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## *Structural Changes in the Economy of Hong Kong since 1997\**

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### *Abstract*

The Asian financial crisis which became evident around 1997, the time of the return of Hong Kong to Chinese sovereignty, challenged the city to maintain its growth trajectory as the global metropolis for Asia. The subsequent severe recession caused a retrenchment in various intermediary sectors of the city's economy, especially in financial services. Recovery in sectors such as trade and financial services remained below the heady years of growth prior to 1997. Hong Kong has entered a new period of structural change with the increasing shift of back-office jobs to Guangdong province. More sophisticated intermediary service jobs such as those in private equity and hedge funds are growing, but their expansion is obscured for now in aggregate figures because exiting back-office jobs far out-number the new jobs. The city continues to expand as the regional corporate management centre for the world's leading firms from the most developed economies in Europe, North America, and Asia. Producer services are maintaining their high growth rate, positioning the city as a service provider for Asia. Global

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firms continue to validate Hong Kong as Asia's leading business centre, positioning it as a partner with London and New York. Hong Kong's growth benefits from the bonds with its sovereign power, China.

### **Success Is Challenged**

As the 1990s unfolded, Hong Kong soared as the global metropolis for Asia. Its real gross domestic product (GDP) rose at annual rates of 4% to 6%. The strength of its financial sectors, international regional corporate headquarters, global trade, and business services increased at rapid rates, and this success alleviated concerns about the return of Hong Kong to China's sovereignty on 1 July 1997.<sup>1</sup> At the same time, China had explicitly enshrined its guarantee to preserve Hong Kong as an international financial centre in Article 109 of the Basic Law, the constitution governing Hong Kong under Chinese law and which was approved at the third session of the Seventh National People's Congress on 4 April 1990. Senior officials of the Chinese government repeated that guarantee time and again, including an explicit statement by Dai Xianglong, Governor of the People's Bank of China, at the Conference on Financial Integration in Asia and the Role of Hong Kong held on 7 March 1997, just prior to the handover, and they continue to do so right up to the present.<sup>2</sup>

The euphoria of the smooth handover quickly turned to concern, not because of anything China did, but because of events outside Hong Kong and China. Hints of the looming Asian financial crisis appeared in various countries already in 1996 and continued into the following year. During the second half of 1997 countries such as Thailand, Indonesia, the Philippines, and South Korea faced currency crises and bank collapses. Over the next year or so Hong Kong experienced several speculative attacks on its currency, which is pegged to the United States dollar. The Hong Kong Monetary Authority withstood the attacks using various defences, including buying in the securities markets. This was funded by its huge foreign currency reserves; at the time they were the third largest in the world. Nevertheless, with economic distress sweeping across Asia, the heady growth of Hong Kong and its global businesses came to a halt. The real GDP of Hong Kong fell from 1997 to 1998 and then began an erratic, laboured recovery. The pace of GDP growth did not pick up in a sustained way until after 2003.<sup>3</sup>

The economic difficulties of Hong Kong during this period from the

late 1990s to around 2003, when the turmoil of the severe acute respiratory syndrome (SARS) epidemic hit, generated questions in the media and in academic publications about the future viability of Hong Kong as Asia's leading business centre. Some of these concerns became linked to China's influence over Hong Kong, even as Chinese officials never wavered in their support of the city as the nation's pivotal international financial centre.<sup>4</sup> Yet these questions about Hong Kong's future did not take into consideration the position of the city's business people in the economy of Asia since the late nineteenth century. That position must be interpreted theoretically in order to explain why the challenges that Hong Kong has faced since 1997 have not impaired its status as Asia's leading global business centre.

### **A Theoretical Lens on Hong Kong**

Hong Kong has been the pivotal meeting place in Asia of the Chinese and foreign social networks of capital since the late nineteenth century.<sup>5</sup> After the British defeated China in the Opium War of 1840–1842, Hong Kong became a British colony. During the decade of the 1840s leading British trading firms set up their Asian headquarters in the city, and other foreign firms soon followed. This agglomeration of top firms made Hong Kong the key centre of information about the trade of Asia, and many Chinese trading firms from around the region likewise set up operations in the city by the 1850s. The formation of the Hongkong and Shanghai Bank by the leading trading firms of Asia in 1864–1865 confirmed Hong Kong as the pivotal trading and financial centre of the region. The city housed the bank's global headquarters, and major branch offices were established in Shanghai, Yokohama, and London. Because the bank drew on the trading contacts of its founding firms, it quickly acquired a financial reach to major business centres around the world.<sup>6</sup>

This juxtaposition of the top trading and finance firms in Hong Kong with many leading Chinese trading firms, meant that the knowledge cluster in the city circulated the latest and most sophisticated information about business throughout Asia and around the world. Within the region the Chinese firms occupied a special place because they had contacts both within China and with the countries of East and Southeast Asia where many overseas Chinese lived. The expansion of the Hongkong Bank in Asia, as represented by its establishment of branch offices throughout the region during the late nineteenth and early twentieth centuries, epitomized

the reach of the networks of capital which emanated from Hong Kong. Similarly, the leading Chinese trading firms headquartered in the city expanded their ties to Asia. By the early twentieth century the trading areas of major Chinese exporters and importers headquartered in Hong Kong mirrored closely the organizational reach of the Hongkong Bank, testimony that the foreign and Chinese networks of capital operated in an integrated manner. Case studies of firms demonstrate this competitive and coordinative feature of the foreign and Chinese firms in Asia. In fact many foreign firms employed *compradors* who were leading Chinese traders. These individuals aided the foreign firms in running their Asian business, especially including their ties to Chinese firms around the region.<sup>7</sup>

