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Hong Kong 20 Years
after the Handover」

研討會 Conference



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Becoming Part of One National Economy: Maintaining Two Systems in the Midst of the Rise of China

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1. Introduction

- ◆ Econ Integration proceeded rapidly since 1979; HK built a world factory in Guangdong that depended on HK's producer services; HK transformed into a services hub.
- ◆ Started with 'shallow integration' in goods, proceeding to 'deeper integration' in services with China's progressive liberalization of services (1992 Deng's southern tour, 2001 WTO entry, 2003 CEPA, 2013 Shanghai Free Trade Zone).
- ◆ Trade in goods is arms-length while trade in services requires people to people contacts or foreign investors to set up shop in the home market.
- ◆ Unlike trade liberalization in goods, services liberalization is *always & everywhere slow & gradual* (high-end services usually dominated by monopolistic, state-owned firms, needs changes in complicated regulations). China's services liberalization is far from complete.



1. Introduction (continued)

- ◆ HK crucial to China's opening in early reform era & China tailored its opening to capture business opportunities from HK (e.g., establishment Shenzhen SEZ).
- ◆ However, with econ crisis in HK from 1997 to 2003, tables were turned in Mainland's favor. HK has to tailor its policies to capture Mainland business.
- ◆ HK's reversion in 1997 facilitated policy coordination & deeper integration in services.
- ◆ Watershed in mid 2003 with implementation of CEPA & IVS (Individual Visitors Scheme).
- ◆ Rapid increase in Mainland tourists led to severe congestion & overcrowding in HK. Coupled with slowdown of Chinese economy; Renminbi devaluation & slowdown of financial liberalization, Mainland-HK econ integration entered a difficult phase since 2015.



2. Framework governing economic integration under OTCS

- ◆ Framework is laid down in meticulous detail in the Basic Law.
- ◆ In terms of ‘Two Systems’, HK-Mainland econ relations looks like international econ integration.
- ◆ High *formal* barriers to movements of goods, labor, & capital between HK & Mainland (Higher than those among EU members, though geographic & cultural proximity imply low *informal* barriers).



2. Framework governing economic integration under OTCS (continued)

- ◆ Movement of goods: HK & Mainland are separate customs territories with different tariffs.
- ◆ Movement of labor: Unlike EU, migration between HK & Mainland is quite strict.
- ◆ Movement of capital: Unlike Mainland's capital controls are quite strict.
- ◆ Currency integration: Unlike the Euro Area, currency risks exist between HK & Mainland.
- ◆ 'One Country' principle: HK's autonomy in external economic relations is subservient to China's foreign policy.
- ◆ Economic policy coordination between HK & Mainland is difficult due to 'Two Systems'. There is nevertheless growing coordination in infrastructure & in economic policy.



3. Asymmetries in Mainland-HK economic integration

- ◆ Three significant asymmetries:
 - 1) In level of economic development
 - 2) In economic size
 - 3) In degree of economic openness
- ◆ Such asymmetries, though common in international economic integration, have important bearings for both partners.



3.1 Asymmetry in level of economic development

- ◆ Benefits for HK (the more developed partner):
 - 1) Developing economies tend to have higher growth potentials. HK can share in the higher growth potential of the Mainland.
 - 2) Difference in level of economic development means it is easier to form a complementary rather than a competitive relationship.



3.1 Asymmetry in level of economic development (continued)

Costs for HK:

- ◆ Wage gap between developed & developing economies will shrink through 3 channels: Trade, investment, & migration.
- ◆ Will improve global income distribution but worsen income distribution in developed economies (HK labor has to compete with Mainland labor).
- ◆ Pressure on HK wage is huge due to size of Mainland, & also due to geographic & cultural proximity, which lower barriers between HK & Mainland (even small manufacturing firms in HK can relocate).
- ◆ Unlike elsewhere, even front-end services workers (e.g., tailors, retail sales workers) in HK face Mainland competition due to geographic & cultural proximity.



