capital invested on the service industry has only been about 10% of the overall investment. Relative to Hong Kong and other foreign investments in the Mainland, Taiwan's investments on the service industry are relatively low.⁵ Such relative low investment ratio on the service industry of Taiwan is obviously related with the previous policy control imposed by the Taiwan government on the trade across straits.⁶ Under many limitations (such as the "No Haste, Be Patient" policy and the "Three Noes Policy"), before the announcement of "Three Direct Links" in 2008, Taiwan's ship and flight cargo companies could not transport tourists and products directly across straits and the individual communication between Taiwan and the Mainland was also limited. All these drawbacks restricted the development of the Taiwan service industry in the Mainland.

In the near future, when the "Three Direct Links" policy across straits is implemented, the investment from Taiwan on the Mainland's service industry is expected to increase greatly. As the development level of Hong Kong's service industries is higher than that of Taiwan by a great extent, and Hong Kong maintains a wide and complete business network both in Taiwan and the Mainland, it is likely that when Taiwan capital flows into the service industry of the Mainland, Taiwan enterprises will find relevant Hong Kong companies as cooperative partners. In addition, following the allowance of the Taiwan government for Mainland capital to flow in Taiwan, more Mainland companies will enter the Taiwan market. This will bring huge business opportunities to Hong Kong since they will also find Hong Kong enterprises as appropriate partners.

Due to historical reasons, most of Hong Kong's government officials are not familiar with Taiwan affairs. In addition, the Hong Kong and Taiwan governments have many concerns in communication and have even imposed unnecessary regulations. At this critical moment of the breakthrough in the relationship across straits, Hong Kong government officials need to strengthen their acknowledgement and understanding toward Taiwan's political aspect, economy, and social institutions. Furthermore, they should open up their minds and be more progressive to enhance the cooperation with Taiwan in the areas of trade and commercial activities and to cope with the challenge brought about by the "Three Direct Links" policy.

For Southeast Asian countries, Hong Kong was a re-export center between their own countries and the Mainland and their gateway to enter the Mainland market. In the beginning of year 2010 though, the so called 10+1 China-ASEAN Free Trade Area (CAFTA) will be set up, bringing both challenges and opportunities to Hong Kong.

With regard to the challenges, the formation of CAFTA undermines the importance of Hong Kong as a re-export center for the visible trade between Southeast Asian countries and the Mainland. Moreover, the privileges in entering the Mainland market under CEPA are the same as

⁵ Investment in the service industry represents 50% of the overall investment of Taiwan outside Mainland China. At the end of 2007, the manufacturing industry accounted for only 2.3% of the final position in FDI.

⁶ Chiang Ching-kuo maintained the "Three Noes Policy", insisting that there were to be "No Contact, No Compromise, and No Negotiation". Similarly, Lee Teng-hui advocated the "No Haste, Be Patient" policy, explicitly stating that this is especially applicable to high technology involving an amount exceeding 50 million, as well as an infrastructure component. In contrast, Chen Shui-bian advocated the relaxation of restrictions on investment in Mainland China and employed the policy of "Proactive Liberalization with Effective Management", but switched to "Proactive Management with Effective Liberalization" later.

those under CAFTA, which reduces the incentive for these countries to use Hong Kong as a gateway to do business with the Mainland.

As regards opportunities, CAFTA will certainly increase the trade and investment between the Southeast Asian countries and the Mainland. Having a good reputation for high quality financial and commercial services, combined with the intensive network between the two regions, Hong Kong could gain a lot if it can take a hold of these valuable opportunities. For instance, Hong Kong can partner with businessmen in both Southeast Asia and the Mainland in order to enter their respective markets or these businessmen may be interested in the high quality services being provided by Hong Kong.

The Chinese government has planned to use the Beibu Gulf in Guangxi as a foundation to improve the interaction with the Southeast Asian countries. Hong Kong enjoys a similar geographical environment and dialect with Beibu Gulf, which will bring about advantages. The establishment of the Hong Kong-Zhuhai-Macau Bridge will greatly reduce the travel time from and to Hong Kong. The Hong Kong government should increase the communication with Guangxi under the framework of the Pan Pearl River Delta and improve the relationship with Beibu Gulf. The service providers, including logistics, finance, telecommunication, and commercial services, should also actively search for more business opportunities in this area. In relation to this, the Chinese government is building a 10 billion US dollar fund (i.e., the “*China-ASEAN Fund on Investment Cooperation*”). The Hong Kong government should actively persuade the central government to use Hong Kong as a base for the fund operation.

Chapter 3: Consolidation and Enhancement of Existing Pillar Industries

The economy of Hong Kong relies heavily on the service industries. Over 92% of its GDP is attributed to the services industries (based on the factor cost approach), of which Financial services, Tourism, Trading and Logistics, and Professional Services are listed as the four pillar industries. In 2007, the value-added created by the four pillar industries amounted to 59.7% of Hong Kong's GDP (see Figure 3). The employment they provided amounted to 46.9% of the total employment. As such, Hong Kong's economic prospect is closely related to the development of the four pillar industries. In this chapter, we shall investigate the development opportunities and challenges faced by the four industries under the new policy and economic environments.

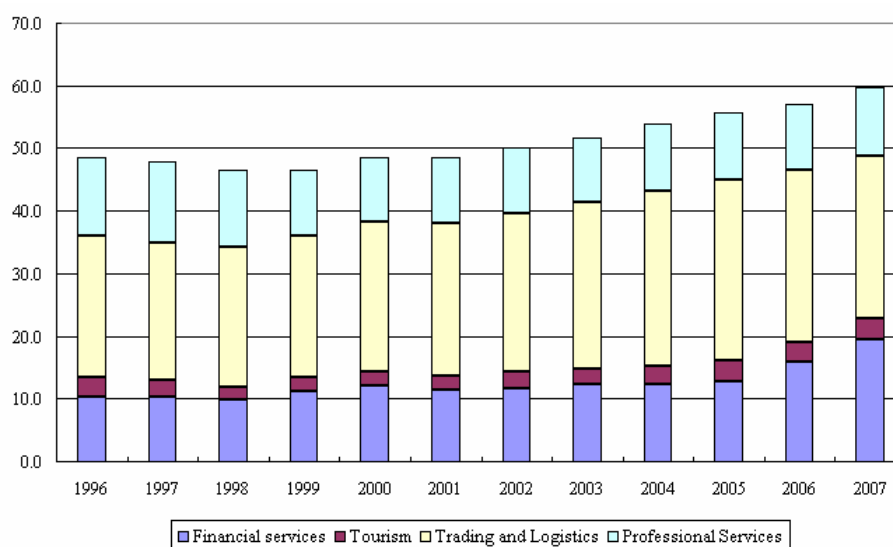


Figure 3: Value-added Share of the Four Pillar Industries in GDP (1996-2007)

Note: Unit is %.

Source: Census and Statistics Department, Hong Kong SAR.

3.1 Financial Services

In 2008, Hong Kong's Financial Development Index⁷ ranked eighth worldwide, just below Japan among the Asian countries. The pillar indices of Institutional Environment, Business Environment, and Size, Depth, and Access also ranked second, fourth, and third worldwide, respectively. Hong Kong has an obvious institutional advantage. Although Hong Kong is the seventh largest stock market in terms of market value globally, it has already been transcended by Shanghai; consequently, its attractiveness to the Mainland enterprises has begun to fall.

⁷ The Financial Development Index (FDI) is a by country indicator system reflecting the development level of financial systems in different perspectives issued for the first time by the World Economic Forum in the "Financial Development Report 2008". FDI comprises seven pillars, including Institutional Environment, Business Environment, Financial Stability, Banks, Non-banks, Financial Markets, and Size, Depth, and Access. Source: World Economic Forum (2008), Financial Development Report 2008.

The “*Research Report*” employs the Unit Labor Cost (ULC)⁸ to measure the average labor compensation adjusted by the labor productivity of the Hong Kong financial services industry. This research updates the calculation results of the ULC. We find that, although the average labor compensation has been increasing rapidly since the 1990s, the labor productivity has either kept the same pace or underwent an even faster increase (especially after 2002). In turn, the ULC decreased steadily after 1997. From 2005 to 2007, this trend remained. It indicates that there exists an efficient competitive labor market in the Hong Kong’s financial services industry (see Figure 4).

Furthermore, we compare Hong Kong’s financial competitiveness with its counterparts (i.e., New York and London). We find that the ULC of Hong Kong used to be higher than that of New York and London before 2003, but became lower than that of New York and close to London after 2003. We believe that with further integration of Hong Kong with the Mainland and more participation into the Mainland financial markets, the ULC of Hong Kong’s financial services industry can further decrease. In other words, the increase of the labor productivity of Hong Kong’s financial services industry tends to steadily and continuously offset the increase of the average labor compensation.

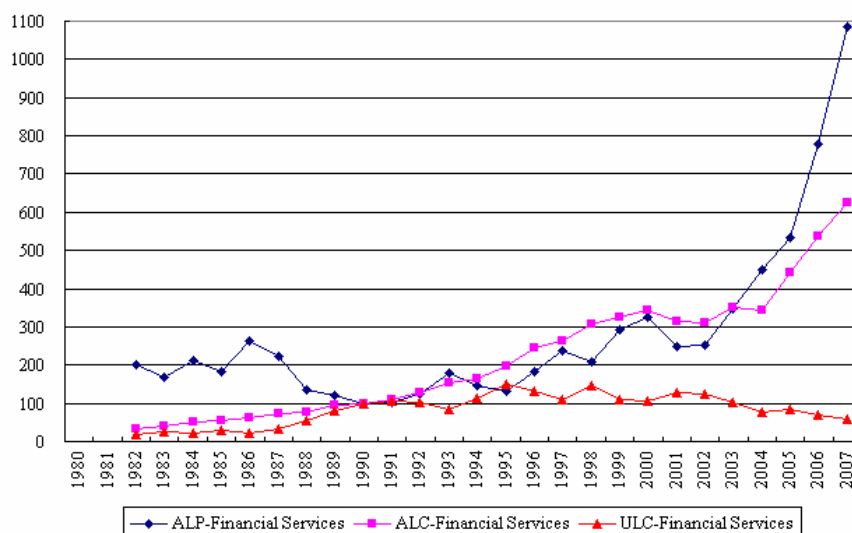


Figure 4: The Unit Labor Cost of Financial Services Industry (1982-2007)

Note: ALP, ALC, and ULC represent Average Labor Productivity, Average Labor Cost, and Unit Labor Cost, respectively. Values for 1990 are set at 100 for ALP, ALC, and ULC.

Source: Census and Statistics Department, Hong Kong SAR.

However, we have to clearly realize the competition and cooperation in the financial services industry between Hong Kong and Shanghai. In April 2009, the State Council issued documents concerning the promotion of Shanghai as an international financial and shipping center, with the aim of making Shanghai an international financial center by 2020 in accordance with China’s economic power and the international role of RMB, along with high-level, globally competitive, and industrially influential financial market and financial institution systems (see Appendix 3.1). In the following month (May 2009), the “*Shenzhen Overall Comprehensive*

⁸ Unit Labor Cost is the average labor compensation adjusted by labor productivity. It can be computed by dividing average labor cost (ALC) by labor productivity (ALP).

Reform Plan” (*Shenzhen Reform Plan*) was also issued by the State Council, which supported the areas of Hong Kong and Shenzhen in their establishment of an international financial center, logistics center, trade center, and culture and innovation industrial center together. Within one month, the plans of developing two international financial centers in a country were approved by the central government. It shows that the establishment of the double financial centers in China has been included in the national plan and supported by the central, as well as local, governments. It will bring about both opportunities and challenges to Hong Kong.

The position of Shanghai as a future international financial center obviously brings challenges to Hong Kong. In the long-run, Shanghai will become the center for RMB related services and IPO of Mainland companies. Hong Kong will lose the current advantages of RMB services and attraction of IPO for Mainland enterprises gradually. However, we also need to see the important development opportunities. Shanghai is positioned as “an international financial center in accordance with China’s economic power and the international role of RMB”. Therefore, it will take a certain period for Shanghai to establish its role of an international financial center, which highly depends on China’s economic development, international economic environment and China’s finance policies. Hong Kong has been and will be an international financial center and the hub of foreign capital investing in China for decades. Furthermore, Hong Kong will also take on part of the responsibility of RMB’s internationalization.

Hong Kong’s financial services industry has obvious institutional advantage, solid institutional guarantee, well-trained financial experts, adequate cross-border financial transaction experience, and close relationship with international financial capital markets. All these constitute Hong Kong’s comparative advantages relative to Shanghai. To cope with the national plan of building double financial centers, on the one hand, Hong Kong must promote the cooperation with financial industries of Shenzhen, must be based on the Pearl River Delta and must actively satisfy the market demands from the Pan Pearl River Delta. On the other hand, Hong Kong should positively cooperate and communicate with the Shanghai financial services industry and seek for differentiated development and benign competition. The rise of Shanghai as an international financial center will promote the openness of the Mainland financial industries. Coupled with further commercialization, financialization, marketization, and internationalization of the Mainland economy, it will lay the foundation for the entry of Hong Kong’s financial services industry into the Mainland markets. The *Central 14 Measures*, *PRD Plan*, and *Shenzhen Reform Plan* further strengthen Hong Kong’s role as an international financial center. If Hong Kong’s financial services industry behaves appropriately, with a higher and broader vision in facing the challenges, Hong Kong’s future role as an international financial center will not be superseded by Shanghai. On the contrary, it is likely that China can develop double financial centers, similar to the situation after World War II when London held the advantage of its financial services industry along with the rise of Frankfurt as a new international financial center.

Based on the above judgments, we have the following recommendations for the medium and long-term development of Hong Kong’s financial services industry.

First, Mainland China is the largest market of Hong Kong’s financial services industry. However, the attractiveness of Hong Kong to the Mainland enterprises has begun to fall. Therefore, Hong Kong should actively adjust to attract more enterprises from Mainland China and other countries toward enlistment in the Hong Kong’s stock market. In the last 20 years, the listing of China-related enterprises constituted the most important IPO source for Hong Kong’s financial

services industry. Hong Kong has been the capital financing center for the Mainland enterprises (see Appendix 3.2).⁹ However, after 2007, the Hong Kong-listed China-related enterprises began to revert to the Mainland's A shares market. Therefore, both the market value and the turnover of Shanghai stock market exceeded those of Hong Kong. Due to the financial tsunami, the total amount of IPO from the Mainland dropped significantly. Although Hong Kong's capital market has obvious advantages for the time being, from the long-term view, Shanghai should be the first choice for the enlistment of the Mainland enterprises. Thus, Hong Kong should adjust actively, taking the opportunities generated by the *Central 14 Measures* and *PRD Plan* which promote the enlistment of Mainland enterprises in Hong Kong, and implementing the detailed policies supporting the Mainland enterprises' listing in Hong Kong. This should be done while strengthening the cooperation with the Shanghai Stock Exchange and Shenzhen Stock Exchange in order to achieve a win-win situation concerning information sharing and market opening. Aside from these, the Hong Kong's financial services industry should consider attracting more enterprises from other countries to enlist as an important development goal.

Second, Hong Kong should actively take the historic chance of the internationalization of RMB, being the forerunner and beneficiary of the entry of RMB into the international financial markets. This chance might be a short-term one. The gradual opening of China's capital markets determines the step-by-step principle concerning the internationalization of RMB. During this process, Hong Kong will be positioned as the "entry point", "buffer zone", and "transition zone" of the internationalization of RMB. On January 20, 2009, the People's Bank of China and the Hong Kong Monetary Authority signed a currency swap agreement.¹⁰ The *Central 14 Measures* also permits qualified enterprises to settle their trade contracts by RMB. The *PRD Plan* also proposes to price and settle trading contracts in the Hong Kong-Macau area by RMB as a pilot effort. All the above measures are aimed at the internationalization of RMB. Although Hong Kong is the largest off-shore RMB center, the scale of its offshore business is not huge. From the long-term perspective, the restrictions on China's capital accounts will be removed and RMB will be freely convertible. After that, the current advantage of Hong Kong might not exist.

Third, Hong Kong should promote the cooperation with Shenzhen's financial services industry and confirm the detailed policies and implementations of building Hong Kong and Shenzhen as an international financial center in line with the *Shenzhen Reform Plan*. In the future development of the financial services industry, Shenzhen will establish the national foreign currency bond market, future market, and property market in which Hong Kong has a significant advantage because of its abundant experience and complete system. Hong Kong could take this opportunity to expand its influence and market share in Shenzhen's financial services industry. Furthermore, Shenzhen has obtained the policy support of four kinds of "Trying First" from the *Shenzhen Reform Plan*. The stock market integration of Hong Kong and Shenzhen may be an

⁹ According to the data from the Hong Kong Exchange, from 1993 to March 2009, the total equity fund raised by China-related enterprises in Hong Kong was nearly 870 billion HK\$. There are 246 listed China-related companies (202 in the main board, and 44 in GEM), accounting for 22.6% of the total number of listed companies. In 2009, the market value of listed China-related companies exceeded 5.59 trillion, accounting for 56% of the total market value. In 2008, the turnover of China-related listed companies was about 8.41 trillion, which was about 67% of the total turnover.