The networks of capital of the trading and financial firms operating within Hong Kong and reaching throughout Asia and to the leading business centres in North America and Europe had reached great strength. They remained resilient during the turmoil in Asia: the First World War, the depression of the 1930s, the conflicts leading up to the Second World War, the devastation of that war, the subsequent turmoil of the battles between the Communists and Nationalists within China, and the remaking of the politics of Asia with the overthrow of imperialism in many countries and the establishment of the People's Republic of China. Although Hong Kong possessed a modest industrial sector prior to 1940, the movement of many industrialists from Shanghai and Guangdong province to the city after the triumph of Chinese Communist Party in 1949 provided the entrepreneurial base for the growth of the city as a major export industrial centre. Hong Kong's trading and financial firms gave these manufacturers access to world markets. The city's shipping and port facilities, which had been among the best in Asia, continued to expand. These services moved the industrial goods of Hong Kong to world markets, as well as bringing imports to Asia and redistributing them in the region.<sup>8</sup>

After the reforms of Deng Xiaoping in 1978, Hong Kong's industrialists began their move into Guangdong province. By the time the city's factory production had peaked in the mid-1980s, the shift across the border had reached such a scale that Hong Kong's manufacturing soon commenced a precipitous drop that continued into the 1990s. The city, therefore, had become primarily a corporate management centre for manufacturing, while the factories mostly operated in mainland China. At the same time the economic development of Asia encouraged foreign financial firms to expand their existing operations in Hong Kong, and many new ones entered the city, choosing it as their chief Asian

headquarters. Swelling numbers of global nonfinancial firms also established their Asia-Pacific, Southeast Asia, East Asia, or China regional headquarters in Hong Kong. This behaviour of the financial and nonfinancial firms, which had roots in the late nineteenth century, confirms that Hong Kong remains the pivotal meeting place of the Chinese and foreign networks of capital. The expansion of these firms in Hong Kong, and of the supporting corporate services sectors (for example, law, accounting, management consulting), through the uncertainty leading up to the return of the city to Chinese sovereignty in 1997 testified that all of these businesses saw the city as the leading global business centre of Asia.<sup>9</sup>

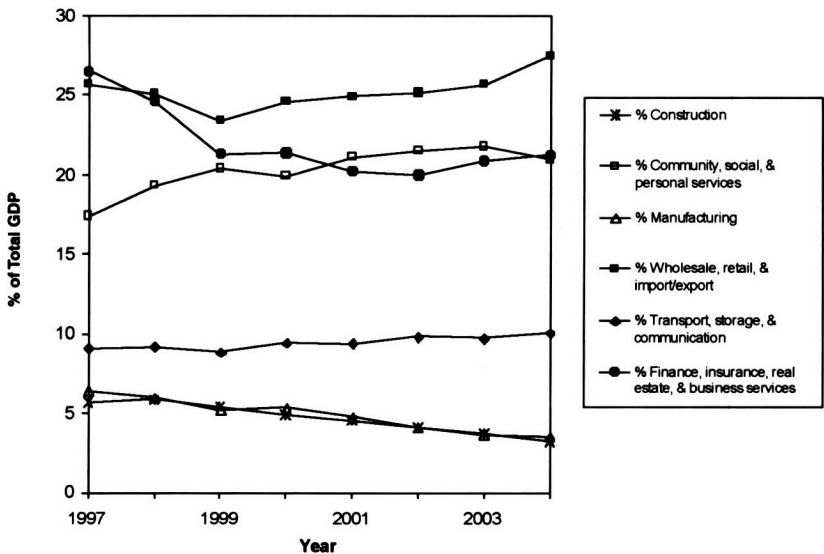
Hong Kong's financial institutions and other key business sectors underwent retrenchment during the period of economic difficulties from 1997 to 2003. Nevertheless, the networks of capital which link the city's international firms to Asia and to the rest of the global economy set the basis for the recovery. Hong Kong's economy transformed to more sophisticated intermediary services for China, the rest of Asia, and the global economy.

### **Sectoral Shares of the Economy Stabilize**

The return of Hong Kong to China's sovereignty benchmarked a new era for the city's economy. The period of the graft of local manufacturing production onto the trade and finance character of Hong Kong, which had lasted for about a half century from the 1950s through the first part of the 1990s, had to a large extent ended. The manufacturing share of total gross domestic product (GDP) fell to just over 6 per cent in 1997 and continued its downward path to just below 4 per cent by 2004 (Fig. 1). This recent decline, however, was too small to have a consequential impact on the relative sectoral shares of the economy. Thus a broad stabilization of the sectoral shares of GDP has become the signature feature of the city. Hong Kong operates as a centre of finance, trade, corporate management, and business services. A significant share of the remainder of the economy consists of retail activity to serve the local population and the large number of visitors and of community, social, and personal services which meet a diverse set of the population's needs.

