

# **The Economic Link-up of Hong Kong and Guangdong: Structural and Developmental Problems**

Tsang Shu-ki and Cheng Yuk-shing  
Department of Economics  
Hong Kong Baptist University

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## **Abstract**

The phenomenal economic link-up between Hong Kong and Guangdong has so far been the result of a regional reallocation of resources, made possible by China's open policy. It has not yet led to a process of long run upgrading which strengthens the foundation for productivity and competitiveness enhancement. Various structural and developmental problems have indeed emerged on both sides, as there has been a lack of countervailing forces that promote far-sighted strategies against short-term profit maximization. While better coordination should be pursued to ensure mutually beneficial developments and to avoid duplicating structures, the future trajectories of the two economies will not and cannot be identical. Independent efforts to nurture specific advantages and to solve internal problems, plus a certain distancing in economic relations, will indeed be healthy.

## **I. Introduction**

The phenomenal link-up between the Hong Kong and Guangdong economies has been proceeding at a remarkable speed since the launching of the Chinese economic reform in late 1978. The process has largely been market-driven and seems to suit the short-run comparative advantage on both sides. In essence, however, it has been a result of a reallocation of resources across the border, made possible by China's open policy. It has not yet led to a benign form of developmental upgrading which embodies the strengthening of the long-term foundation for productivity and competitiveness enhancement. Indeed, the tremendous "windfall profits" obtained so far could be regarded as a disincentive for R & D investments as well as beneficial decisions that may incur painful side effects in the short run.

Problems which are structural and developmental in nature, including bias and duplication in production patterns, inflationary pressure, widening income inequality, and the loss of competitiveness, have emerged in both Hong Kong and Guangdong. These problems could be traced to the lack of countervailing forces that promote far-sighted strategies, vis-à-vis "short-termism" driven by market supplies and demands and yearly profit maximization.

In this paper, we argue that while better coordination should be pursued to ensure mutually beneficial developments and to avoid duplication in efforts and undesirable convergence in industrial structures, the future trajectories of the two economies will not and cannot be identical. Hong Kong and Guangdong are different in size and endowments, and face

dissimilar political and economic frameworks. Independent policies and measures to nurture specific advantages and to solve internal problems have to be made. Indeed, a certain distancing in economic relations between the two economies will be healthy.

## **II. China's open policy and structural change in Hong Kong**

A decade or so after 1978, the Pearl River Delta of the Guangdong province became an important hinterland of Hong Kong's manufacturing industries. This form of economic linkage between the two places has totally altered the development path of Hong Kong. In the 1960s and the 1970s, Hong Kong experienced a process of rapid export-led industrialization. A large labour-intensive manufacturing sector was established. In the second half of the 1970s, however, Hong Kong was troubled by the problems of rising costs, external market constraints, and the pressure of technological upgrading. The Hong Kong government, which had been proud of its commitment to economic *laissez faire*, realized that something had to be done. The Committee on Industrial Diversification was set up in 1977 with an objective to study what strategies Hong Kong should adopt to tackle the escalating problems.

Two years later, in 1979, the Committee submitted a report to the Hong Kong government. The timing was indeed ironical. As soon as China opened its door in the same year, the whole thinking about climbing the technological ladder and diversifying products and markets was de-railed. Literally unlimited supply of labour, asking wages at less than 10% of the on-going rates in Hong Kong, became available in southern China. Similar bargains existed in land, energy and other charges. Even without technological upgrading and industrial diversification, this new-found advantage was sufficient to propel the Hong Kong economy forwards for many years to come.

In retrospect, if China had not implemented the "open door" policy, Hong Kong might have been forced to go along the trajectory of technological upgrading of the other three "Asian Tigers" (Singapore, Taiwan, and South Korea). Instead, what has happened is a massive relocation of manufacturing industries to the Pearl River Delta and a further expansion of the labour-intensive industries. Up to now, 3 to 5 million workers in Guangdong are reportedly working directly or indirectly for Hong Kong, compared with the total work force of about 3 million in the territory itself.

The immediate implication of this "transformation" is the release of a great deal of manpower to other sectors. On the other hand, export processing of Guangdong has boosted the demand for Hong Kong's transport and trading services. Since the development of transport and other services of China has been lagging behind the rapid expansion of trading activities, China's reliance on Hong Kong to provide re-export and financial services has grown.

The industrial restructuring, or *de-industrialization*, of Hong Kong has proceeded with full force. In 1980, manufacturing accounted for 23.7% of GDP in 1980, while the service sectors took up 67.5%. In 1995, the former's share fell to 8.8% as the latter's rose to 83.8% (see Table 1). In terms of employment, Table 2 shows the dramatic changes. In 1980, the manufacturing sector employed over 900,000 persons. The number had fallen below 400,000 by

1995. That the manufacturing workforce of an economy could be halved within the horizon of a decade must be one of the records in world economic history.

To critics, however, it also reveals that employment in the territory has largely been non-sector-specific in nature. It reflects rather poorly on the skill level that has been required in the major sectors. To put it dramatically, anyone here can be a textile worker in one month, a salesman in another, and a property agent in yet another. This does not augur well for the long-run prospect of productivity enhancement, which requires specialization, professionalization, and accumulation of expertise in specific areas. It adds weight to the skeptical view that the Hong Kong economy is still ravelling in the bonanza of the China factor for cost reduction and "re-rating" by international investors and speculators. No serious efforts in industrial and technological upgrading have been performed.

**Table 1 Production-based GDP at current prices by economic activity**

	(unit: %)			
	1980	1985	1990	1995
Agriculture and fishing	0.8	0.5	0.3	0.1
Mining and quarrying	0.2	0.1	#	#
Manufacturing	23.7	22.1	17.6	8.8
Electricity, gas and water	1.3	2.6	2.3	2.3
Construction	6.6	5.0	5.4	4.9
Wholesale/retail, import/export trade, restaurants and hotels	21.4	22.8	25.2	27.4
Transport, storage and communications	7.4	8.1	9.5	9.8
Financing, insurance, real estate & business services	23.0	16.0	20.2	24.9
Community, social and personal services	12.1	16.7	14.5	17.1
Ownership of premises	8.9	10.5	10.6	12.7
Adjustment for financial intermediation services indirectly measured	-5.4	-4.6	-5.5	-8.0
	100.0	100.0	100.0	100.0

Source: Hong Kong Government, *Estimates of Gross Domestic Product 1961-1996*, Table 11.

Note: # - insignificant share.

**Table 2 Employment by Industry Group**

	(persons engaged)			
	1980	1985	1990	December 1995
Manufacturing	902,521 (46.5)	859,648 (39.6)	741,366 (30.1)	375,766 (14.9)
Wholesale/retail, import/export trades, restaurants and hotels	441,892 (22.8)	588,040 (27.1)	805,411 (32.7)	1,018,198 (40.6)
Transport, storage and communications	74,109 (3.8)	94,560 (4.4)	129,551 (5.3)	172,174 (6.9)
Financing, insurance, real estate and business services	123,883 (6.4)	177,346 (8.2)	270,610 (11.0)	378,244 (15.1)
Other industrial sectors	396,767 (20.5)	453,330 (20.9)	517,107 (21.0)	564,314 (22.5)

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Sources: *Quarterly Report of Employment, Vacancies and Payroll Statistics*, various issues.

Note: Figures in parenthesis represent percentage shares of the total.

### **III. The strengthening of the Hong Kong-Guangdong linkage**

In the opening up of China, it is natural that Hong Kong rapidly increased her linkage with the Guangdong economy, given the latter's geographical and sub-cultural proximity. Table 3 shows the relevant trade figures.