¹⁰ With this currency swap arrangement, short-term liquidity support can be provided to the Mainland operations of Hong Kong banks and the Hong Kong operations of Mainland banks in case of need.

important pilot component of this policy. With the establishment of Hong Kong-Shenzhen international financial center, the IPO and turnover of the Shenzhen Stock Exchange will be more active, which will be a precious opportunity for the Hong Kong stock market in view of its declining attractiveness to the Mainland enterprises.

Fourth, Hong Kong's banking industry should expand its development continuously and try to open a broader market in the Mainland. CEPA reduces Hong Kong-based banks' threshold to enter the domestic financial markets of the Mainland,¹¹ which makes Hong Kong-based banks enjoy more favorable policies compared to the banks from Europe and the US. The following CEPA Supplements further release the restriction of establishing branches in Guangdong for Hong Kong-based banks.¹² In this connection, Hong Kong should further exploit its advantages in legal protection and financial regulation, which will attract the Mainland capital to use wealth management services in the Hong Kong financial services industry.

Fifth, Hong Kong should strengthen the communication of financial professional experts and the mutual recognition of professional qualifications with the Mainland. Human resource, especially professional experts, is the most important resource for financial development. The *PRD Plan* proposes promoting the work of mutual recognition of professional qualifications in the area of banking, securities and insurance, and other fields. Hong Kong's financial services industry should be well-prepared to open businesses in the Mainland markets and facilitate Mainland financial professional experts working in Hong Kong.

Sixth, Hong Kong's financial regulatory authorities should enhance the cooperation with its Mainland counterparts to resist common external shocks. In the case of a financial tsunami, although both the Hong Kong and Mainland stock markets are subject to shocks, no Mainland financial institutions face bankruptcy or government intervention. Financial regulatory authorities and institutions in Hong Kong and the Mainland must work together to resist against the external shocks by increasing communication and cooperation.

Seventh, Hong Kong should attract central institutions, including sovereign funds and policy banks, to set up businesses in Hong Kong. China has been experiencing a relatively stable economic development and domestic financial institutions are still in the development stage, therefore it is less affected by this financial tsunami. Financial institutions of the Mainland need to open international financial businesses. The *Central 14 Measures* puts forward that the domestic enterprises should be encouraged to use Hong Kong's financial platform and open international financial businesses. Large-scale institutions, including the China Investment Corporation and China Development Bank, are especially encouraged to set up branches and open business in Hong Kong. For its part, Hong Kong should implement this as soon as possible. Furthermore, the 4000 billion RMB investments to expand domestic demands proposed by the central government should be funded by issuing bonds in the next two to three years. The Hong Kong SAR government should consider putting forward suggestions to the central government to increase the bond issuance scale in Hong Kong.

3.2 Trade and Logistics

Hong Kong is one of the global trading centers. In 2007, Hong Kong ranked 12th in trading

¹¹ The CEPA reduced the requirement of total assets for the establishment of branches in Mainland China by foreign commercial banks from USD 20 billion to USD 6 billion.

¹² See CEPA Supplements VI, signed May 9, 2009.

volume, which, however, is lower than its 8th ranking in 1997. The total container throughput handled by the Hong Kong Port ranked 3rd worldwide in 2008, following Singapore and Shanghai and followed by Shenzhen and Guangzhou, which ranked 4th and 7th, respectively. Trading and logistics¹³ play key roles in the Hong Kong economy. In 2007, this industry accounted for 25.8% of Hong Kong's GDP, and contributed to 21.6% of the total employment in Hong Kong.

From the perspective of the Unit Labor Cost (ULC) in the trading and logistic sector, labor productivity has been increasing at an accelerated rate since 1997, whereas the increase in the average labor compensation slowed down. As a consequence, the ULC of this industry decreased quickly. We believe that the increasing demand caused by China's rising need for the services of Hong Kong's trading and logistics industry, as well as the economic integration between Hong Kong and the Mainland, are the main reasons. Obviously, we find that after 2005, the increase rate of average labor compensation started to exceed that of labor productivity. Consequently, the ULC increased slightly, which indicates that the competitiveness of this industry faced severe challenges in the past three years (see Figure 5).

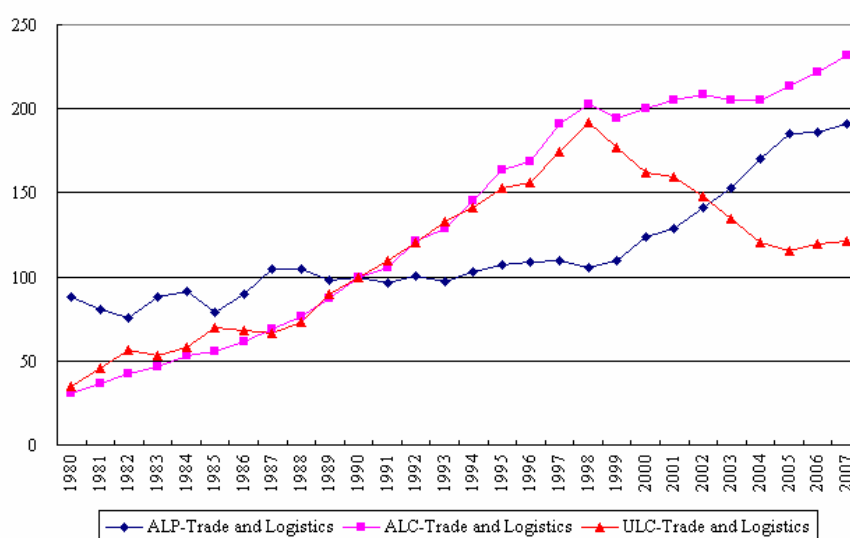


Figure 5: The Unit Labor Cost of Trade and Logistics (1980-2007)

Note: ALP, ALC, and ULC represent Average Labor Productivity, Average Labor Cost, and Unit Labor Cost, respectively. Values for 1990 are set at 100 for ALP, ALC, and ULC.

Source: Census and Statistics Department, Hong Kong SAR.

As the challenges of the international economic environment have been appearing one after another since 2008, Hong Kong's export-oriented economy was hit hard during the financial tsunami. The increase rate of the total trade dropped dramatically from 15% in January 2008 to -20% in January 2009, and the decrease rate slowed down only in February.

Moreover, with the high growth rate of the Chinese economy, each coastal and riparian province in the Mainland has been developing its own container terminals. From the view of the growth rate of the container terminal throughput over the period 2004-2006, for instance, the growth rate of Guangdong is 19.98% and that of Shanghai is 22.14%. Meanwhile, China's State

¹³ Trade and Logistics includes Trading (wholesale trade, and import and export trade) and Logistics (Freight transport and storage services, and Postal and courier services).

Council issued detailed plans in April 2009 to build Shanghai into an international financial and shipping center. The competition among districts has been intensified.

Facing the competition from Shanghai and the Yangtze River Delta, Hong Kong has to move actively to enlarge its source boundary and collaborate with Shenzhen and Guangzhou to realize cluster-developing and cooperation. In 2008, the three ports' container throughput reached 5.672 million TEUs, which was very close to the sum of Singapore and Shanghai (5.793 TEUs). The recently approved *Shenzhen Reform Plan* proposes to establish the areas of Hong Kong and Shenzhen as an international trade and logistics center. The key problem so far is how to integrate the port sources and logistics sources of the Pearl River Delta to realize the mutual development and prosperity.

First, act jointly with the Pearl River Delta to establish the pattern of Cooperative Development and Differentiated Development of trade and logistics. The *Central 14 Measures*, the *PRD Plan* and the *Shenzhen Reform Plan* propose to foster the functional complementary and differentiated development between the Hong Kong-Macau district and the Pearl River Delta and make them centers for international shipping, logistics and trading, and other spheres. Hong Kong should actively take this strategic opportunity and positively communicate with the central government and the Guangdong government to further clarify the development position and major diversification of Hong Kong and the Pearl River Delta such that the ports in the Pearl River Delta could thoroughly utilize their own advantages and mutually develop with Hong Kong. We suggest establishing the Pearl River Delta Ports Development Council¹⁴ under the Guangdong-Hong Kong Chief Executive Joint Conference to work out the development strategies and schemes of the Pearl River Delta ports. This should be done to realize the complementary and mutual development and to build an institutionalized, flexible, and pragmatic management pattern and communication mechanism.

Second, confronted with the established competitive relationship among Hong Kong, Guangzhou, and Shenzhen, as well as other areas, Hong Kong should also move actively to adjust its trading and logistics industry structure, in addition to the strategic diversification and mutual development with other cities in the Pearl River Delta. Aside from forming a reasonable diversification in the Third Party Logistics¹⁵ industry with the Pearl River Delta, Hong Kong should develop the Fourth Party logistics.¹⁶

Third, along with the economic rise and openness of the Mainland markets, Hong Kong's logistics industry still has broad development space. On August 5, 2004, nine ministers, including the ministers of the National Development and Reform Commission (NDRC) and Department of Commerce, jointly issued "On Promoting the Development of China's Modern Logistic Industry". This clearly proposes to actively push forward the opening of the logistics market. Hong Kong's

¹⁴ From the Hong Kong side, the members include representatives of the Hong Kong Trade Development Council and enterprises operating Hong Kong ports. From the Guangdong side, the members include Port Management Bureau of Guangdong Communication Department, Guangzhou Port Authority, Shenzhen Port Authority, and Zhuhai Authority representatives.

¹⁵ Third Party Logistics comes from the concept of outsourcing in management theory. It is the supply chain practice where one or more logistics functions of a firm are outsourced to a Third Party Logistics provider.

¹⁶ Fourth Party Logistics mainly refers to logistics consultant services provided by specialist companies. It is the arrangement in which a firm contract outsources its logistical operations to two or more specialists firms (the Third Party Logistics) and hires another specialist firm (the fourth party) to coordinate the activities of the Third Parties.

logistics capital has been taking an active part in the Mainland's construction of ports and terminals, which can, to some level, improve the balance between the development of the logistic industry in Hong Kong and the Mainland and obtain munificent returns from the investment.

Fourth, CEPA has opened a door for Hong Kong's logistics industry to enter the Mainland. CEPA's preferential terms towards the Hong Kong logistics industry (see Appendix 3.3) make the industry enjoy the leading advantage in the Mainland logistics development. Hong Kong's logistics industry should actively utilize the preferential policies of CEPA and transfer these policy advantages into industry advantages to expand the Mainland market.

3.3 Tourism

Although tourism-related industries¹⁷ contribute to about 3% of Hong Kong's GDP, the number of persons engaged in these industries accounts for 5% of Hong Kong's employment. Both the value-added share in GDP and the employment share in the total labor force have been increasing. Thus, tourism has important implications for the purpose of preserving jobs and stimulating other industries. Meanwhile, Hong Kong inbound tourism services constitute the major part of this industry. Currently, the value-added and the employment of inbound services account for 70% of the total tourism industry (see Figure 6).

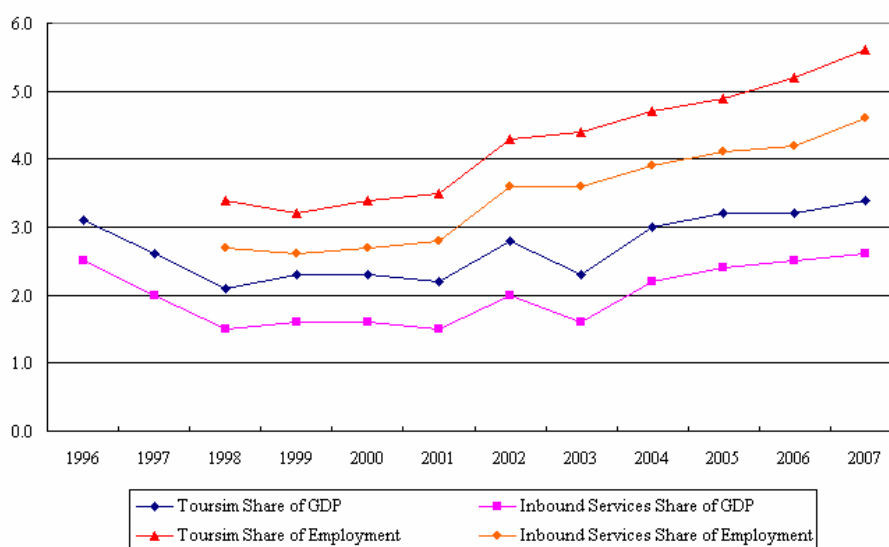


Figure 6: Value-added Share and Employment Share of the Tourism Industry (1997-2007)

Note: Unit is %.

Source: Census and Statistics Department, Hong Kong SAR.

Since the implementation of CEPA, the *Individual Visit Scheme* has directly increased local consumption needs with an immediate effect on Hong Kong's economy. From April 1, 2009, valid applicants from Shenzhen's 2.3 million registered household (*hukou*) populations can apply for a multiple entry travel visa. After May 1, non-Guangdong *hukou* Shenzhen residents can also apply

¹⁷ The tourism industry includes Inbound Services (retail trade, hotels and boarding houses, restaurants, cross-boundary passenger transport services, and other services) and Outbound Services (travel agents and airline ticket agents, and cross-boundary passenger transport services).

for a travel visa to Hong Kong in Shenzhen. Moreover, the central government has agreed to actively analyze the expansion of the number of cities covered by the *Individual Visit Scheme*. These are the measures related to *Individual Visit Scheme* immediately put in effect after the *Central 14 Measures* was issued. These measures will undoubtedly facilitate the travel of more than eight million Shenzhen residents to Hong Kong for the entertainment or shopping purpose. In addition, this will provide a new impetus for stimulating Hong Kong's tourism industry and economic growth.

From the perspective of the Unit Labor Cost (ULC) of tourism, the incessant decrease of the ULC after 1997 could only be attributed to the significant decrease of the average labor compensation. The labor productivity remained almost the same. After the launch of the *Individual Visit Scheme* in 2003, the labor productivity of tourism increased significantly and maintained a relatively high growth rate in the following five years. However, after 2003, the average labor compensation quickly increased, which is a manifestation of the main impetus of the development of Hong Kong tourism (i.e., to integrate with the Mainland economy and to open the tourism market). However, it also indicates that the recent increasing labor cost is the obvious pressure that the industry has to contend with (see Figure 7).

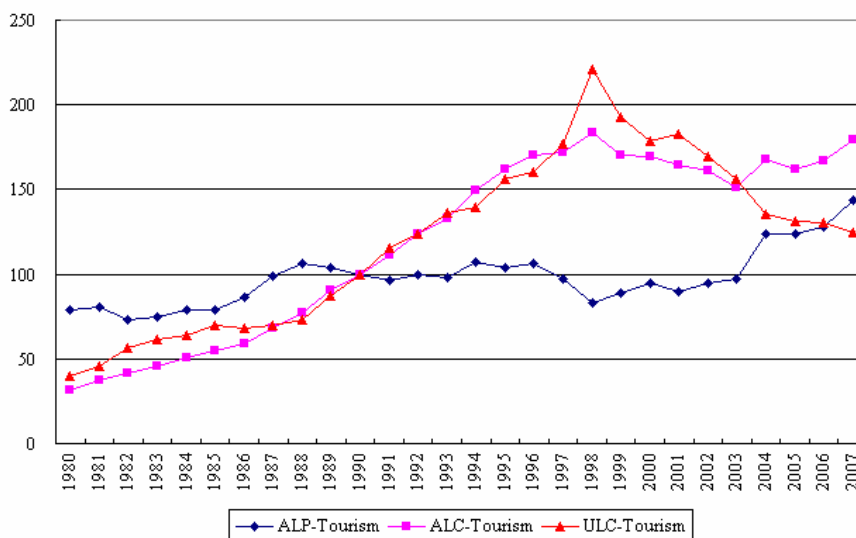


Figure 7: The Unit Labor Cost of Tourism Industry (1980-2007)

Note: ALP, ALC, and ULC represent Average Labor Productivity, Average Labor Cost, and Unit Labor Cost, respectively. Values for 1990 are set at 100 for ALP, ALC, and ULC.

Source: Census and Statistics Department, Hong Kong SAR.

On the other hand, China's tourism is a recent rapidly growing industry. The development of the Mainland tourism market is a new growth point of Hong Kong's tourism industry. Concerned with the openness of China's tourism, the central government formulated strict regulations about the entry and business range of foreign ventures, which means that the administrative approval process for the entry of foreign ventures is quite tiresome (see Appendix 3.4).

