

CAROLA B. RAMÓN-BERJANO, SIMON ZHAO XIAOBIN,
AND CHAN YING MING

Hong Kong's Transformation into a Service Hub

Regional Development within "One Country, Two Systems"

ABSTRACT

Following the return of Hong Kong to Chinese jurisdiction in 1997, there has been concern about the potential marginalization of Hong Kong within China's development. We argue that far from being marginalized, Hong Kong together with the Pearl River Delta is becoming the most dynamic region within China.

KEYWORDS: "One Country, Two Systems," regional development, Pearl River Delta, service hub, economic transformation

INTRODUCTION

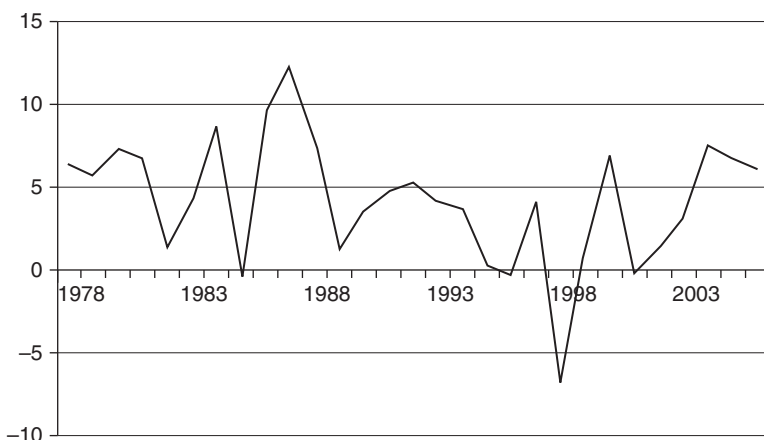
With China's creation of the Pearl River Delta (PRD) as a region¹ in 1985 and the reversion of Hong Kong to Chinese sovereignty in 1997, Hong Kong faced many unprecedented challenges. The Hong Kong Special Administrative Region (HKSAR) was established under the principle of "one country, two systems" (OCTS). Within a few years, Hong Kong had endured both the

CAROLA B. RAMÓN-BERJANO is Research Fellow at the International Center for China Development Studies, the University of Hong Kong. SIMON ZHAO XIAOBIN is Associate Professor of Geography at the University of Hong Kong and Director of the university's International Center for China Development Studies. CHAN YING MING is a Research Project Officer at the International Center for China Development Studies. The authors wish to acknowledge the financial support for this study from the Mrs. Li Ka Shing Fund, the Hui Oi Chow Trust Fund, and the Strategic Research Theme in Contemporary China Studies at the University of Hong Kong. Emails: <carola_marstrand@hotmail.com>, <sxzhao@hkucc.hku.hk>, <neo_ymc@yahoo.com.hk>.

1. The PRD comprises the Pearl River Delta Economic Development Zone portion of Guangdong Province, consisting of nine prefectures: Guangzhou, Shenzhen, Zhuhai, Dongguan, Zhongshan, Foshan, Huizhou, Jiangmen, and Zhaoqing. The Greater PRD region adds the special administrative regions of Hong Kong and Macao, for an overall population of 55.5 million (2011). See Statistics Bureau of Guangdong Province, *Guangdong Sheng 2010 Nian Diliuci Quanguo Renkou Pucha Zhuyao Shuju* [Statistics of Guangdong Province on the sixth national population census], <http://www.gdstats.gov.cn/tjgb/t20110511_83329.htm>, accessed July 22, 2011.

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FIGURE 1. Hong Kong's Growth of Per Capita GDP (in constant 2005 US\$)



SOURCE: By authors, based on Hong Kong statistics.

Asian financial crisis (1997–98) and its associated recession, and the outbreak of SARS (Severe Acute Respiratory Syndrome) in 2003. The average rate of gross domestic product (GDP) growth per capita in Hong Kong in the period 1989–97 was 5%, followed by a 6% decrease in 1998, chiefly because of the Asian financial crisis. In 1999–2006, GDP growth recovered to an average of 4.5% (see Figure 1).

By contrast, the economy of China exhibited one of the highest growth rates in the world, with GDP growing between 9% and 10% per year between 1997 and 2007. China had been ranked as the third-largest economy in the world since 2007 and overtook Japan in 2010 to become number two.² The subsequent economic recovery after 1997–98 helped the strong growth of China's economy. In fact, with Hong Kong's economy integrating into China's, many low-end value-added industries relocated from Hong Kong, particularly into the PRD, because of lower production costs. As the economies converged, people in Hong Kong worried about the SAR's future role within China, Asia, and even internationally. Toward the end of 2005, Hong Kong began to address whether it would be marginalized and replaced by other Chinese cities such as Shanghai or Guangzhou.

2. World Bank, *World Development Indicators Database*, <<http://data.worldbank.org/data-catalog/world-development-indicators>>, accessed July 1, 2011.

Will Hong Kong be marginalized in the economic landscape of China? Or will it continue and deepen its international status under OCTS, ultimately becoming a global city within the People's Republic of China (PRC)? We believe that two effects will resonate to provide Hong Kong with sufficient incentives to maintain its current unique position. On the one hand, under China's development strategy, coastal areas have been foregrounded: they received broad incentives, and businesses were relocated there. This spurred the significant development of the PRD, which in turn had profound implications for the economy of Hong Kong. On the other hand, the privileged position of Hong Kong as a main gateway to China within the Greater PRD and the framework of the Closer Economic Partnership Agreement (CEPA)³ are both likely to help Hong Kong retain and reinforce its role as a regional service hub.

REGIONAL DISPARITIES: CHINA, THE PRD, AND HONG KONG

In order to investigate the relocation of economic activities within China and the emergence of the Hong Kong-Shenzhen megalopolis, we summarize the main theories underpinning these regional issues. According to neoclassical economic theory, the inter-regional disparities of a country (or areas in an integrated market) automatically level off over time, without any need for policy interventions.⁴ However, other theorists assert that economic integration (or removal of trade barriers) will only be beneficial for those regions with development poles, i.e., with better development that can create linkages with other regions.⁵ The impact upon the less-developed regions is indirect, operating through the effect on the more-developed ones (given that both had already achieved some sort of coexistence within the national market).⁶ Accordingly, towns and regions with artificial advantages would be expected to suffer from the removal of barriers to trade as a consequence of a new reallocation of resources, reinforcing the attractiveness of those highly industrialized centers for both capital and labor. Conversely, borders that

3. The CEPA is a free-trade agreement between the Mainland, Hong Kong, and Macao, which became effective from January 1, 2004.

4. Robert J. Barro, "Economic Growth in a Cross Section of Countries," *Quarterly Journal of Economics* 106:2 (1991), pp. 407-43.

5. Xavier Sala-i-Martin, "On Growth and States," Ph.D. diss., Harvard University, 1990.

6. F. Perroux, *L'Europe Sans Rivages* [Europe without banks] (Paris: Presses Universitaires de France, 1954); M. B. C. Robertson, *Regional Development in the European Economic Community* (London: Political and Economic Planning, 1962).

had suffered from barriers imposed by agglomeration forces (e.g., locating firms near each other, or in clusters of economic activity, to benefit from economies of scale) would blossom after the abolition of those barriers.⁷

Attention has also been drawn to the importance of geographical factors such as proximity for international trade. Barriers to trade between countries including tariffs, language and cultural differences, and lack of factor mobility are usually enough to block the expansion of an industrial center beyond its domestic market. As integration proceeds, it is then expected for some industries to serve the market from a single local agglomeration rather than from several.⁸ Both physical location and geographical spillovers matter more than national macro factors for regional distribution dynamics.⁹ In the case of neighboring regions, both geographical and economic proximity will favor trade once the barriers are removed. This will be particularly strong if both are backward regions. In the case of one developed region pairing up with an economically lagging region, the removal of trade barriers will increase trade but the benefits may be unevenly distributed.¹⁰

The above-mentioned consequences of trade barrier removals are significant, if not imperative, in the restructuring of economic activity and the dynamics of disparities in Hong Kong and China. This is especially so in the PRD region as cross-border economic integration under OCTS deepens.

