Chapter III

Return of Hong Kong and Regional Economic Fluctuations in China

Introduction

What will happen to Hong Kong after it reverts to China on July 1, 1997? The Hong Kong government, the Chinese government and industrial circles believe that the best solution is to maintain the current status quo. After July 1, the Chinese government will do its utmost to ensure that the after-effects of the return of Hong Kong are kept to a minimum. They will bolster share prices and real estate transactions and take other measures. Vice Premier Zhu Rongji appears to have stated that he would not hesitate to use the Chinese foreign currency reserve ($95.3 billion as of September 1996) to protect the Hong Kong dollar, if necessary(1).

Hong Kong will compensate for the Chinese mainland situation, which is lagging in its conversion to a market economy, and will allow Chinese state-run enterprises to increase their experience of international transaction. What of Hong Kong in the medium- and long-term? The situation at home and abroad will have some bearing on this. Hong Kong's status will unavoidably be affected by development of the port, telecommunications and financial market of the surrounding Southeast Asian nations and of other countries such as the Philippines, Singapore, Thailand and Taiwan. It is a fact that neighbouring countries have shown remarkable progress in these areas.

Economic modernization of the Chinese mainland will also have some influence on the role of Hong Kong. Regional economic trends of the Pearl River Delta, Yantze River Delta, Bohai Rim economic bloc, northwest, southwest and other economic blocs are crucial. Most important of all is whether or not the Pearl River Delta, adjoining Hong Kong, can maintain its growth into the future.

This report focuses on the role played by Hong Kong in Chinese regional economic fluctuations since the 1980s. The emergence of the Yantze River Delta region, centered on Shanghai, as a new growth area since the late 1990s has meant that Hong Kong's role cannot help but change. I would like to clarify this point by reviewing regional economic developments in China.

1. Regional Economic Development Model for the 1980s

(1) South China Economic Bloc

In 1979, the Chinese government set up the five special economic zones of Shenzhen, Zhuhai, Shantou, Amoy and Hainan Island as models, opening them to foreign influence, and adopted a special policy toward the two provinces of Guangdong and Fujian. Prompted by these actions, state funds were invested in the five special economic zones on a massive scale in order to create building bases by constructing the necessary infrastructure and other measures and set up a window to foreign influence under government instruction.

In other coastal cities and regions, independent development was anticipated through an easing of regulations and greater autonomy. The central government had no clear blueprint for its development strategy. As a result, the regions drafted "models" based on their conditions of location and special historical character. Examples include the Pearl River Delta, Wenzhou, Hainan Island, Sunan (south Jiangsu) and Dalian models. Development models emerged, one after another, focusing on the coastal cities. A common issue of these self-help efforts was what would be the source of development, given that government financial support could not be counted on. Let us first look at the experience of the Pearl River Delta region.

The Pearl River Delta region laid its emphasis on commissioned processing with Hong Kong for cities along the banks of the Pearl River such as Dongguan, Zhongshan, Nanhai and Shunde, seizing the right timing for transfering Hong Kong's manufacturing industry to Guangdong to survive increasingly fierce international competition. This strategy called for the development of local industries and utilized surplus labor from rural areas. The income from processing commissions served to stimulate the regional economy. As time passed, the industrialization of Guangdong progressed steadily with the combination of Hong Kong capital and 4 million migrant workers from Guangdong, Sichuan province and other areas. Guangdong came to lead the country in exports, and acquired a strong competitive position in the domestic market, as shown by a popular saying indicating that Guangdong products were invading the north.

At the outset, Hainan Island was a special economic zone; however, in 1986, it became a province. Trade was adopted as a means for funds procurement to develop this tropical Asian island, with no otherwise promising resources or industry. Import duties for the island were kept low as an incentive to support development, allowing cars imported cheaply to be resold to the mainland, earning massive profits. This abusive trading system could not continue indefinitely, and in 1988, these reselling practices were prohibited. The new development strategy adopted by Hainan Island involved a development take-over by foreign investment, and called for complete reliance on foreign investment, without looking domestically for markets, capital or resources. To this end, in 1992, a large-scale industrial development zone with a bonded area was constructed in Yangpu, about 100 kilometers from Haikou, and a foreign firm, Kumagai Gumi of Hong Kong, was entrusted with the tasks of development through to management. Naturally enough, the project faced stormy waters, receiving criticism that the settlement was no better than that before the revolution. Finally, in 1992, it was approved and construction was scheduled to commence.

