

Hong Kong's Economic Strategy Reconsidered

[Tsang Shu-ki \(www.sktsang.com\)](http://www.sktsang.com)

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The Policy Address of the Chief Executive of the HKSAR Government delivered at the beginning of this year was basically an economic manifesto. It emphasised that Hong Kong must strengthen its ties with the Pearl River Delta. But under the guiding philosophy of “big market, small government”, what the government could do was only to concentrate on reducing the barriers to cross-border flows of resources, and to “open up the circulation within the network” (「打通經脈」), as the Chinese would have it.

The latest Budget, on the other hand, was almost entirely preoccupied with the issues of the fiscal deficit, lamentably lacking in any foresight about the economic future of the SAR. Where lies Hong Kong's economic growth engine? How should the local economy be upgraded to match the challenges ahead? These are the key questions. Without restoring relatively high growth rates, all sorts of crises would befall on Hong Kong, or they would further deteriorate. The chances for balancing the Budget would also be slim.

Resource flows are a two-edged sword

My comments on the Policy Address are simple indeed. I criticised the perspective that underpinned it---the “factor flow” view (「要素流動論」)---last year in two Chinese articles on Ming Pao (《不應沈溺放任經濟》 on 25 February, and 《歷史的困局、香港的自困》 on 17 June). I contrasted it with the view of “local advantage”(「本地優勢論」). In the light of the rapidly emerging competition among Chinese city economies, the resource flow perspective is short-sighted in that it fails to realise that the enhancement of the freedom and efficiency in the flows of factors of production is a “two-edged sword”. As Hong Kong and the Mainland cities strengthen their exchanges of resources, the SAR's implicit and explicit costs of being “caged” under the “one country, two systems” framework could be reduced. But finally, that could result in a net inflow or a net outflow of resources of different qualities. In other words, it could be a blessing, or a curse, depending on how we handle the challenges.

As Paul Krugman puts it in his *Geography and Trade*, under the trend of globalization, high-grade factors would only flow to cores or centers with economies of scale, industrial clusters, with large and substitutable labour pools. The decisions by the government and the private sector during crucial junctures would have important historical, or even irreversible, consequences on the developmental path of an economy.

Entities of common interests: competition or cooperation?

Theoretically, regional economies should both cooperate and compete with each other. They should engage in a virtuous circle of mutual advancement on fair competition and cooperation regarding Pareto-improving ventures and projects, and to avoid low-quality interdependence, or even unfair competition and vicious rivalry. Nevertheless, there needs to be an economic basis for cooperation. In my previous writings, I also emphasised the need to build a “entity of common interests” (「利益共同體」) between Hong Kong and the Mainland (especially Guangdong), so that a “win-win” situation can be created.

In the private sector, “entities of common interests” have long existed and are developing all the time. The linkages among Hong Kong enterprises and their branches, subsidiaries, partners, upstream suppliers and downstream buyers, and various local government institutions in the Pearl River Delta are the most obvious examples. Certainly, there is also very keen competition among them and the other Hong Kong enterprises, Taiwanese and Japanese investments, not to say the vast number of Mainland companies. Moreover, the patterns of cooperation and competition are constantly evolving.

Therefore, everyone’s attention at the present is on competition and cooperation between governments. Projects of capital construction, policy coordination, and long term planning etc. simply could not be accomplished without cooperation on the governmental level. However, unlike ties among private businesses, it is much more difficult to establish common interests among governments with regard to linkages in funding, production and services, as they are affected by complex considerations beyond the profit motive

In any case, government policies would have direct influence on enterprises’ long term investment plans and even locational decisions. “Capital has no border!”

Only governments care about borders. That is why all the authorities in the region and indeed in most of the world are trying hard in implementing measures to promote economic development and to attract outside investments. If Hong Kong continues to be trapped by its self-imposed ideology of the “free economy”, it would be equivalent to continue the “handicap” match. Could we afford to do so?

Locational versus quality advantages

A locality may show different kinds of advantages. One could be its geographical location. All the important ports in the world have such “locational advantage”. Another example is those centrally located cities that can be reached from, and reaches out into, various directions.

A different form of superiority arises from historical and non-spatial factors. It is more a result of the quantitative and qualitative combination of resources. Depending on the product circle, such an advantage can be reaped by “first movers” or “late movers”. A winner would have accumulated tangible assets (hardware) and intangible assets (software), which if suitably developed and reinvested, could result in advantages that can hardly be matched by potential competitors. Switzerland, for example, possesses these kinds of “quality advantages” in the fields of drugs manufacturing, watch making, finance, high-mountain engineering, and as an international diplomatic centre. All these sectors show the same crucial characteristic: the importance of credibility.

On this issue, Hong Kong's traditional belief is that we have both locational and quality advantages compared with the rest of China. In fact, Hong Kong's geographical superiority is declining. In the past, transportation and port facilities in the Pearl River Delta lagged far behind the expansion in external trade, and its international connections were rather limited. But now, with the rapidly emerging highway and railway networks, container ports, and airports, as well as the large number of foreign invested firms in the region, the problems of high costs and congestion for the SAR as a re-export centre are revealed mercilessly. Even our location, at the southern tip of the Delta, is being regarded as a disadvantage! What we can still count on is the harbour with the deepest water in Southern China and our efficient airport with its world-class connections and frequent flight schedules.