The small and declining share of construction in GDP, however, does not fully indicate that sector's importance to the economy of Hong Kong. Construction, as well as real estate (which is grouped with finance,

Figure 1. Sectoral Shares of Total GDP in Hong Kong, 1997–2004



Source: Census and Statistics Department, *Annual Digest of Statistics* (Hong Kong: Hong Kong Special Administrative Region, various years).

insurance, and business services), together constitute significant components of the economy. The government of Hong Kong controls most of the land in the city. It is allocated to developers through land auctions, and they hold the land for a specified time period. Large real estate development companies dominate building in Hong Kong. These firms are among the largest corporations headquartered in the city, and some of them, such as Hutchison Whampoa and New World Development, are transnational corporations. Through the 1990s the big real estate development companies accounted for as much as one third of the stock market capitalization of the Hong Kong Stock Exchange. The price movements of the companies' stock had a significant influence on overall stock prices. These companies' share of total stock market capitalization has declined since 2000 because large mainland corporations, including the country's big state banks, are being listed on the Hong Kong exchange. Beijing leaders have strongly encouraged these listings in Hong Kong as a demonstration of China's support of the city as its global business centre.

Nonetheless, the absolute importance of the real estate development companies continues to grow as they expand in Hong Kong and elsewhere in Asia.<sup>10</sup>

Although industrial production in Hong Kong has declined dramatically, manufacturing remains strongly embedded in the city's economy. The contributions to GDP are hidden under other sectors. In the corporate management sector there are tens of thousands of Hong Kong Chinese manufacturing firms whose headquarters are in the city and whose factories are in mainland China, for the most part, and also elsewhere in Asia. This makes Hong Kong the greatest management centre of Chinese manufacturing firms in the world. That supervisory role extends the legacy of the industrialization of Hong Kong, as well as of other parts of Asia. Since the 1950s the city has been a controller/manager of the commodity trade in intermediate and finished goods manufactures within Asia and between that region and the rest of the world. The continued large-scale growth of industry in China enlarges this role of Hong Kong's trading firms.

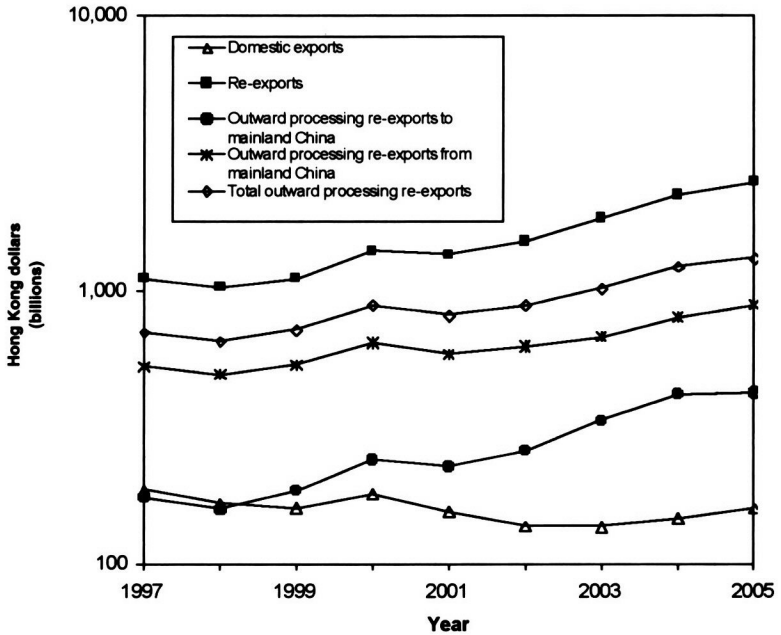
## **The Trade Sector**

Although trade retains a strong connection to manufacturing, the tie to domestic manufactures continued to decline to a low level (Fig. 2). Because the price level changed significantly during this period, the measures of trade flows in Hong Kong dollars are adjusted using the implicit price deflators (2000=100) published by the Census and Statistics Department of the Hong Kong government. Re-exports recovered from the dip during the immediate aftermath of the Asian financial crisis which commenced in late 1997, and by 2000 the upturn in re-exports gained traction. Nevertheless, the pace of growth of re-exports is much reduced from the rate of increase during the three decades following 1960.<sup>11</sup>

The shift of much of Hong Kong's manufacturing to mainland China, especially nearby Guangdong province, had been mostly completed by the mid-1990s. This established the city as a hinge for commodity flows. Inputs are brought into Hong Kong for re-export to factories in the mainland, and intermediate and finished goods from the mainland are re-exported to Asian and global markets. While these outward processing re-exports are growing, their pace lags behind the rate of increase in total re-exports. This reflects the rising share of total re-exports which involve trade elsewhere in Asia and globally. This share has grown from 36% in



**Figure 2. Real Value of Domestic Exports and Re-exports of Hong Kong and of Re-exports to and from Mainland China Involving Outward Processing, 1997–2005 (2000=100)**



Sources: Census and Statistics Department, *Annual Digest of Statistics* (Hong Kong: Hong Kong Special Administrative Region, various years); Census and Statistics Department, *Gross Domestic Product, 2006* (Hong Kong: Hong Kong Special Administrative Region, 2007).

1997 to 47% in 2005. The growing coordination and management of trade in manufactures, apart from production in mainland China, reinforces Hong Kong's position as a hub of business in Asia.