At the end of July 2008, the State Council authorized the Ministry of Commerce to sign CEPA Supplement V in Hong Kong and Macau, respectively. This offers more openness to Hong

Kong and Macau on the basis of CEPA and the previous four Supplements.¹⁸ The following signed CEPA Supplement VI further opened the Mainland market to Hong Kong and launched the “One Trip, Multiple Destinations” tour package.¹⁹ Compared with foreign ventures from other countries, Hong Kong’s tourism industry has the leading advantage with regard to opening businesses in Mainland China. Entering the Mainland market could not only expand the development prospect of Hong Kong’s tourism industry, but also exerts positive effects on the further integration of the Pearl River Delta tourism industry resources. However, it should be noted that CEPA does not offer full-range openness for Hong Kong’s tourism industry.

Therefore, the future development of Hong Kong’s tourism relies on two important directions. One, promote Hong Kong as a tour destination to attract Mainland Chinese and international tourists by improving the quality of the tourism resources and seeking more favorable policy supports. Two, further prepare the Hong Kong tourism industry by actively investing in Mainland tourism enterprises and entering the Mainland tourism markets.

First, Hong Kong has to improve the quality of its tourism products and expand its tourism resources content. The Hong Kong SAR government should foster a breakthrough in the negotiation with Disney on the expansion plans of the Hong Kong Disneyland by investing through debt-equity swap and adjusting the operations of the joint venture, and should also seek the support from the Legislative Council. Facing the competition from the incoming Shanghai Disneyland, which might be approved by the central government soon, the expansion plans of the Hong Kong Disneyland seem imminent. Moreover, Hong Kong’s professional service with high quality could contribute a lot to the expansion of Hong Kong’s tourism resources. The *PRD Plan* proposes that the Pearl River Delta and Hong Kong jointly build a high-quality living area, which will improve the connotation of Hong Kong’s tourism resources. This is feasible through simplifying the procedures for the residents of the Pearl River Delta visiting Hong Kong, and expanding and transforming the local education services, medical services, and cultural and art services to be the new tourism products for the residents of the Pearl River Delta visiting Hong Kong.

Furthermore, since there are no major tourism projects and infrastructure constructions in the short-run, the attraction of Hong Kong’s traditional tourism services to international tourists is diminishing. However, Hong Kong is more attractive as a food heaven, a shopping city and an entertainment center. To attract more international tourists to Hong Kong, on the one hand, Hong Kong can be designed as the starting station (or an important station) of the “One Trip, Multiple

¹⁸ According to “CEPA Supplement V”, effective January 1, 2009, Guangdong will be delegated the authority to approve applications submitted by Hong Kong service suppliers for forming travel agents on a wholly owned, equity joint venture, or on a contractual joint venture basis in Guangdong. Hong Kong permanent residents with Chinese citizenship will be allowed to take the Mainland Qualification Examination for Tourist Guide. Those who have passed the examination can obtain the Mainland Tourist Guide Certificate in accordance with the requirements.

¹⁹ According to “CEPA Supplement V”, to take effect starting October 1, 2009, Mainland travel agents are authorized to operate group tours to Taiwan and can organize group tours for Mainland residents who hold valid exit-entry permits for traveling to and from Taiwan, as well as travel endorsements to enter and remain in Hong Kong in transit. Hong Kong permanent residents with Chinese citizenships can obtain Mainland outbound tour escort credentials. They can be employed by the Mainland, Hong Kong, and Macau as international travel agents authorized to operate outbound group tours.

Destinations” in the China tour package (or Asia tour package). Hong Kong can provide quality services in applying for China visas, providing international tourist guide, based on the cooperation with tourism industries in the Mainland. As a result, Hong Kong could be the beneficiary of China’s abundant tourism resources. On the other hand, Hong Kong can improve the quality of its shopping environment, food services and entertainment services so that the international tourists (especially international young tourists) could be attracted for visit and consumption.

Second, actively strive for simplifying the procedures for the residents of the Pearl River Delta who will be visiting Hong Kong and for expanding the number of cities covered by the *Individual Visit Scheme*. Negotiate actively with the central government and immigration departments to promote the policy of multiple entries presently enjoyed only by the Shenzhen registered household (*hukou*) residents to other cities in the Pearl River Delta. Meanwhile, expand the policy that the non-Guangdong *hukou* residents can apply for the Hong Kong and Macau travel visa locally to the entire Guangdong Province. Aside from these, strive for expanding the *Individual Visit Scheme* policy from the current 49 cities to the other major Mainland cities to increase the number of the Mainland tourists visiting Hong Kong.

Third, the Hong Kong tourism industry must be prepared as soon as possible to enter the Mainland tourism industry and markets. The measures concerning tourism policies in Guangdong Province stipulated in CEPA and the operation of those measures in different places undoubtedly face many questions. The Supplements of CEPA do not stipulate explicitly the business range of the Hong Kong tourism industry’s operation in the Mainland markets. Therefore, the Hong Kong-based companies still face a series of problems in registering and opening businesses in Guangdong. For the Hong Kong tourism industry, the following two fields are significant: First, the Hong Kong Tourism Board should organize the local tourism industry companies to investigate the Mainland tourism markets, especially the Guangdong market, to prepare the “Abroad Tourism” service. Second, the Hong Kong Tourism Board should establish cooperation mechanisms with the travel departments of Guangdong Province to facilitate the mutual discussion of cooperation pattern and problems along with development.

3.4 Professional Services and Other Producer Services

The industry of professional services and other industrial and commercial supporting services (professional service industry for simplicity) is one of Hong Kong’s pillar industries, which accounts for about 11% of Hong Kong’s GDP and provides about 11% of the total employment.

From Figure 8, we can find that in 2003, the labor productivity of professional services has remained the same as 20 years ago, whereas the average labor compensation keeps increasing and even maintained the level similar to that before 1997 even after the Asia financial crisis. From 2003-2006, the growth rate of the labor productivity of the professional services has been accelerated while the average labor compensation has remained unchanged and consequently the Unit Labor Cost (ULC) has significantly declined. Over this period, the increasing demand for professional services from the accelerated integration of the Hong Kong and Mainland economies has become one of the major forces that pushed forward this change. It should be noted that the average labor compensation resumed increasing in 2007 and the ULC stopped declining. Both the *PRD Plan* and the *Shenzhen Reform Plan* promote the cooperation and integration of Hong Kong and the Pearl River Delta, which will be the major source of the increase of demand for Hong

Kong's professional services.

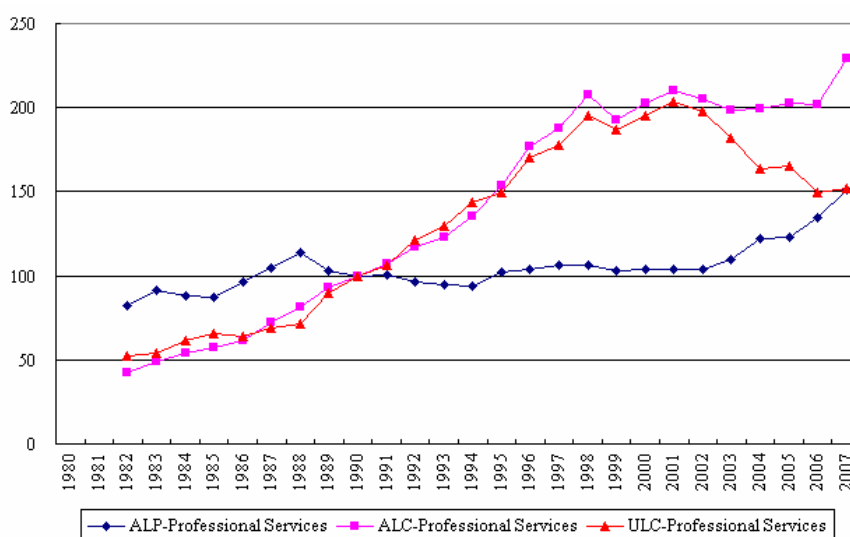


Figure 8: The Unit Labor Cost of Professional Services Industry (1982-2007)

Note: ALP, ALC, and ULC represent Average Labor Productivity, Average Labor Cost, and Unit Labor Cost, respectively. Values for 1990 are set at 100 for ALP, ALC, and ULC.

Source: Census and Statistics Department, Hong Kong SAR.

The professional services industry covers many areas such as law, accounting, auditing, architecture, survey, project engineering services, business management and consulting, and other forms. Therefore, the mobility of professional experts and the mutual recognition of professional qualifications constitute the key issues for the professional services industry.

Compared with the Mainland professional services industry, Hong Kong has the upper hand in this industry. Therefore, a major problem in the medium and long-term development of this industry is the entry of Hong Kong's professional services companies and professional experts into the Mainland markets. The entry of Hong Kong residents into the Mainland to work in professional services industry involves two channels. First, Hong Kong residents can obtain the Mainland professional qualifications by passing the Mainland professional qualification examinations. Thus far, the Mainland has opened only 30 professional technician qualification examinations to Hong Kong residents. Second, Hong Kong and the Mainland must implement mutual recognition of professional qualifications. This qualifies Hong Kong professional experts for the Mainland businesses.

CEPA Supplement VI signed in May 2009 further reduced the entry restrictions for Hong Kong professional services industry particularly in some sensitive areas such as law. It shortened the number of service years required for Hong Kong legal practitioners. This arrangement also made important progress in the mutual recognition of professional qualifications.²⁰

In general, the mutual recognition of professional qualifications has made certain progress. However, constrained by the differences in institutions, the progress is uneven: relatively slower in

²⁰ CEPA Supplement VI includes a number of measures to encourage the mutual recognition of professional qualifications as well as technical exchange work among professionals from the accounting, construction, real estate, and printing sectors. Hong Kong pharmacists can take an examination and register in the Mainland.

the areas of accounting, security, law, and patent agency, although relatively faster in the construction and medical areas (see Appendix 3.5). As compared to the Mainland, Hong Kong has very significant differences in professional standard and qualification system in some areas such as laws. In some areas such as accounting, the Mainland is approaching the international standard and the difference is diminishing. In some high-tech professional services industries, the difference is relatively smaller so that the mutual recognition could be realized soon. From a long-term view, obtaining the Mainland professional qualifications through examinations remains an important channel, although this needs time. Hong Kong's college education needs to make some adjustments. For example, in Hong Kong's colleges, the schools of law should add more Mainland law courses and the business schools may add courses concerning Mainland commercial institutions.

Chapter 4: Development and Cultivation of High Potential Industries

In the industrial structures of Hong Kong economy, the four existing traditional pillar industries account for 60% of the GDP and provide 50% of the employment. The small local market and high factor costs restrict the development of the traditional service industries. We can see this clearly from the Unit Labor Cost (ULC) analysis of the whole service sector. Since 1980, the average labor compensation has kept on rising. Although the uptrend slowed down after 1997, the labor cost was under increasing pressure to rise after 2004. Meanwhile, the labor productivity of the service industries did not change much before 1997, which made the ULC kept on increasing. The labor productivity has gained rapid growth since Hong Kong's handover to China in 1997, which tends to lower the ULC. However, the fast rise of the labor cost after 2004 brought significant pressures on the development of the Hong Kong's service sector (see Figure 9).

Meanwhile, Hong Kong is facing fierce competition from some emerging metropolises in Mainland China, such as Shanghai, as the new service centers. Moreover, Hong Kong's export-oriented economy and floating capital-led economic structure showed its vulnerability after the financial tsunami. Therefore, it is necessary for Hong Kong to investigate new industries for economic growth that will benefit Hong Kong's economic growth in the medium and long term, in order to alleviate the economic fragility when facing external shocks and to increase the sustainability of economic growth.

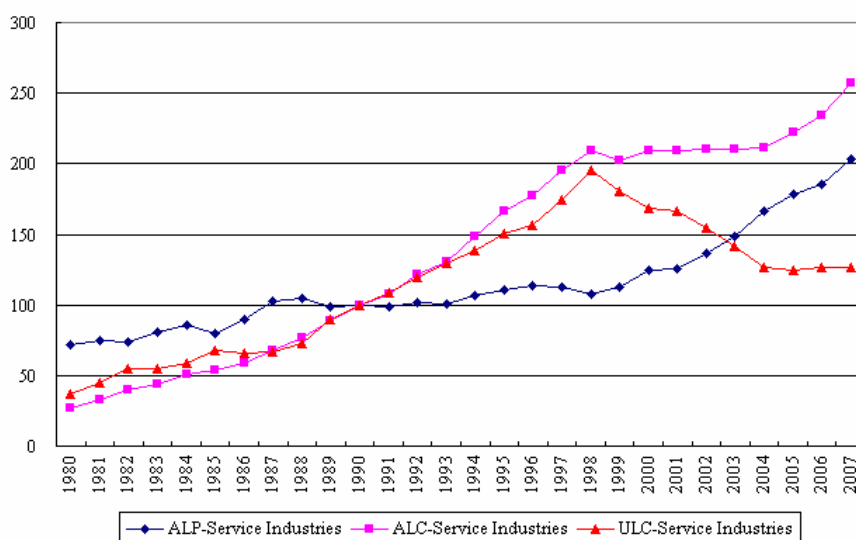


Figure 9: The Unit Labor Cost of the Whole Service Sector (1980-2007)

Note: ALP, ALC, and ULC represent Average Labor Productivity, Average Labor Cost, and Unit Labor Cost, respectively. Values for 1990 are set at 100 for ALP, ALC, and ULC.

Source: Census and Statistics Department, Hong Kong SAR.

4.1 Medical Services

There are currently 39 public hospitals and 13 private hospitals in Hong Kong, providing more than 31,000 beds. There are 4,723 doctors and 19,273 nurses providing services to the residents.²¹ Comparing these with the 7 million Hong Kong population and the potential medical

²¹ Data source: Hong Kong Hospital Authority

service demands from the Pearl River Delta, the scale of Hong Kong's medical service is still relatively small. The private hospitals only account for 11% of the total beds in Hong Kong. The public hospital system is overburdened. However, the medical services provided by private hospitals are very expensive. As Hong Kong is entering the aging society, it will increase the burdens of public finance expenditure continuously if the medical services are only provided by the public hospitals. The immense price difference between public and private medical services shows that it is possible to improve the capabilities of medical services and reduce the burdens of public finance expenditure by establishing a public-private partnership²².

Compared with the medical services in the Mainland, Hong Kong has two obvious advantages: (1) Hong Kong has a complete medical service system, including public hospitals, private hospitals, and private clinics. The system not only ensures public welfare and equality, but also gives the private sector enough space in providing medical services. (2) Hong Kong has excellent medical staffs and equipments. In addition, the strict management system and occupational integrity of the medical practitioners guarantee the quality of the medical services, which is a widely accepted observation. It is also a very important aspect of the competitiveness of Hong Kong's medical services.

The medical reform proposal in the Mainland has become the focus of the whole society.²³ However, the lack of high-quality medical services in the Mainland will not disappear in a short period. With the economic development, especially the growth of high-income populations in large cities, the demand for high-quality and high-price medical services will grow continually, which provides many opportunities for the medical practitioners and investors of Hong Kong. However, the medical services industry of Hong Kong is also facing significant challenges. First, the immense wage difference between Hong Kong and the Mainland makes it less attractive for Hong Kong's medical practitioners to work in the Mainland. Second, the development of Hong Kong's medical service industries in the Mainland depends on the approval of the health authorities of the Mainland government. The Hong Kong SAR government could only play a bridging role in the area.

Moreover, the *PRD Plan* also provides a clear position for the medical industry development in the Pearl River Delta: "Actively promote the development of non-public medical institutions, and establish a medical system with diversified investors and diversified investment channels". This plan also encourages the medical industry to implement pilot projects with joint-venture and cooperation between the Mainland and foreign capital, which is an important policy opportunity for the Hong Kong medical services industry and capital entering the market of the Pearl River Delta.

In general, the medical services industry of Hong Kong with high labor cost does not have a significant advantage over the Mainland counterparts. The development space of local medical services may be limited. Therefore, the future development of the Hong Kong medical service industries should focus on improving the quality of medical services and helping the

²² A public-private partnership describes a government service or private business venture which is funded and operated through a partnership of the government and one or more private companies.

²³ The newest 2009 proposal proposes to "Further perfect the medical service system, remain committed to the principles that non-profit medical institutes are the main body, with non-profit institutes as complements, and that public institutes play a leading role and co-exist with non-public institutes". The proposal aims to "gradually realize the objective that every person receives the basic medical and health services".

development of private medical institutes to satisfy the medical demand of local residents in Hong Kong. Moreover, the Hong Kong medical service industries can develop some superior medical service contents, actively involve themselves into the Mainland market, and provide high quality medical services to the Mainland visitors, especially those from the Pearl River Delta metropolis area in the future.