Development of Disparities in China (1978–2006)

We start by addressing the evolution of disparities in China as significant for the rise of the province of Guangdong and the PRD in particular. Since 1978, China has undergone a process of dramatic change. The average rate of GDP growth was 10.2% during the 1980s and 12.8% during the first half of

7. H. Giersch, "Economic Union between Nations and the Location of Industries," *Review of Economic Studies* 17:1 (1950), pp. 87–97.

8. P. Krugman, "Increasing Returns and Economic Geography," *Journal of Political Economy* 99:3 (1991), pp. 483–99; P. Krugman and A. Venables, "Integration, Specialization, and Adjustment," *European Economic Review* 40:1–5 (1996), pp. 959–67.

9. D. Quah, "Empirics for Economic Growth and Convergence," *European Economic Review* 40:6 (1996), pp. 1353–75; idem, "Twin Peaks: Growth and Convergence in Models of Distribution Dynamics," *The Economic Journal* 106:437 (1996), pp. 1045–55.

10. P. Auverny-Bennetot, "L'Intégration Économique Regionale en Europe: La Région Franco-Italienne des Alpes du Nord," Ph.D. diss., Université de Grenoble, 1975; G. Petrakos, "A European Macro-Region in the Making? The Balkan Trade Relations of Greece," *European Planning Studies* 5:4 (1997), pp. 515–33; J. D. Sachs, "Geography and Economic Transition," Working Paper (1997), Center for International Development, Harvard University.

the 1990s, compared with 5.5% in the 1970s. Given that the annual rate of population growth was 1.4% throughout the whole period, GDP per capita grew at a dramatic rate.

The impact on disparities of China's reform and opening up drive, according to Khan and Riskin,¹¹ can be divided into two phases. From 1978 until the mid-1980s, China's growth seemed to have been focused on agriculture; the dismantling of the communes and other reform efforts helped develop the rural economy, with incomes increasing relative to urban ones. In the second half of the 1980s, however, the rate of growth of agricultural output slowed and the trend reversed. Growth was then led by exports and international integration. The opening up of the economy, with exports as a proportion of GDP rising from 10.1% in 1980 to 21.2% in 1995, is often associated with increasing economic inequality. Export production was concentrated in the affluent coastal regions in the east, which enjoyed easy access to ports, good infrastructure, and foreign direct investment (FDI).

In August 1980, four special economic zones (SEZs) were established. Three were in Guangdong Province (Shenzhen, Zhuhai, and Shantou) and another was in Fujian Province (Xiamen). These SEZs offered incentives to foreign investors including lower tax rates, foreign exchange privileges, lower land use fees, and greater economic autonomy. To reinforce the advantages of the coastal areas, preferential investment and taxation policies were implemented along with flexible employment rules, a more powerful and efficient bureaucracy, and investment in infrastructure. In April 1984, 14 other coastal Chinese cities were granted special policies for foreign investment.¹² Opening up continued and coastal economic development zones (CEDZs) were created (the lower Yangtze River Delta, PRD, and the Xiamen-Zhangzhou-Quanzhou triangle) in 1985. In 1988 Hainan Island was administratively separated from Guangdong Province and became China's 30th province and largest SEZ. In 1990, Shanghai was authorized to launch the development of Pudong (East Shanghai) New Area.¹³

The Chinese government deliberately developed the coastal region first, with its comparative advantages. Development of the western regions lagged

11. Azizur Rahman Khan and Carl Riskin, *Inequality and Poverty in China in the Age of Globalization* (New York: Oxford University Press, 2001).

12. These coastal open cities were Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhangjiang, and Beihai.

13. D. L. Yang, "Beyond Beijing," in *Routledge Studies on China Transition*, ed. David S. G. Goodman (New York: Routledge, 2003); J. J. Wen and C. A. Tisdell, *Tourism and China's Development* (Singapore: World Scientific Publishing, 2001).

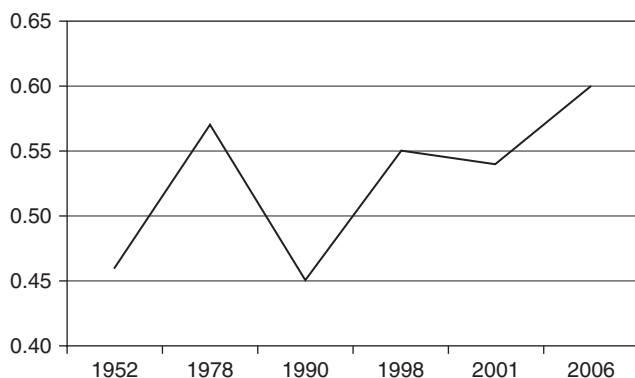
but has been targeted in recent years. Initial divergent standards of living were thus a by-product of the government's policy. Another objective was to boost the overall level of income in China despite increasing divergence, thereby reducing the poverty level. The "ladder step" doctrine postulates that optimal investment allocation should be made in the regions where capital productivity is highest, and development efforts should maximize regional comparative advantage by concentrating on the east coast. This development should later be diffused to the second and third steps of the ladder (the central and western regions).

In this section, we have studied the evolution of disparities in China in order to test the presence of converging and diverging trends for the period 1978–2006. The variability of GDP per capita as per the sigma convergence analysis,¹⁴ across all Chinese provinces in the period 1978–2001 (see Figure 2), shows a sharp decrease in disparities until 1990 and from then on increases until 1998. Over the period 1998–2001, the dispersion of incomes among provinces shows a decrease, indicating that the divergent trend has stopped. It increases thereafter until 2006. By conducting a more thorough analysis based on the above findings, the beta convergence analysis¹⁵ (see Table 1) reveals that 1978–2001 was a period of convergence. Between 1978 and 2006 the coefficients are of the right sign—negative, because income dispersion decreases across time. Still, they were not statistically significant enough to accept the hypothesis of convergence. When taking a closer looking at the sub-periods, there was a strong convergent trend in 1978–90 and a diverging one for the period 1990–2006. These results indicate that from the beginning of the opening up process in 1978 until 1990 there was a convergence among

14. The sigma convergence shows how the dispersion of real per capita income (in logarithms) across a group of countries (or regions) evolves over time as measured by the variance of income per capita. If it decreases over time, there is said to be sigma convergence between the countries (regions), i.e., the variability is lower. X. Sala-i-Martin, "On Growth and States"; R. Barro, "Economic Growth in a Cross Section of Countries."

15. Summarized in Table 1. Absolute beta convergence tests the neo-classical hypothesis that poorer countries (or regions) grow faster than richer ones. If this is the case, there will be a negative relationship between the initial level of income and its average rate of growth for the period under consideration. Conditional beta convergence, as opposed to absolute beta convergence, analyzes the incomes per capita of countries (or regions) that have identical structural characteristics and converge in the long run to their own equilibrium. In order to test for conditional convergence you can either introduce explanatory variables or study sets of economies for which it is safely assumed that they have similar variables. See *ibid.*; X. Sala-i-Martin, "Regional Cohesion: Evidence and Theories of Regional Growth and Convergence," *European Economic Review* 40 (1996), pp. 1325–52.