3.2 Asymmetry in economic size

- ◆ Small economies benefit more (relatively) from international econ integration than large economies as ratio of international business to GDP is higher in small economies.
- ◆ However, small economies are vulnerable to economic fluctuations in their large partners. For a small econ, the preferred strategy is not isolation but strengthening its flexibility & adaptability to weather external shocks.
- ◆ Integration in services requires extensive people to people contacts. The flow of people from large economies can easily overwhelm the capacity of small economies. Though HK can offer attractive tourist, medical, & educational services, HK's facilities can easily be overwhelmed.
- ◆ Services integration needs careful management to avoid overcrowding.



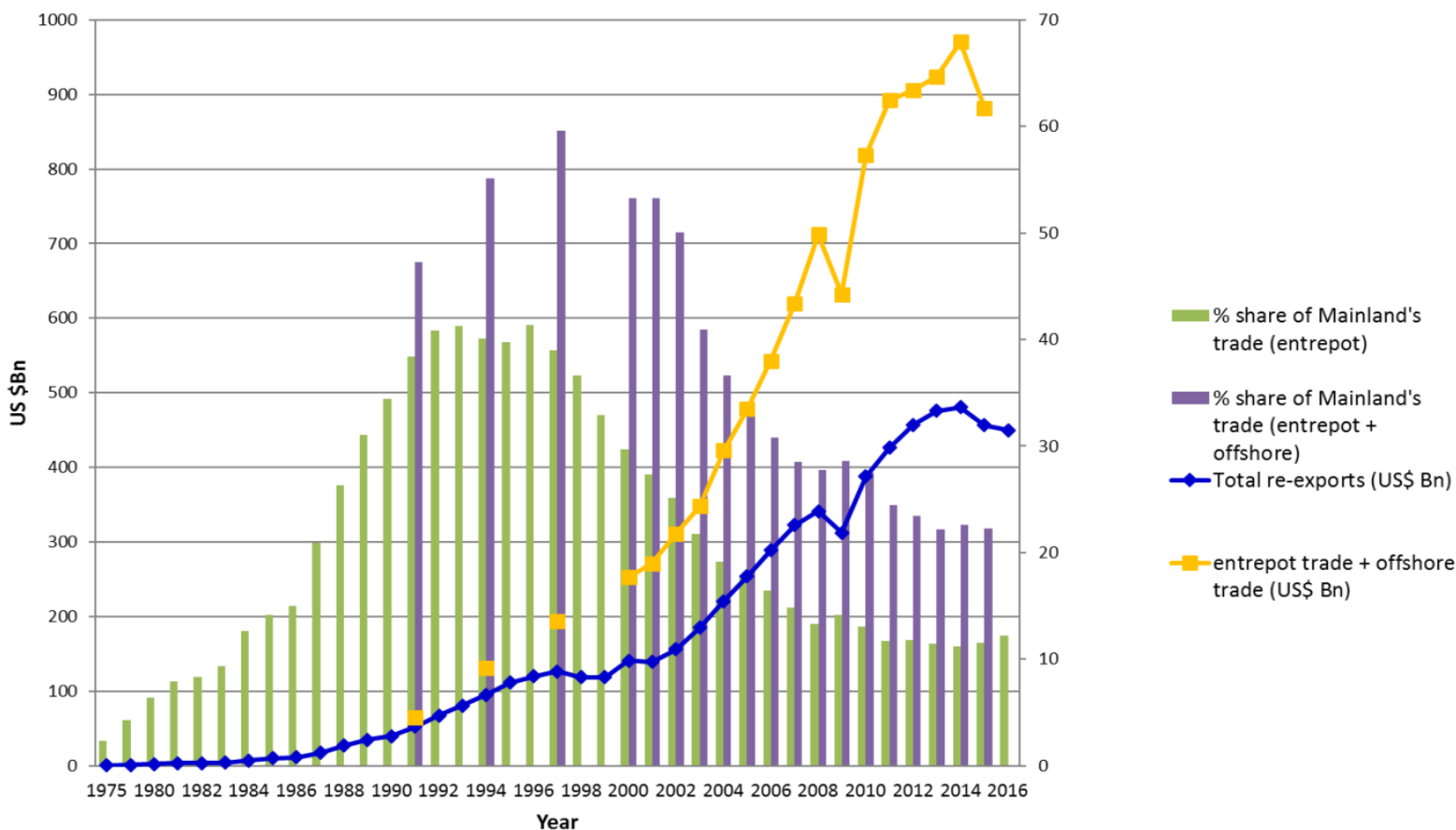
3.3 Asymmetry in openness: HK generally more open than Mainland