CEPA sets up the rules for the mutual recognition of physicians in the Mainland and Hong Kong, which lays the foundations for Hong Kong doctors to practice in the Mainland in the future. The CEPA Supplement V states, “Allow the service providers from Hong Kong to set up wholly-owned medical clinics in Guangdong Province”. Currently, there are already several Hong Kong and Mainland co-built hospitals, such as “the Chinese University of Hong Kong Luohu Hospital” jointly established by Shenzhen Luohu Hospital and the Chinese University of Hong Kong, and the “Suzhou Kowloon Hospital” jointly established by the Hong Kong Kowloon Group and the Shanghai Jiaotong University. In the future, the Hong Kong government should further encourage Hong Kong physicians to open clinics in the Mainland, and encourage joint-venture hospitals in various forms. Meanwhile, the Hong Kong government should also comprehensively evaluate the effect of such policies on the physician resources in Hong Kong. Especially, the government should analyze whether there will be large scale movements of Hong Kong physicians to the Mainland, and whether this will affect the physician supplies in Hong Kong.

Second, add “medical tourism” into the *Individual Visit Scheme* package, and focus on the development of superior service programs. The traditional *Individual Visit Scheme* benefits some services industries such as retail trade, hotels, and restaurants. However, medical tourism will further improve the added value of *Individual Visit Scheme*. However, because the cost of medical services in Hong Kong is quite high, the price for medical services will also be relatively higher. Hong Kong will therefore face competitions from low-cost medical service provider countries such as Thailand. As such, Hong Kong needs to develop special programs of superior medical services, such as nutrition and health care, psychology consulting, and other programs. On the other hand, the Hong Kong medical service industry needs to find an appropriate market position, promote itself actively, and cultivate the consumption demand of high-quality medical service in the Pearl River Delta.

Third, the Hong Kong government should coordinate the communication and cooperation between Hong Kong and Mainland medical industries. The government should organize conferences and panels discussions on Chinese medical and health development, and invite the officials from health authorities in the Mainland, health economists, and medical practitioners. The government should also actively implement of the “cooperation of Chinese medicine industry” stipulated in the CEPA Supplement III.

Fourth, actively study the possibility and realization roadmap of establishing the public-private partnership in medical services. If the medical systems based on the public-private partnership could be set up in medical services, it will not only improve the capability of medical services supply, but also reduce the burdens of public hospitals and public finance expenditures.

4.2 Educational Services

Developing the educational services industry has multiple benefits for Hong Kong. First, human capital is the key factor for a sustainable economic growth, especially for Hong Kong whose economy is dominated by the service industries. Demands for human capital are more

urgent and important than physical capital in current situations. Second, the investments in human capital have a positive externality. The long-term returns for human capitals are fairly large. However, the goods with a positive externality are usually under-invested in the private sectors, so the government needs to subsidize the investment in education using public funds. Third, the expansion of external demand for Hong Kong's education services, especially in the neighboring areas, could boost local demands directly. In addition, the expansion of higher education will provide more employment to local residents, because the non-local students will create consumption demand for the Hong Kong economy.

The educational services of Hong Kong, especially the higher education, have many significant comparative advantages over the neighboring areas including: (1) course programs, educational visions, and management system widely accepted globally; (2) international recognition and reputation built through decades of teaching and research achievements; (3) high-quality teaching staffs, abundant research funds from various sources, and advanced research facilities; (4) multi-lingual environment with the use of English and Chinese (Cantonese and Putonghua) languages, and diversified cultural environment.

Meanwhile, Hong Kong's educational services have some obvious restrictions and potentials. (1) All of the eight government-funded universities recruited more than 15,000 students in the academic year of 2007-08, only accounting for 18% of the corresponding age group population.²⁴ The proportion is relatively low. About 10,000 students chose to study in overseas universities. (2) The non-local students in the public universities only account for 10.9% of the total number of students, far below those countries that Exporting Educational services, such as Singapore and Australia. (3) The high-level service industries and knowledge economy of Hong Kong have vigorous demands for talents. The Hong Kong government has implemented a series of admission programs for talents,²⁵ but the corresponding policies toward non-local graduates lag behind.²⁶ (4) The demand for higher education is quite huge in the Pearl River Delta yet there are only two universities (Shenzhen University and the Jinan University Shenzhen Campus) and several graduate schools of other universities in Shenzhen. Due to the policy restrictions, the universities from Hong Kong could not operate college education independently in the Mainland, and could only cooperate with Mainland universities, which greatly restricts the advantages of Hong Kong universities in terms of management, educational visions, teaching staffs, and other advantages. (5) Vocational education is listed as one of the key areas for educational investment in the Mainland. Guangdong Province also emphasizes the development of vocational education (see Appendix 4.1). In addition, pre-school education is not included as a compulsory education and private capitals have great potentials in the investment of pre-school education. Therefore, the educational industries of Hong Kong should also pay attention to vocational and pre-school education in the Mainland.

Therefore, we suggest "Exporting Education" as the development strategy of Hong Kong's educational services industry. In order to develop the educational services industry as a future

²⁴ The corresponding age group is 17-20 years-old. Data Source: University Grants Committee.

²⁵ These include Admission Scheme for Mainland Talents and Professionals, Capital Investors Entrant Scheme, and Quality Migrant Admission Scheme, among many others.

²⁶ In 2008, the Hong Kong government began to relax the employment and immigration restrictions towards non-local students and graduates, such as allowing non-local students work part-time, and allowing 12-month unconditional stay at Hong Kong after graduation for non-local graduates.

pillar of the Hong Kong economy, the following directions are suggested:²⁷ increasing the proportion of enrolment in college of local students, attracting non-local students studying in Hong Kong, encouraging and supporting non-local students to work in Hong Kong after graduation, expanding the development space of Hong Kong universities both in Hong Kong and the Mainland, strengthening communication and cooperation between Hong Kong and Mainland universities, developing training program and examination services for professional qualifications, and expanding the vocational and pre-school education markets in Mainland.

To be able to work toward these directions, several efforts should be undertaken. First, Hong Kong government should help to integrate various resources of the educational service industries and position Hong Kong as a Regional Center for Higher Education and for the Qualification Training and Examination which provides “Exporting Education” services. This needs to draw up the development perspective and strategies for the educational services industry, and strengthen the cooperation between Hong Kong and international professional certificate and examination agencies to develop training and consulting services related to professional qualifications and examination.

Second, the education department of Hong Kong government should promote development in the training services of professional courses, diploma, and skills, and provide training and certification of professional qualifications related to the high-potential industries in the medium and long run.

Third, Hong Kong government should strengthen the cooperation among Hong Kong universities, spread the visions and perspectives of higher education of Hong Kong to the neighboring areas, and attract non-local students studying in Hong Kong. Meanwhile, further encourage and support non-local graduates work or further study in Hong Kong, and provide a reserve of professional talents for Hong Kong’s economic development.

Fourth, expand the development space in Hong Kong for local universities. Encourage universities to actively participate in the development of the Lok Ma Chou Loop. For the possible development of Education Town, the government should propose corresponding financing policies and build the supporting facilities. The government should also negotiate favorable immigration policies with the Mainland authorities for the educational service industries.

Fifth, Hong Kong government should consider expanding the development space in the Mainland for Hong Kong universities. Take the opportunity provided by the *PRD Plan*, negotiate and cooperate with related Mainland government authorities, and put into effect the supporting policies and favorable conditions for Hong Kong universities operating college education. All of the eight public universities are expected to seek cooperation with universities in the Pearl River Delta, but the number of high-level universities is limited in this area. Hence, the government should take the responsibility for coordinating the cooperation between Hong Kong and Mainland universities to avoid unnecessary competitions. Moreover, we suggest that the Hong Kong government negotiate with the Ministry of Education and Guangdong Province to explore some cooperation innovations, such as the establishment of one university (Guangdong-Hong Kong University) in the Pearl River Delta to be undertaken by the eight Hong Kong universities.

Sixth, expand the development space for vocational and pre-school education. In terms of vocational education, the Hong Kong government could establish a platform to bring together the

²⁷ Hong Kong government has implemented some policies to support the development of educational services. Please refer to Appendix 4.2.

strengths of Hong Kong educational institutions and business, and to cooperate with the vocational education institutions in Guangdong. With regard to pre-school education, the government should communicate with Ministry of Education, bring together the Education Bureau, pre-school education institutions, and universities; attract investments, and establish pre-school education institutes in the Mainland. Bring the advanced pre-school education system to the Mainland, and train the Mainland pre-school teachers. Meanwhile, the government should promote Hong Kong pre-school education services in the Mainland.

4.3 Cultural and Creative Industry

Cultural and creative industries are emerging industries with cultural creativity, intellectual properties, and high technology as the core contents. They are closely connected with knowledge-based economies. Cultural and creative industries lie at the high end of the value chain of the cultural industries. The creative industry originated in the UK, and has gradually become the new growth pole of the UK economy since the concept was proposed in 1998.²⁸

The development of cultural and creative industries not only requires the necessary hardware construction and scientific planning among regions, but also software support from many areas. Comparatively, Hong Kong possesses the basic conditions for developing the cultural and creative industries. In terms of hardware, the architectural style of buildings and the city management in Hong Kong fully reflect the elements with originality. In terms of software, the high-level openness and freedom of the Hong Kong society, its position as an international trade and finance center, and the sound intellectual property protection provided by the rule of law are all major foundations for the cultural and creative industries. The diversity of Hong Kong society that merges both Chinese and Western cultures further endows Hong Kong with unique advantages in developing cultural and creative industries. The *2003 Hong Kong Creative Industry Research Report* analyzed the creative industries in Hong Kong for the first time, and covered 11 creative industries. In 2007, the cultural and creative industries accounted for 3.9% of Hong Kong's GDP, and they have great growth potentials compared to their counterparts in the U.K., which account for 8%.of U.K.'s GDP.

There are both opportunities and challenges for Hong Kong to develop the cultural and creative industries. Hong Kong's cultural and creative industries should not be confined in Hong Kong, but should be integrated into the development of the Mainland's cultural and creative industries, which are currently experiencing a fast growth period. According to the *2009 Chinese Cultural Industry Development Report* released by the Chinese Academy of Social Sciences, the growth rate of the cultural industries was more than 15% in recent years, higher than those of GDP and the whole services sector. The value-added of cultural industries accounted for 2.6% of China's GDP, and the total value was about 641.2 billion RMB in 2007. The development of the cultural and creative industries of Hong Kong will inevitably face the competitions from the Mainland. Along with the development of cultural industries in the Mainland, some developed regions began to pay more attention to the development of cultural and creative industries, such as

²⁸ According to the estimation in Creative Industry Economic Estimation Statistics released by the Department for Culture, Media and Sport in August 2004, the UK creative industry accounted for 8% of the total value-added in 2002, more than the old traditional financial services industry (5%). Moreover, the creative industry created a large amount of employment. In 2003, total employment in the creative industry was 1.9 million. Likewise, the growth rate of the export of the creative industry was very high.

Beijing, Shanghai, Guangzhou, Shenzhen, and other areas. Cultural and creative industries are listed as one of the major sectors to boost economic growth, create employment, and enhance urban culture, among which Beijing and Shenzhen are the two ambitious cities (see Appendix 4.3).

The *PRD Plan* and *Shenzhen Reform Plan* provide an important policy support to the development of cultural and creative industries of the Pearl River Delta and Shenzhen. The *PRD Plan* promotes the building of a modern industrial system wherein cultivating the creative industries is one of the major implementation points. This Plan also proposes some detailed schemes such as promoting the construction of a national software base and comic industry base in the Pearl River Delta. Furthermore, the *Shenzhen Reform Plan* proposed to develop Shenzhen and Hong Kong as an international cultural and creative industry center. Hong Kong should evaluate the influences of the *Shenzhen Reform Plan* on the cooperation and coordination in developing cultural and creative industries between Hong Kong and Shenzhen.

Hong Kong's cultural and creative industries are also facing many challenges. For one thing, compared with the traditional pillar industries such as financial services, the talents in cultural and creative industries are relatively rare. Moreover, the local market for cultural and creative industries is small. Therefore, Hong Kong needs to further expand to the Mainland market. Lastly, the cultural and creative industries in Hong Kong are dominated by small- and medium-sized enterprises, and thus do not get sufficient financing support.

Hong Kong should take full advantage of diversified and international cultural and social background, and the complete institution of intellectual property rights protection to develop the cultural and creative industry and cooperate with Shenzhen and the Pearl River Delta. Through cultivating the talents of Hong Kong and the Pearl River Delta, and exploring the Mainland and overseas markets, Hong Kong and Shenzhen could jointly establish an international cultural and creative industry center. The cultural and creative industry is very likely to be one of the pillar industries of the Hong Kong economy in the long run.

Hence, we suggest the government pay attention to the following aspects.

First, Hong Kong government can establish the commission for cultural and creative industries, in charge of the coordination of government authorities such as the Communication and Technology Branch of the Commerce and Economic Development Bureau, Intellectual Property Department, Hong Kong Custom, and industry associations. The commission can consider making a comprehensive action plan for cultural and creative industries development, intellectual property protection, and market expansion so as to make the cultural and creative development as one of the long-term economic growth strategies of Hong Kong. Recently, the government has set up a special office for "Creative Hong Kong". This is a good start.

Second, Hong Kong needs to speed up the hardware and software constructions for cultural and creative industries and create creative atmospheres. The West Kowloon cultural zone project should be accelerated and the basic infrastructures of the cultural and creative industries should be enhanced. Hong Kong can be developed into an important center for global cultural and creative industries. Meanwhile, set up training for creative industry skills, provide government support, and cultivate the creative talents. Moreover, cultural and creative industries could be integrated with the tourism industry, fully enjoying the synergy effects and adding new elements to Hong Kong's tourism services.

Third, Hong Kong should cultivate local creative industries and encourage the development

of local creative firms. Hong Kong lacks large cultural and creative firms. Most firms in the cultural and creative industries are social groups, individual workshops, and small- and medium-sized firms. The government could consider providing start-up funds to social groups and small- and medium-sized firms, as well as to propose favorable terms for financing and taxes.

Fourth, Hong Kong should strengthen the cooperation with Shenzhen and build the Shenzhen-Hong Kong cultural and creative industry groups together. The *Shenzhen Reform Plan* considers building Shenzhen-Hong Kong as an international cultural and creative center as an important development goal. Hong Kong and Shenzhen should enhance the cooperation in order to make full use of their comparative advantages to achieve the win-win development. In addition, this cooperation can create distinct advantages compared with other Mainland cities in developing cultural and creative industries.

4.4 Environmental Protection Industry

Hong Kong is well-known for its environmental protection, such as pollution control, environmental protection law enforcement, and the commercial application of the environment protection technologies. Generally, environmental protection industries have the characteristics of public goods, which lead to a low level of private capital investment. Meanwhile, the land and environment resources in Hong Kong are very limited. The service sector accounts for more than 92% of Hong Kong's GDP while the manufacturing sector accounts for only 2.5%. The local market for environmental protection products is very small, but very huge for the Mainland market. Therefore, the environmental protection industries of Hong Kong should focus on the Mainland market. The development policies in the Mainland provide the preferential conditions for the environmental protection industries.

The global environmental protection industries have entered a fast-growing period since the beginning of 21st century, and gradually became one of the major emerging industries. Many countries take the development of environmental protection industries as one of important aspects of the innovation and industrial structure adjustments. As for China, with the rapid economic growth, the "environment deficits" problem became more and more striking, and became one important threat for China's sustainable development. Therefore, the central government made sustainable development as the national strategy, and made environmental protection as one of the basic national policies in the *11th Five-Year Plan*. Environmental protection industries and circular economy industries have been recognized as the national key development industries. The demand for environmental protection is very high (see Appendix 4.4).

China's environmental protection policies have a dominant effect on the performance of environmental protection programs.²⁹ However, the input for environmental protection in the Mainland is much lower than the actual demand. Inputs in the environmental protection started to enter a fast-growing period in the *11th Five-Year Plan*. The environmental protection industries in China are estimated to keep a high growth rate in the next 15-20 years, with an annual growth rate above 15%. In the midst of the current global financial crisis situation, investment in environmental protection industries has become one the major areas to boost domestic demand. The support for the development of the environmental protection industries will also be further enhanced.

²⁹ In 2007, China adopted comprehensive measures to reduce pollution emissions. As a result, the major pollution emissions declined compared to 2006, which was the first turning point for China.