**Table 3 Imports and Exports of Hong Kong and Guangdong**

(Unit: US\$ 100 million)

	1992	1993	1994	1995
(1) Total exports of Guangdong	184.40	270.27	469.93	556.67
(2) Exports of Guangdong to Hong Kong	155.58	229.51	391.59	484.50
(3) (2)/(1)	84.4%	84.9%	83.3%	87.0%
(4) Total imports of Guangdong	111.79	198.98	342.70	381.67
(5) Imports of Guangdong from Hong Kong	82.68	155.40	254.40	303.17
(6) (5)/(4)	74.0%	78.1%	74.2%	79.4%
(7) Total Imports of Hong Kong	1237.07	1386.50	1603.47	1911.69
(8) (2)/(7)	12.6%	16.6%	24.4%	25.3%
(9) Share of Hong Kong imports from China	37.1%	37.5%	37.6%	36.2%
(10) Total Exports of Hong Kong	1194.88	1352.44	1500.02	1723.24
(11) (5)/(10)	6.9%	11.5%	17.0%	17.6%
(12) Share of Hong Kong exports to China	29.6%	32.3%	32.8%	33.3%

*Source: Guangdong Statistical Yearbook, 1994, 1995, 1996; Hong Kong Monthly Digest of Statistics, various issues.*

As can be seen from the table, China's shares in Hong Kong's imports and exports amounted to about one-third in 1992-94. Guangdong's shares, ranging between 7% and one-fourth, increased very fast during those years. Also, the figures indicate that as much as 70%-85% of Guangdong's imports and exports were transacted directly or indirectly through Hong Kong.

Apart from trading, investment across the border from either side also expanded tremendously. Hong Kong has been China's largest "outside" investor, contributing over 60% of the inflow of investment capital. At the end of 1993, a total of 167,500 foreign-invested enterprises (FIEs) were set up in China. Among them, 106,914 or 63.8% were from Hong Kong. Ranked in terms of the total number of foreign-invested enterprises attracted, the best-performing ten provinces in China were, from top down: Guangdong, Jiangsu, Shandong, Fujian, Zhejiang, Shanghai, Hainan, Liaoning, Beijing, and Tianjin. The number of foreign-invested enterprises in Guangdong amounted to 44,705, which represented 26.7% of the national total.<sup>1</sup> During 1990-94, the pledged and the actual amounts of utilization of foreign capital of Guangdong totalled US\$ 90.12 billion and US\$ 30.57 billion respectively. Of the amounts, Hong Kong constituted US\$ 71.42 billion (79.2%) US\$ 22.41 billion (73.3%) respectively.

On the other hand, mainland China's investment in Hong Kong has also been increasing at an impressive rate. As Table 4 shows, by 1994, China's cumulative stock of direct investments in Hong Kong accounted for about 18% of total foreign direct investments in manufacturing and non-manufacturing sectors and ranked third in value after the UK and Japan, followed by the US. The inflow of capital from Guangdong has been very important. In October 1994, the total market value of the shares of Guangdong Enterprises (Holdings) Limited, which was listed in Hong Kong's stock market, amounted to HK\$ 8.816 billion (US\$ 1.141 billion). On 30 November 1994, it became one of the component shares of the Hang Seng Index, reflecting its rising status.

**Table 4 Net Assets Attributable to Inward Direct Investments  
in Manufacturing and Non-manufacturing Sectors in 1994**

Major investor country	Manufacturing	Non- manufacturing	Total	Value (HK\$bn) % share
UK	2.97	203.1	206.07	28.2
Japan	14.74	136.4	151.14	20.7
China	4.23	129.8	134.03	18.4
US	11.80	75.9	87.70	12.0
Others	10.23	141.1	151.33	20.7
Total	43.97	686.3	730.27	100.0

Sources: Industry Department, Hong Kong Government, *1994 Survey of External Investments in Hong Kong*; Census and Statistics Department, Hong Kong Government, *External Investments in Hong Kong's Non-manufacturing Sectors*.

The rapid strengthening of the China-Hong Kong or Guangdong-Hong Kong economic ties has profound impact on Hong Kong. According to the estimation of the Economic Research Department of Hang Seng Bank, the contribution of the “China factor” to Hong Kong’s GDP rose from 5.3% in 1980 to 25.7% in 1990.<sup>2</sup> Given the trend of increasing linkage in recent years, the share probably has risen to over 30%.

#### **IV. Emerging problems in Hong Kong**

With the big push of the “China factor”, Hong Kong has sustained a respectable growth rate and experienced drastic changes in its economic structure. However, some problems are noteworthy. First, the growth rate has still been declining. In the 1970s, average annual growth in real terms of Hong Kong’s GDP was as high as 9.2%. In the 1980s, it was 7.5%. During 1990-95, it slipped to only 5.5%. One explanation of the declining growth rate often invoked is the slowing down of the growth of the labour force. The average annual growth of the local labour force in the 1970s and the 1980s was 4.2% and 1.7% respectively. During 1990-95, however, it actually revived to a yearly rate of 2.2%, as local demographic factors, returned migrants and increased in-takes from China generated relatively more labour supply.

If we scrutinise the issue more carefully, we can observe some worrying trends. The annual growth of per capita GDP in Hong Kong during 1980-89 averaged 5.5%. It fell to 3.8% in 1990-95. If we further examine the statistics of GDP per worker, we find that the respective growth rates in the two periods were 5.7% and 3.3%. These figures suggest that, *prima facie*, there have been some problems with Hong Kong’s productivity. The Hong Kong economy should not have become “mature” so quickly.

The availability of cheap labour from Guangdong has no doubt helped Hong Kong's manufacturing industries to lower production costs. It has also, ironically, alleviated the pressure for Hong Kong to upgrade technology and to improve productivity. As a sudden widening of the hinterland leads to a drastic reduction of labour and related costs, the incentives to invest in R&D and to adopt advanced techniques can hardly become visible. This is particularly true when short-term profits are huge and the authorities are not taking any pro-active measures to induce long-term optimality.

In a way, the Chinese reform has rendered Hong Kong's consideration to upgrade its industry superfluous. To Hong Kong, it is similar to an unexpected discovery of a new gold mine or an oil field. How to make use of the "windfall profit" of such a discovery is crucial. If the "windfall profit", for instance, is not used for reinvestment in productive activities that can raise Hong Kong's long-term advantage, but instead channelled into the pursuit of further short-term profits, asset inflation and consumer inflation will then accelerate. As a result, operation costs in Hong Kong will be pushed up. The sectors that cannot generate "windfall profit" in the short run (e.g. high-tech industries in their formation stages) will encounter heavy pressure and eventually be crowded out. The economy will inevitably suffer from the phenomena of "hollowing out" or the "Dutch Disease".<sup>3</sup>

Whether "hollowing out" or the "Dutch Disease" will occur or has already emerged in Hong Kong is debatable. In any case, there are some noteworthy trends. First, it appears that Hong Kong manufacturers have not used the huge profits that have been earned in Pearl River Delta for investment in technological upgrading. The profits are either used for "extensive expansion", that is, building more factories of the same (or even somewhat lower) technological level in cheaper localities in southern China, or repatriated to Hong Kong for investment in non-manufacturing or even non-productive, speculative, activities.

Conventional wisdom has it that the Hong Kong economy has undergone a "structural transformation" towards higher status: namely from a manufacture-based to a service-based economy, presumably with larger value-added. Such a characterization is in our view misleading. In the textbook case of development economics, such a transformation is a result of technological enhancement and a rise in productivity. In the process, human as well as other resources in the traditional sector are released and allocated to the growing sector. The development of the latter in turn further facilitates the productivity growth of the traditional sector. A virtuous circle will thus be formed, with falling employment in the traditional sector and rising employment in the leading sector.