- ◆ An economy can benefit from unilateral opening (HK practices unilateral free trade). Since the 1970s, many developing economies, including China, have liberalized unilaterally.
- ◆ HK complaint before 2003 that the Mainland-HK border was a ‘gortex border’ was obsolete: that the Mainland only encouraged forex earnings (exports, inflows of capital & tourists) but restricted forex outflows (imports, outflows of capital & tourists).
- ◆ Asymmetry in openness between HK & Mainland has diminished rapidly since China’s opening, especially since 2003. Liberalization of outflows of capital & tourists have overwhelmed capacity in HK (China’s pace of liberalization has been too rapid for HK).
- ◆ Liberalization of services is *always & everywhere gradual & slow*. HK is still more open than China in services (Some important exceptions: Cross-boundary trucking & driving, establishing hospitals).



4. Integration in the goods market

Figure 1: Mainland's trade taking the form of Hong Kong's entrepot trade and offshore trade





4. Integration in the goods market (continued)

- ◆ Dependence of Mainland on HK for trade peaked in the mid 1990s, when HK handled around 60% of China's trade (40% as HK's entrepot trade, & another 20% as HK's offshore trade).
- ◆ Dependence ratio fell to 23% in 2014 (11% as HK's entrepot trade, & another 12% as HK's offshore trade) due to competition from Mainland's ports & services providers.
- ◆ However, in *absolute* terms, Mainland's trade handled by HK grew till 2014.
- ◆ From 2014 – 16, Mainland's trade fell by 14.3% (but Mainland's trade via HK in the form of HK's entrepot trade only declined by 6.3%), mostly due to relocation of its export-oriented manufacturing to countries along the silk road.
- ◆ This implies the ratio of Mainland's trade in the form of HK's entrepot trade has risen to 12.2% in 2016. Maybe because HK is the hub for managing relocation of Mainland's manufacturing to countries along the silk road?



5. Integration in services

- ◆ The pattern of Mainland-HK services trade has changed from Mainland's lopsided dependence on HK to mutual interdependence as Mainland's services liberalization stimulated development its service sectors.
- ◆ The CEPA further opened Mainland's services markets to HK. Besides importing producers services, Mainland also became a major market for HK in consumer services (tourist, medical, educational, & financial services).



5.1 Mainland-HK CEPA

- ◆ CEPA opens Mainland's services market to HK further. The Guangdong Agreement under the CEPA signed in Dec 2014 was the first 'high standard' FTA (Free Trade Agreement) drawn up by the Mainland with a 'negative list' approach in market access for foreign investors.
- ◆ The high standards of the Guangdong Agreement in services trade was adopted in the negotiations of China's BITs (Bilateral Investment Treaties) with the US and the EU, & also in China's Free Trade Zones.
- ◆ In the long run, this would upgrade China's services trade regime to meet 21st century standards, strengthening China's leadership in global economic governance.