In Guangdong province, including the Pearl River Delta, a special policy allowed price liberalization to develop, resulting in a flood of consumer and other goods such as agricultural produce into Guangdong from surrounding areas such as Hunan and Jiangxi. The response of surrounding provinces was to adopt a protectionist stance, setting up checkpoints along provincial borders to secure commodities. In the 1990s, this type of behavior lessened as price liberalization progressed alongside the merging of market blocs, increasing the infiltration of Guangdong products into the domestic market.

The momentum of the resulting South China economic bloc slowed in 1993. That year marked a contraction in the large ongoing trade surplus, and in 1994, Guangdong, too, felt the affects of the burst bubble economy. They took the form of strict regulations imposed on real estate investment in large coastal cities brought about by the strengthening of central government real estate investment regulations, causing investment to stagnate. To make matters worse, trade routed through Hong Kong fell an incredible 56% in the first half of 1996. The drop in the commissioned processing trade was a particularly hard blow to the province(2). Along with strong hopes for China's economic recovery, there is a need for structural adjustment to establish an industrial structure that is economically self-reliant from a medium- to long-term perspective.

(2) Yantze River Delta Economic Bloc

Since the 1980s, the Sunan region, close to the Yantze River Delta of Jiangsu and Zhejiang, has developed at a similar pace to the Pearl River Delta region. The amassment of capital from higher productivity in the agricultural sector has led to the growth of local industries, giving rise to a development pattern dependent on internal demand, that is, the increased income of local inhabitants. This development has been self-generated, unlike the dependence on external capital and demand of the Pearl River Delta and Hainan Island. The prerequisites are a temperate climate, an abundant water supply and a traditionally highly productive agricultural system, not to mention the background presence of the large consumer and economic center of Shanghai. The Sunan region is located in the environs of two nearly completed freeways, running from Shanghai to Nanjing and from Shanghai to Hangzhou, and has been the focus of aggressive foreign investment. In some affluent rural areas in the Sunan region, local industries are run as independent companies. Agricultural workers have given up the pretence of never abandoning their hometowns, although they had left their farms, and are now choosing to leave their homelands. The region is well on its way to becoming an industrial bloc linked with Shanghai(3).

The Pudong development commenced after the central government's development approval was given in April 1990. From phase 1 through 3, lasting from 1991 through to the year 2000, the Lujiazui financial and trade zone, Jinqiao export processing zone, Waigaoqiao bonded area, Zhangjiang hi-tech zone, Nanpu and Yangpu bridges, surrounding roads, the second Shanghai international airport and other projects will be underway. Funds procurement for this development zone has taken the form of bonds issue, and international financing from the World Bank, IMF (International Monetary Fund) and other organizations, in addition to central and Shanghai city financing. Private capital has been mobilized by land sales. The Pudong development is a state project, although the old township in the Puxi district has been involved in it, greatly accelerating development, and particularly the urban redevelopment project, through land sales.

The redevelopment of Shanghai, including Pudong and Puxi, is considered a development which encompasses Jiangsu, Zhejiang, and even the Yantze River Valley (referred to as a T-shaped development), and not only the Pudong and Puxi regions. It would be true to say that Shanghai carries great economic influence; however, it is uncertain whether it still holds the power to affect these surrounding regions. For the time being, until the year 2000, the goal is for Shanghai to be one of many centers of international economy, finance and trade.

2. Review of Development Strategy

(1) Economic Recession

Facing severe inflation since 1992, the government adopted a policy of tight fiscal regulation from the end of 1993. Real estate prices, considered the main culprit of the speculation, were repeatedly frozen, and any related investment was also severely restricted. Coastal cities are still suffering from the after-effects of the bubble economy. According to a report dated at the end of August 1996, there are 50.31 million square meters of newly constructed unsold housing nationwide, valued at 1710 yuan per square meter if sold, totaling 86 billion yuan. Most of the housing that is completed or under construction has been abandoned, and the capital laid out by investors for this real estate by regional governments, large state-owned enterprises and companies is unrecoverable(4).

The quoted report states that there are 33 million square meters of housing that has deteriorated and needs to be rebuilt throughout 640 cities nationwide. In spite of this, the existence of 50.31 million square meters of housing which is privately owned and for which buyers have not been found illustrates the clear absence of a government housing policy.

If we consider real estate investment as a gauge for the economic potential of a region, looking at the end result, there has been excessive investment in economic hubs. Since 1992, Shenzhen, Guangzhou, Amoy, Shanghai, Hangzhou and other eastern coastal regions have attracted considerable real estate investment, much of which has turned into bad debt. The author has found that the problem of stockpiled real estate is most serious in Shenzhen, Guangzhou and other regions of southern China. Although Shanghai has been affected, there is still some hope for local industrial investment and other development.