The so-called structural transformation of the Hong Kong economy is quite different from this kind of upgrading. What has happened is more a change in the regional division of labour and some of its derived consequences. Originally, the mobility of resources (particularly labour and capital) between China and Hong Kong was very low. Once China adopted the open-door policy, most of the barriers to resource flows were lifted. The new mode of division of labour, often called *qian dian hou chang* (the shop at the front, the factory at the back), thus emerged. Obviously, Hong Kong is the *dian* (shop), and southern China is the *chang* (factory). Since production costs differ a lot across the border, a large amount of benefits can be reaped from the simple relocation of industries by both sides. This simply reflects the operation of the law of static comparative advantage.<sup>4</sup>



The side-effect is however a significant *reduction* in the pressure on technological upgrading. The technological sophistication of Hong Kong's manufacturing industries (including their off-springs in the Pearl River Delta) has been lagging behind their competitors in South Korea, Taiwan, and Singapore. What Hong Kong is still relying on is low production costs in its hinterland.

Moreover, Hong Kong has been faced with the problem of "relatively low growth and relatively high inflation" in recent years. Real economic growth has been about 5%, but the consumer inflation rate has been double-digit or close to double-digit for quite some time. As for asset inflation, the situation has been worse. During 1991-93, the prices of residential property rose more than one time. It did not fall until the government introduced a series of measures to cool down the market in early 1994. In any case, the prices and the rental rates of real estates in Hong Kong are among the highest in the world. Certainly, with the upward trend in China's economic power and international status, Hong Kong as a stepping stone is still an attractive site to invest. Even Chinese capital has been flowing into Hong Kong in huge amounts. All these phenomena have contributed to Hong Kong's high inflation; and the ways that Hong Kong businessmen have utilized their "windfall profit" have also added to the price pressure. The rising price level then serves to push up production costs and crowd out unprofitable industries in the short term. Even the profits of the service sector have been eroded. Some of the services have been moving northwards or outwards.

Third, Hong Kong has witnessed a worsening distribution of incomes. Table 5 shows some relevant figures.

**Table 5 Changes in household income distribution in Hong Kong**

Income group	Income share (%)					
	1971	1976	1981	1986	1991	1996
Lowest quintile	6.2	5.4	4.6	5.0	4.3	3.7
2nd quintile	10.2	10.1	9.8	9.8	9.0	8.2
3rd quintile	14.3	14.9	14.3	14.0	13.5	12.7
4th quintile	20.0	20.1	20.9	20.5	20.4	19.1
Highest quintile	49.3	49.5	50.4	50.7	52.8	56.3
Total	100.0	100.0	100.0	100.0	100.0	100.0
Gini coefficient	0.43	0.43	0.451	0.453	0.476	0.518

Seen from changes in the quintile distribution of income and the Gini coefficient, there has been a secular trend of increasing inequality. The situation worsened notably during 1986-96. Indeed, Hong Kong's distribution of income is the most unequal among the countries/areas of similar development levels.<sup>5</sup> The reasons are manifold. First, as the income distribution in the service sector is more dispersed, an increase in Hong Kong's inequality is in a way "natural" in its move towards a "service economy". On the other hand,

although the economic ties between Hong Kong and China have benefitted both sides, the distribution of the benefits among recipients is highly uneven. The major beneficiaries have been the Hong Kong enterprises which have invested in China, followed by local authorities, enterprises and workers in Guangdong. As to employees in Hong Kong who work in sectors that do not have close ties to China, they have not benefitted much from the process of economic link-up. Moreover, many in the affected sectors (e.g. mid-aged skilled manufacturing workers who have been replaced by their much cheaper counterparts further north) have been disadvantaged and have suffered from a fall in real incomes, or outright unemployment.

## **V. Economic development and resource flow in Guangdong**

Guangdong's economic performance since the launch of the open policy has been very impressive. During 1979-93, Guangdong's GDP registered an annual average growth of 13.9% in real terms, much higher than the national average of 9.3%. Apart from the efforts of Guangdong itself, the central policy of letting Guangdong "go one step ahead of other provinces" as well as the geographical proximity factor (lying along the coast and neighbouring Hong Kong) have also helped.

Similar to the case of Hong Kong, China's open policy has facilitated resource mobility and regional division of labour between Guangdong and other places in the country. The only difference is that while Hong Kong has moved factories to Guangdong to make use of its cheap labour, Guangdong has instead absorbed a large amount of labourers from other provinces. In the early 1990s, according to estimates, the labourers coming from other provinces to work in Dongguan and Baoan totalled 1.4 million.<sup>6</sup> Some other reports say that there are already over 10 million "outside" workers in Guangdong, although more official sources put the figure at 7-8 million. Thus, Hong Kong has exported factories, capital, technologies and outside connections to Guangdong. At the same time, Guangdong has imported labourers from other provinces, many of which are working in Hong Kong-invested plants.

As far as labour is concerned, Hong Kong is more reliant on Guangdong than Guangdong is on other provinces. A popular estimation of labourers working in Hong Kong-invested factories in Guangdong is about 3 million, which is already larger than the total labour force in Hong Kong. From another angle, total employed labour in Guangdong amounted to 34.3391 million in 1993.<sup>7</sup> If the report of 10 million "outside" workers in Guangdong is accurate, the share of "outside" worker in total employment is significant, but not to the extent of Hong Kong's external reliance.

Besides, taking "first mover" advantage and making use of its special status, Guangdong has absorbed quite a significant amount of capital and investment from other provinces, which has contributed to its economic growth. One key piece of evidence is the change in the deposit-loan gap in Guangdong's banking system. At the end of 1985, bank loans exceeded deposits by Rmb 19.482 billion, equivalent to 64.1% of total deposits. In end-1990, the gap fell to Rmb 12.602 billion, or 11.0% of total deposits. More notably, outstanding loans became less than deposits in Guangdong's banking system since April

1991 onwards. For the whole financial system in Guangdong (including all non-bank financial institutions) as a whole, total loans have been less than total deposits since June 1991. At the end of 1992, deposits in the banking system exceeded loans by Rmb 56.304 billion, the gap representing 23.7% of total deposits. This change reflects not only the increase in the available capital in Guangdong itself, but also the inflow of capital from other provinces.

Nevertheless, the supply of outside capital to Guangdong does not seem to have been very stable. After China had adopted the macro-control measures in mid 1993, large amounts of the “hot money” in real estates, stock and futures markets were withdrawn. Tens of billions yuan were repatriated back to their home provinces. The financial situation of Guangdong deteriorated dramatically. Deposits declined sharply, giving rise to some liquidity problems. At the end of 1993, the positive deposit-loan gap in Guangdong’s banking system fell to Rmb 24.839 billion, which was only 10.0% of total deposits (compared with 23.7% a year ago). The situation did not stabilize until the second quarter of 1994.

On the whole, the rapid economic development of Guangdong after 1979 has been a result of a large increase in factor mobility. A huge amount of short-term profits has been generated by this kind of factor mobility. How to consolidate the development and to derive reliable long-term advantage will be a big challenge to Guangdong in the future.

## **VI. Characteristics and problems of Guangdong’s economic structure**

Similar to Hong Kong, the impressive economic growth record in Guangdong has arisen from a regional relocation of resources, more than genuine technological upgrading. Short-term benefits, therefore, coexist with potential long-term difficulties. The problems, moreover, are largely structural in nature.