### Intermediary Businesses and Support Services

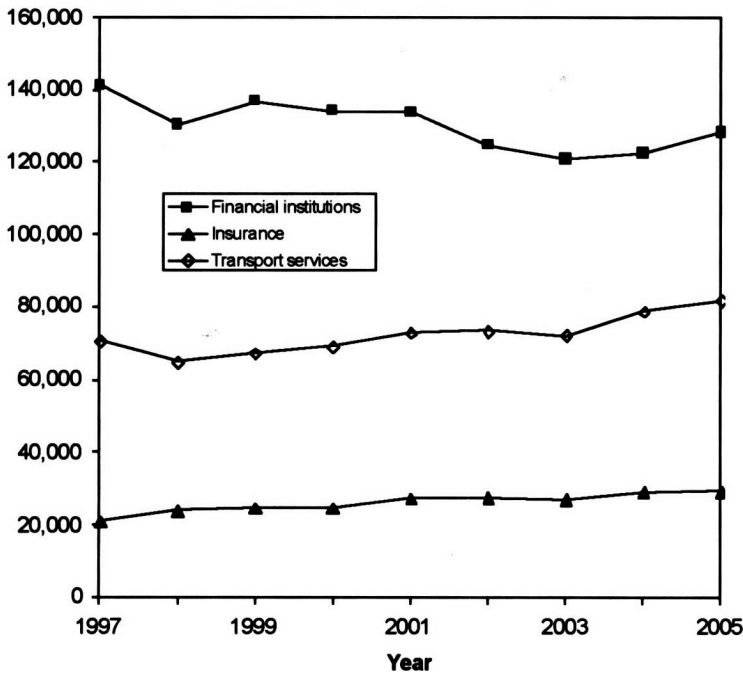
In contrast to the recovery in re-exports, employment in the various sectors of intermediary businesses and their support services has followed divergent paths. These alternative paths, after more than two decades of heady growth since 1980 in all of the sectors, seemingly raise cautionary points about the future of Hong Kong as the key business centre of Asia.<sup>12</sup>



The number employed in financial institutions, which grew dramatically in the earlier years, has declined somewhat, though there is some sign of a turnaround since 2003 (Fig. 3). The smaller sectors of insurance and transport services have slowly increased their number employed over the years since the return of Hong Kong to China. The trends in employment in the two largest sectors, business services and imports and exports, have diverged. The former has increased over 25% since 1997, whereas the latter has stabilized (Fig. 4).

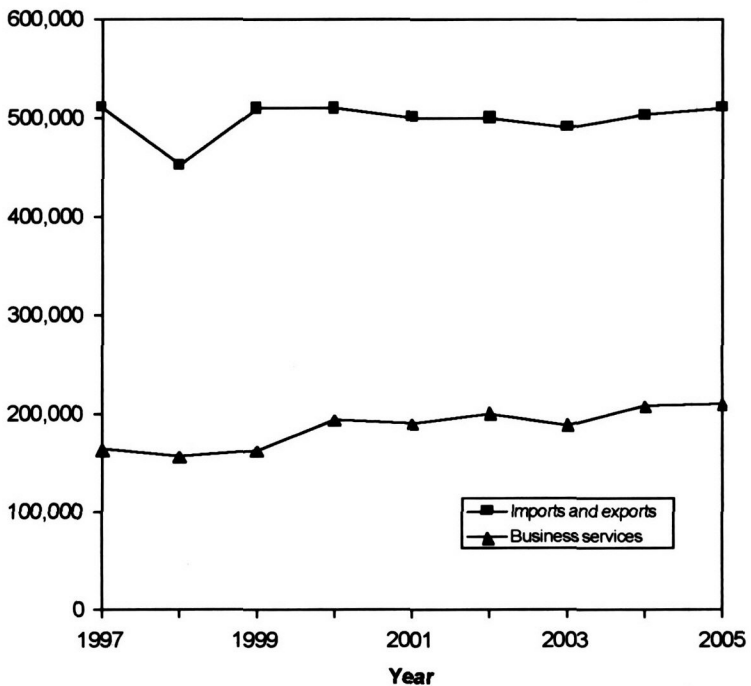
The recent slowdown in the growth rate of employment in intermediary businesses such as financial institutions and imports and exports was inevitable simply because the earlier rapid growth during the

**Figure 3. Employment in Financial Institutions, Insurance, and Transport Services in Hong Kong, 1997–2005**



Source: Census and Statistics Department, *Annual Digest of Statistics* (Hong Kong: Hong Kong Special Administrative Region, various years).

**Figure 4. Employment in Business Services and in Imports and Exports in Hong Kong, 1997–2005**



Source: Census and Statistics Department, *Annual Digest of Statistics* (Hong Kong: Hong Kong Special Administrative Region, various years).

1980s and most of the 1990s rested on a small base. After the massive increase the base has reached a high level. Yet, more fundamental processes are at work that are consistent with the way the world's leading business centres such as New York City and London grow. Financial institutions and nonfinancial corporations with large numbers of white-collar workers performing tasks which do not rely much on face-to-face communication, the so-called back-office jobs, can relocate these jobs to cheaper office space in suburban areas or in satellite cities of the global business centre. These back-office jobs far outnumber the sophisticated financial and high-level corporate management positions.