FIGURE 2. Sigma Convergence in China



SOURCE: By authors, calculating data from the National Bureau of Statistics of China, *China Statistical Yearbook* (2000, 2002, 2007).

TABLE I. Econometric Results of Beta Convergence Analysis among Chinese Provinces, Selected Sub-periods

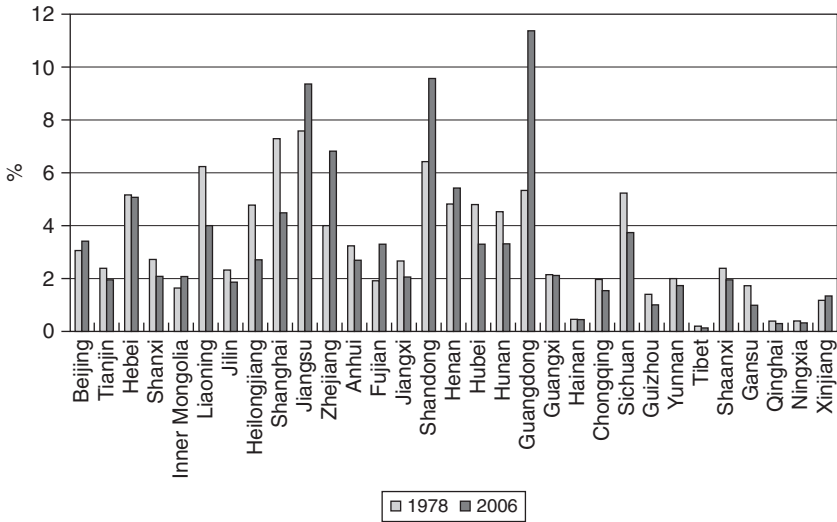
	<i>Regression</i> 2006–1978 (x = in 1978; y = in 2006 – in 1978)	<i>Regression</i> 2001–1978 (x = in 1978; y = in 2001 – in 1978)	<i>Regression</i> 1990–1978 (x = in 1978; y = in 1990 – in 1978)	<i>Regression</i> 2006–1990 (x = in 1990; y = in 2006 – in 1990)
R square	0.02	0.14	0.42	0.30
Std. error	0.12	0.33	0.18	0.20
D.F.	29	29	29	29
Coefficient	–0.08	–0.23	–0.26	0.29
T-stat	–0.67	–2.15	–4.46	3.52
F-stat	0.45	4.64	19.88	12.41

SOURCE: Ibid. to Figure 2.

the Chinese provinces, which is consistent with the literature. Thereafter in the nineties, however, there was divergence.

We have also analyzed changes in income within China by looking at the percentages of national GDP per province. As shown in Figure 3, the percentages of national GDP for 1978 and 2006 can be compared for each province. Shanghai Municipality, a provincial-level entity, with the largest proportion of GDP in 1978, showed a decrease in 2006. The provinces of Zhejiang, Fujian, Shandong, and Guangdong show an increase in 2006

FIGURE 3. Percentages of GDP Contribution in 1978 and 2006

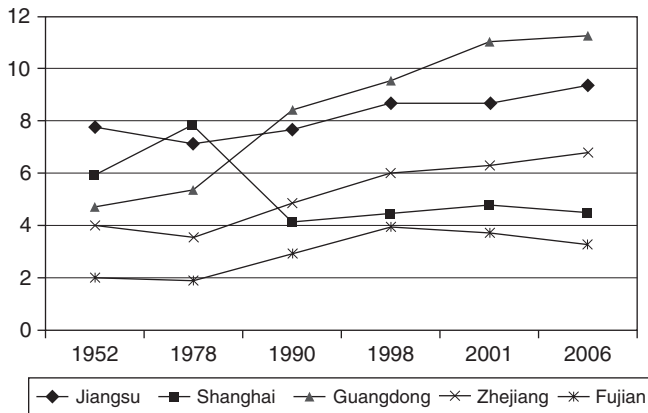


SOURCE: Ibid. to Table 1.

when compared to 1978. In fact, when looking at the top six provinces in proportion of GDP in 1978 (Shanghai, Jiangsu, Liaoning, Shandong, Guangdong, and Sichuan, respectively), it can be seen that while Guangdong and Shandong rose to the top positions, Jiangsu decreased to third place. In 2006 Shanghai, Liaoning, and Sichuan decreased their share of GDP and fell to seventh, eighth, and ninth positions, respectively.

This pattern can be further seen in Figure 4, which only depicts some selected provinces. As mentioned above, four SEZs were created in 1980. Three were in Guangdong, which went from fifth place in 1978 with a 5.35% share of GDP to an impressive 11.34% in 2006 and a number one ranking. The other SEZ was created in Fujian, which also demonstrated remarkable growth, increasing from 23rd place in 1978 to eleventh in 2006 while doubling its share of GDP. Moreover, this highlights another feature of the last decades in the regional disparities of China, the relative growth of the coastal region at the expense of the interior. While the coastal region slightly increased its proportion of national GDP, the western and central regions lost out. Given that the population shares remained constant throughout the period, this indicates the coast enjoyed a higher percentage of GDP distribution per capita (see Table 2).

FIGURE 4. GDP Contribution (Various Years), Selected Provinces (in %)



SOURCE: Ibid. to Figure 3.

TABLE 2. Distribution of % GDP

	1952	1978	1990	1998	2001	2006
Coastal	50.09	52.41	54.12	58.27	60.70	61.75
Central	32.39	30.67	29.70	27.72	25.72	25.31
Western	17.52	16.93	16.18	14.00	13.58	12.94

SOURCE: Ibid. to Figure 4.

Pearl River Delta: Hong Kong-Guangdong Closer Economic Ties

In addition to the relative increase in income levels of the coastal regions, another relocation within each region is worth studying, i.e., uneven distribution of income within the coastal regions. In this section, the economic integration between Hong Kong and Guangdong will be analyzed to examine whether there was a relocation of economic activities within that region.

Guangdong had been chosen as a testing ground for implementing novel policies “one step ahead” of other Chinese regions. Thus, Shenzhen was designated as the first SEZ in 1980 while the PRD was created as the CEDZ in 1985. The PRD comprises the prefectures of Guangzhou, Shenzhen, Zhuhai, Dongguan, Zhongshan, Foshan, Huizhou, Jiangmen, and Zhaoqing in Guangdong Province. Back in the early 1970s, Guangdong had received little investment, and its infrastructure was not highly developed. However,

by the end of the nineties, half of the total investment from Hong Kong into China was concentrated in Guangdong, and 80% of foreign investment in Guangdong originated from Hong Kong.¹⁶ Guangdong's proximity to Hong Kong and Macao, together with its preferential status, has given the region unique developmental opportunities. In the last few decades, the level of development has greatly increased, particularly in the PRD. Since the early 1980s, the regional division of labor between Hong Kong and cities in the PRD has expanded as the former's manufacturing industries moved to the PRD. Similarly, the regional division of industries between Hong Kong and the PRD, particularly Shenzhen, has deepened since the mid-1990s as Hong Kong's low-end value-added services moved north. These included retailing, recreation and leisure, accounting, data processing and back office operations of banks and telecommunication companies, as well as trade-related services.¹⁷

The Greater PRD has emerged as one of the world's most dynamic economic regions and manufacturing centers. If the region were a country, it would be the world's sixteenth largest in terms of size and tenth in terms of exports.¹⁸ Two factors gave the region a further boost: the 2001 accession of China to the World Trade Organization (WTO) and the CEPA economic agreement between Mainland China and the two SARs of Hong Kong and Macao.