Without a doubt, the Mainland environmental protection efforts are creating a huge business opportunity. Hong Kong may take the opportunity and actively participate in the development of the Mainland environmental protection industries. The advantages of Hong Kong are as follows. (1) Hong Kong has advanced experiences in environmental protection, which are beneficial to the environmental protection firms in conducting environmental-protection related consulting business. (2) Some of Hong Kong's environmental protection firms are familiar with the international environmental protection industries. They could purchase, learn, and develop the advanced environmental protection technology and equipment from Europe, America, and Japan. (3) Hong Kong capitals have good foundations in the Pearl River Delta, and are also connected to the international market. The Hong Kong capital-funded manufacturing firms could cooperate with international environmental protection firms to invest in the Pearl River Delta jointly.

Meanwhile, the disadvantages of Hong Kong are likewise very significant. For example, Hong Kong does not have a large environmental protection equipment manufacturer, and has to rely on the import. In effect, Hong Kong has no long-term advantages in terms of providing environmental protection equipment. Moreover, it takes time for Hong Kong firms to establish connections with the local governments in the Mainland towards cooperation in environmental protections. Therefore, we suggest:

First, set up Commission on Environmental Protection Industry and Policy Consulting. Members of the commission should include government and civil bodies such as the Environmental Protection Department, the Federation of Hong Kong Industries, Hong Kong Environmental Industry Association, Environmental Campaign Committee, Hong Kong Marine Environmental Protection Association, and Hong Kong Environmental Protection Association. The major functions of the commission should be to provide policy consulting for the Hong Kong government, to strengthen communications with the Mainland environmental protection authorities, and to provide environmental protection information to the industries.

Second, hold environmental protection industry fairs in Hong Kong. Invite environmental protection equipment manufacturers, government agencies, research institutes, policy makers from the Mainland, and various environmental protection institutes and firms from Hong Kong to take part in the fairs. On one hand, the fairs could display the competitive advantages and practices of Hong Kong in environmental protection industries, and promote the Hong Kong environmental protection industries. On the other hand, the platform of environmental protection fairs could promote the communications and cooperation between the Hong Kong environmental protection industries and their counterparts in the Mainland.

Third, pay special attention to the environmental protection policies in the Pearl River Delta. This includes two points. (1) The environments in Pearl River Delta affect Hong Kong directly. Hong Kong should actively seek cooperation with the Guangdong provincial government. (2) The *PRD Plan* proposes to “develop environmental protection technology and equipment, environmental service industries in environmental protection areas”. It also predicts that the environmental protection industry will grow fast in the next decade. The Hong Kong government should provide industrial development consulting and technology support to the Hong Kong enterprises that operate in Guangdong Province.

4.5 Innovative Science and Technologies

It is commonly agreed that high technology has become an engine for economic growth and

national competitiveness in the current context of globalization and knowledge-based economy. Improving the national development ability through innovations has become an important development strategy in China.³⁰ It is very likely that the central government will propose even bigger favorable policies for innovations in the 12th Five-Year Plan.

After the handover of Hong Kong, the Hong Kong SAR government established the Innovative Science and Technology Committee and carried out the “Cyber Port” and “Chinese Medicine Port” programs. The government also supported innovative science and technology through Innovation, Science, and Technology Funds.³¹ In addition, the Hong Kong government set up research and development centers and held innovative science and technology fairs to promote the development of new technologies.³² Although these programs did not achieve the expected outcomes, they have promoted the development of Hong Kong' science and technology to some extent.

Some people doubt whether Hong Kong should develop innovative science and technology. They say that Hong Kong, as a small open economy, has always relied on the free economy institution for economic development in the past. Furthermore, Hong Kong does not have enough talent reserves for innovative science and technology. These doubts are not reasonable. The development of innovative science and technology industries in Singapore can be a good example. In addition, Hong Kong has other favorable factors for science and technology innovations, and Hong Kong could afford to have its share in the global innovative science and technology industries. First, the free market economy system, developed financial market, and advanced intellectual property protection system consolidate the basis for the industrialization of the science and technology innovations. Second, as an international metropolis, the wage level and life quality are attractive to foreign and overseas Chinese technology talents. Third, the Pearl River Delta is one of the world's manufacturing centers, which has great demand for innovative science and technologies.

However, in the past decade, the innovative science and technologies in Hong Kong did not achieve the expected goals. This is mainly due to the high cost of developing innovative science and technology without comparative advantages for Hong Kong. It is also partly due to the burst of American network bubbles, and is partly due to the fact that the manufacturing firms in Pearl

³⁰ At the end of 2005, the State Council released the *National Long-Term Science and Technology Development Plan Outline (2006-2020)*, explicitly proposing to “build innovative country through improving innovative abilities”. At the beginning of 2006, President Hu Jintao announced at the National Science Conference that China will become an innovative country by 2020, and the development in science and technology will become a major support for economic and social development. The basic objective is to increase the contribution from science and technology advancement to 60% from 39% by 2020, and the total R&D input should account for 2.5% of the GDP.

³¹ By February 2009, the Innovation, Science, and Technology Fund had allocated 3.85 billion Hong Kong dollars, and supported 1,313 projects. The supported areas include biotechnology, electricity and electronics, environmental protection, information technology, textile, clothing, and shoe industries. The programs include innovation, science and technology support program, normal support program, university and industry cooperation plan, and small-sized firms research fund program.

³² The Hong Kong Innovation and Technology Commission set up five R&D centers in April 2006, focused on the following areas: textile and clothing, car parts, logistics and supply chains, nano-technology, advanced material, and information and communication technologies. In the same year, the Hong Kong Trade Development Council held the First Hong Kong Innovation Science and Technology Design Fair. Four fairs have been held since then.

River Delta are mostly labor-intensive and low-value-added. Currently, many external factors give Hong Kong the opportunity to develop innovative science and technologies. (1) The *PRD Plan* clearly proposes development goals of “building modern industry system” and “enhancing independent innovation abilities”. Therefore, Guangdong and Hong Kong currently have the same demand for innovative science and technologies. (2) The long-term support for innovative science and technologies and infrastructures such as science and technology parks from the Hong Kong government has created the environment for innovative science and technologies. (3) The “Talent Admission Program” aims to attract talents to work in Hong Kong, and the graduate students admitted by local universities from the Mainland also reinforce the talent supply for the development of innovative science and technologies.

First, Hong Kong must fully utilize all the resources to develop innovative science and technologies, adopting open modes, actively and pragmatically attracting talents, and creating good work environments for talents through such platforms as Hong Kong Science Park. The Hong Kong government could also work with the universities to set up post-doctorate work stations in Hong Kong Science Park, hence actively promoting the development and applications of innovative science and technologies.

Second, Hong Kong must cooperate with the Mainland, especially with the Pearl River Delta, and build the Shenzhen-Hong Kong innovation cluster. The Pearl River Delta proposes the building of the Shenzhen-Hong Kong innovation cluster so that Guangzhou-Shenzhen-Hong Kong will be the axis of the regional innovation pattern. The *Shenzhen Reform Plan* also has the important development goal of building Shenzhen-Hong Kong as an international innovative center. It is crucial to establish an institutional environment in order to promote attracting innovative talents for building an international innovative center. Compared with Beijing and Shanghai, the talents supply of Pearl River Delta is relatively limited as a result of lacking high-level universities. Therefore, Hong Kong should set up a collaborative mechanism with the research institutes in the Pearl River Delta, especially with the universities, to achieve a win-win development.

Third, focus on the development of innovative science and technologies since this requires not only integrating with some traditional industries (such as logistics), but also needs to provide new products and services to the industries through new technologies. Innovative science and technologies could serve those Hong Kong firms operating in Mainland, help them develop new products and enhance the industrial added-value.

4.6 Inspection and Certification

The advantages of Hong Kong in the development of the inspection and certification industries are quite obvious. (1) Hong Kong already has the complete certification system. The Hong Kong Accreditation Service is the official agency for inspection and certification in Hong Kong, and has three accreditation schemes,³³ which constitute the inspection and certification system based on “public-private partnership”. (2) The reputation and independence of Hong Kong inspection and certification institutes is the foundation in promoting the inspection and certification services. It not only attracts overseas customers to employ Hong Kong inspection and

³³ This includes the Hong Kong Laboratory Accreditation Scheme (163 accredited laboratories), the Hong Kong Certification Body Accreditation Scheme (14 accredited institutes), and the Hong Kong Inspection Body Accreditation Scheme (20 accredited institutes).

certification services, but also helps the expansion to the Mainland.

On the other hand, Hong Kong also has some significant disadvantages. (1) The Hong Kong economy is concentrated in the service industries and the inspection and certification industries mainly provide services for the manufacturing industries. (2) The current inspection and certification industries are very small in scale, and could not yield the clustering effect. (3) The labor cost in Hong Kong is very high, which leads to a high inspection cost and, thus, a lower demand for such services. (4) The inspection and certification industries have high requirements for technology, capital, and talents. The specialized technology, combined with its small scale results in the lower attractiveness for professional talents.

However, the inspection and certification industries are now facing great opportunities. (1) Food in Hong Kong is mainly imported, and the Mainland is one of the biggest importing partners. Hong Kong has always emphasized food inspection and has a complete food inspection system.³⁴ (2) The central government released the “Food Safety Act of People’s Republic of China” on February 28, 2009, which detailed the regulations on all the links in food processing. This act is a positive response from the central government to a series of food safety incidents, and also shows the potential demand for food safety inspections and certifications. (3) The environmental protection industry will have a significant development during the *12th Five-Year Plan*. Many of the certification institutes in Hong Kong are related to environmental inspection and certification. They are expected to open consulting business related to environmental protection in the Mainland. (4) During the period of *12th Five-Year Plan*, as the manufacturing industries in the Pearl River Delta upgrades, new manufacturing products entering the international market will require the inspection and certification services. Hong Kong’s international recognized inspection and certification industries are expected to expand their business in the Pearl River Delta.

In general, the inspection and certification industries could be cultivated as an advantageous industry, which also can become an important aspect of the “Hong Kong Services”. We propose the following strategies for their development.

First, perfect the public-private partnership in the inspection and certification industries. The Food and Health Bureau encourages and supports food sellers to conduct food inspection in advance of sale. It also encourages government laboratories to outsource regular food inspection work to private institutes. The Hong Kong Accreditation Service is the regulative agency for the inspection and certification industries, and it should work closely with international peers, Hong Kong universities, and private laboratories to set up the standard for the certification service of private laboratories, to help private laboratories improve the quality of inspection, to promote the industry, and to train professional talents.

Second, Hong Kong government should strengthen communication with the State Certification and Accreditation Administration and set up an information sharing system. In addition, the Hong Kong government should actively lobby toward allowing the Hong Kong inspection and certification industries to open businesses in the Mainland. This is a necessary condition for the development of the Hong Kong inspection and certification industries. Hong Kong should consider building closer cooperative relationship with the central government in the future CEPA Supplements. Moreover, the government should encourage private institutes to begin inspection, certification, and consulting businesses for Mainland firms.

³⁴ It is noted that the Hong Kong SAR government revised the food law after the Sanlu poisonous milk incident. The new food law was released on September 23, 2008, which shows the attention the government pays to food.

Third, Hong Kong Accreditation Service should set up the work scheme with the corresponding Mainland authorities (Environmental Protection Bureau, Industry and Commerce Administration, Quality and Technical Supervision Bureau, Food and Drug Inspection Bureau, Inspection and Analysis Institute, and the Product Quality Inspection Center of Guangdong Province). The Hong Kong Accreditation Service should strengthen the cooperation between Hong Kong and Guangdong Province in the area of inspection and certification, and build the platform for Hong Kong inspection and certification institutes to hasten the opening of businesses in the Pearl River Delta.

Chapter 5: Conclusions and Policy Suggestions

The study finds that the economic integration between Hong Kong and Mainland China is an important factor that has sustained the growth of the Hong Kong economy. In 2007, the bilateral trade between Hong Kong and the Mainland accounted for 47.5% of the total trade of Hong Kong, and the position of outward direct investment of Hong Kong in the Mainland accounted for 43.4% of the total position of outward direct investment of Hong Kong. The economic relationship between Hong Kong and Guangdong has played an important role in Hong Kong's integration with the Mainland. In 2007, Guangdong accounted for 12.3% of China's GDP. From 1985 to 2007, the bilateral trade between Hong Kong and Guangdong accounted for 30.9% of the total trade between Hong Kong and the Mainland, and Guangdong's utilized Foreign Direct Investment (FDI) from Hong Kong accounted for 15.7% of the total utilized global FDI in Mainland China.

Hong Kong's economic integration with the Mainland, especially with the Pearl River Delta, has made positive contribution to the development of the Hong Kong economy through three effects, namely, (1) Economies of Scale (Market Expansion), (2) Resource Re-allocation, and (3) Internalization of Externalities. Our empirical analysis shows that 1 percentage point increase of the Mainland factor (represented by the growth of Hong Kong's re-export from the Mainland) and the Guangdong factor (represented by the growth of the total trade between Hong Kong and Guangdong) will result in 0.322 and 0.047 percentage point increases of real per capita GDP in Hong Kong, respectively. Besides, if Hong Kong's manufacturing industry share in GDP decreases by 1 percentage point (through cross-border resource re-allocation), Hong Kong's real GDP per capita will rise by 0.618 percentage point.

Based on our Unit Labor Cost (ULC) analysis, defined as the average labor compensation adjusted by labor productivity, for the four existing pillar industries as well as the whole service sector, we find that the ULC of traditional service industries experienced dramatic decline during the period 1997-2002, mainly attributed to the growth of labor productivity that significantly exceeded the growth of the average labor compensation. It implies that the economic integration between Hong Kong and Mainland China had notably improved the economic efficiency while slowing down the growth of labor cost. However, after 2003, the average labor compensation of traditional service industries began to surge and gradually exceeded the growth of labor productivity. Therefore, the decline of ULC has significantly slowed down and the increasing labor cost has become a severe challenge to the traditional service industries. We argue that this suggests that a further integration with the Mainland economy is the key to sustain the growth of the Hong Kong economy since the narrow local market and high factor cost are the major challenges to the traditional service industries. Furthermore, both the free economic system and export-oriented industrial structure make the Hong Kong economy vulnerable to external shocks and hence enhancing the integration may better support the Hong Kong economy when it suffers external shocks.

The future economic integration of Hong Kong with the Mainland will be a complicated dynamics that will bring both opportunities and challenges to the development of the Hong Kong economy. There will be both winners and losers during this integration process. However, to clearly understand the process and its impacts on different industries and groups of people in different time range is beyond the scope of the current study, and thus separate studies would be

needed. The impact of such a further economic integration on the Hong Kong economy depends on the degree and the way of further institutional adjustment and innovation that require political wisdom and administrative efforts of the Hong Kong government, Shenzhen government and Guangdong government as well as the support of the central government. However, initiatives from local governments are more important than the Central Government's policy push.

In the short run, Hong Kong will still benefit from the "*One Country, Two Systems*" framework due to its institutional guarantee and policy flexibility. Measures and arrangements under this framework, such as the *Closer Economic Partnership Arrangement* (CEPA) and the *Central Government's 14 Measures*, allow Hong Kong to further selectively relax restrictions on factor mobility (e.g., employment priority of local residents and employment restrictions of non-local residents) to improve the efficiency of the Hong Kong economy.

In the medium and long run, both opportunities and challenges will appear and the Hong Kong Government should be prepared for the both and carefully handle them. The following factors and policy initiatives will play important roles in the further integration and hence a good understanding of them is required:

(1) The removal of the restrictions on factor mobility and boundary control will result in supply shocks for low-cost factors. Therefore, the unemployment rate will probably increase, the wage level of unskilled workers in service industry will remarkably decline, and the price of housing and real estate will probably decrease. However, the price level of consumption products will likely converge to that in the Mainland, and thus the purchasing power of Hong Kong residents will probably increase.

(2) The increase in the openness of the Pearl River Delta will promote its catch up with Hong Kong especially through the development of high quality service industries in that area, and in turn will increase its demand for Hong Kong-made goods and services and also bring increasing competitions between Hong Kong and its counterparts of Pearl River Delta.

(3) The support of the Central Government for Shanghai in building up an international financial center as well as a trade and logistics center will challenge Hong Kong's long-established position and raise a big question to Hong Kong on how to couple with it and turn the challenge into an opportunity.

(4) The *PRD Plan* proposes to promote the cooperation between Hong Kong and the Pearl River Delta and hence raise a big question on how to best use Hong Kong's comparative advantage in such cooperation while minimizing Hong Kong's cost.

(5) The *Shenzhen Reform Plan* proposes to develop Shenzhen-Hong Kong as an international financial, logistics, trade, and cultural and creative industry center.

From a long-term perspective, the important position of Hong Kong as an international finance and trade and logistics center will be definitely challenged by the emergence of Shanghai, although the establishment of the double financial centers is included in the national plan. The IPO attraction of the Hong Kong capital market will decline. The RMB business will be gradually dominated by Shanghai. Harbor and aviation services will suffer severe competition from Shanghai and the Yangtze River Delta harbor group due to limited upgrading capability. The improvement space of the tourism industry with narrow local market remains limited. Professional service will also be influenced by the Mainland service industry.