5.1 Mainland-HK CEPA (continued)

- ◆ In mid 2016, the majority of the Guangdong pilot liberalization measures was extended to the whole Mainland & basically achieved the goal of liberalization of trade in services between the Mainland & HK.
- ◆ Benefits of CEPA to HK can be large in the long run. However, services liberalization *is always & everywhere gradual & slow.*



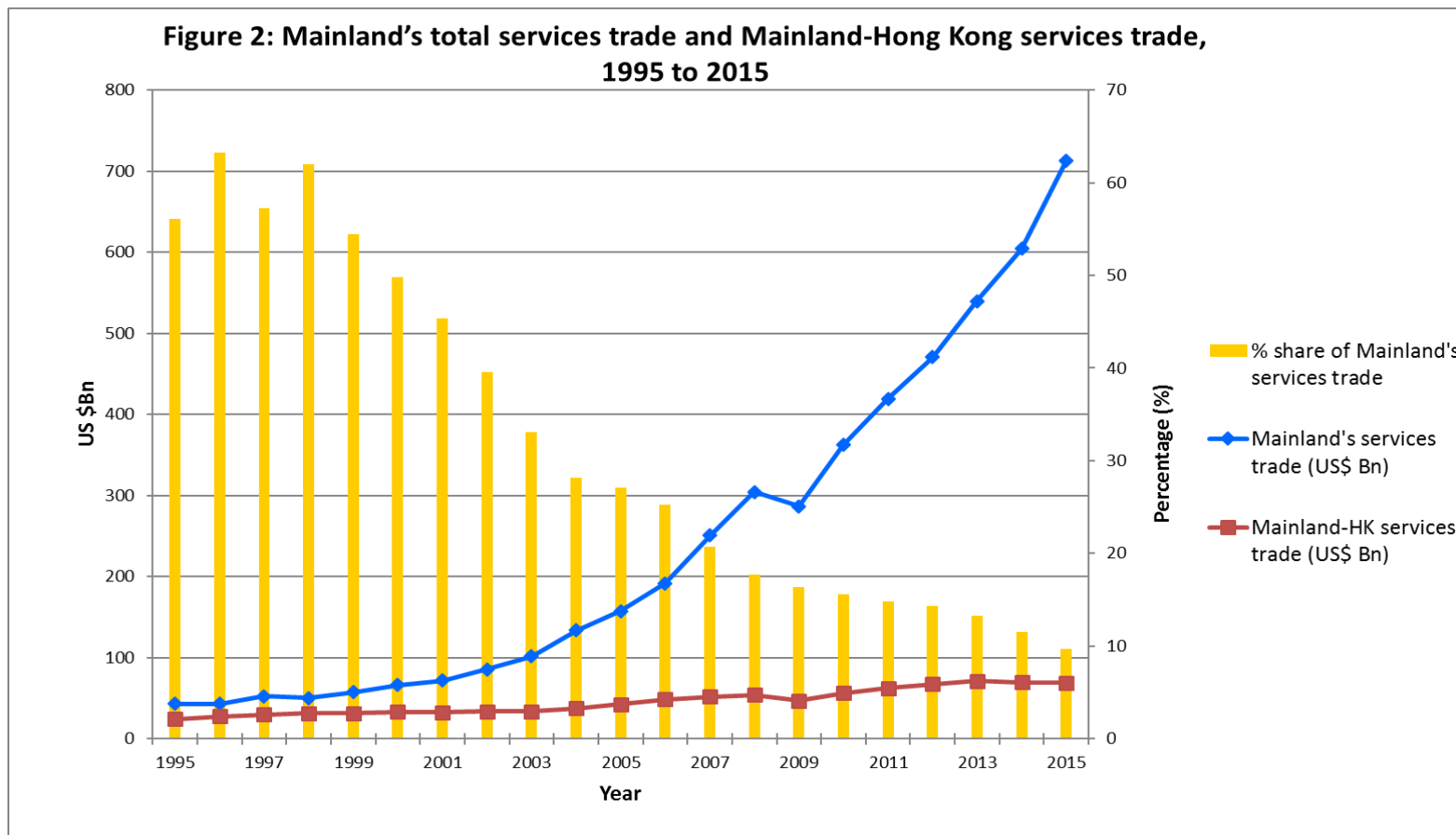
5.2 Explosion of Mainland visitors & the IVS