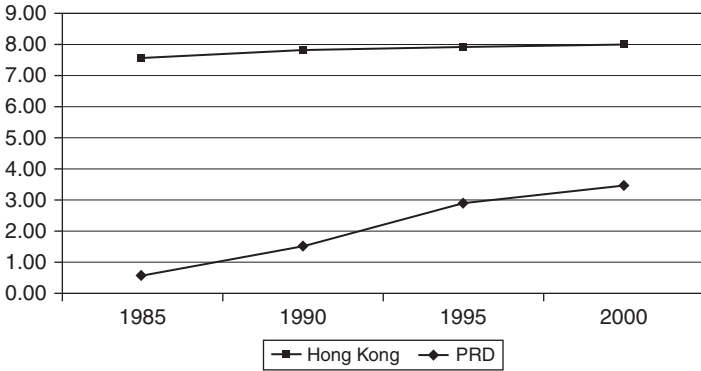
In-between the establishment of the PRD in 1985 and 2000, the region's GDP per capita has increased dramatically, while Hong Kong's has lagged (see Figure 5). Moreover, when performing a sigma analysis of the two areas (see Figure 6), the indicator steadily decreased as a result of the accelerated growth in the PRD region and the relative stagnation of Hong Kong. As mentioned above, the growth of the PRD points at a further relocation of economic activity within Guangdong. The eastern portion of the PRD (Shenzhen, Dongguan, and Guangzhou) is economically the most developed. Up until the mid-eighties, these areas were mostly rural, but after the reforms and opening up, investment flew into the region. While the city of Guangzhou lost a share of national income in the period (although it still remained at the top), other

16. J. Shen, C. Gu, F. Zhen, and K. Wong, "Regional Polarisation in Guangdong Province in South China," *Occasional Paper*, no. 113, Hong Kong Institute of Asia-Pacific Studies, Chinese University of Hong Kong, November 2000.

17. Yang Chun, "An Emerging Cross-Boundary Metropolis in China," *International Development Planning Review* 27:2 (2005), pp. 195–226.

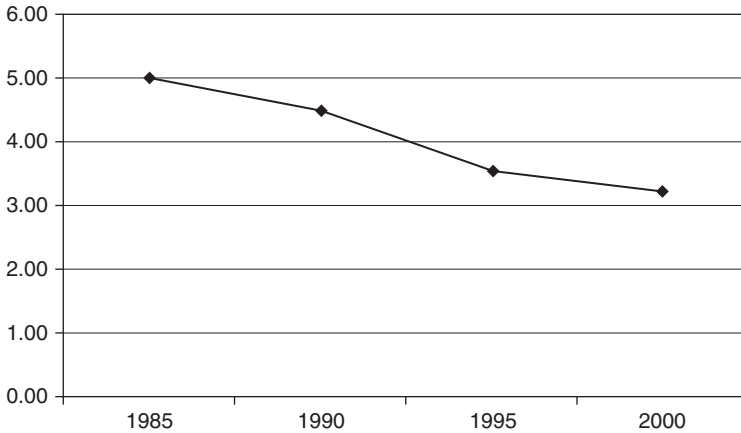
18. M. J. Enright, E. Scott, and K. Chang, *Regional Powerhouse: The Greater Pearl River Delta and the Rise of China* (Singapore: John Wiley & Sons [Asia], Inc., 2005).

FIGURE 5. GDP Per Capita (in Logarithmic Trend)—PRD and HK (1985–2000)



SOURCE: Ibid. to Table 2 (2002); Statistics Bureau of Guangdong Province, *Guangdong Statistical Yearbook* (2000, 2002).

FIGURE 6. Sigma Convergence between Hong Kong and PRD (1985–2000)



SOURCE: By authors, calculating data from National Bureau of Statistics of China, *China Statistical Yearbook* (2002).

cities like Shenzhen gained in share (as seen in Table 3). Comparing share of national income per capita, in 1980 Shenzhen ranked 58th; in the years from 1985–95, it ranked number two.¹⁹ Further, between 1996 and 2005, Shenzhen increased its GDP share within Guangdong from 13% to 21%, as can be seen

19. Shen, Gu, Zhen, and Wong, “Regional Polarisation in Guangdong Province in South China.”

TABLE 3. Share of GDP within Guangdong Province in 1996 and 2005

Cities	2005			1996		
	GDP (10,000 yuan)	% of GDP Contribution	GDP Per Capita (yuan/person)	GDP (10,000 yuan)	% of GDP Contribution	GDP Per Capita (yuan/person)
Guangdong Province	22,971		24,435	6,883		9,513
Guangzhou City	5,154	22.44	69,268	1,445	20.99	22,183
Shenzhen City	4,951	21.55	60,801	950	13.80	93,813
Foshan City	2,383	10.37	41,266	637	9.25	20,327
Dongguan City	2,182	9.50	33,263	245	3.56	16,969
Zhongshan City	880	3.83	36,208	181	2.63	14,371
Maoming City	808	3.52	13,934	351	5.10	6,083
Jiangmen City	805	3.50	19,636	429	6.23	11,502
Huizhou City	803	3.50	21,896	272	3.95	10,537
Zhanjiang City	658	2.86	9,899	321	4.66	5,266
Shantou City	651	2.83	13,196	314	4.56	7,759
Zhuhai City	635	2.76	45,284	207	3.01	32,243
Zhaoqing City	451	1.96	12,315	289	4.20	8,045
Jieyang City	420	1.83	7,531	254	3.69	5,236
Shaoguan City	340	1.48	11,708	160	2.32	5,443
Qingyuan City	323	1.41	9,070	135	1.96	3,730
Meizhou City	314	1.37	7,666	138	2.00	2,998
Yangjiang City	295	1.28	12,758	117	1.70	4,871
Chaozhou City	288	1.25	11,422	130	1.89	5,600
Yunfu City	214	0.93	9,174	146	2.12	6,167
Shanwei City	211	0.92	7,608	93	1.35	3,711
Heyuan City	205	0.89	7,488	69	1.00	2,311

SOURCE: Ibid. to Figure 6 (2000, 2007).

in Table 3. When comparing Shenzhen and Dongguan with other cities in China, these two appeared in 2006 at the top in terms of average disposable residential income, not only ahead of Guangzhou (number six) but also ahead of Shanghai and Beijing (numbers three and four, respectively).²⁰

The growing importance of Guangdong Province at the national level shows the effects of the coastal development strategy pursued in China since

20. National Bureau of Statistics of China, *China Statistical Yearbook* (2000, 2002, 2007).

the mid-1980s. However, the further relocation of growth geographically within Guangdong and the PRD toward Shenzhen (i.e., Hong Kong) shows the significance of the Hong Kong factor, i.e., a relocation of activity toward the closest city as a consequence of the rise of the Greater PRD under the CEPA agreement. Therefore, despite Hong Kong's relatively lower growth rate, it remains the region's center.

Hong Kong's Development into a Regional Service Hub

Economic development in the PRD has complemented Hong Kong's over the past quarter-century. As the two developed a partnership on the strength of export-oriented manufacturing investment, Hong Kong provided management and global supply chain services; the PRD supplied land and labor for production. Since the 1980s, most manufacturing in Hong Kong had been relocated to the PRD (the "front shop, back factory" model), particularly to neighboring cities such as Shenzhen and Dongguan. Hong Kong was thus transformed from a manufacturing-based into a service-based economy. In this section, we complement analysis of the economic integration with a study of Hong Kong's competitive advantage as a service-based city.