Once firms commence moving back-office jobs to cheaper office

space on the periphery of the metropolitan area, the number of centrally located jobs may grow more slowly, stagnate, or even decline as the dispersal of the back-office jobs overwhelms the number of new sophisticated jobs. Only after a large share of the back-office jobs have relocated will the growth of sophisticated intermediary jobs contribute to significant net growth.

In Hong Kong's case, few of its back-office jobs relocated prior to 1997. Thus the large-scale expansion of back-office jobs in the intermediary businesses occurred within the city, though not always within the major international corporate clusters in Central, Admiralty, Wan Chai, and Causeway Bay. The onset of the Asian financial crisis, the subsequent downturn in Asia, and the resulting severe recession in Hong Kong resulted in a sharp retrenchment by many international financial firms in the city.

As Asia's economies commenced a recovery during the early 2000s, Hong Kong's financial firms faced a new locational landscape for their back offices. The rising quality of urban infrastructure, construction of office buildings, and increasing sophistication of telecommunications infrastructure in nearby Guangdong province, especially in the Shenzhen and Guangzhou metropolitan areas, created the option of relocating back-office work across the border. Furthermore, the growing cooperation between the governments of Hong Kong and of Guangdong province gave assurance to international financial firms that they had little to fear about moving sensitive financial information or access to it to offices in mainland China. In a sense these changes replicated the earlier transformation of Guangdong province as a site for manufacturing after the reforms of Deng Xiaoping in 1978. Hong Kong's manufacturers slowly began to filter across the border. As they became convinced that they could effectively and efficiently manufacture there, they began a pell-mell rush to set up factories in Guangdong province.

The pace of the shift of back-office jobs across the border picked up around 2001 when Ernst & Young moved into offices in Guangzhou, and within two more years several major banks, including the Bank of East Asia, HSBC, and Standard Chartered had established offices in Guangdong Province. The full extent of this development of back offices remains unknown, but the large development of office buildings in Shenzhen stands as a rough indicator that the back-office move is well underway.<sup>13</sup> This means that the growth of financial jobs in Hong Kong will be retarded for some years to come as large numbers of back-office

workers are relocated to Guangdong province and the net expansion of these offices of financial firms occurs mostly across the border.

These large numbers will overwhelm the growth of sophisticated financial jobs in Hong Kong. After much of the easily moved back-office jobs in Hong Kong are relocated, then we can expect to see a greater upturn in Hong Kong's financial jobs with the continued influx of sophisticated financial firms and the expansion of these jobs in existing firms.

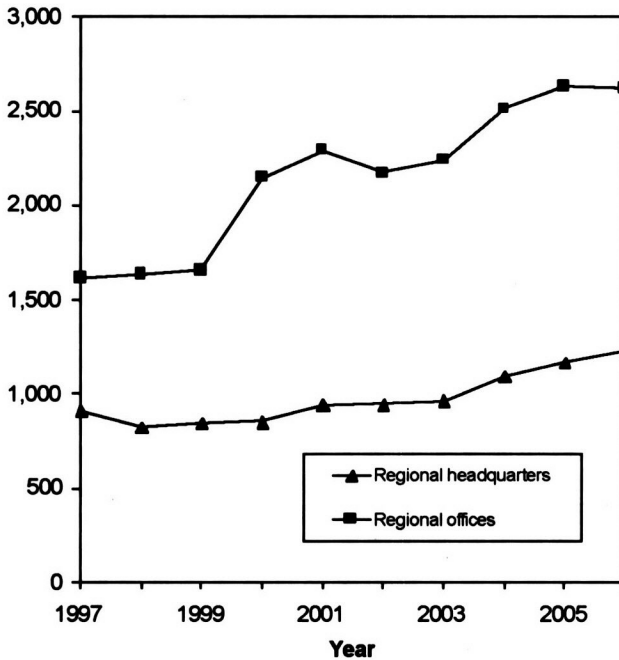
The expansion of sophisticated financial jobs in Hong Kong is not a hope; it is already a reality. The city is the leading Asian centre for private equity firms and hedge funds who use it as the headquarters for their Asian investments. Hong Kong far surpasses Tokyo and Singapore in private equity investments in Asia (outside Japan). Hedge fund management in Hong Kong soared between 2004 and 2006 as the number of hedge fund managers doubled from 58 to 118 and their assets under management rose almost four times from US\$9 billion to US\$34 billion. Large mainland China banks are running their initial public offerings (IPOs) through the Hong Kong Exchange and this provides substantial business for the global financial firms in the city. Since 2005 six banks, including Bank of Communications, China Construction Bank, Bank of China, China Merchants Bank, Industrial and Commercial Bank of China, and China CITIC Bank, have raised billions of US dollars each and some of them rank among the largest IPOs in world history.<sup>14</sup>

As China's financial firms increase their sophistication and engagement with the global economy, including extending their participation in Hong Kong's financial sector, this will provide greater opportunities for the city's financial institutions to offer more specialized services to China. As the Hong Kong offices of the mainland banks boost their skills they will supply better knowledge of financial prospects within China. That sharing of expertise within the networks of capital of the Hong Kong financial community is a key competitive advantage which the city maintains.