(2) Foreign Direct Investment Policy Adjustments

Since 1992, the ratio of commissioned processing in the Chinese trade framework has been increasing. This involves a Chinese business importing materials, processing and assembling them and then exporting them, or importing materials and parts at the request of a foreign firm, processing them, and then having them collected by the overseas firm. In the first half of 1996, 50.8% of total nationwide imports and exports involved commissioned processing(5). Much of this has lacked a domestic industrial linkage, this bearing testimony to the export slump of state-owned enterprises. Commissioned processing export has been unavoidably responsible for port cities along the eastern coastline coming to the forefront, and is widening the economic gap between coastal and inland regions.

The entry of foreign enterprise into local markets has also had a substantial impact on the Chinese production framework. For color televisions and videotape recorders, among other products, this entails renowned firms from around the world such as Sony, Matsushita, Philips and Samsung, which have already established incorporated companies holding the relevant rights, penetrating local markets by using their brand names. Competition with famous-name brands from around the world has forced domestic brands such as Changhong, Xiangmao and Mudan to become entangled in fierce price-cutting.

The Chinese government is undertaking a review of its policy toward foreign investment, starting from the fall of 1995 and continuing throughout this year. The focus of the review is the following abolition of import incentives.

- Abolition of duty exemptions for 20 office equipment and related items imported by foreign firms for their own use (early 1995)
- Abolition of import duty exemptions for building-related equipment required for real estate construction such as materials for building construction imported by foreign firms (May 1995)
- In the purchase of materials, for example, the tax on value added when purchases are made domestically is refunded when the product is exported. This refund was reduced (from July 1995) from 14% to 9% for 17 items and from 10% to 6% for 13 others.
- Abolition of import duty exemptions for production machinery and facilities imported by foreign firms as a part of their total investment for their own use (April 1996)

In addition to the abolition and reduction of incentives to foreign investors just described, more stringent monitoring of the fulfillment of contractual clauses, foreign currency bank accounts and other matters related to foreign investment is being undertaken. This is in order to support the people benefiting from foreign investment and to eliminate the abuse of incentives for foreign investors by domestic firms forming "sham joint venture." In practice, the number of sham joint venture is believed to be considerable, and many are considered to be for the convenience of the import of foreign products and materials. The reason for this is the wide disparity between the foreign exchange control and trade control systems overseas (mainly in Hong Kong) and at home.

3. Regional Economic Fluctuations and Industrial Policy

(1) Domestic Industrial Adjustments

The aim of policy adjustments toward foreign investment is to attract interest by fostering domestic industry. The re-organization of state-owned enterprises is essential to achieve this. Currently, the general policy for the reform of state-owned enterprises has been to be extremely thorough with the larger firms and to liberalize the smaller ones. This initially entails protecting and developing 1000 firms (focusing on 500) large state-owned enterprises as businesses essential to the socialist market economy system. Although this is no more than 0.3% of the total number of state-owned enterprises, they wield great economic influence, accounting for 51% of total state-owned capital and 52% of domestic taxes(6). Many of the remaining firms are medium- to large-sized state-owned enterprises on a regional level, and the policy will reorganize them through M&As (mergers and acquisitions), public auctions, bankruptcies and so on. Unsuccessful cases may have to face bankruptcy, close-downs or the like.

At present, there is a need for the reorganization of 20 to 30 million of the total 100 million-plus employees of state-owned enterprises in urban areas Workers will have to face the harsh reality of unemployment should they be unsuccessful in finding alternative jobs. A third of existing industrial facilities will have to be replaced.

The reason for the rush to re-organize state-owned enterprises is none other than the quickening pace of domestic market liberalization. On April 1 1996, the Chinese government will drop duties to an average of 23%. This is still high compared to the 13-14% in developing countries, however the Chinese state that duty exemptions in special zones, reduced duties in economic zones and other measures will make actual taxes no more than 15%. The focus on the abolition of the tax incentive system concerning import duties for foreign firms is only natural, given this background.

The south China economic bloc is already experiencing an economic recession from the results of the government review of the refunding system for the tax on added value. In Guangdong, taxes to date on added value of 17% for Hong Kong exports had been refunded. This was reduced to 9%, and has served to greatly diminish the desire to export. Measures to counter smuggling, illegally copy products, evade taxes and other illegal practices that have been implemented on a nationwide scale and have had a substantial impact on Guangdong trade. As already stated, exports to Hong Kong in the first half of 1996 dropped sharply. Real growth in the first half of this year was 9.7%, falling below the national average of 9.8%, and industrial production also dropped to 11.1%, below the national average of 15.2%[7].