- ◆ Author's estimates of econ contributions of tourism: In 2013, all visitors, Mainland visitors, and IVS visitors respectively generated 4.2%, 2.6%, and 1.6% of GDP, and also generated 6.4%, 4.5%, and 2.7% of total employment.
- ◆ From 2004 to 2013, the increase in IVS visitors (all visitors) accounted for 18% (24.3%) of the increase in total employment in HK.
- ◆ Negative externalities of tourism in congestion & overcrowding are highly visible.
- ◆ Positive externalities of tourism in investment & services trade (demand for financial, educational & medical services) can also be large, but they are difficult to estimate.



5.3 Mainland-HK services trade

- ◆ Rapid growth in absolute terms, though HK's share has declined





6. Integration of labor market

- ◆ OWP (One Way Permit) quota of 150 per day is an exit quota of the Mainland rather than an immigration quota of HK.
- ◆ Over one million Mainlanders migrated to HK from 1997 to 2006. 880K (84%) were OWP migrants (mostly unskilled); 174K came under schemes to import Mainland skills or investment entrant scheme.
- ◆ Despite liberalization after 1997, controls on migration from the Mainland were still stricter than those from elsewhere due to fears of population pressure from kinship links. Migration to HK from the Mainland for family reunion still involves a long wait.



7. Integration of financial & capital markets

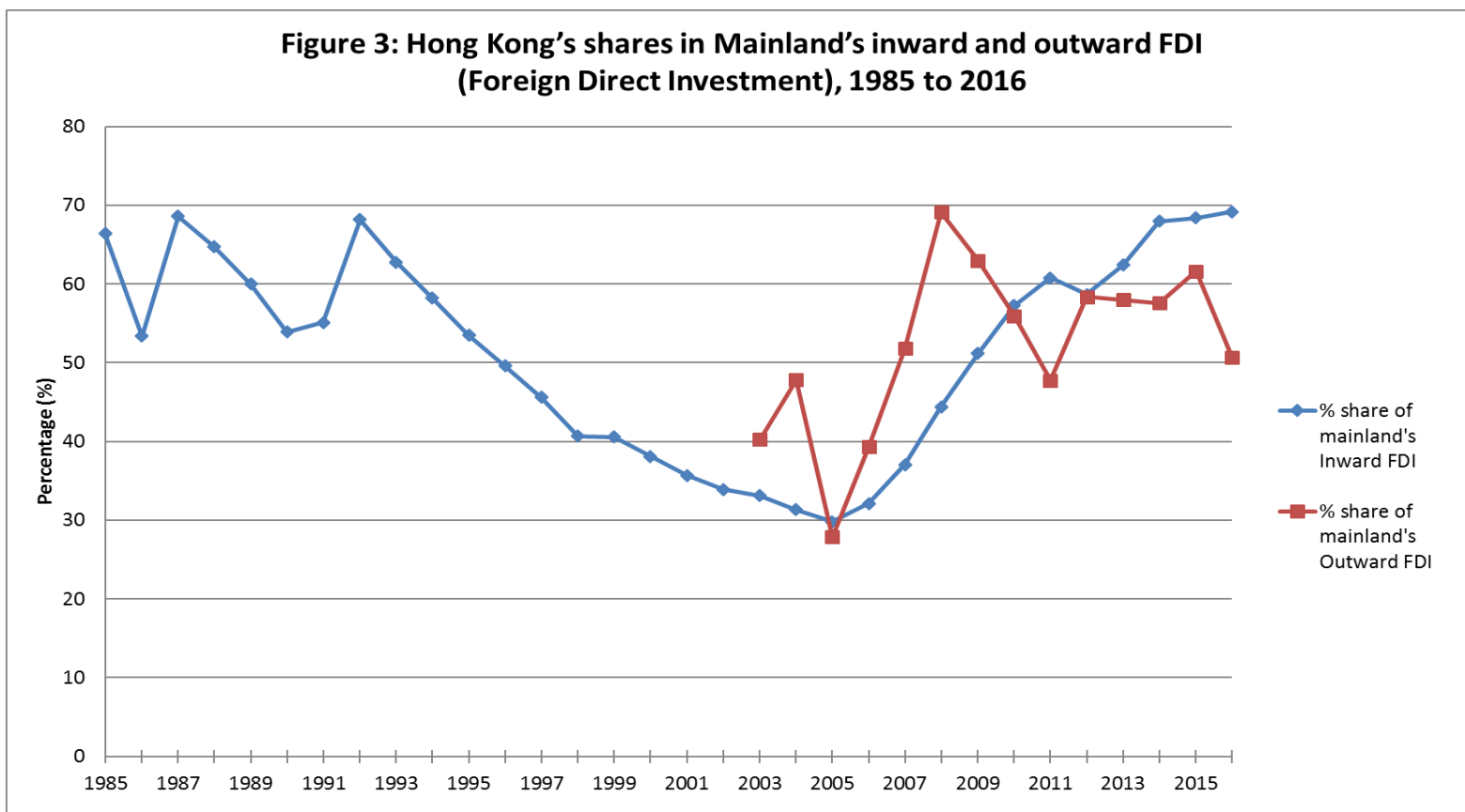
- ◆ HK & Mainland are each other's foremost partner in FDI (Foreign Direct Investment). Half of mainland's inward (outward) FDI comes from (goes to) HK.
- ◆ HK also important in portfolio investment & loans.
- ◆ Mainland enterprises have been listed in HK (H-shares) since 1992. H-shares & Red Chips accounted for more than half of HK's stock market capitalization.