The successful implementation of OCTS has been vital to the development of Hong Kong because public confidence relies on enhancing both stability and prosperity. As an SAR of the PRC, Hong Kong enjoys a high degree of autonomy (except in areas such as national defense and diplomacy), and it boasts independent executive, legislative, and judicial functions. In addition, no departments within the central or local Chinese governments can intervene in the internal affairs of the HKSAR. With the Basic Law ensuring its free port status, the HKSAR remains a separate customs territory. Neither tariffs nor policies against the free trade and flow of goods, intangible assets, or capital can be imposed by the central government. The HKSAR has an independent taxation regime, as well as monetary and financial systems (its financial revenues are not handed over to the central government). The Hong Kong dollar continues to circulate as the legal tender, and this helps maintain competitiveness in attracting FDI and serving as a business base for MNCs (multinational companies) in the region.

Several factors contribute to Hong Kong's unique position in attracting foreign companies and MNCs. These factors are low taxes, being a gateway to China, geographic location, clean government, human resources (HR) development, innovation, and a free economy.

Tax System

Hong Kong's tax system is simple and relatively inexpensive to administer, with tax rates among the lowest in the world. Profit tax is charged only on net profits arising in or derived from Hong Kong, either through trade, profession, or business carried on there. Salaries tax is calculated in a similar way. While profit tax is derived from assessable profits after all expenses incurred in production have been deducted, salaries tax is calculated on net income (income after deductions and allowances). For the assessment year 2007–08, profit tax was 17.5% while salaries tax was calculated on a scale progressing from 2%, 7%, and 12% for the first, second, and third segments of HK\$ 30,000 (US\$3,850) net income each, and 17% thereafter on the remaining net income, according to the Hong Kong Inland Revenue Department. Furthermore, there are no capital gains tax, Value Added Tax (VAT), or Goods and Services Tax (GST) levied in Hong Kong. This low tax rate system is a main factor in Hong Kong's competitiveness for attracting foreign investment and for serving as a business base for MNCs.

Gateway to China

As a result of China's opening up and strengthening links with Hong Kong, the latter has become the main gateway to and from the Mainland for both business and travel.²¹ According to the tourist statistics published by the Hong Kong Tourism Board (HKTb), the number of trips by foreign visitors to the Mainland through Hong Kong rose by an annual average of 6% in the past 10 years, with four million visitors in 2008. Conversely, the number of trips made by Mainland residents to or through Hong Kong grew 19% annually, reaching 16.8 million visitors the same year.²²

The Mainland has become Hong Kong's largest trading partner, while Hong Kong was the Mainland's fourth largest trading partner in 2006. Moreover, according to the Hong Kong Census and Statistics Department, by the end of 2008, 47.5% of trade and 62.5% of reexport trade were related to the Mainland,²³ making it not only the largest market but also the largest

21. Government of HKSAR, *Travel and Tourism, Hong Kong Yearbook 2009*, <<http://www.yearbook.gov.hk/2009/en/index.html>>, accessed January 31, 2011.

22. HKTb, *Visitor Arrival Statistics, 2008*, <<http://tw.partnernet.hktb.com/pnweb/jsp/comm/index.jsp?charset=b5&pageContent=%2Fjsp%2Frso%2Frso.jsp>>, accessed November 1, 2009.

23. Hong Kong Census and Statistics Department, *Annual Review of Hong Kong External Merchandise Trade 2008* (Hong Kong: Government of HKSAR, Hong Kong Census and Statistics Department, July 2009).

source of Hong Kong's re-exports. According to Chinese statistics, by the end of 2006, US\$260 billion from the Mainland had been invested in Hong Kong, or 35% of total investment there. In fact, over 2,600 Mainland-backed enterprises have established their flagship companies in Hong Kong. In addition, by the end of 2010, a total of over 260 Mainland enterprises were listed on the Hong Kong Stock Exchange (HKSE), raising equity capital amounting to HK\$ 2,395.1 billion (US\$307.4 billion).

Geographic Position

Owing to its prime geographic as well as economic position within Asia, Hong Kong is a major international and regional aviation center and container port. The state of the art Hong Kong International Airport (HKIA) is one of the busiest airports in the world, and one of the most important gateway hubs for China. Under the OCTS framework, Hong Kong can continue to conclude bilateral air services agreements for scheduled service. By the end of 2006, there were 85 airlines providing flight services between Hong Kong and more than 150 cities worldwide. Most metropolises in Southeast Asia can be reached in five or less hours. With China's international trade on the rise, the demand for flight services between Mainland cities and international destinations is expected to balloon in the next 20 years.

As a result of the increase in demand for international flight services, particularly within the PRD area, the Airport Authority now provides cross-boundary ferry service between the airport and five PRD ports. Passengers aboard these ferries do not have to go through customs and immigration procedures again in Hong Kong before boarding international flights.²⁴ In addition, the Airport Authority provides cross-boundary bus services between HKIA and 40 destinations in the PRD. To cope with the increase in transit passengers from four other airports in the PRD region, the Airport Authority will build a permanent cross-boundary ferry terminal to link up with passenger terminal buildings using the Automated People Mover system.²⁵ In 2006, the airport handled a record 44.45 million passengers and 3.58 million tons of air cargo, a respective increase of 9.1% and 5.2% relative

24. Government of HKSAR, *Hong Kong Yearbook* (Hong Kong: Government of HKSAR, Information Service Department, 2006, 2008).

25. The HKIA Automated People Mover is a driverless people-mover system. For departures, the train runs from Terminal 2 to the East Hall to the West Hall. For arrivals, the train runs only from the West Hall to the East Hall.

to 2005. According to the Airports Council International (ACI), in 2008 HKIA ranked number one and number five worldwide, respectively, in terms of international freight and international passenger throughput, ahead of Tokyo (number 4 and 9, respectively) and Singapore (number 7 and 7, respectively).²⁶

Geography has also enhanced maritime trade. Hong Kong is ranked as the seventh largest maritime center in the world.²⁷ It is home base for some of the world's largest and oldest shipping companies and provides embarcations to about 80 international shipping lines for an average of 500 weekly sailings to 500 destinations worldwide. In accordance with the Basic Law, the HKSAR in terms of international shipping, as with civil aviation, participates under the name "Hong Kong, China" in the International Maritime Organization and negotiates relief from double taxation for its trading partners.

The significance of Hong Kong's ties to the fast industrializing PRD area can also be seen in shipping. In 2006, the container port at Hong Kong handled a record 23.5 million TEUs (twenty-foot equivalent units) of containers, of which 70% corresponded to smaller coastal and river trade vessels entering or leaving the port via the Pearl River. Although the regional competition for container terminals and alternative modes of cargo handling is dramatic, Hong Kong still maintains its status as Asia's premier international transport and logistics hub. This is not only because of its privileged location but also its efficient and reliable handling facilities at HKIA and the Kwai Chung Container Terminal. Logistics has undoubtedly contributed significantly to Hong Kong's economy and the job market, and this in turn is vital to the development of the PRD region to achieve synergies in logistics development.