Therefore, it is necessary for Hong Kong to fully utilize the institutional guarantees and policy flexibilities provided by the framework of "*One Country, Two Systems*". In addition, Hong

Kong should enhance the economic collaborations and integration with the Mainland (especially with the Pearl River Delta); make use of the short-term industrial and policy advantages, and take appropriate steps to deal with the long-term challenges and opportunities. In general, three strategies for Hong Kong government need to be considered: (1) To take the initiative to apply for the support from the central government; (2) To establish a regional inter-governmental cooperation mechanism; and (3) To develop multi-partner relationships among the functional departments of the Hong Kong government, industry associations, enterprises, and academia. While Hong Kong's future economic development should still be market-driven under a free enterprise system, the government policy support for foreseeable impacts of institutional adjustment and innovation for promoting the further integration is necessary. For the industry development, it requires not only taking advantage of the potentials of the four existing pillar industries, but also exploring new high-potential industries in the medium and long run. Not only should the employment issues be well-resolved, but the appropriate industries should be sought as investment opportunities for Hong Kong capital as well.

5.1 Enhance the Communication with the Central Government

First, take CEPA as the framework of communication between Hong Kong and the central government. Since the signing of CEPA in 2003, the Hong Kong government and the central government have signed another six Supplements during the following six years. In general, CEPA has achieved great success. It will still act as the important mechanism for the Hong Kong government in obtaining the policy support from the central government for the economic collaboration with the Mainland in the future. The Hong Kong government should make full use of the CEPA mechanism to further study how to expand the coverage of the *Individual Visit Scheme*, how to implement more convenient visa application systems for the residents of Shenzhen and other Pearl River Delta cities, and how to accelerate the openness of the Mainland market of financial services, professional services, and tourism for Hong Kong.

Second, pay close attention to the policy movement of the Mainland's 12th Five-Year Plan and analyze how Hong Kong can participate in the Mainland development during the period 2011-2015. It would definitely bring lots of disputes and require a lot of effort to frame a "Five Year Plan" like what the Mainland has done since Hong Kong is a free market economy. However, with the increasing degree of the economic integration with Mainland, it is very essential for Hong Kong government to organize the industries and the academia to investigate the Mainland economic development trend and relevant tackling tactics in order to improve the competitiveness of the Hong Kong economy. From the present day point of view, fields such as livelihood, environmental protection, new energy and new material, and scientific and technical innovation would be the main content in the Mainland's 12th Five-Year Plan.

Third, the cooperation between China and the ASEAN has become increasingly close. Hong Kong, as the geographic foreland of the "China-ASEAN" regional cooperation, should take full advantage of its international trade and finance center capability to explore businesses on the trade and finance services in the China-ASEAN economic cooperation. Currently, the central government is contemplating the establishment of a "*China-ASEAN Fund on Investment Cooperation*" with a total amount of 10 billion USD earmarked for such. Hong Kong may endeavor to be the operation base of this kind of fund.

5.2 Establish the Regional Economic Cooperation Mechanism

From the view of regional cooperation, there are three aspects through which Hong Kong may establish economic the cooperation mechanism with the Mainland, including the construction of the Hong Kong-Shenzhen Metropolis, Guangdong-Hong Kong economic cooperation, and Pan Pearl River Delta economic cooperation.

First, further enhance the Hong Kong-Shenzhen economic collaboration in the fields of harbor, logistics, finance, tourism, and exhibition. Investigate the possibility, realization roadmap, and timetable of the construction of the Hong Kong-Shenzhen Metropolis with the Shenzhen government. The *Shenzhen Reform Plan* proposes to build Hong Kong-Shenzhen as an international financial, logistics, trade, and cultural and creative industry center in the long run, which should also become an important strategy of the national plan. The current industrial structure, population mobility, economic relationship, and cross-border infrastructure construction between Hong Kong and Shenzhen provide a foundation for the Hong Kong-Shenzhen integration. The recent relaxation in the restriction for Shenzhen residents³⁵ in visiting Hong Kong will be conducive to the mutual development of the two cities. In the next ten years, given the difference of growth rates between the two cities and the impacts of RMB appreciation, the gap of per capita GDP between these two cities will probably drop to 1.5 times or even lower.³⁶ In such situation, the economic basis for two cities to construct the “Hong Kong-Shenzhen Metropolis” can be found. From the demographic viewpoint, the establishment of the “Hong Kong-Shenzhen Metropolis” will favor the resolution of the aging issue of Hong Kong.³⁷ The *Central 14 Measures* released on December 19, 2008 also aimed to “support the mutual exploitation of the border area between Hong Kong and Shenzhen”, which indicates that the central government encourages the formulation of a “Hong Kong-Shenzhen Metropolis”.

Certainly, the construction of a “Hong Kong-Shenzhen Metropolis” does not simply means abolishing the border and merging the two cities. The ideal economic integration requires free trade system, common market, and common currency for the two cities although such kind of complete integration is not realistic for Hong Kong in the short run. Under the framework of “*One Country, Two Systems*”, Hong Kong still has relatively independent political and economic institutions, which will be its institutional advantage. Therefore, a radical economic integration may be detrimental to the local economy and employment of Hong Kong. The construction of the “Hong Kong-Shenzhen Metropolis” should gradually eliminate the institutional and infrastructural barriers of the economic integration between the two cities and promote the mobility of labor and

³⁵ From April 2009, qualified registered household (*hukou*) Shenzhen residents can apply for a multiple-entry Hong Kong visas, and from May 2009, qualified Shenzhen residents (non-Shenzhen *hukou*) can apply for a Hong Kong travel visa in Shenzhen.

³⁶ In 2008, the GDP of Shenzhen reached 780.7 billion RMB (114.4 billion USD), and the per capita GDP was 12.9 thousand USD, ranked first in the Mainland. In the same year, the GDP of Hong Kong reached 215.2 billion USD, and the per capita GDP was 22.5 thousand USD, about 1.74 times that of Shenzhen.

³⁷ By the end of 2008, the Shenzhen residential population reached 8.7683 million, of which 2.2807 million are registered household population. The “*Shenzhen City Plan 2007-2020*” notes that in 2020 the targeted population of Shenzhen will be controlled to 11 million, which means the change in residential population will be 2.5 million. Migrants will still be the driving force of population growth in Shenzhen. Since the registered household population only accounts for 1/4 of the total population in Shenzhen, there will be no severe aging issue in Shenzhen in 20 years. However, Hong Kong is now facing the issue of aging.

capital between them. This will help expand the resource border and market size of the two cities, and improve the efficiency of resource allocation, thus strengthening the economic development of the two cities.

Therefore, the core of constructing the “Hong Kong-Shenzhen Metropolis” is the elimination of the institutional barriers, and the promotion of the mobility of factors between the two cities. With this in mind, we present the following advices: (1) Strive to integrate the construction of the “Hong Kong-Shenzhen Metropolis” into the national, as well as Guangdong’s development plan. (2) Innovate the collaborative mechanism, and set up the Hong Kong-Shenzhen Development Joint Conference. (3) Accelerate constructing the connection of major infrastructure between the two cities, and mutually establish a high-quality living zone. (4) Enhance the collaboration in airport and harbor systems. (5) Facilitate the Hong Kong visa application for Shenzhen residents. (6) Promote the construction of an innovative system between two cities. (7) Enhance the collaborative development in education. (8) Enhance the financial cooperation between the two cities, and pilot several financial business in Shenzhen. (9) Reasonably plan the development of the boundary forbidden area, and cooperate to develop the Loop area.

Second, perfect the Guangdong-Hong Kong cooperative development framework. The basic idea of the *PRD Plan* is to eliminate the lagged productivity and promote industrial transition. In addition, the *Central 14 Measures* also points out the need to “strengthen the collaboration between Guangdong, Hong Kong and Macau, establish an international Metropolis, and construct an advanced area with large scale, high tech and low pollution”. In this sense, the future Guangdong-Hong Kong economic cooperative relationship should follow this framework. The Hong Kong government should consider this development trend and policy direction, help and direct the transition and upgrade of Hong Kong manufacture, and extend the collaboration in the service industry (specially in the modern service industry) with Guangdong when making its own economic strategies.

Third, relying on the Pan Pearl River Delta regional cooperative framework, extend the Hong Kong’s business in the Mainland. Based on the “9+2” regional cooperative framework, the Pan Pearl River Delta is a region with the largest scale, widest scope, and highest heterogeneity in the Mainland. The Pan Pearl River Delta cooperative framework includes 10 collaborative fields, 8 of which have promulgated cooperative plans and long-term plans, such as the “*Outline of Regional Cooperative Development Plan for Pan Pearl River Delta (2006-2020)*”. The multi-level functional mechanism within the Pan Pearl River Delta insures the regional cooperation of the areas, and through the business negotiation conference, capital investment between provinces within the area is promoted. Therefore, Hong Kong needs to collaborate with Guangdong in order for it to play a leading role within the Pan Pearl River Delta regional cooperation. On the other hand, Hong Kong also needs to establish a mutual economic connection with the other provinces of the Mainland (e.g., Guangxi, Hunan, and Fujian).

5.3 Construct a Multi-partner Relationship among the Government, Industry Associations, Enterprises, and the Academia

Hong Kong is a small, open economy. The competitiveness of Hong Kong lies in its flexible mechanism to adapt itself to the change of the external economic environment, and fully ensure local employment demand and extension of local capital. It requires the construction of a multi-partner relationship among the government, industry associations, enterprises, and the

academia to maintain such kind of competitiveness.

First, the Hong Kong government and its functional departments should take initiatives to collect the information and listen to the enterprises' complaints provided by the industry associations, collaborate with all kinds of industry associations, frame a strategic plan of industry development, and provide relevant policy support and assistance.

Second, continue to promote the policy research cooperation between the consulting department and the universities in Hong Kong, evaluate all kinds of issues on the Hong Kong economic and social development, and implement timely relevant policy adjustment.

5.4 Suggestions for the Four Existing Pillar Industries

Among the four existing pillar industries, Financing Services and Trade and Logistics are facing increasing competition from emerging Mainland cities such as Shanghai. The development space of Tourism Industry is narrow. The Professional Services have relatively significant advantages. Thus, we have formulated the following suggestions.

Finance Services: (1) Take the initiative to attract firms in the Mainland and neighboring areas to encourage them to be listed in the Hong Kong stock market, and enhance the cooperation with the Shanghai Stock Exchange and Shenzhen Stock Exchange. (2) Prepare and strive to be a forerunner and beneficiary of the RMB's internationalization. (3) Promote cooperation with Shenzhen's financial industries, and confirm details of the building of Shenzhen-Hong Kong as an international financial center. (4) Utilize the favorable agreement of CEPA, explore the Mainland market, and attract Mainland capital to enjoy wealth management services. (5) Enhance the communication among financial professionals and the mutual recognition of the professional qualifications between the Mainland and Hong Kong. (6) Enhance the collaboration in financial supervision and regulation between the Mainland and Hong Kong. (7) Take advantage of the permission given to Mainland enterprises to utilize the Hong Kong financial platform to operate international financial business and attract large Mainland financial units such as the China Investment Cooperation and the China Development Bank to set up branches in Hong Kong. (8) Propose to expand the scale of government debt issuance in Hong Kong.

Trade and Logistics: (1) Act jointly with the Pearl River Delta to establish the pattern of Cooperative Development and Differentiated Development of trade and logistics. (2) Establish the Pearl River Delta Ports Development Council under the Guangdong-Hong Kong Chief Executive Joint Conference. (3) Take the initiative to adjust trade and logistics industrial structures, and develop the Fourth Party Logistics. (4) Participate in the construction of the Mainland harbor, and invest and manage Mainland logistics enterprises related to storage and transportation.

Tourism: (1) Improve the quality of tourism products and expand tourism resources content, including finishing relevant negotiation and the preparation on the expansion plan of Hong Kong Disneyland, developing medical tourism services and culture tourism services. (2) Actively strive for simplifying the procedures for the Hong Kong visit of residents from the Pearl River Delta. Promote expanding the policy of multiple entry visas to the other cities in the Pearl River Delta. Expand the policy that the non-Guangdong *hukou* residents can apply for the Hong Kong and Macau travel visa in local agencies to the entire Guangdong Province. (3) Expand the coverage of the *Individual Visit Scheme* to more Mainland cities.

Professional Services: (1) Promote the further opening of Mainland professional qualification examinations to Hong Kong permanent residents. (2) Accelerate the process of

mutual recognition of professional qualifications. Realize the mutual recognition in the field with relative small differences and more specialized skills as soon as possible. (3) Incorporate Mainland contents in professional education by adding Mainland-related laws, and commercial and institutional courses in college teaching.

5.5 Suggestions for the Six High Potential Industries

Among the six industries considered with high growth potentials, Educational Services, Cultural and Creative Industry, and Inspection and Certification Industries are more promising while the potentials of the other three are relatively limited. These are based on the preliminary analysis of the advantages, disadvantages, opportunities, and challenges of each industry. All of the considered industries are facing the problems of a limited local market, high factor cost, and immature development. Hence, the government policy should be directed to how to expand the market and reduce the factor costs through promoting the further integration with the Mainland, especially with the Pearl River Delta, rather than relying on subsidies, although some government start-up funds are important and necessary.

Medical Services: (1) Encourage local physicians to set up clinics in the Mainland, and encourage joint hospital establishments. (2) Add “medical tourism” into the *Individual Visit Scheme* package, and focus on the development of superior service programs, such as nutrition, health care, and psychology consulting. (3) The Hong Kong government may organize conferences and panels discussions on Chinese medical and health development to facilitate the communication and cooperation between Hong Kong and Mainland medical industries. (4) Actively pursue the implementation of the “cooperation of Chinese medicine industry” as stipulated in the CEPA Supplement III. (5) Actively study the possibility and realization roadmap of establishing public-private partnership in medical services.

Educational Services: (1) Position Hong Kong as a Regional Center for Higher Education and for Qualification Training and Examination which provides “Exporting Education” services, and draw up the development perspective and strategies for the educational services industry. (2) Strengthen the cooperation between Hong Kong and the international professional certificate agencies and examination agencies to develop training and consulting services related to professional qualifications and examination. (3) Promote development in the training services of professional courses, diploma, and skills related to medium and long-term high potential industries. (4) Encourage and support non-local graduates to work or pursue further study in Hong Kong. (5) Expand the development space in Hong Kong for local universities. Attract non-local students to study in Hong Kong. Encourage universities to actively participate in the development of the Lok Ma Chou Loop. The government should also negotiate for favorable immigration policies with Mainland authorities for the educational service industries. (6) Expand the development space in Mainland for Hong Kong universities. Put into effect the supporting policies and favorable conditions for Hong Kong universities. (7) The Hong Kong government should take the responsibility of coordinating the cooperation between Hong Kong universities and Mainland universities to avoid unwanted competitions. (8) The Hong Kong government may negotiate with the Ministry of Education and Guangdong Province to explore some cooperation innovations, such as the establishment of one university (Guangdong-Hong Kong University) in the Pearl River Delta to be jointly undertaken by the eight Hong Kong universities. (9) Expand the development space for vocational and pre-school educations.

Cultural and Creative Industry: (1) Establish the commission for cultural and creative industries, and make the cultural and creative development one of the key, long-term economic growth strategies of Hong Kong. (2) Speed up the hardware and software constructions, and create creative atmospheres in Hong Kong. (3) Accelerate the West Kowloon cultural zone project, and enhance the basic infrastructures. (4) Set up training for the creative industry skills, provide government support, and cultivate creative talents. (5) The Hong Kong government could provide start-up funds to social groups and small- and medium-sized firms, and propose favorable terms for financing and taxes. (6) Strengthen the cooperation with Shenzhen, and build the Shenzhen-Hong Kong cultural and creative industry groups together.

Environmental Protection Industry: (1) Set up the Commission on Environmental Protection Industry and Policy Consulting. (2) Hold environmental protection industry fairs in Hong Kong. Invite environmental protection equipment manufacturer, government agencies, research institutes, and policy makers from the Mainland, as well as various environmental protection institutes and firms from Hong Kong, to take part in the fairs. (3) Pay special attention to the environmental protection policies in the Pearl River Delta. (4) The Hong Kong government should provide industrial development consulting and technology support to Hong Kong enterprises that operate in Guangdong Province.

Innovative Science and Technology: (1) The Hong Kong government could work with the universities to set up post-doctoral work stations in Hong Kong Science Park. (2) Cooperate with the Mainland, especially with the Pearl River Delta, and build a Shenzhen-Hong Kong innovation cluster and a Guangzhou-Shenzhen-Hong Kong innovation axis. (4) Set up a cooperation mechanism with the research institutes in the Pearl River Delta, especially with the universities.