### **Corporate Management Centre**

During the twenty-year period leading up to 1997 Hong Kong dramatically expanded as a centre of corporate decision making for international firms from around the world to manage their Asian business.<sup>15</sup> In contrast to the stability or slow expansion of most intermediary businesses, however, the number of regional headquarters which supervise other offices outside Hong Kong quickly regained an upward trajectory from the dip in 1998

**Figure 5. Number of Regional Headquarters and Regional Offices in Hong Kong, 1997-2006**



Source: Census and Statistics Department, *Report on Annual Survey of Companies in Hong Kong Representing Parent Companies Located outside Hong Kong* (Hong Kong: Hong Kong Special Administrative Region, various years).

(Fig. 5). This number increased without interruption to 1,228 by 2006, an increase of 48%. The number of regional offices which supervise outside Hong Kong, but not over another office, increased more erratically. Nonetheless, after 1999 the number of regional offices expanded by 58%, reaching 2,617 by 2006.

Equally important as this expansion of regional headquarters and offices has been the continued dominance from 1997 to 2006 of firms from the wealthiest countries in the world, including the leading Asian economies (Table 1). These management offices provide critical network links between the decision making centres in these countries and the businesses in Hong Kong. Thus firms of all types in the city have

extraordinary access to sophisticated expert knowledge about the global economy both at the macro level (overall trends and by sectors) and at micro levels (from country to city to rural areas). The United States has the dominant presence, and it is followed by the second largest economy in the world, Japan. This indicates that many Japanese corporations find Hong Kong a better place to run their Asia-Pacific (or parts of Asia) business than Tokyo. The reason is the centrality of Hong Kong in the business networks of Asia, especially because it is the pivotal meeting place of the Chinese and foreign networks of capital, a position it has held since the late nineteenth century.<sup>16</sup>

All of the leading European economies, including the United Kingdom, Germany, France, the Netherlands, Switzerland, Italy, and Sweden, have significantly increased their numbers of regional headquarters and offices between 1997 and 2006. This testifies to the

**Table 1. Number of Regional Headquarters and Regional Offices in Hong Kong by Political Unit of Parent Company, 1997 and 2006**

Political unit of parent	Regional headquarters		Regional offices	
	1997	2006	1997	2006
United States	219	295	262	594
Japan	121	212	378	519
United Kingdom	86	114	130	223
Mainland China	117	112	128	156
Germany	53	76	77	136
France	35	55	65	117
Netherlands	27	48	47	47
Singapore	9	44	44	106
Switzerland	30	42	22	68
Taiwan	28	28	49	149
Italy	3	23	17	52
Australia	6	21	22	65
Sweden	9	19	16	34
South Korea	13	16	81	62
Canada	7	15	20	31
Selected total	763	1,120	1,358	2,359
Other	172	108	253	258
Total	935	1,228	1,611	2,617

Source: Census and Statistics Department, Hong Kong Special Administrative Region.

importance the top firms in these countries assign to Hong Kong as their Asian base to supervise their businesses in the region. Similarly, the leading Asian economies, including Singapore, Taiwan, and South Korea (and of course Japan) likewise use Hong Kong as a major management base even though their corporate headquarters are in the region. Their rationale is that location in Hong Kong embeds them in the pivotal business networks of Asia, far better than they would be in their corporate headquarters base.

Mainland China firms are the fourth largest group in Hong Kong (Table 1). Their large number, even though their corporate headquarters are within the same country, testifies that the senior executives of these firms believe their firms need to interact at a high level in the business networks of Hong Kong, thus they have a regional headquarters there. The large number of regional offices likewise suggests that these firms see Hong Kong as a supervisory centre for their local operations in Hong Kong, as well as outside the city within mainland China and parts of Asia. The numbers of headquarters and offices from mainland China may underestimate the presence of these firms in Hong Kong. Senior Beijing officials have carefully avoided exerting influence on business in Hong Kong, and this means that many mainland firms keep a low profile in the city. In any case, the continued large-scale economic growth and development of China will confer substantial benefits on Hong Kong as increasing numbers of mainland firms place major global management offices in Hong Kong.

### **Producer Services**

The Asian financial crisis and the subsequent recession in Hong Kong, which covered about half of the period from 1997 to 2005 (most recent available data), retarded the city's growth as a business centre. Nonetheless, employment in the producer services which provide a wide range of support for international firms, as well as local ones, in aggregate grew about 27% (Table 2). These activities are quite disparate. A selected set of these services include a contingent of activities which are susceptible to relocation to Guangdong province as back-office jobs. This group increased 11%, whereas a diverse group labelled "other business services" grew 54%.

Hong Kong continues to build on its long-term strategic advantage as the pivot of Asian trade. As of 2005 almost 3,000 firms provided air and



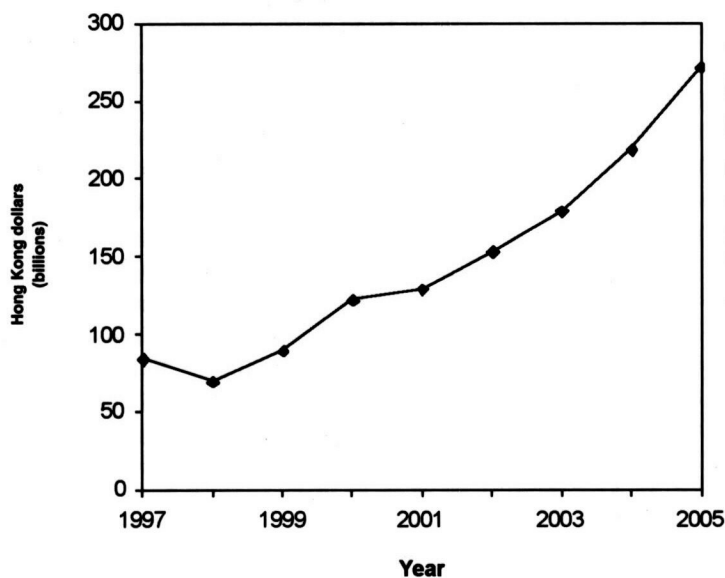
**Table 2. Producer services in Hong Kong, 1997 and 2005**