Clean Government

Hong Kong rates as one of the most corruption-free economies in the world. According to the 2007 Corruption Perceptions Index by Transparency International, Hong Kong was ranked the 14th least corrupt place in the world (ahead of Japan, number 17; and the U.S., number 20). This ranking stems mostly from the successful performance of the Independent Commission against Corruption (ICAC), which uses a threefold strategy of

26. ACI, *2007 World Airport Traffic Report* (Geneva: Airports Council International World Headquarters, July 2008).

27. Government of HKSAR, *Hong Kong Yearbook, 2006 and 2008*.

investigation, prevention, and community education about corruption. As a result of years of strong anti-corruption efforts, cronyism, influence peddling, and bribery—in both government departments and the private sector—are perceived by Hong Kong society as being rare. Consequently, companies are free to pursue their business interests on a level playing field, without concern for corruption. Furthermore, the United Nations Convention Against Corruption (UNCAC) came into effect in Hong Kong in February 2006. The UNCAC advances international cooperation in fighting corruption through information exchange, fugitive pursuit and arrest, and asset recovery. Apart from having regular contacts with overseas law enforcement agencies, the ICAC and the Mainland procuratorate authorities assist each other in corruption investigations carried out under the Mutual Case Assistance Scheme.

Intellectual Capital

The development of a pool of skilled manpower at all levels is considered a key to Hong Kong's competitive advantage in the knowledge-based economy of the 21st century. According to Hong Kong's *2006 Population by Census*,²⁸ the proportion of the population over 15 who received some level of education (either non-degree, degree, or postgraduate) has increased from 15.8% in 1996 to 23.9% in 2006. About 12% of these had some postgraduate education in 2006, twice the level as in 1996. Similarly, post-secondary education opportunities for senior secondary school graduates have expanded in the past few years. The population of young people with a post-secondary education increased from 18.5% in 1996 to 30.6% in 2006.²⁹ As the educated sector grew significantly, the proportion working in knowledge-based positions increased correspondingly. For example, the proportion of employed people who worked as managers, administrators, or professionals increased from 28.9% in 1996 to 36.3% in 2006. That year, to further improve the competitiveness of Hong Kong's work force and upgrade the quality of its manpower in a knowledge-based economy, the Immigration Department introduced the Quality Migrant Admission Scheme,³⁰ the Admission

28. Hong Kong Census and Statistics Department, *2006 Population by Census*, "Thematic Report: Youths" (Hong Kong: Government of HKSAR, Hong Kong Census and Statistics Department, July 2008).

29. *Ibid.*

30. The scheme was launched on June 28, 2006, for attracting talented people to settle in Hong Kong. It is quota-based, with an initial annual quota of 1,000. Selection is done by the General

Scheme for Mainland Talents and Professionals,³¹ and the Arrangement for Employment of Mainland Graduates with Hong Kong Degrees³² to attract talented people and professionals from the Mainland and overseas to work in Hong Kong.

Innovation

Innovation is another key element for enhancing the competitive edge and fostering economic growth. Although the level of investment in research and development (R&D) in Hong Kong is not comparable to that in other developed economies, nonetheless R&D efforts have been gaining momentum. The proportion of total R&D expenditure within GDP increased from 0.43% in 1998 to 0.77% in 2007.³³ It is important to note that the share of business R&D expenditure within total R&D expenditure has surpassed that of the higher education sector since 2005. Another important issue is that although Hong Kong's R&D base is not as sizable as that in other economies, Hong Kong can capitalize on the production base in the PRD by putting research results into practice to meet industry needs. Finally, while Hong Kong's investment in R&D is small relative to that of other

Points Test or the Achievement-based Points Test. Successful applicants are not required to secure an offer of local employment before entering Hong Kong for settlement. See Government of HKSAR Immigration Department, *Quality Migrant Admission Scheme*, <<http://www.immd.gov.hk/ehhtml/QMAS.htm>>, accessed on February 20, 2008.

31. This scheme was launched in July 2003 to attract talented people from the Mainland to work in Hong Kong. This scheme has no restrictions on sectors or quota and only covers professionals in the commercial and financial fields, as well as talented people and professionals in the arts, culture, sporting, and culinary professions. The selection criteria are consistent with those of the General Employment Policy. There is no automatic right of abode in Hong Kong granted to successful applicants, but ordinarily, they can apply for this status after residing in Hong Kong for a continuous period of not less than seven years. See Government of HKSAR, Immigration Department, *Admission Scheme for Mainland Talents and Professionals*, <http://www.immd.gov.hk/ehhtml/faq_asmt.p.htm>, accessed on February 20, 2008.

32. The arrangement started on August 1, 2001, which allowed mainland students who graduated from University Grants Committee (UGC)-funded institutions to work in Hong Kong. In July 2005, it was extended to those who were admitted to study at non-UGC-funded institutions and who subsequently graduated from full-time locally accredited degree-level or above programs. This arrangement aims to attract outstanding Mainland students who have graduated from locally accredited academic institutions at degree or above levels to work in Hong Kong. See Government of HKSAR, Immigration Department, *Immigration Policy on Education*, <http://www.immd.gov.hk/ehhtml/faq_ipoe.htm>, accessed on February 20, 2008.

33. Hong Kong Census and Statistics Department, *Hong Kong Monthly Digest of Statistics: Statistics on Research and Development of Hong Kong, 2003 to 2007* (Hong Kong: Government of HKSAR, Hong Kong Census and Statistics Department, July 2009).

economies, its pool of innovative talent is a powerful engine spearheading its transformation into a knowledge-based economy.

Free Economy

Hong Kong is widely recognized as one of the most open, internationally oriented economies in the world, with free trade at its core. The Heritage Foundation in the U.S. has consistently rated Hong Kong as the world's freest economy—ahead of Singapore—since the Index of Economic Freedom was created in 1995. Apart from its strategic location in the heart of East Asia on China's southern coast, Hong Kong's continuing economic success derives from numerous factors: a low-tax regime, transparent legal system, impartial judiciary, robust financial system, state-of-the-art infrastructure, free flow of capital and information, entrepreneurial spirit, clean government, and commitment to free trade and free enterprise. In addition, the local government has created a business-friendly environment by providing support services and infrastructure, as well as encouraging innovation and technological improvements in order to shift toward knowledge-based and high value-added activities. For example, the capacity for international telecommunications facilities (in cable) has been enhanced 180-fold over the past seven years by the market-oriented government approach.

Over the past two decades, the structure of Hong Kong's economy continued to shift away from manufacturing to services, becoming one of the most open, external-oriented economies in the world. OCTS ensures that Hong Kong remains an ideal metropolis for conducting business and a bridge between China and the world. The current economic restructuring toward a knowledge-based economy, coupled with the foregoing advantages and well-matched policies outlined for Hong Kong by the central government, give the SAR a rare opportunity to develop into a regional service hub in the next decade. If Hong Kong succeeds in these transformations, worries about its being marginalized will vanish. Another element favoring this shift is CEPA. The accord adopts a building block approach to gradually liberalize three broad areas: trade in goods, trade in services (with mutual recognition of professional qualifications), and facilitation of trade and investment. The two sides have been working closely to introduce further liberalization measures. In fact, six supplements have been signed, CEPA I (October 27, 2004); CEPA II (October 18, 2005); CEPA III (June 27, 2006); CEPA IV (June 29, 2007); CEPA V (July 29, 2008); and CEPA VI (May 9, 2009). Goods from

Hong Kong entering China enjoy zero-tariff treatment, and this was extended in the revisions to most products. Preferential access to China was also expanded to cover a wide range of service sectors.