Inspection and Certification: (1) Further perfect the public-private partnership in the inspection and certification industries. (2) The Hong Kong Accreditation Service should work closely with the international inspection and certification institutes, Hong Kong universities, and private laboratories to set up standard and certification services for private laboratories, to help private laboratories improve the quality of their workers, to promote the industry, and to train professional talents. (3) Strengthen communication with the State Certification and Accreditation Administration and set up an information sharing system. (4) The Hong Kong government should actively lobby toward allowing the Hong Kong inspection and certification industries to open business in the Mainland. (5) Hong Kong should consider building a closer cooperation relationship with the central government in future CEPA Supplements. (6) Set up the work scheme between the Hong Kong Accreditation Service and the corresponding Mainland authorities.

Appendix

Appendix 1.1: The history of Hong Kong's economic development and structural changes in Hong Kong's economy

Since the handover in 1997, Hong Kong has accomplished amazing economic achievements despite the ups and downs experienced, and its economic structure has also further changed.

Hong Kong's real per capita GDP increased from HK\$166,758 in 1997 to HK\$230,436 in 2008, representing an average annual growth rate of 2.98%¹. Hong Kong's position as an international financial centre has been enhanced. The Financial Development Index of Hong Kong ranked eighth in the world in 2008, just below that of Japan and Shanghai in Asia². At present, Hong Kong is the world's seventh largest stock market in terms of market capitalisation³ and continues to attract enterprises from the Mainland and other Asian countries and regions to list here. However, with the gradual opening up and continuous rise of the Mainland economy, re-exports to and from the Mainland via Hong Kong have been shrinking, leading to a drop in Hong Kong's global ranking in total trade volume from 8th in 1997 to 12th in 2007⁴.

It terms of industrial structure, the share of the services sector in Hong Kong's GDP reached 92.3% in 2007, representing an increase of 6.4% since the handover and about 20 percentage points higher than that of other comparable countries and regions such as Singapore, Taiwan, Finland and Switzerland. In the same period, the share of the manufacturing sector in Hong Kong's GDP declined from 6.0% in 1997 to 2.5% in 2007 (see Figure A1). Meanwhile, the employment in manufacturing, as a percentage of total employment, dropped from 14.0% in 1997 to 5.8% in 2007, while the employment in services sector rose from 75.5% to 85.7%. The employment share of other sectors remained more or less the same (see Figure A2). Within the services sector, the contribution of trade and logistics industries to GDP, which currently stands at 25.8%, has been relatively stable while that of financial services has been increasing after 1997, rising from 10.3% that year to 19.5% in 2007. This shows that the services sector has become more dominant in Hong Kong's economic and employment structure since the handover, while the share of the manufacturing sector in the economy has declined further.

¹ The real per capita GDP figures are in chained 2006 dollars. Source: Census and Statistics Department, Hong Kong SAR.

² The Financial Development Index is an indicator published by the World Economic Forum, reflecting the development levels of the financial systems of different countries and regions in the world.

³ Source: World Federation of Exchanges – Statistics/Monthly.

⁴ Meanwhile, the Mainland's global ranking in total trade volume jumped from 11th in 1997 to 3rd in 2007, next only to the United States and Germany and ahead of Japan, which ranked 4th.

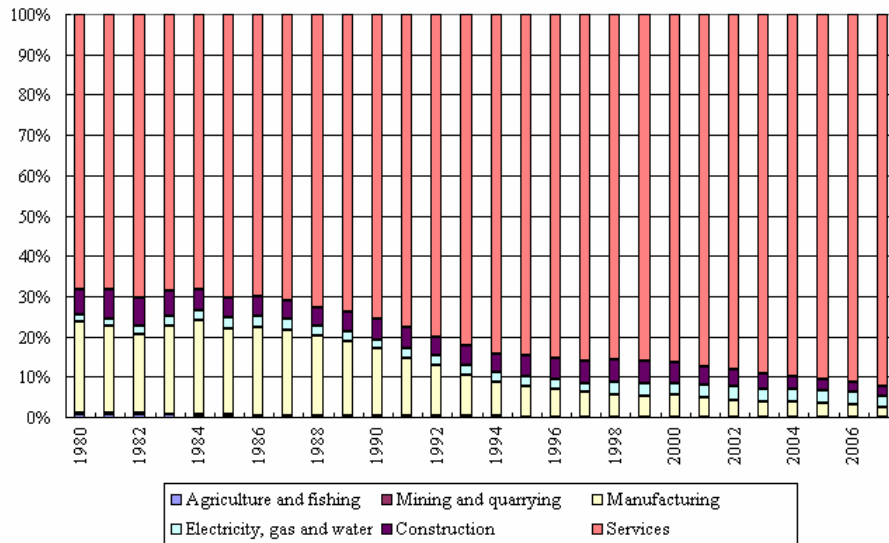


Figure A1: Changes in the industrial structure of Hong Kong's economy (1980-2007)
 Source: Census and Statistics Department, Hong Kong SAR.

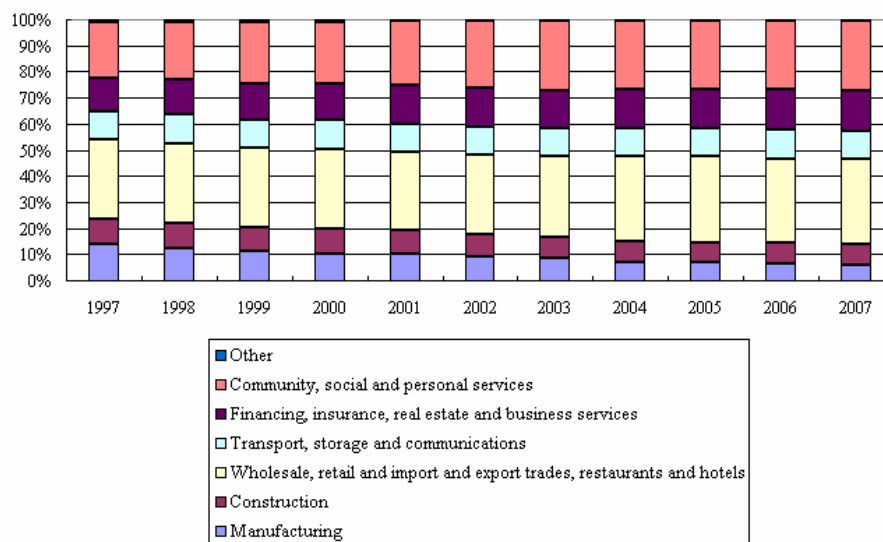


Figure A2: Changes in the employment structure of Hong Kong's economy (1997-2007)
 Source: Hong Kong Annual Digest of Statistics (2001-2008).

Appendix 1.2: Impact of the financial tsunami on the Mainland and Hong Kong

The financial tsunami has swept the world since 2008. The Mainland, which has been gradually opening up and integrating into the world economy, has also been hard hit. The momentum for rapid growth since 1999 started to weaken. The growth of household consumption dropped significantly, and inflation, which started at the end of 2007, quickly turned into deflation at the end of 2008. Specifically, China's GDP growth slackened significantly in the first quarter of 2008, and the downward trend persisted in the following four quarters. The GDP growth rate dived to 6.1% in the first quarter of 2009 from 13% in the fourth quarter of 2007 (see Figure A3). Since October 2008, the growth of household consumption has plunged from 23% in September 2008 to 11.6% in January 2009, but rebounded slightly in the recent three months (see Figure A4). Similarly, inflation, which used to be a serious macroeconomic issue in 2007 and 2008, turned rapidly into deflation as a result of the Chinese Government's macro-control measures and the impact of the current financial crisis. The Consumer Price Index (CPI) exhibited a continuous decrease from about 9% in February 2008 to the current -1.5%, and the Producer Price Index (PPI) also declined from over 15% in August 2008 to the current -10% (see Figure A5).

Facing the current financial crisis, the Chinese Government announced 10 measures and policies in November 2008 to expand domestic demand and stimulate economic growth, with an estimated investment of RMB 4 trillion in the following two years. Among these 10 measures and policies, infrastructure construction (covered by five policies), including housing projects for low-income residents, rural infrastructure projects and other major infrastructure projects, was accorded top priority, followed by investment stimulation measures, including value-added tax transformation and reform and strengthened financial support. It is evident that the measures and policies introduced by the Chinese Government aim to counter the impact of the international liquidity crunch and plunge of external demand resulting from the financial crisis by stimulating domestic demand and investment. However, it remains to be seen whether this policy package can achieve its intended objectives.

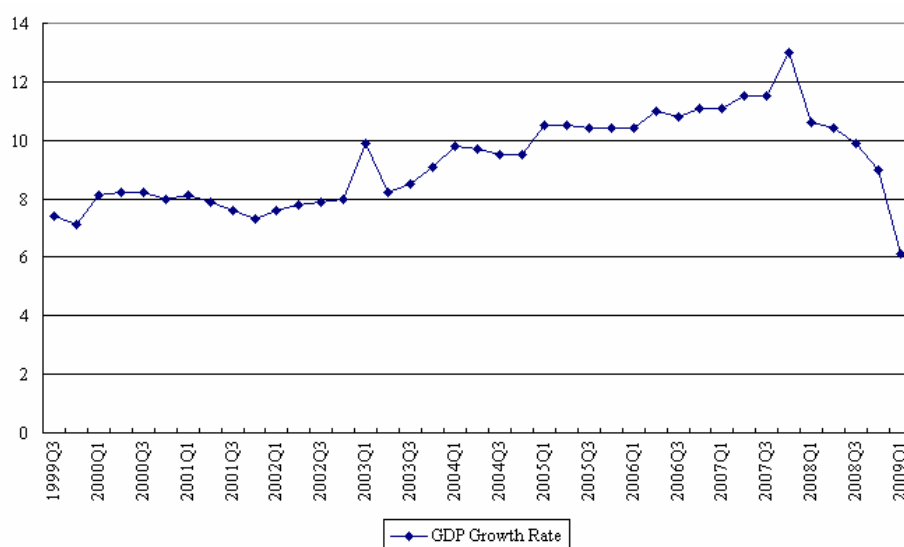


Figure A3 : GDP growth rates of Mainland China (1999-2009)

Note: The figure shows the data from the third quarter of 1999 to the first quarter of 2009. The GDP growth rate for each quarter refers to the year-on-year percentage change in GDP.

Source: National Bureau of Statistics, China Data Online.

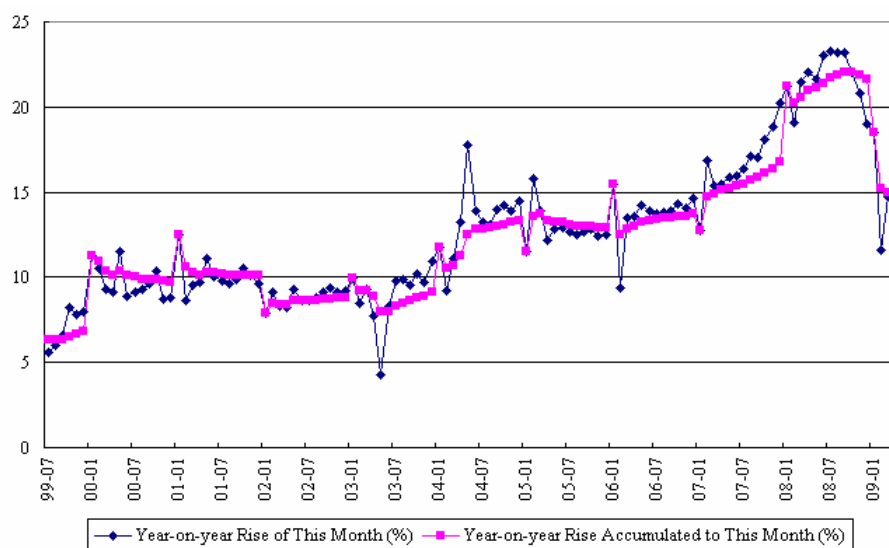


Figure A4: Growth rates of total retail sales of social consumer goods in Mainland China (1999-2009)

Note: The figure shows the data from July 1999 to April 2009.

Source: National Bureau of Statistics, China Data Online.

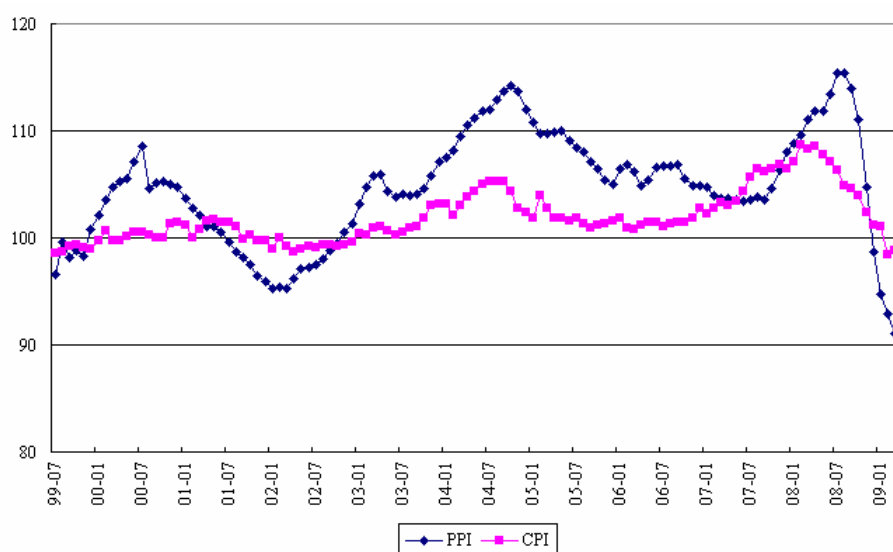


Figure A5: PPI and CPI in Mainland China (1999-2009)

Note: The figure shows the data from July 1999 to April 2009. In calculating the PPI and CPI for each month, the PPI and CPI respectively for the same month of the previous year were taken as the base indices of 100.

Source: National Bureau of Statistics, China Data Online.

Hong Kong, as a typical small open economy, was naturally not spared from the financial tsunami. From 2004 to early 2008, Hong Kong's GDP growth rate largely stayed above 6%. However, it started to decline in the second quarter of 2008 and dropped to a negative value

(-2.5%) by the fourth quarter of the same year. The growth rate of gross domestic fixed capital formation took an even more significant plunge from 15.3% in the first quarter to -19.3% in the fourth quarter of 2008. Similarly, the growth rate of private consumption declined sharply from 13.0% in the first quarter to -4.7% in the fourth quarter of 2008. (See Figures A6 and A7.)

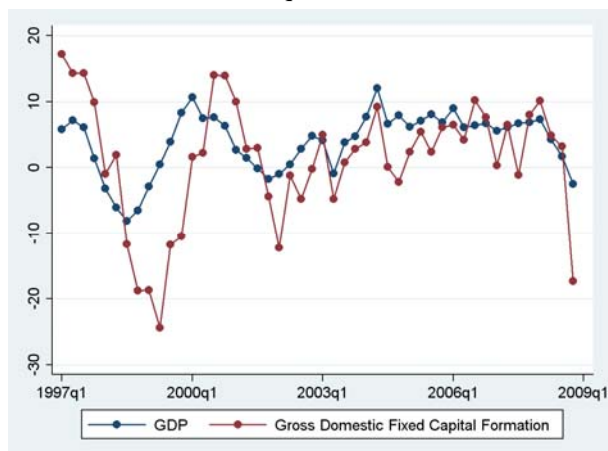


Figure A6: Growth rate of GDP and gross domestic fixed capital formation (1997-2008)

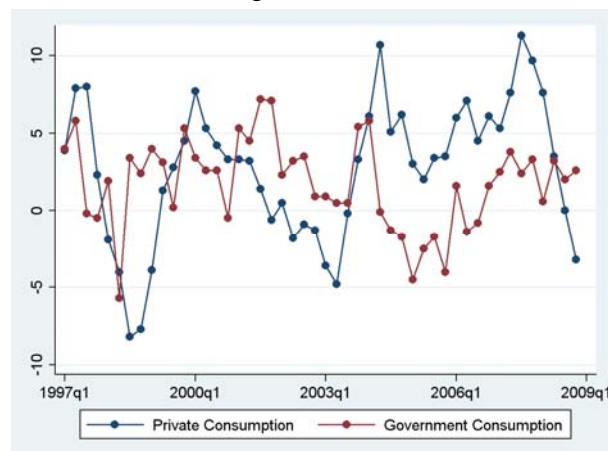


Figure A7: Growth rate of private consumption and government consumption (1997-2008)

Source: Census and Statistics Department, Hong Kong SAR.