First, on the whole, the external linkage of Guangdong is much stronger than its internal linkage. In other words, the industrial sectors inside Guangdong have rather weak inter-connections among themselves. There has been little coordination of production amongst various sectors inside the province. Production in various sectors in fact is predominantly dictated by the external market. On the basis of the input-output table of Guangdong in 1987, it has been estimated that the multipliers of the industries (the increase in the output of the whole economy resulting from one dollar's increase in the output of a particular industry) in Guangdong only ranged from 2.3 to 3.2, which implies a rather loose linkage between the industries.<sup>8</sup>

Second, there has been a convergence in the output structure of various production centres in Guangdong. The implication is that cities and townships in the province are increasingly engaged in similar production activities (in particular labour-intensive export processing), with little division of labour and coordination. Table 6 lists the results of a comparative study of the functional structures of cities in some major provinces in China conducted by Dai Hezhi, a geographer from Shandong. Eleven economic functions, measured in terms of per capita output values of specific sectors, are examined. A city is said

to be specializing in one function if its per capita output value of that function is higher than the provincial average. If a city is found to be specializing in more than one functions, the function with the highest above-average output value will be chosen. Moreover, the designated specialized function must rank in absolute output terms among the top four in the city. If a city does not have any specialized function, it is then classified as a “general city”.

**Table 6 A comparison of the economic functions of cities in major provinces in China**

Economic functions	Shandong		Liaoning		Jiangsu		Zhejiang		Hebei		Guangdong		Henan		Sichuan	
	N	P	N	P	N	P	N	P	N	P	N	P	N	P	N	P
Mining	2	5.9	3	15.0	2	7.7	1	4.0	3	13.0	1	5.3	4	15.4	2	8.7
Electricity	2	5.9	1	5.0	2	7.7	1	4.0	2	8.7	1	5.3	1	3.8	2	8.7
Metallurgy	1	2.9	2	10.0	1	3.8	2	8.0	2	8.7	0	0.0	3	11.5	1	4.3
Petro-chemical	2	5.9	4	20.0	2	7.7	2	8.0	2	8.7	1	5.3	1	3.8	2	8.7
Construction material	0	0.0	1	5.0	3	11.5	1	4.0	1	4.3	1	5.3	2	7.7	3	13.0
Machinery and electronics	4	11.8	1	5.0	2	7.7	3	12.0	1	4.3	1	5.3	2	7.7	5	21.7
Textiles	4	11.8	2	10.0	5	19.2	4	16.0	2	8.7	2	10.5	3	11.5	2	8.7
Paper-making	1	2.9	1	5.0	0	0.0	0	0.0	0	0.0	1	5.3	1	3.8	1	4.3
Foods	2	5.9	0	0.0	1	3.8	2	8.0	2	8.7	2	10.5	4	15.4	4	17.4
Transport, postage and telecommunications	1	2.9	0	0.0	1	3.8	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0
Commerce and catering	0	0.0	1	5.0	0	0.0	0	0.0	0	0.0	1	5.3	1	3.8	1	4.3
General cities	15	44.1	4	20.0	7	26.9	9	36.0	8	34.8	8	42.1	4	15.4	0	0.0

Notes: N represents the number of cities and P the percentage share in the total number of cities.

Source: Dai Hezhi, "A study of the structure of the city system in Shandong," *Jingji dili* (Economic Geography), Vol.14, No.2, 1994, p.29. The results are computed with figures published in *Zhongguo chengshi tongji nianjian 1991* (China Statistical Yearbook of Cities 1991).

As shown in Table 6, among the 19 cities in Guangdong, eight or 42.1% are “general cities”. The share is the second highest among the eight provinces under examination. It is just below the 44.1% of Shandong, the province with the least specialized functions.

Another simple indicator that can show the convergence in the output structure of various Guangdong cities is the index of regional divergence used by Paul Krugman, which is defined as:

$$\sum_i |s_i - s^*|$$

where  $s_i$  is the share of industry  $i$  in the total manufacturing output of a city and  $s_i^*$  is the share of industry  $i$  in the total manufacturing output of the whole Guangdong province.<sup>9</sup> The index ranges from 0 to 2 and a higher value indicates a bigger difference between the average (provincial) output structure and that of the city under investigation. If, on average, the manufacturing structure of the cities has become closer to the average (provincial) structure, we can say that there is a convergence in the structure. Here we utilize the data of 40 manufacturing industries in 18 Guangdong cities (prefectures) to determine whether there had been a convergence or a divergence of the manufacturing structure between 1988 and 1994.<sup>10</sup> As shown in Table 7, out of the 18 cities, nine registered a decrease in the index of regional divergence. The average of the index for the 18 cities decreased from 0.713 to 0.663, implying an increase in the convergence of the output structure.

The problem of the convergence in the output structure probably has not been fully reflected in the above index, as it is based on aggregate data of forty industries. Anecdotal reports show that the duplication of the investments in some specific industrial products has been very serious in the Pearl River Delta. For instance, most cities have their own production factories for air-conditioners and there are a total of 30 such factories in the Pear River Delta. On the other hand, there are 250 cement factories in the Delta, 86% of which have small production capacity of less than 200,000 tons. As for the automobile industry, as many as 97 enterprises had been established by the end of 1993. There has been little coordination among the cities in the development of these industries.<sup>11</sup>

**Table 7 Index of regional divergence**

	1988	1994
1 Guangzhou	0.391	0.385
2 Shenzhen	0.751	0.754
3 Zhuhai	0.686	0.484
4 Shantou	0.522	0.613
5 Shaoguan	0.923	1.007
6 Heyuan	1.000	0.751
7 Meizhou	0.702	0.765
8 Huizhou	0.670	0.700
9 Shanwei	0.978	0.695
10 Dongguan	0.580	0.546
11 Zhongshan	0.540	0.448
12 Jiangmen	0.435	0.469
13 Foshan	0.505	0.587
14 Yangjiang	0.878	0.806
15 Zhanjiang	0.662	0.731
16 Maoming	1.152	0.949
17 Zhaoqing	0.542	0.522
18 Qingyuan	0.908	0.714
Average	0.713	0.663

The weak internal linkage and the low level of specialization in Guangdong are not necessarily a bad thing. This kind of phenomena may merely reflect the openness of Guangdong. With a strong outward linkage, Guangdong needs not worry much about the internal division of labour. By responding promptly to external market signals, huge profits can already be earned. The operational mode of “the shop at the front, the factory at the back” in the Hong Kong-Guangdong linkage has been a major factor leading to this structure of “strong external linkage, weak internal linkage, and low specialisation”. Moreover, in the process of export-oriented labour-intensive industrialisation, Guangdong's competitiveness has largely been based on low production costs and preferential policies from the central government. Within a certain period of time, coordination of internal production was therefore not relevant.

Yet, there are doubts whether this kind of external linkage can be relied on as the only momentum of growth for very long. The pertinent questions are: should the mode of external linkage (the shop at the front, the factory at the back) be upgraded? If yes, in this process of upgrading, should internal linkage and coordination of production within Guangdong be strengthened? Should regional division of labour and cooperation be promoted and improved?

The last question brings us to the third structural characteristic of Guangdong's economic development: regional imbalances. In 1978, the gross value of industrial and agricultural output of the Pearl River Delta constituted 32.7% of the provincial total. The share rose to 57.6% in 1990 and 68.7% in 1994. In contrast, the share of the mountainous areas, which constitutes 60% of total land area and 40% of total population, fell from 16% to 13.4% during 1978-1990.