Four key industries underpinned Hong Kong's development into a knowledge-based economy: financial services,³⁴ trading and logistics,³⁵ tourism,³⁶ and producer and professional services.³⁷ Together these four industries generated 59.6% of Hong Kong's GDP and provided 46.9% of total jobs in 2008.³⁸ We believe these four industries will pave the way for Hong Kong's further development into a high-value-added and knowledge-based economy. Therefore, for Hong Kong to become a complete regional service hub, the four key industries should be further developed within the CEPA framework.

HONG KONG'S DEEPENING TRANSFORMATION INTO A SERVICE HUB

Leading Financial Integration in the PRD

Before providing a deeper analysis of how OCTS affects development of the financial sector, we will briefly mention Hong Kong's tourism and trading sectors, as these have also benefitted significantly under the principle. Before 1997, Mainlanders were only able to visit Hong Kong under a quota system, the "Hong Kong tour," for visiting relatives. After 1997 the quota system was relaxed, and in 2001 it was discontinued entirely. To facilitate the implementation of CEPA, the Individual Visit Scheme was introduced whereby since July 2003, Guangdong residents have been allowed to visit for no more than seven days on an individual basis. The scheme was extended to cover 49 cities in the Mainland (totaling around 260 million of China's population), and

34. Financial services includes banking, insurance, stock brokerage, fund management, and other financial services.

35. Logistics refers to freight transport, freight forwarding, storage, postal, and courier services.

36. Tourism covers inbound and outbound tourism. Inbound tourism covers retail trade, hotels and boarding houses, restaurants, other personal services, travel and airline ticket agents, and passenger transport services. Outbound tourism covers travel and airline ticket agents as well as cross-boundary passenger transport services.

37. Professional services cover legal, accounting, auditing, information technology related services, advertising and related services, engineering and related technical services, and architectural design and surveying services. Producer services refer to services for use by other companies in the local economy, as well as exports of services to companies and individuals.

38. Hong Kong Census and Statistics Department, *Hong Kong Monthly Digest of Statistics: The Situation of the Four Key Industries in the Hong Kong Economy in 2007* (Hong Kong: Government of HKSAR, Hong Kong Census and Statistics Department, July 2009).

TABLE 4. Export Value of Goods Benefitting from CEPA and Their Shares in Hong Kong's Domestic Exports

<i>Year</i>	<i>Value (HK\$ mn)</i>	<i>% Share in Domestic Exports to China</i>	<i>% Share in Total Domestic Exports</i>
2004	1,150	3.0	0.9
2005	2,366	5.3	1.9
2006	3,254	8.1	2.4
2007	4,430	10.9	4.1
2008	4,819	13.9	5.3
2009 (Jan.-Apr.)	1,409	18.2	8.3

SOURCE: Hong Kong Trade and Industry Department (2009); Hong Kong Census and Statistics Department (2009).

the number of visitors soared from 6.8 million (14.2% of total visitors) in 2002 to 16.8 million (54.6%) in 2008, respectively.³⁹ Liberalization measures within CEPA allowed Hong Kong's travel agencies to set up wholly owned or joint-venture travel agencies in Guangdong, as well as apply to run group tours in Hong Kong for the province's residents. More than 6.76 million Guangdong residents visited Hong Kong under the scheme in 2006, comprising nearly half of total Mainland visitors (13.59 million that year). Hong Kong's economy benefitted greatly from these guests' spending. Moreover, cross-boundary tourism aided the ability of the SAR's financial system to handle RMB transactions, strengthening its status as an international financial center. Tourists either spend RMB or convert them into Hong Kong dollars once they arrive (by unwritten practice, Hong Kong's companies welcome Mainland shoppers to pay in RMB.)

Another interesting issue is that despite higher production costs relative to the Mainland, manufacturers of some famous Hong Kong brand names chose to relocate part of their production back to Hong Kong in order to benefit from brand-name differentiation of their products. Indeed, the export value of goods benefiting from CEPA can be seen from the growing number of products eligible for tariff-free treatment, which has surged from 374 items in 2004 to 1,565 in July 2009. The share of Hong Kong exports benefiting from CEPA in Hong Kong's overall domestic exports to the Mainland has increased from 3% to over 18% (see Table 4). Hong Kong

39. HKTb, *Visitor Arrival Statistics, 2008*.

serves as a major channel for overseas importers of products sourced in the Mainland, providing trade-related services for financial management, accounting and auditing, business negotiation/liaison, banking and finance, insurance, marketing, and transport and logistics, among others. Another key issue is access to information on business activities, production technologies, product trends, company news, and trade leads worldwide, all of which can help companies make better decisions on product positioning, choice of skills, and customer targeting. Some Mainland enterprises would benefit from more of an international mind-set or management style, as well as greater experience and more capital and technology in order to make an impact on the international market in terms of brand quality and influence. To tackle these difficulties and increase competitiveness, many private enterprises make use of Hong Kong's professional expertise and international experience. Some companies even set up a direct presence there, leveraging the SAR's advantages as an international financial and business center.

The financial service industry greatly benefitted from the implementation of OCTS, not only by reinforcing Hong Kong's position as a global financial center but also by contributing to the development of Mainland financial markets. According to the Basic Law, the SAR government formulates independent monetary and financial policies, the Hong Kong dollar must be backed by a 100% reserve fund, no foreign exchange control policies shall be applied, and the Hong Kong dollar shall be freely convertible. In addition, freedom and privacy of communication are protected by the Basic Law. Financial services have become the pillar industry in Hong Kong, generating around 19.5% of GDP and engaging 5.5% of the work force in 2007.⁴⁰

Hong Kong also boasts one of the highest concentrations of banking institutions in the world. With 145 licensed banks, 135 of which are foreign-owned, Hong Kong is also home to 69 of the world's top 100 banks.⁴¹ Increasing interest and optimism in Hong Kong's banking sector associated with China's accession to the WTO and CEPA's "first mover" advantages will only further strengthen Hong Kong's strategic position as a springboard into Mainland China. In China's 11th Five-Year Plan, as well as in Supplement V of the CEPA package, it is stated that China will support Hong Kong's position and further development as a financial center and help to enhance financial cooperation. Among other policies, the thresholds for market entry (i.e.,

40. Hong Kong Census and Statistics Department, *Hong Kong Monthly Digest of Statistics: The Situation of the Four Key Industries in the Hong Kong Economy in 2007*.

41. Government of HKSAR, *Hong Kong Yearbook 2008*.

minimum requirements for total bank assets) have come down considerably, and the Mainland market is now more open for smaller Hong Kong banks. For example, the requirement for total assets is US\$6 billion, significantly lower than the requirement under WTO commitments of US\$20 billion. Under CEPA V, the “Substantial business operation” requirement will also be lowered. A Hong Kong bank can qualify as a Hong Kong service supplier if it has operated as a branch for at least two years and as a locally incorporated entity for three years or more (as opposed to five or more previously). Smaller banks in Hong Kong are given the additional flexibility of entering the Mainland market: under CEPA V, for a Hong Kong bank to acquire shareholdings in a Mainland bank, the total asset requirement at the end of the year preceding the application was lowered from a minimum of US\$10 billion to US\$6 billion. In other words, Hong Kong banks entering the Mainland’s banking sector, whether setting up a branch or body corporate (including wholly owned subsidiaries and joint-venture banks) or acquiring a shareholding in a Mainland bank, will be subject to a uniform asset requirement of not less than US\$6 billion. Hong Kong banks like the Chong Hing Bank and the Fubon Bank will thus benefit from the new CEPA V provisions.