7.1 HK's role in inward & outward FDI

- ◆ HK's shares reached historic highs in recent years

Figure 3: Hong Kong's shares in Mainland's inward and outward FDI (Foreign Direct Investment), 1985 to 2016





7.2 HK's role in portfolio investment

- ◆ H-shares (since 2002), QFII (Qualified Foreign Institutional Investor, since 2002), QDII (Qualified Domestic Institutional Investor, since 2006) & dim sum bonds (since 2007), RQFII (R for Renminbi, since 2011).
- ◆ Dim sum bonds & RQFII promote HK's offshore RMB business. HK accounted for 60% of total RQFII quota of 444 bn. Yuan at end of 2015.
- ◆ Shanghai-HK stock connect (2014), Shenzhen-HK stock connect (2016), & China-HK bond connect (2017)



7.3 HK's role in RMB internationalization

- ◆ HK is the global hub of offshore RMB business, handling around 70% of offshore RMB payments.
- ◆ Offshore & onshore RMB are differentiated products with different policy risks. Convertibility of RMB will not end offshore RMB business (thriving offshore USD business in London despite convertibility of USD).
- ◆ Hiatus in pace of RMB internationalization due to recent RMB depreciation is likely to be temporary. RMB internationalization should continue in the long run with rise of China.



8. Economic integration under OCTS: Cooperation & competition

- ◆ Benefits of ‘One Country’ for HK: Access to China’s national market, ease of tapping Mainland’s talents, skills, & capital, and policy support from China (e.g., HK’s offshore RMB business).
- ◆ Costs of ‘One Country’ for HK: Pressures of immigration on local wages, social services, & income distribution. HK also vulnerable to econ fluctuations in the Mainland.
- ◆ Benefits of ‘Two Systems’ for HK: Maintain HK’s uniqueness & autonomy.
- ◆ Costs of ‘Two Systems’ for HK: Difficulties in cross-boundary policy coordination. Difficult for Hongkongers to work & reside in Mainland. Beijing allegedly favors Shanghai over HK as HK is less dependable.