Advantages under credibility asymmetry

Anyhow, the SAR still holds quite a good deal of quality advantages, at least in the short run, especially with regard to credibility. There is a significant “credibility asymmetry” (「信用不對稱」) between the Mainland and Hong Kong. The most obvious manifestation is that Mainlanders like to purchase gold and jewelry in Hong Kong when they visit the SAR. Why? It is because they have more confidence in the content and genuineness of those expensive items, here in Hong Kong. The chances for the tourists to be sold fake decorative items and gold rings with much less than 99.9% of the yellow metal in them are far less than in the Mainland.

The SAR must nurture and develop this kind of credibility advantages. This is the appropriate direction to which the economy should head. Let me analyse here an example of an industry that is based on credibility asymmetry: Chinese drugs manufacturing (not the testing and laboratory verification of Chinese drugs, which would produce much less value-added).

As a result of all sorts of factors, fake and poor-quality drugs and pharmaceuticals abound in the Mainland. On the other hand, Hong Kong is an excellent place to develop the techniques of combining Chinese and western medicines, as knowledge of both sides meets, and the SAR is close to the sources of materials and the vast markets for the end products. More importantly, we possess a relatively high degree of credibility. It is easier for us to utilise advance methods including biotechnology to extract essences and ingredients and experiment on different forms of drugs that satisfy (and are seen to satisfy) international standards. Drugs manufactured in Hong Kong would have a much better chance of penetrating foreign markets than those produced within the Mainland.

However, drugs manufacturing is an extremely high-risk industry. I once visited one world-renowned pharmaceutical company; its administrative staff told us that on average out of 6,000 experiments performed, only one marketable drug would successfully emerge! Hence, at least in the initial stage, and given that the foundation for the industry is not yet firmly built, government's involvement and assistance to the industry is an essential condition for its eventual take-off. Singapore is the obvious recent example. I shall revert to it below.

Besides Chinese drugs making, there are also other industries which are closely associated with credibility: e.g. fields of biotechnology besides pharmaceuticals, high-security financial and commercial service, sophisticated software development (say by using LINUX as the operating system), micro-electronics, nano technology,

material sciences applications. All these products and services require a high degree of quality control and manifest credibility by the suppliers. As for creative industries, cultural and entertainment software and so on, while credibility is not a crucial element, the SAR obviously also has quality advantages.

Hong Kong to become the Switzerland of Asia-Pacific

In brief, Hong Kong should become the Switzerland of China or of the Asian-Pacific area. Mr. Wang Zhan, the chief policy advisor to the Shanghai Municipal Government made a similar recommendation during his visit to the SAR last year. It was an opinion of deep insight. Actually, successful small open economies like Switzerland, Denmark, Finland and so on have all adopted a highly focused strategy of concentrating on taking the lead in a few frontier industrial and service sectors.

Certainly, advantages are always relative, not absolute, in nature. It is just like travelling against the tide in a boat: if one does not advance, one retreats. The Mainland is unceasingly improving with regard to quality. In the past, post-sale maintenance service was poor in the household electrical appliances industry, but has now been greatly enhanced, defeating most imported brands. Products that require higher technology like DVD equipment are making notable inroads into the Hong Kong and foreign markets. On another front, Singapore is breathing down the SAR's neck. Resorting to various vigorous forms of incentives (including preferential tax treatments, affordable space in technology parks built by the government, R&D funding and benefits, start-up capital provision and matching etc., to the tune of billions of US dollars), the Singapore Government has been able to help launch the pharmaceuticals industry, which has become the island republic's third largest exporter behind the petroleum and electronic sectors. Several world-class drugs manufacturers have invested and set up plants in the country. Pharmaceutical exports grew by nearly 60%, amounting to 4.7 billion US dollars, in 2002.

To effectively compete with Singapore, Hong Kong needs a good deal of efforts and coordinated measures. Other than working out the "Closer Economic Partnership Agreement" (CEPA) with the Mainland, the SAR Government should proactively negotiate with foreign countries in Europe, America, and Asia for free trade agreements (FTAs), with a view to dismantle tariff and non-tariff trade barriers, particularly the latter relating to high-tech products and service.

If the SAR fails to quickly develop the quality and credibility advantages that it still holds, so as to create sustainable cores of growth for the economy, the intangible assets that it has accumulated (including goodwill) will drain off. The economy prospect for the Hong Kong will then be worrisome.

References

- (1) Paul Krugman, *Geography and Trade*, Leuven University Press and MIT Press, 1991.
- (2) Singapore has entered into free trade agreements with New Zealand, Japan, Australia, EFTA and the US. It is negotiating with Mexico, Canada, ASEAN, China and South Korea. See the web page of its Ministry of Trade and Industry: http://www.mti.gov.sg/public/FTA/frm_FTA_Default.asp?sid=27.
- (3) On FTAs in the world, see “Frequently Asked Questions: FTAs” at http://www.mti.gov.sg/public/FAQ/frm_FAQ_Default.asp?sid=2&did=33&cid=113.
- (4) On a report of the pharmaceuticals industry in Singapore, see “Little Island, Big Pharma”, *Business Week*, 17 February 2003, p.24. Regarding the developments of its biomedical sciences (including basic characteristics, the recent trends, and the government’s preferential policies and measures, see the websites at <http://www.biomed-singapore.com/bms/index.jsp>, or alternatively, at the Economic Development Board’s <http://www.sedb.com/edbcorp/index.jsp>. The official goal is to turn Singapore into the “Biopolis of Asia”.