Accordingly, Mainland banks will be supported in setting up subsidiary operations in Hong Kong. This builds on the Mainland’s prior CEPA commitments regarding financial cooperation, which encourage Mainland financial institutions actively participating in Hong Kong to acquire international best practices, relocate their international treasury and foreign exchange trading centers there, and develop networks in Hong Kong. Further, Mainland financial institutions are also encouraged to seek stock listings in Hong Kong, which became highly visible in 2006 as some top Mainland banks made mega-sized listings. Under CEPA V, the Chinese Mainland is committed to setting up green lanes for processing applications of Hong Kong banks to open branches in Guangdong as well as central, western, and northeastern regions. Hong Kong banks will also be encouraged to set up branches in rural areas to facilitate banking and financial development.

In addition, Hong Kong is the first economy outside Mainland China to be allowed to conduct RMB banking services. The central government indicated in 2006 that as part of Mainland-Hong Kong cooperation, it would study the scope for further expansion of the RMB business in Hong Kong, allowing import settlements and financial bond issues in RMB on a pilot basis. In July 2007, the China Development Bank (CDB) became the first Mainland financial institution to issue RMB bonds in Hong Kong. Its issue

of RMB 5 billion (US\$675 million) to both retail and institutional investors was about three times oversubscribed, laying a good foundation for the subsequent development of the RMB bond market in Hong Kong.

Thanks to hundreds of Mainland Chinese companies that want to raise money in global markets, the capitalization of Hong Kong's stock market jumped almost fourfold in the 10 years from 1997, ranking seventh-largest in the world and third in Asia, after Japan and Shanghai.⁴² In 2008, equity funds raised by Mainland enterprises amounted to HK\$ 223.8 billion (US\$28.7 billion), which was 52.3% of the total equity funds raised through the HKSE during the year. About HK\$ 29.4 billion (US\$3.7 billion) was raised in new listings of Mainland enterprises in Hong Kong, accounting for 44.6% of the total equity funds raised in IPOs (Initial Public Offerings) on the HKSE. In 2006, the listing of the Industrial and Commercial Bank of China, which was the world's largest IPO to date, raised HK\$ 124.9 billion (US\$16 billion) in Hong Kong. In 2008, the total annual trading turnover of Mainland enterprises accounted for 66.1% of the total annual equity turnover of the Hong Kong stock market.⁴³ It is expected that Mainland issuers will continue to be major growth drivers of the stock market in the future. Hong Kong not only possesses a stable and less risky legal environment than the Mainland but also a mature market and diversity of funding. More important, with no foreign exchange controls, Hong Kong is a favorable financial market for Mainland enterprises "going global." However, with China's further opening up, competition from Shanghai, Beijing, and Shenzhen has intensified, and the differences such as separate currency and customs have inevitably made Hong Kong less advantageous in grasping the Mainland market.

Furthermore, under CEPA IV, qualified Mainland fund management companies are allowed to set up subsidiaries in Hong Kong. Together with prior commitments under CEPA, Mainland securities and futures companies, as well as fund management firms, can now participate in the Hong Kong market through their subsidiaries, thus enhancing the breadth of the financial intermediary base in Hong Kong.⁴⁴ Recently, funds from non-Hong

42. World Federation of Exchanges, *Statistics: Domestic Market Capitalization and Investment Flow—Capital Raised by Shares Issues*, <<http://www.world-exchanges.org/WFE/home.asp?menu=396&document=4645>>, accessed March 1, 2008.

43. HKSE, *Data Statistics: China Dimension*, <<http://www.hkex.com.hk/data/chidimen/chidimen.htm>>, accessed November 1, 2008.

44. Government of HKSAR, Hong Kong Trade and Industry Department, *Mainland and Hong Kong Closer Economic Partnership Arrangement: Liberalization Measures*, <http://www.tid.gov.hk/english/cepa/further_liberal.html>, accessed November 1, 2009.

Kong investors have consistently accounted for around two-thirds of the asset management business.⁴⁵ Non-Hong Kong-sourced funds are expected to show further growth. Hong Kong-based fund managers, with knowledge and experience in asset management, have already successfully established joint ventures with Mainland fund managers. Hong Kong managers have also embarked on efforts to enable foreign investors to capture investment opportunities in the Mainland.

So far under OCTS, Hong Kong's fundamental strengths—high market liquidity, robust regulation, and efficient information flow—remain unchanged. In addition, CEPA enables Hong Kong's financial industry to enjoy greater market access and flexibility for their operations in the Mainland. The increase in cross-boundary links between Guangdong and Shenzhen reflects overall increasing economic integration. In August 2009, the governments of Hong Kong and Guangdong signed a cooperation agreement. Hong Kong and Shenzhen will jointly develop a demonstration zone, a free finance and service zone for the modern service industries in Qianhai in Shenzhen's Nanshan District, covering 3.7 square kilometers. This area would be used to test pilot measures under CEPA, aimed at granting Hong Kong's service industries easier access to the Guangdong market. These would include measures for free trade and the free flow of people and capital between Hong Kong and the Mainland.

It is impossible for the Mainland to remain just the world's factory: the development of its service industry must follow. Shenzhen is keen on developing its service industries and will do so with Hong Kong's assistance. The agreement stipulates that the Qianhai financial zone will most likely adopt the Hong Kong model, i.e., rules and management systems. This gives Hong Kong an opportunity to lead financial services integration in the PRD, so the zone does not simply serve local companies. Hong Kong would serve also businesses in other parts of the Mainland. All service providers that abide by Hong Kong rules must meet international standards such as stringent confidentiality and ample freedom of information for operating successfully. This would be China's first experimental zone to allow a service industry base to adopt rules and regulations different from those in force in other parts of the country. It can also be regarded as a pilot scheme to reform Mainland law in accordance with the development of modern service industries in China.

45. Hong Kong Securities and Futures Commission, *Market & Industry Statistics*, <<http://www.sfc.hk/sfc/html/EN/research/stat/stat.html>>, accessed October 1, 2008.

With a general trend toward Hong Kong-Guangdong integration, it is right for Hong Kong to lead efforts to coordinate economic, financial, and producer service integration under OCTS.

CEPA enhances economic complementarity between both sides and acts as a springboard for helping Mainland enterprises and capital in “going international” as well as a gateway for international companies and capital to enter China. This, in turn, generates demand for a wide range of financial services to support increasing trade and investment flows between the Mainland and the rest of the world. Hong Kong’s financial market provides many products of high quality and liquidity, enabling Mainland investors to use the SAR as their base for undertaking global investment. The development of the RMB business is expected to increase and would enhance Hong Kong’s international financial market position.

CONCLUSIONS

The main objective of this paper was to study the role of Hong Kong within the OCTS framework. The central concern for many in the SAR is whether Hong Kong’s growth will stagnate as poorer regions in the Mainland catch up from below, or whether Hong Kong will develop as a growth pole together with other coastal areas in China. As we have shown, the Chinese government’s explicit strategy insisted on developing the coastal areas first in order to spread the benefits inward to poorer areas at a later stage. This led to the relocation of activities to coastal areas such as Guangdong Province, long regarded as the testing ground for reforms and China’s open door policy. In Guangdong, a regional polarization toward the core of the Pearl River Delta has occurred. The delta’s importance will most likely continue to deepen and create further growth following the signing of CEPA, which fostered greater economic integration. This article has highlighted a further regional relocation of activities under CEPA. In fact, the medium- and long-term effects of the regional growth pole in the PRD will provide the whole region with the potential to become the southern growth pole in China. Despite its higher operating costs, Hong Kong as an international financial and trading center offers Chinese enterprises broad business opportunities and benefits, giving it an edge over Mainland cities.