Interestingly, the share increased to 15.6% in 1994. Whether this was the result of a shift in government policy to alleviate inequality has to be scrutinised. The per capita figures, on the other hand, show an unambiguously rising inequality. Per capita GDP of the Pearl River Delta was Rmb 1106.4 higher than that of the mountainous areas in 1985. The gap widened to Rmb 2281.5 in 1990 and further to Rmb 12500 in 1994. During the same period, the difference between the average per capita savings deposits rose from Rmb 548 to Rmb 2254 and then to Rmb 3135. One apparent cause of the imbalances has been the uneven allocation of resources. According to the figures of the regional lending of the five major banks and the rural credit cooperatives in Guangdong provided by Han Houyuan, the share of loans provided to the Pearl River Delta increased from 57.94% in 1978 to 68.67% in 1989, while the share for the mountainous areas declined from 14.27% to 12.52%.<sup>12</sup>

This kind of regional imbalances is related to Guangdong's peculiar development path. As external linkage is the major engine of growth, those areas that have poor endowments and unfavourable geographical locations are not attractive to outside investors. Relatively low /economic growth thus results. On the other hand, because of very weak internal linkage, the development of the relatively rich areas could not have benefitted the poorer areas, as both forward and backward linkage effects across different regions within the province have almost been absent.

## **VII. Guangdong's troubles in 1996: A warning for Hong Kong?**

Before the authorities could implement any effective measures to redress these structural problems, the Guangdong economy suddenly faced serious difficulties in 1996, which many regarded as the worst year for the province since the Chinese economic reform began in 1978.

The situation was particularly bad in the first half of 1996: Guangdong's GDP growth, at 9.7%, was below the national average of 9.8% (a rare phenomenon in the reform period);<sup>13</sup> so were industrial production (11.1% for the province versus 15.2% for the country as a whole), retail sales of consumer goods (17.9% versus 21.3%) and fixed asset investment (5.3% versus 16.5% in the first 4 months). The trade front was even more critical: Guangdong's exports in the first six months fell by more than 20% compared with the same period in 1995.<sup>14</sup>

The situation improved somewhat in the second half of 1996, but still the whole year was a big let down by the province's standard. GDP growth was 10%, only slightly higher than the national average of 9.7%. That was a far cry from the average performance in the preceding seventeen years (1979-1995), when Guangdong grew by an average rate of 14.2%, compared with the national average of 9.8%. The province's inflation rate in 1996 was 4.4%, lower than the nation-wide 6.1%---an indication however of sluggishness more than economic balance. Other discomfiting figures are that industrial production expanded by only 16% for the whole year (compared with the average of 33% in 1991-1995), while exports, after the depression in the first half, managed with a meagre 4.9% increase.<sup>15</sup>

Moreover, serious problems have persisted. The number of unemployed was widely estimated to have risen by 700,000 in 1996, bringing the unemployment rate to 3%, although the official records put them at 650,000 and 2.2% respectively.<sup>16</sup> Urban income grew by less than



2.4% in real terms, in sharp contrast to the double-digit rates in the preceding years.<sup>17</sup> Another key concern is the property sector: backlog developments amounted to nearly Rmb100 billion and would take several more years to digest.<sup>18</sup> The factors might continue to constrain the economy.

It is too early now to pass a definitive assessment of the causes of the troubles in 1996, but several prominent explanations stand out. The structural problems that we discussed in the last section are obviously important. Given the lack of internal division of labour and the tendency towards duplication and convergence, any external shock would have generated serious depressing effect on the whole of the province, as it would have spread equally fast across all localities which were structurally similar. A more diversified structure could obviously have been more robust in withstanding adversity.

The situation has been aggravated by the prevailing investment patterns in the 1990s: mainly on infrastructure (57% of the total) and property development (18%); while technical renovation and transformation (which would have enhanced productive efficiency) only took 11%. In a way, this has been a result of Guangdong following too closely the example of Hong Kong in “modernization”, concentrating on grand infrastructure and paying insufficient attention to economic fundamentals. Moreover, there has been the problem of “economic warlordism”, where different cities and counties have strived to do the same things without or resisting central coordination, i.e. structural duplication in infrastructure as against that in production, which we discussed above. This has led to a decline in investment efficiency (output/investment ratio). In the Eighth Five-year Plan (covering 1991-1995), investment efficiency for the whole of China increased by 19.1%, while that in Guangdong declined by 10.6%. Not surprisingly, the other side of the coin has been rising production and servicing costs, which have eroded the province’s competitiveness within and outside China.<sup>19</sup>

These longer-term factors would not have produced a major upset without short-term policy and environmental shocks. A key consideration has been that of the loss of special advantages for Guangdong, with the opening up of the whole country after the “Deng whirlwind” in 1992. The “first-mover” status of the province was rapidly eroded in the following years. Indeed, the central government has been keen in promoting Shanghai and the Yangtze Delta as a new growth area and in curbing the Guangdong’s excesses in exploiting its preferential policies. The macroeconomic reforms of 1994, which covered the fiscal, foreign exchange, and financial systems went a long way in creating a “level playing field” for the country and enhancing the controlling power of Beijing.<sup>20</sup>

It appears that both long-term and short-term causes converged in 1996 to produce a notable downward pressure on Guangdong in 1996. Of course, a 10% real growth could hardly be regarded as a disaster. In any case, the warning signal was loud and clear. Guangdong could not afford to be complacent. In so far as Guangdong’s economic development had been driven by Hong Kong to a significant extent, at least up to the recent past, Hong Kong must also take note that without efficiency enhancement and a balanced economic structure, adversity could produce surprisingly harsh results.

### VIII. Future development strategies of Hong Kong and Guangdong

As regards the future, both Hong Kong and Guangdong face a similar set of questions: How to re-invest the “windfall profits” earned in the past decade in a way that can benefit the most the future development of the economy? How to convert short-term and static advantages into long-term and dynamic advantages? During the process of change, how to contain or alleviate problems and negative side-effects that have arisen from structural imbalances?

There are two mostly likely future trajectories for the Hong Kong economy: (1) Continue the “de-industrialization” process, without caring about the phenomenon of “hollowing out”, and allocate more resources in the development of the financial and service sectors. In this way, Hong Kong will develop into a world-class financial centre similar to New York and London. We have coined the term “Manhattanization” for this process.<sup>21</sup> (2) Follow a development strategy that emphasizes both financial services and manufacturing industries with higher value-added and technological content. This requires the investment of the short-term profits from the China bonanza into the manufacturing sector to upgrade technologies and to develop new industries. Singapore and, to a less extent, Shanghai and Greater Tokyo, are successful examples of metropolises with industries. Obviously, the current trend in Hong Kong is to go along where “quick money” can be earned, i.e. down the first road of “Manhattanization”. To switch to the second trajectory, a good deal of efforts, buttressed by long-term vision and courage, on the part of the private sector as well as the government, is needed, which lamentably may be lacking around the 1997 political transition.

Down the path of Manhattanization, the problems that we discussed in section IV above, de-industrialization, lack of technological progress, inflation, worsening inequality etc., would tend to aggravate in Hong Kong. Moreover, as the Chinese economy starts to take off, Hong Kong may have to undergo further “structural transformation” to keep ahead of other competing cities and regions in China, in particular Shanghai. In the end, the territory could be forced into a peculiar mode of specialization, under which only activities of “high-risk, high-returns” find it viable to be based here. The trouble is that a limited proportion of the local population can engage profitably in these activities. Structural unemployment may replace labour shortage as a headache. Ironically, Hong Kong will then be even more “Manhattanized” under such a scenario, as de-industrialization becomes total, financial wizardry dominates, and the ugly reality of poverty in the midst of affluence surfaces. The social consequences could be daunting.<sup>22</sup>

Some would argue that even total de-industrialization of Hong Kong is nothing to worry about. Why is it necessary for Hong Kong to have any manufacturing industries at all, while New York does not have such industries, nor does London or Paris? The answer is simple: because Hong Kong, unlike these metropolises in relation to their home country, is supposed to be a separate economic system from the Chinese one under the Joint Declaration and the Basic Law. After 1997, Hong Kong will continue to issue an independent currency, keep its fiscal autonomy, and determine its own migration policy. So in theory the Hong Kong economy cannot be *fully* integrated with the Chinese counterpart because there will not be totally free flows of monetary, fiscal and human resources across the border. The Hong Kong economy must maintain her own *coherence*.