Selected services	No. of establishments		No. employed	
	1997	2005	1997	2005
Air cargo forwarding	793	750	11,690	14,208
Sea cargo forwarding	2,076	2,126	16,354	20,369
Ship brokerage	126	55	661	226
Solicitors	694	786	16,710	15,433
Barristers	468	800	730	1,073
Accounting & auditing	1,302	1,937	13,591	14,082
Bookkeeping & general accounting	1,578	1,829	4,131	6,689
Advertising companies & agencies	821	944	6,908	5,504
Other advertising services	2,558	3,045	8,618	7,925
Public relations	109	274	805	1,451
Market research	66	95	717	762
Business management & consultancy	3,277	3,732	19,909	24,407
Selected total	13,868	16,373	100,824	112,129
Other business services	8,258	12,219	60,149	92,430
Total business services	22,126	28,592	160,973	204,559

Source: Census and Statistics Department, *Employment and Vacancies Statistics (Detailed Tables), Series A (Services Sectors)*, Hong Kong, various years.

sea cargo forwarding services, and their aggregate employment had expanded by 23% since 1997. The employees of these firms do not physically move cargo; instead, these are office workers who coordinate global logistics for international firms. The limited expansion of accounting-related employment probably results from the beginnings of the shift of back-office jobs in these firms to Guangdong province and elsewhere in Asia, similar to the shift of financial back-office jobs. In contrast, the number of firms in business management and consultancy rose by almost 500, and their total employment grew by 23% over the 1997–2005 period. These firms provide sophisticated advice to international companies, and their robust expansion confirms the dynamism of Hong Kong as Asia's leading business centre.

The growing significance of Hong Kong as a supplier of business services to Asia is reflected in the dramatic increase in the value of the real net exports of services between 1997 and 2005 (Fig. 6). Because these are net values, they measure the so-called balance of trade in services, which is in Hong Kong's favour. During this short period the real net gains more

**Figure 6. Real Net Exports of Services from Hong Kong, 1997–2005 (2000=100)**

Source: Census and Statistics Department, *Annual Digest of Statistics* (Hong Kong: Hong Kong Special Administrative Region, various years); Census and Statistics Department, *Gross Domestic Product, 2006* (Hong Kong: Hong Kong Special Administrative Region, 2007).

than tripled. The net gains to Hong Kong rose from US\$11 billion to US\$35 billion, a sizable boost to the city's economy.

This growing importance of services to the economy of Hong Kong was well underway during the 1980s even as manufacturing jobs shifted to Guangdong province and elsewhere in mainland China. The workers displaced from manufacturing have not possessed the educational skills which make them suitable for the jobs in sophisticated business services. Although the real income of those in the bottom of the income distribution has risen, income inequality has also increased somewhat from its already high level.<sup>17</sup>

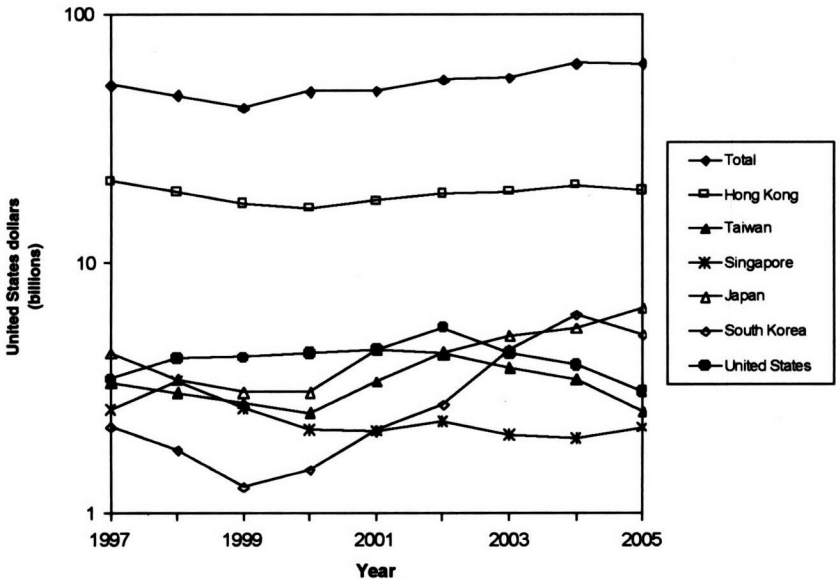
### **Pivot of Foreign Direct Investment in China**

Even with the importance of the rest of Asia to Hong Kong's status as the

leading business centre of the region, China still looms as the key driver of Hong Kong's status as a decision making centre of capital. The total foreign direct investment (FDI) utilized in China continued to grow after 1997, though the rate of increase has slowed from the rapid rates of the 1980s and early 1990s, when the base was much smaller (Fig. 7). Over the 1997–2005 period the total annual new FDI rose from US\$52 billion to US\$64 billion, an increase of 23% over that time span. Hong Kong continues as the unquestioned leading source of FDI in China, as it has been since the opening of China after the reforms of Deng Xiaoping in 1978, but its share of the total has declined from 41% in 1997 to 31% in 2005.