8.1 Cooperation & competition

- ◆ More advanced cities in China have reached the ‘developed’ threshold. 2015 per capita GDP of Nanshan district of Shenzhen was USD 49K, surpassing HK’s.
- ◆ This will NOT end Mainland-HK econ cooperation. A developed economy has a bigger market & more business opportunities. Moreover, large differences in level of development are obstacles to deeper integration. Trade & investment are usually more intense among developed partners than between developed-developing partners.
- ◆ Shenzhen-HK (or Shanghai-HK) econ cooperation will be based on complementarity among equals with strengths in different niches, e.g., HK has strengths in financing, legal arbitration, & headquarter functions.
- ◆ Despite emerging competition between Mainland & HK, there are more areas of complementarity as HK is highly unique, not only in econ structure, but also in political, legal, social, & cultural arenas.



8.1 Cooperation & competition (continued)

- ◆ Mainland's society is top-down, while that of HK is bottom-up. Mainland's NGO's & social enterprises are less developed, & they have a lot to learn from counterparts in HK.
- ◆ HK's niche services & softpower is important for China's opening & reform.
- ◆ China's 13th Five Year Plan (2016-10) expresses clear support for Hong Kong in leveraging its unique advantages to enhance its role in China's econ development & opening, enhancing HK's status as international financial, transportation & trading hubs.



8.2 Managing economic integration under OCTS

- ◆ *HK needs to harness the benefits & minimizes the costs of OCTS* as improved access to Mainland's market in services can overwhelm HK's capacity. Antipathy of HK public to Mainland visitors is highly detrimental to future cooperation.
- ◆ The responsibility for managing surge in Mainland tourists lies with HK rather than Beijing (Beijing has repeatedly fore-warned HK on risks of liberalizing Mainland's outgoing tourism).
- ◆ The implementation of CEPA & IVS scheme since 2003 helped HK to recover from a deep recession, but HK failed to overcome capacity constraints, & also failed to use the opportunity to diversify & upgrade its economy towards more innovative & high-tech industries.



9. HK's role in BRI (Belt & Road Initiative)

- ◆ BRI is expected to bring business opportunities to HK in finance, logistics, professional services, & arbitration.
- ◆ Besides strengths in economic niches, HK has the softpower that Mainland lacks. HK is a hub of international media & NGO activities, & has a long history of solving multi-cultural conflicts. HK provides an open & pluralistic platform to promote the BRI.



10. Problems & prospects of Mainland-HK economic integration

- ◆ Two mega cross-boundary projects, the HK-Zhuhai-Macao bridge & the Express Rail Link with Shenzhen & Guangzhou, will be completed soon. HK will need time to digest, utilize, & fine tune their operation.
- ◆ Given political mistrusts and the many problems of deep integration, it is unlikely that the vision of a seamless Greater Bay Area will be realized any time soon.
- ◆ While the pace of Mainland-Hong Kong integration may slow down, it will not be halted nor reversed as Hong Kong and the Mainland are highly complementary.
- ◆ To overcome mistrust, the top-down approach to Mainland-Hong Kong integration needs to be supplemented by a bottom-up approach. HK's businesses, chambers of commerce, professional groups, NGO's, think tanks, and political parties need to voice their needs and concerns to forge a way ahead.



10. Problems & prospects of Mainland-HK economic integration (continued)

- ◆ In the Trump era, China is taking on more responsibilities in global economic governance to fill the void of US isolationism. This enhances the importance of HK in China's external relations as HK is China's bridge to the world.
- ◆ Since 1842, HK has thrived on its unique position as a city that is close to but yet distinct from the Mainland. OCTS is designed to preserve HK's unique position.
- ◆ Under OCTS, HK needs to further strengthen its uniqueness in economic freedom, freedom of media & information, rule of law, & maintain a level playing field for businesses.
- ◆ *To achieve these goals, Beijing and the HK government need to faithfully implement the many provisions of the Basic Law safeguarding personal freedoms, human rights, & rule of law.*