Hong Kong residents cannot migrate to Guangdong in the same way as US citizens move from New York to California. Hence, any local structural unemployment cannot be easily solved by an expedient transfer of human resources to the north. In the case of a fiscal or a balance-of-payments crisis, Beijing is not supposed to come to our rescue, at least not directly. We also have to look after our own inflation and distribution problems. In a nutshell, Hong Kong is a very special case of regional economics.

As a service economy, Hong Kong faces possible contraction in the internal and external demands for its services. Due to the rise of a number of service centres in China, including Shanghai, Guangzhou, Shenzhen, Zhuhai etc., Hong Kong is under some pressure, particularly as it has been criticized as being too expensive by Chinese sources (see below). However, and this brings us back to Manhattanization again, Hong Kong in the ultimate analysis still has an edge over these competing cities because of its systemic advantage as a capitalist economy (guaranteed for 50 years) vis-à-vis the "socialist market economy" of Shanghai and the like. There must be some financial and related activities which would be regarded as outright "speculative" or "non-productive" by China, which the latter would not want to engage in and for which Hong Kong would excel. In this sense, socialist China would still have to depend on capitalist Hong Kong. We can already observe that Hong Kong is taking a lead in the so called "derivatives revolution" in finance over China. This reinforces our argument that the territory may in the end be shifting into a peculiar mode of specialization that focuses on activities of a very "high-risk, high-returns" nature, under which structural employment could emerge as a problem.

As to internal demand for services, Hong Kong down the road of Manhattanization is likely to be constrained by the trend of widening income inequality (see Table 5 above). It is well established in Marxian as well as Keynesian economics that an expanding income gap would harm average consumption as the rich show a much lower marginal propensity to consume than the poor. A concentration of money in the former's hands inevitably results in weak sales of normal goods; and in the extreme, leads to an "underconsumption crisis". As a small open economy, Hong Kong still would not be exempted from such a crisis, as domestic demands for non-tradables (food, housing, transportation etc.) are key pillars of the economy. Weak retail sales in Hong Kong for the past few years have alerted many to such a possibility, although again both cyclical and long-run factors have been at work.<sup>23</sup>

Hong Kong probably could learn more from the experience of city economies that aspire to maintain a balance between industry and service, such as Singapore and Shanghai. Singapore has even set a lower limit for the share of manufacturing in GDP at 25% (Hong Kong already went down to 8.8% in 1995, as Table 1 shows); and Shanghai has unveiled ambitious plans to develop high-tech industries on its outskirts. So perhaps instead of becoming the "Manhattan" of southern China, Hong Kong should serve as its "Singapore" or "Shanghai". A possible mode of operation for Hong Kong's industries is the combination of China's capabilities in technological R & D with the territory's expertise in design, packaging, and commercialization. Genuine efforts need to be made to climb the technological ladder and to maintain a viable industrial base, which will bring long-run benefits. It is foolhardy to abandon short-run comparative advantage. Trading and service sectors should no doubt be further promoted, but not one-sidedly. In any case, a balanced strategy like this can only be implemented through conscious effort by the

authorities with regard to macroeconomic and microeconomic policies, as well as cooperation by the Chinese enterprises and the local private sector.

In the recent past, the Hong Kong government seems to have become aware of the pitfalls of complete de-industrialization and letting short-termism prevail. It has put some money into providing matching grants for private sector R & D; establishing technology centres, and most notably, embarking on the construction of a "science park". Without much fanfare, these moves represent a shift from the hands-off attitude of the past (which was often pronounced, but not strictly followed anyway). Whether these moves will have any significant effect on the development of the Hong Kong economy, we can only wait and see.

As far as Guangdong is concerned, Manhattanization was not and never will be an option. With a population of about 70 million, more than 10 times the size of Hong Kong, Guangdong cannot sweep aside manufacturing industries, or even agriculture (lest huge imports, from other provinces or outside the country, will drain provincial resources heavily). On the other hand, services have no doubt been underdeveloped in Guangdong, in a relative sense at least, because of the traditional socialist bias and the rapid rise in living standards that raises demands. Overall, Guangdong has to maintain a more balanced economic structure among the primary, secondary, and tertiary sectors, compared with Hong Kong.

In 1978, the ratio among the three sectors in Guangdong was 29.9 : 46.4 : 23.7; then it changed to 17.3 : 50.4 : 32.3 in 1993.<sup>24</sup> The surge of manufacturing industries in the province has been remarkable, but these industries have been troubled by two key problems: (1) Their technological level was not high; and (2) There was an acute imbalance in sectoral structure, with the raw material and energy sub-sectors lagging seriously behind, thus constraining the improvement in overall efficiency.

Even under the one-sided outward orientation of the Guangdong economy in the past, some notable difficulties already emerged. One classic example is the province's foreign exchange imbalance in 1993. On the basis of customs statistics, Guangdong's exports in the year totalled US\$27.03 billion while imports amounted to US\$19.90 billion, hence producing a trade *surplus* of US\$7.13 billion. However, according to an article on *Guangdong jinrong*, actual foreign exchange receipt from exports turned out to be only US\$7 billion whereas the actual usage of foreign exchange for imports was US\$10.4 billion. So a *deficit* of US\$3.4 billion resulted, and "had to be solved by going through the swap centres".<sup>25</sup> The deviation of the trade-related foreign exchange balance from the recorded trade balance is well known in China because of various forms of leakages and statistical discrepancies.<sup>26</sup> Nevertheless, the very low receipt rate from exports (only 26%), compared with the import utilization rate of 52%, was striking even by Chinese standards.

The low receipt of foreign exchange from exports reflects the outward nature of the Guangdong economy as a large number of foreign-invested enterprises uses the province as an outward processing zone, with the result that the ratio of value-added accrued to Guangdong remains small. Imports of agricultural produces, raw and semi-processed materials and other industrial products, on the other hand, continue to drain valuable financial resources from the province.

The cold reality is that Guangdong faces difficulties even in balancing its foreign exchange under the operational mode of "shop at the front, factory at the back". Therefore, Guangdong must apparently do two things: (1) enhance the value-added of its production; and (2) develop a more balanced industrial structure with a higher degree of internal linkage and coordination.

The Guangdong authorities appear to have been aware of these problems. With a series of policy statements and measures announced in the past few years, the province has actually embarked on a course of economic upgrading, that is in marked contrast with the "liberal", "non-interventionist" stance of the Hong Kong government. An industrial policy has emerged in the province, under which strategic industries including petro-chemical, automobile, electronics, metallurgy, construction material, textiles and drugs are targetted for promotion. On the other hand, a plan for regional division of labour with the province has also been nurtured, with the western region specializing in raw material, energy and heavy industries and the eastern region focussing on light and consumer goods industries. The centre, in particular Guangzhou, would spearhead the effort to develop services.<sup>27</sup>

This newly emerging economic strategy is encouraging, but its concrete implementation would certainly require more than just official pronouncements. What is needed is a more rational structuring of both industrial and locational patterns within the province, with a view to promote internal linkage, division of labour and cooperation as well as technological upgrading. Moreover, structural duplication and wastage of resources must be minimized, especially with regard to infrastructural developments, a hot issue in the 1990s.

## **IX. The future mode of economic linkage of Hong Kong and Guangdong**

Obviously, the economic linkage between Hong Kong and Guangdong should be upgraded in the future. Instead of continuing the old mode of "the shop at the front, the factory at the back" operating at a more or less stagnant technological level of "the shop", a new mode of multi-sphere and multi-dimensional interfaces and cooperation is needed. Greater effort should be spent on creating long-term competitive advantage.