Hong Kong's declining share of China's FDI accounts for all of the declining share of the leading investors in China over the 1997–2005. Japan remains the second greatest source of FDI for China, and its share has risen from around 7% to 10%. Taiwan's share has fluctuated, and its annual totals have been in a downtrend since 2002. However, Taiwan's

Figure 7. Annual Foreign Direct Investment Utilized in China by Origin, 1997–2005



Source: State Statistical Bureau, *China Statistical Yearbook* (Beijing: China Statistics Press, various years).

actual capital investment flows remain obscure, with continued suspicion that some of them are hidden within the figures for Hong Kong. Singapore's relative and absolute position as a source of FDI remains stable, and there is little evidence that its firms are usurping the position of Hong Kong's firms as investors in China. The key transformation of FDI for China is the dramatic rise of South Korea to a position approximately on a par with Japan as being the next largest source of FDI after Hong Kong.

On a larger scale, however, the most important change in China's FDI has been the greater number of countries, especially from Europe, which are investing in China, thus diversifying its sources of FDI. This growing involvement of European countries, albeit still small compared to the leaders, may be behind the significant increases in the number of regional headquarters and offices in Hong Kong which come from the biggest European economies (Table 1). Thus Hong Kong's position as the global business centre of Asia is enhanced, and its absolute amount of FDI sent to China still remains triple the size of the next closest sources by amount, Japan and South Korea.

### **The Next Stage for Hong Kong**

The global businesses who operate in Hong Kong, making it the pivotal meeting place of the Chinese and the foreign business networks of Asia, continue to position the city as the greatest business centre of Asia. Many of the challenges and difficulties the city faced and the retrenchments which firms engaged in during the first years after 1997, while economic crises and recession hit Asia, had only temporary effects. Even as these difficulties loomed, structural changes were underway in Hong Kong which are the same that other top global business centres such as London and New York City have faced. The very success of these cities in attracting global firms to base their most sophisticated employees and operations in these cities has led these firms to relocate their lower-level white collar workers, the so-called back-office jobs, to the periphery of the cities in suburbs or satellite cities or even farther afield. Hong Kong entered that process in a significant way around the year 2001. The capacity of its global firms to relocate their back-office work to Guangdong province has arisen because the growing integration of the city with mainland China rests on an increasingly trustworthy partnership between the city's businesses and the government officials and domestic businesses of its sovereign power, China.

Shanghai looms as a potential competitor to Hong Kong both as China's leading business centre and as Asia's most important global metropolis. The development of the office sector in Pudong for the international financial firms and corporate regional headquarters for firms with extensive China operations seemingly enhanced Shanghai's position as challenger. The Beijing government has made progress in improving financial regulation, especially through the operations of the China Banking Regulatory Commission and the China Securities and Regulatory Commission. Nonetheless, the structures and implementation of regulations remain far below the standards in London, New York, and Hong Kong. This weakness of commercial law within China undercuts Shanghai's capacity to be a competitive financial centre. Foreign nonfinancial firms are increasingly looking to Beijing as their China headquarters because it offers convenient access to top governmental officials and their ministries. Thus Shanghai is not competitive with Hong Kong as a financial or a nonfinancial headquarters centre. As a result, on most measures of financial importance and overall status as a global city, Shanghai currently ranks far below Hong Kong.<sup>18</sup>

Global firms continue to use Hong Kong as their Asia-Pacific base, and the city is gaining growing numbers of the new, sophisticated intermediary services. Some of these are new firms, and many others are units of the greatest global firms in Europe, North America, and other parts of the world. This transformation of Hong Kong is positioning the city to be the third partner of the two great global business centres, London and New York. With the ever-growing integration of Hong Kong with the Greater Pearl River Delta Region, Hong Kong's economy increasingly resembles London and New York, each of which is also a pivot of a vast metropolitan region. The base-level strength of Hong Kong is that it is China's key link to the global economy, and the rapid economic development of China will continue to fuel the transformation of Hong Kong. At the same time the beginnings of more rapid economic development in India add another dimension to the transformation of Hong Kong, as its intermediary firms have the opportunity to be the key bridge between India and China.<sup>19</sup>

The Chinese government's unequivocal support of Hong Kong as the nation's global business centre stands as a powerful undergirding of the city's economy. Under British rule the city faced many business crises which local colonial officials and prominent local business people resolved, for the most part, on their own, sometimes with the support of the

distant British government. Fundamentally, however, local people had to deal with the crises. If those business crises had risen to levels beyond the capacity of local people to resolve, the city could not count on an absolute guarantee that the British government would rescue Hong Kong. Today, China gives great leeway to the city's government and its leading businesses to resolve these crises on their own. However, no doubt exists that if a business crisis became too difficult for the city's officials and businesses to resolve on their own, China's government would step in with full political and economic backing. That absolute guarantee of support is the most significant positive transformation of Hong Kong's relations with the global economy. The city no longer stands alone.

## Notes

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