As an open economy, Hong Kong has been struck all the more severely by the financial tsunami. The growth rates of both import and export trade dropped dramatically from around 15% in January 2008 to below -20% in January 2009, with the fall only slightly easing in February. Obviously, under the negative external shocks, the problem of unemployment and underemployment in Hong Kong gradually emerged. The unemployment rate grew rapidly from about 3.3% between January and August 2008 to 5.2% in early 2009. It is evident that the unemployment rate in Hong Kong may further increase in the near future since the rise of unemployment always lags behind the worsening macroeconomic indicators (see Figures A8 and A9).

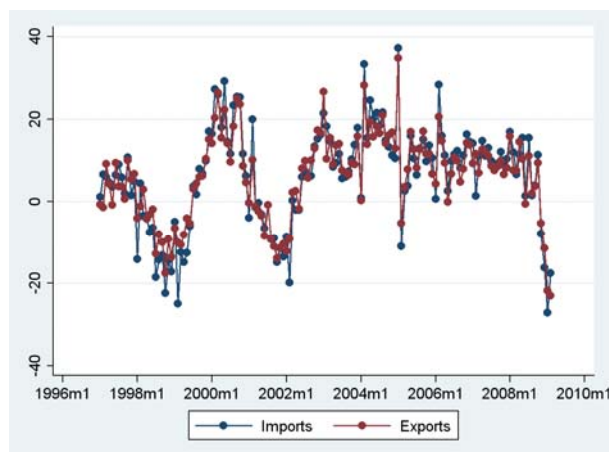


Figure A8: Growth rate of imports and exports (1997-2009)

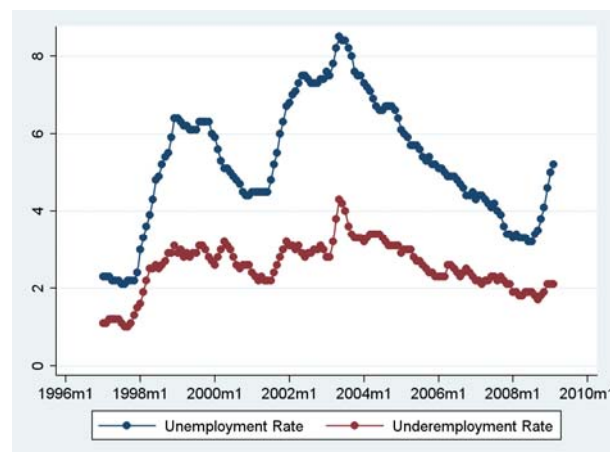


Figure A9: Unemployment and underemployment rates (1997-2009)

Source: Census and Statistics Department, Hong Kong SAR.

Appendix 3.1: Opinion of the State Council on Accelerating Shanghai's Developing its Modern Service and Advanced Manufacturing Industries, and its Development into an International Financial Center and an International Shipping Centre

The overall goal of Shanghai's development into an international financial centre is, by 2020, to basically establish an international financial centre which is commensurate with the economic strength of the Mainland and the international status of RMB; to basically establish a highly internationalized, multi-tier financial market system equipped with all functions of trading, pricing and information and participated by both domestic and foreign investors; to basically establish a system of financial institutions with major support from financial institutions with international competitiveness and sectoral influence and which facilitates the mutual development of various types of financial institutions. Centered on this goal, Shanghai's development into an international financial centre will focus on strengthening the development of a financial market system and a system of financial institutions and businesses, enhancing the standards of financial services and improving the environment for financial development.

The overall goal of Shanghai's development into an international shipping center is, by 2020, to basically establish an international shipping centre with high concentration of shipping resources, a full range of shipping service functions, a good shipping market environment, with efficient modern logistics services, and the capacity of allocating global shipping resources. The key measures include five aspects: improving the maritime transportation system, developing a modern shipping service system, establishing an integrated experimental zone for the development of international maritime industry, enhancing policies for supporting the development of a modern maritime industry, and promoting and regulating the development of cruise industry.

Appendix 3.2: Mainland shares in Hong Kong's stock market

Table A1: Statistics on H shares and red chips issued in Hong Kong by Mainland enterprises (1993-2008)

Year	No. of H share companies	Total equity funds raised (HK\$ billion)	No. of red chip companies	Total equity funds raised (HK\$ billion)
1993	6	8.14	5	27.67
1994	8	9.88	6	47.58
1995	1	2.99	1	0.21
1996	6	7.87	6	107.33
1997	15	33.08	10	1353.72
1998	2	3.55	1	0.35
1999	3	4.26	4	6.51
2000	3	51.75	3	214.96
2001	3	6.07	3	346.37
2002	4	16.87	1	83.84
2003	10	46.85	2	70.04
2004	8	59.25	4	10.35

2005	9	158.68	4	5.35
2006	17	338.23	2	5.70
2007	9	69.20	7	79.82
2008	6	30.91	-	-

Source: Website of Hong Kong Exchanges and Clearing Limited.

<http://www.hkex.com.hk/data/chidimen/chidimen.htm>

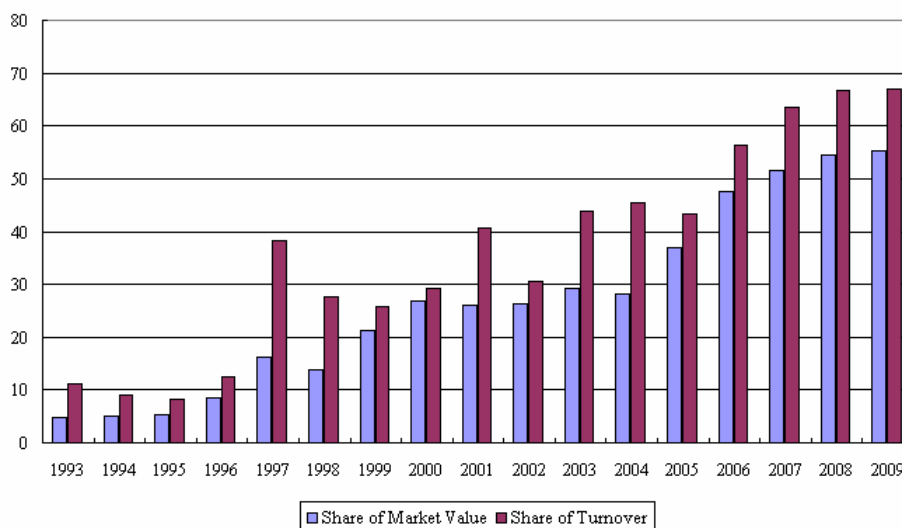


Figure A10: Share of market capitalization and equity turnover of Mainland enterprises in the Hong Kong Main Board (1993-2009)

Source: Website of Hong Kong Exchanges and Clearing Limited.

<http://www.hkex.com.hk/data/chidimen/chidimen.htm>

Note: Data for 2009 reflect the position as at end March 2009.

Appendix 3.3: CEPA arrangements on logistics and transportation

The major CEPA arrangements on logistics and transportation are as follows: on logistics services, Hong Kong service suppliers are allowed to provide, in the form of wholly-owned operations, logistics services in the Mainland, which include road transportation, storage and warehousing, loading and unloading, value adding processing, packaging, delivery and related information and consultancy services for ordinary road freight; freight transportation agency services within the Mainland; and the management and operation of logistics services through computer network. In particular, Hong Kong service suppliers are allowed to provide freight forwarding agency services and storage and warehouse services in the form of wholly-owned operations, and the minimum registered capital requirements for Hong Kong enterprises providing such services in the Mainland will be the same as those for Mainland enterprises. As regards road and maritime transportation services, both the scope of business and regions of operation for Hong Kong enterprises in the Mainland have been expanded.

Appendix 3.4: The requirements on overseas investors in its tourism market

In June 2003, the China National Tourism Administration and the Ministry of Commerce

(MoC) jointly promulgated the *Provisional Regulations on the Establishment of Foreign-controlled and Wholly Foreign-owned Travel Agencies*. Under this regulation, overseas investors of foreign-controlled travel agencies are required to fulfill five criteria, including having an annual gross volume of tourism business of US\$ 40 million or more. As for Chinese investors, they “shall fulfill the criteria stipulated in Article 29 of the *Administration Regulations on the Travel Agencies*”, namely, (1) being a company established according to laws; (2) having no record of law breaking or serious regulation breaking in the past three years; and (3) meeting the prudence requirement and the requirements for special industry specified by the competent tourism administration department of the State Council. On the scope of business, it is stipulated in the regulations that “foreign-controlled or wholly foreign-owned travel agencies shall not overtly or covertly engage in the business of overseas travel of Chinese citizens or travel of persons from other regions of China to the Hong Kong and Macao SAR and Taiwan”. That means that they are only allowed to engage in inbound and domestic tourism services.

Appendix 3.5: Progress in mutual recognition of professional qualifications between Hong Kong and the Mainland

According to a briefing on the progress in mutual recognition of professional qualifications and co-operation on professional examinations between the Mainland, Hong Kong and Macao given in early March 2008 by the Ministry of Commerce (MoC), concrete progress had been made in the areas of architectural and accounting services since efforts began in September 2003. For architectural services, 13 mutual recognition exercises had been conducted, with 1,064 and 973 professionals from the Mainland and Hong Kong respectively obtaining recognition of their professional qualifications by the other side through the mutual recognition mechanism. For accounting services, a total of 38 Hong Kong accountants and 127 Mainland registered accountants had completed the formalities for examination exemption. For securities services, as at the end of 2007, 4 and 6 licensing examinations for securities practitioners and futures practitioners respectively had been conducted in the Mainland, and 98 and 9 Hong Kong professionals had obtained the securities practicing qualification and futures practicing qualification in the Mainland respectively. For medical services, as at the end of 2007, a total of 248 permanent residents of Hong Kong and Macao had passed the relevant examinations and obtained the medical practitioner’s qualification certificate. For legal services, a total of 1,301 Hong Kong and Macao residents took the National Judicial Examination between 2004 and 2007, but only 44 of them passed. For patent agent services, only 8 candidates passed the relevant examination and obtained the Patent Agent Qualification Certificate between 2004 and 2007.

Regarding the mutual recognition of professional qualifications, CEPA proposes that: the two sides shall encourage mutual recognition of professional qualifications and promote the exchange of professional talents between each other; and competent authorities and professional associations of both sides will, in consultation with each other, consider and design specific methodologies for mutual recognition of professional qualifications. Under the CEPA contents about of the opening of the Mainland’s services sector, Hong Kong lawyers, accountants and medical practitioners may obtain, subject to conditions, practicing certificates recognized by the Mainland professional authorities and engage in a specified scope of practicing activities in the Mainland.

Appendix 4.1: Policies on the development of vocational education in Guangdong Province

Guangdong Province has attached due importance to the development of vocational education since 2006 and successively promulgated the *Decision of the CPC Provincial Committee and Provincial Government on the Development of Vocational Education* and the *Outline for Implementation of the Development of Vocational Education in Guangdong Province (2006-2020)*, which state for the first time that Guangdong Province as a whole is to achieve the modernization of vocational education by 2020 and become a national leader in terms of the overall standard and integrated strengths of its vocational education and technical training. According to its plan, by 2010, Guangdong Province will have 1.74 million students studying in secondary vocational schools, with an enrollment of 0.65 million in that year, accounting for about 45% of the total enrollment at senior secondary schools; and 0.65 million students studying in higher vocational institutions, with an enrollment amounting to over 50% of the total number of new students in the higher education sector. During the “11th Five-Year Plan” period, the secondary vocational schools and higher vocational institutions in Guangdong Province will generate 2 million and 0.75 million graduates respectively. Judging from this plan, the vocational education in Guangdong Province is currently in a stage of massive development. The Governor of Guangdong Province, Mr Huang Huahua, has clearly stated that vocational education in Guangdong Province will undergo a structural adjustment. Over 800 existing vocational institutions will be upgraded, abolished, merged and reorganized. Municipalities in the Pearl River Delta will be developed into a hub and a demonstration area for Guangdong’s vocational education. Local governments at prefecture level in the eastern and western wings and the northern mountain areas of the province will focus their efforts on the successful operation of a number of key vocational institutions, advanced technical schools and technician colleges in their own areas.

Appendix 4.2: Some measures taken by the HKSAR Government in support of the development of education

The Hong Kong SAR Government has implemented some measures to support the development of education, which include: (1) increasing the non-local student admission quota for publicly-funded programmes at the sub-degree, degree and taught post-graduate levels from 10% to 20%; (2) relaxing the restrictions on non-local students taking up employment and internship, allowing them to take up part-time on-campus jobs and, during vacation, off-campus jobs as well; (3) relaxing the immigration control on non-local students, allowing, on application, non-local fresh graduates to stay in Hong Kong for 12 months after graduation without any restriction under the Immigration Arrangements for Non-local Graduates (IANG), subject to the requirement that the remuneration package for these non-local students is set at market level; and (4) adopting other supporting measures for non-publicly funded institutions.

Appendix 4.3: Development of cultural and creative industries in Beijing and Shenzhen

Beijing has specially developed its plan for the development of cultural and creative industries during the “11th Five-year Plan” period. The plan sets out Beijing’s policy measures on developing cultural and creative industries in 10 major areas and 32 aspects. On 14 December 2006, the Beijing Municipal Government published a list of ten Cultural and Creative Industry Cluster Areas. Eleven more were added to the list on 15 April 2008, bringing the total to 21. In general, cultural and creative industries have become pillar industries for the capital’s economic development. In 2005, Beijing’s cultural and creative industries had total assets amounting to RMB 514.03 billion and created a value-added of RMB 70.04 billion, accounting for 10.2% of the city’s GDP.

The first China (Shenzhen) International Cultural Industries Fair (ICIF) was held in Shenzhen in 2005. Since then, ICIF has been held annually in May. Following the guidelines of promoting “internationalization, specialization, mercerization, standardization and high quality” and focusing on the key goals of “promoting the development of China’s cultural industry” and “promoting the export of Chinese cultural products”, Shenzhen endeavors to further enhance ICIF's characteristics, consolidate its positioning, and establish its reputation as a leading exhibition and export fair for Chinese cultural products. In 2009, the 5th ICIF will further highlight the development of the core cultural industries and creative industries, with its “authoritativeness” and “influence” enhanced, and its national and international positioning strengthened. Currently, Shenzhen mainly focuses on seven types of creative industries: creative designs, leisure tourism, animations and games, performing arts and entertainment, digital films and televisions, media and publishing, and arts and crafts.

Appendix 4.4: Development of environmental protection industries and circular economy industries in Mainland China

According to the *China Green National Accounting Study Report 2004* jointly released by the National Bureau of Environmental Protection and the National Bureau of Statistics, environmental pollution cost China RMB 511.8 billion in economic losses in 2004, and remedial costs were high. To clean up all the pollutants discharged in 2004, China would need to make a one-off direct investment of RMB 1.08 trillion, which accounted for 6.8% of the GDP in 2004. Additional operational expenses (imputed treatment costs) of RMB 287.4 billion, equivalent to about 1.8% of the GDP in 2004, would also be required for pollution treatment. However, China’s investment in pollution abatement and control only accounted for 1.18% of the GDP during the “10th Five-Year Plan” period. Hence, its increasingly prominent “environmental deficit” with China’s rapid economic growth has become a major factor restricting its sustainable economic development and a major concern of the decision makers of our nation.

According to the preliminary estimate provided by the Ministry of Environmental Protection³⁸, total investment in environmental protection projects in Mainland China during the

³⁸ The National Bureau of Environmental Protection was upgraded to the Ministry of Environmental Protection in 2008.

“11th Five-Year Plan” period will reach RMB 1.4 trillion and the environmental protection industries are expected to maintain an average annual growth rate of 15% to 17%. Priority areas will include aquatic environment, atmospheric environment, solid wastes, ecological environment, nuclear safety and radiation protection, and environmental capacity building. The total annual revenues of environmental protection industries will reach around RMB 880 – 1,000 billion in 2010, of which RMB 660 billion will be generated by comprehensive utilization of resources, RMB 120 billion by the production of environmental protection equipment and RMB 100 billion by environmental services.

The resolutions of the 4th and 5th plenary sessions of the 16th Central Committee of the Chinese Communist Party proclaimed the active development of circular economy as a major initiative to adjust the economic structure and layout and change the economic growth approach. Also, the *State Council's Circular on the Near-term Priorities in Building a Resource Conserving Society* (guofa No. 21[2005]), the *State Council's Views on Speeding up the Development of Circular Economy* (guofa No. 22[2005]) and other related documents have been issued successively. Actively developing circular economy and building a resource conserving and environmental-friendly society has become the fundamental strategy of national development and has been included as an important area for “implementing the principle of scientific development”. China’s legislation on circular economy mainly includes the *Cleaner Production Promotion Law* and the *Circular Economy Promotion Law*, which came into effect in 2003 and 2009 respectively. Given the requirement of developing circular economy, environmental expenditure has been formally included in the national budget of China since 2007.