No matter what development paths Hong Kong and Guangdong will follow and no matter what changes in the economic structure will take place in the two places, improvement in infrastructure will be a crucial factor determining the rate of growth. In the 1980s, Guangdong to a very large extent had made use of Hong Kong's infrastructural facilities to conduct external trade, as shown in Table 3 above. Into the 1990s, like other provinces, Guangdong has emphasized the construction of infrastructure so as to relieve the bottleneck sectors and to sustain high economic growth. On the other hand, if Hong Kong is to develop further, infrastructural facilities have also to be strengthened. One problem that has emerged is that in order to be cost effective and efficient, infrastructural constructions in Hong Kong and Guangdong, including airports, ports, highways, railways, energy and environmental protection projects, should be coordinated.

Owing to the lack of vision on the part of Hong Kong government and Sino-British conflicts over 1997, the construction of some important infrastructural facilities (particularly the

new airport, additional container terminals and related transport systems) has been delayed in Hong Kong. Hence, Hong Kong is in the danger of failing to satisfy the fast-growing demand from China in general, and from Guangdong in particular. Seen from this angle, Guangdong should no doubt expand its own capacities in airports, ports, railways and even water transport, so as to reduce its reliance on Hong Kong.

Another factor is of course the surging charges of re-exports and voyage services in Hong Kong. According to an analysis of China's General Customs, total profits earned by Hong Kong businesses (including Chinese and foreign companies registered in Hong Kong) from serving re-exports to and from China rose from US\$5.4 billion in 1980 to US\$14.5 billion in 1993. The average gross profit margin thus rose from 21% to 31%.<sup>28</sup> Other studies also point to some worrying statistics. For example, the handling fee for one container ranges from HK\$1200 to HK\$1800, which is 5 to 7 times that of the normal fee in Mainland China, one-third to one half higher than that charged by Singapore, and double that of Kaohsiung in Taiwan.<sup>29</sup> The underlying cause is not just the imbalance between supply and demand, but also the existence of market power among the small number of operators in Hong Kong. Even if Hong Kong speeds up the construction of infrastructural facilities in the future, re-exporting charges are unlikely to fall, unless China and other places can generate effective competition.

To this, there could be two entirely different kinds of response. The first one is an insensitivity to the situation. The traditional mode of planning and construction of transportation system in the 1980s could still be followed - with major routes all pointing from north to south, converging to Hong Kong. The underlying assumption is that Hong Kong should still be the major port for Chinese imports and exports in the future.

Another kind of response is a large scale of "diversion" of the congested transportation system in Guangdong. In the euphoria after the "Deng whirlwind" of 1992, various localities have been striving to build their own airports, railways, ports, highways, voyage and communication facilities, often with minimal coordination among themselves. Taking airports as an example, as pointed out by Professor Zheng Tianxiang of Zhongshan University, the new airports in Hong Kong, Guangzhou, and Shenzhen all have an ultimate annual capacity of 80 million person-times, while the airports of Zhuhai and Macau have a designed annual capacity of 1.2 million and 8 million respectively. Besides, there is the extension or establishment of airports in Foshan, Weizhou, Xianning and Jiangmen. Therefore, eventually, nine airports will thrive in the Pearl River Delta, with a total annual capacity of 280 million person-times, which will be about 9 times of the projected population in the region. In contrast, the Kai Tak International Airport of Hong Kong had a total capacity equivalent to only 4 times of the population in the territory in 1993. Whether there is sufficient demand to support all the nine airports in the future is a big question.<sup>30</sup>

Obviously, both types of responses are inappropriate. To be cost-effective, there should be coordination in the construction of infrastructural facilities between Hong Kong and Guangdong and within Guangdong itself, so as to avoid duplication and waste on the one hand, and to make use of economies of scale and to enhance efficiency on the other.

As for the issue of technological upgrading in industries, cooperation between Hong Kong and Guangdong will probably not be at a very high level. As discussed above, the choices

facing Hong Kong are either (1) "Manhattanization" or (2) the "combination of financial services and high value-added manufacturing industries". The technological upgrading of Guangdong will, in theory, induce Hong Kong to follow the second path. However, as discussed above, the industries that Guangdong is planning to develop include petrol-chemical, automobile, electronics, metallurgical, construction material, textiles, and pharmaceutical industries etc. Among them, Hong Kong has some advantage only in electronics, textiles and perhaps construction material. Hong Kong's industrialization was traditionally based on light industries. Thus, to promote the industries it has targetted, Guangdong should go beyond just cooperation with Hong Kong. Closer ties to European and other East Asian countries, which have comparative advantage in these fields, should be developed. What Hong Kong can help is probably just to provide capital, information and some connections.

At the end of 1994, an official of Guangdong's Commission for Foreign Economic Relations and Trade was cited by a Hong Kong newspaper as saying, "Guangdong will coordinate its economic development with the industrial transformation of Hong Kong. Development centres for high technologies will be established together. Through Hong Kong, findings of foreign research on high technologies will be absorbed and extension to product development and sales will be made. Production and industrial structures will be adjusted in an optimal way."<sup>31</sup> To us, this viewpoint is too optimistic and the description of the economic relationship between Hong Kong and Guangdong too idealistic. The contribution of Hong Kong to Guangdong's development of high-technology industries should not be over-estimated. Hong Kong does not have notable advantage in this aspect. The development, transfer and absorption of high-technology industries are usually effective only through actual investment and production. Will it not be more effective and efficient for Guangdong to absorb foreign technology by dealing with foreign partners directly than through the intermediation of Hong Kong?

As regards financial services and other tertiary industries, the cooperation between the two places is rather complicated. Hong Kong, as a "first-mover", should be able to contribute more to Guangdong than the development of high technology industries. This is particularly true in financing. Guangdong can raise funds by issuing bonds and stocks in Hong Kong's financial markets. Hong Kong's expertise in this area can also facilitate the development of financial and other services in the province. Yet, there will still be a high degree of competition. As far as high-level financial services are concerned, China has already got Shanghai which will soon be at par with Hong Kong. The roles of financial services among Guangzhou, Shenzhen, and Zhuhai, which all aspire to be "international financial centres", should be planned and coordinated. It will be stretching credibility too far to advocate that southern China can host four "international financial centres" in the true sense.

Competition between Hong Kong and Guangdong also exists in trade-related services. When Guangdong has expanded its capacity in airports, ports and other transportation facilities, accumulated sufficient human resources and experiences, its reliance on Hong Kong will be reduced. Part of Hong Kong's re-exporting business will be "diverted" to other places in Guangdong. The problems of congestion and "over-charging" in Hong Kong will only reinforce the trend.

Nevertheless, Hong Kong and Guangdong are not playing a “zero-sum game”. Under virtuous competition, it may become a “variable-sum game” and a “win-win” outcome is possible. Taking trading as an example, there has already been the suggestion that Hong Kong and Guangdong should cooperate in building an efficient transportation network, which can be extended to other provinces in middle China. In this way, some of the foreign trade businesses in the middle regions of the Yangzi River can be channelled southward to the Pearl River Delta, benefitting Guangdong as well as Hong Kong.

## **X. Concluding remarks**

In the ultimate analysis, the developmental path of either Hong Kong or Guangdong is not entirely determined by the mode of economic linkage between the two economies. In Hong Kong, questions such as whether Manhattanization is the choice or whether a more balanced production structure should be nurtured are hard ones that must be answered by local entrepreneurs and the government, although as we analyzed above, it is not easy to transcend beyond the temptations of easy money and short-term profits that have arisen from the opening of China and the regional re-allocation of resources. As to Guangdong, a much larger entity with even more complicated factors affecting economic development, the pursuance of a balanced strategy and regional coordination is a very difficult art. Hong Kong's assistance in this aspect can only be limited.

As to the negative side-effects and problems of the bonanza of the past fifteen years, such as inflation, regional and income disparity, "hollowing out" etc., Hong Kong and Guangdong will have to deal with them independently through suitable policies and remedial measures. In any case, the troubles that Guangdong faced in 1996 should serve as a healthy reminder not yet to the province. Hong Kong should also be able to learn something from them.

These conclusions are not meant to undermine the importance of the economic linkage between Guangdong and Hong Kong. The short-term benefits that it has brought about have been tremendous to both sides, and we have analyzed them in some details in this paper. Our message is indeed simple: while the mutually beneficial mechanisms should be maintained and improved, there is a strong need to develop long-term competitiveness and dynamic advantage, a task which is likely to call for more independent efforts on the part of Hong Kong and Guangdong than in the past decade. Hence, a certain distancing in economic relationship is healthy.



## Notes :

<sup>1</sup> *Jingji yangjiu cankao* (Economic Research Reference Material), Beijing, China, 12 October 1994.

<sup>2</sup> Hang Seng Bank, Hong Kong, *Hang Seng Economic Monthly*, June 1993.

<sup>3</sup> For a survey on the literature of the "Dutch disease", see W.M. Corden, "Booming Sector and Dutch Disease Economics, Survey and Consolidation", *Oxford Economic Papers*, Vol. 36, 1984, pp.359-380.

<sup>4</sup> For an earlier analysis of the lack of long-term productivity enhancement in the so called "structural transformation" in the Hong Kong economy, see Tsang Shu-ki, "Inflation", *The Other Hong Kong Report 1992*, The Chinese University Press, pp.425-445.

<sup>5</sup> See Tsang Shu-ki, "Income Distribution", *The Other Hong Kong Report 1993*, The Chinese University Press, pp.361-368.

<sup>6</sup> Yang Ming, "Yaoyou quanxin di silu, zhengce he tizhi" (Completely New Thinking, Policy and System are needed), *Gang-Au jingji* (Hongkong-Macau Economics), No.7, 1992, pp.17-18.

<sup>7</sup> *Guangdong Tongji Nianjian 1994* (Guangdong Statistical Yearbook 1994).

<sup>8</sup> Zhou Jianhua, "*Zhujiang sanjiaozhou jingji fazhen huigui yu qianjian*" (Review and Prospects of the Economic Development of the Pearl River Delta), in Zhongshan University (ed.), "*Zhujiang sanjiaozhou jingji fazhen huigui yu qianjian*" (Review and Prospects of the Economic Development of the Pearl River Delta), Zhongshan University Publishing House, 1992, pp. 22-37.

<sup>9</sup> See Paul Krugman, *Geography and Trade*, The MIT Press 1991, pp.75-76. Note that Paul Krugman uses share of employment while we use share of output in computing the index.

<sup>10</sup> The data are available in the *Guangdong tongji nianjian* (Guangdon Statistical Yearbook), 1989 and 1995.

<sup>11</sup> Zhang Nan, "'Zhu San Jiao' gongye chanye jiegou qutong de xianxiang yu duice (The current situation of the convergence of the industrial structure in Pearl River Delta and policy prescriptions)", *Zhujiang sanjiaozhou jingji* (Pearl River Delta Economy), No.1-2, 1996, pp.47-48.

<sup>12</sup> See Han Houyuan et al., "Guangdong chanye jiegou tiaozheng yu jinrong tizhi gaige" (Production Structural Adjustment and Financial System Reform in Guangdong), *Guangdong jinrong* (Guangdong Finance), No. 1, 1991, pp.8-10; and Tsang Shu-ki, "Money, Banking and Finance" in Y.M. Yeung and David K.Y. Chu (eds.), *Guangdong: Survey of a Province undergoing Rapid Change*, The Chinese University Press, 1994, pp.159-173.

<sup>13</sup> See Wu Guantong, “Guangdong jingji xiahua chenying yu zaichuang huihuang zhanlue” (The Causes of the Slippage of the Guangdong Economy and the Strategy to Recreate Glory), *Guangdong Jingji* (*Guangdong Economy*), No. 11, 1996, pp.32-34.

<sup>14</sup> *Huashang Shibao* (Chinese Commercial Times), 28 December 1996, p.1.

<sup>15</sup> *Guoji Shangbao* (International Commercial News), 25 January 1997, p.1.

<sup>16</sup> *Xinxi Shibao* (Information Times), 26 December 1996, p.1.

<sup>17</sup> *Yuegang Xinxi Shibao* (Guangdong-Hongkong Information Times), 20 December 1996, p.2.

<sup>18</sup> Wu Guantong, *op.cit.*

<sup>19</sup> For a more detailed discussion of investment bias and inefficiency in Guangdong, see Wu Guantong, *op. cit.*

<sup>20</sup> See Tsang Shu-ki and Cheng Yuk-shing, “China’s Tax Reforms of 1994: Breakthrough or Compromise?” , *Asian Survey*, vol.XXXIV, no.9, September 1994, pp.769-788; and Tsang Shu-ki, “Financial Restructuring”, in Lo Chi-kin, Suzanne Pepper, and Tsui Kai Yen (eds.), *China Review 1995*, Hong Kong: The Chinese University Press, 1995, chapter 21.

<sup>21</sup> See for example Tsang Shu-ki, "The Economy", in Donald McMillan and Man Si-wai (eds.), *The Other Hong Kong Report 1994*, The Chinese University Press, 1994, pp.125-148.

<sup>22</sup> An earlier warning of this scenario was fired by one of the authors. See Tsang Shu-ki, "The Economy", in *The Other Hong Kong Report 1994*, *ibid.* 1994 was still a year when labour shortage was a problem. However, the situation changed drastically and in the second half of 1995, Hong Kong saw a 10-year high in its unemployment rate at 3.6%. Behind the problem were both cyclical and long-run factors.

<sup>23</sup> See Tsang Shu-ki, "Xianggang jingji wang hechu qu?" (Wither the Hong Kong Economy?), *Ming Pao Daily*, Hong Kong, 15 November 1995.

<sup>24</sup> Calculated in current prices from figures in *Guangdong tongji nianjian 1994* (Guangdong Statistical Yearbook 1994).

<sup>25</sup> Li Dan-er, "Jiusi jingrong gaige dui Guangdong jingji di yingxiang" (The Impact of the 1994 Financial Reform on the Guangdong Economy), *Guangdong jingrong* (Guangdong Finance), No.6, 1994, pp.4-6.

<sup>26</sup> See, for example, Tsang Shu-ki, "Towards Full Convertibility? China's Foreign Exchange Reforms", *China Information*, Vol. IX, no.1, 1994, pp.1-41.

<sup>27</sup> The major policy documents are compiled in Wang Dingchang (ed.), *Er ling yi ling nian di Guangdong: guihua ji zhanlue yanjiu* (Guangdong in 2010: Planning and Strategic Studies), Guangdong People's Publishing House, 1994.

<sup>28</sup> Reported by *Shanghai jingji bao* (Shanghai Economic News), 24 June 1994, p.1.

<sup>29</sup> Zheng Tianxiang, "Yue-Gang jichu sheshi jianshe xietiao guanjian" (My Views on the Coordination of Infrastructural Construction between Guangdong and Hong Kong), *Gang-Ao jingji yuebao* (Hong Kong Macao Economic Monthly), October 1994.

<sup>30</sup> See Zheng Tianxiang, "Yue-Gang jichu sheshi jianshe xietiao guanjian", *ibid.*

<sup>31</sup> *Hong Kong United Daily*, 19 November 1994, p.21.

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