The total population of the Pearl River Delta region numbers 22.13 million, or 33.6% of the population of Guangdong province. This 33.6% has been responsible for 70.6% of GDP and 78.19% of exports[8]. Looking at these figures, the future growth of Guangdong is limited; attempts to develop parts and materials face obstacles in that they are geared toward a limited market within the province, and lose out in a cost comparison with Hong Kong imports. Further thought will have to be given to altering the structure of Guangdong province, if the province is to target business with mainland China rather than merely remain an export site for Hong Kong.

Port cities in the north such as Dalian face the same problems as Guangdong. The development model dependent on the system of foreign investment has lost some of its previous authority, and there are fewer advantages for foreign firms no longer receiving incentives to continue to undertake labor-intensive production. As a whole, this region should reform and develop as the Bohai Rim economic bloc. The central government approved the Bohai Rim economic bloc as a new economic zone in the ninth Five-Year Plan, and the combination of industries and markets is jointly in the making.

What of the background behind the Yantze River Delta Infrastructure construction has developed considerably in Pudong, and the Lujiazui region, Waigaoqiao bonded area and other sites are showing significant progress. Japanese companies that have started up there include Yaohan, which has opened the world's largest department store, as well as Sharp and Fuji Bank, among others. Regarding the Pudong development, the private land sales boom has come to a standstill; the *Liberation Daily* recently reported that one third of the 120 square kilometers development zone for Pudong remains untouched. Against this background, the government of the new Pudong zone has adopted a policy prohibiting new land development and the sale of land usage rights[9].

In contrast, a considerable number of service and manufacturing industries have invested in the Shanghai redevelopment business, starting with foreign distribution groups such as Jusco, Lawson (belonging to the Daiei Group), Seiyu and Isetan. The main industrial foreign investment is being focused on automobiles, electronics, petrochemicals and construction materials. The rise in the standard of living of the people of Shanghai has been coupled with an interest in more advanced products.

Let us take a more comprehensive look at the situation in the Shanghai region, including Pudong, from a longer-term perspective. At present, the region is greatly influenced by two freeways, running between Shanghai and Nanjing (about 300 km long and due to be completed in 1996) and between Shanghai and Hangzhou (about 300 km long and already completed). In Shanghai City, investment in labor-intensive industries has already shifted to south Jiangsu and Hangzhou, and investment in automobiles, petrochemicals, electronics and software, and distribution is active. Eventually, it will operate as a large economic bloc encompassing Hangzhou Bay and the Yantze River Valley.

In the future, the Yantze River Delta will support development with Nanjing, Wuhan and Chongqing in the Yangtze River Valley, giving rise to a T-shaped development (a development linking the Yantze River Delta and Yantze River coast). Although the construction of the Sanxia Dam has already begun, exchanges with international links are envisioned for the future, like the case of a project being discussed with Japan which will see Japanese ships sail up the Yantze River.

Shanghai is historically a distribution center, and has served to link the north and south China economies and the southwest region through the Yantze River Valley. Doubtless, it will continue to fulfill this role into the future.

(2) Future Issues

What direction will China take in the future? What will become of the industrialization policy of the Jiang Zemin administration? Slogans such as "Promotion reform and open-door policy, quicken growth" no longer play a part in the Chinese government's public profile.

For the time being, the government will have to promote labor-intensive industries in coastal regions, direct new investment inland, and take other action to prioritize support for inland regions and underdeveloped rural areas. We cannot predict to what degree such a policy of support can be implemented, although from a policy viewpoint, this direction has already started to be pursued.

At the moment, the central government is reducing discretionary rights for regional governments responsible for investment and the introduction of foreign investment to date to recover economic power, and appears to be endeavoring to bolster budget allocation rights for central finances. The reality is that Chinese society since the 1980s has seen a marked tendency for stronger regional government and public activity. Regional cities have already found a solution to their problems through market blocs that are expanding under the market mechanism. The development pattern of this trend varies according to whether an internal or external market is sought. The Chinese government fears the expansion of commissioned processing as an integral part of foreign trade and the decrease of general trade (much of which is conducted by state-owned enterprises). This has brought cities to ask what direction their economic development should take. Pudong in Shanghai has clearly felt the shock from the collapse of the bubble economy. However, Shanghai, as a whole, is attempting to create an immense economic bloc by placing the Suzhou region in Jiangsu province, the Jiaxing region in Zhejiang province and others under its authority. The future success of this massive economic region will hinge on how well it can organize production and distribution.

The acceptance of China's membership in WTO (World Trade Organization) has become a focal international issue. Those in favor of acceptance state that, under the principles of free trade, it is unreasonable to exclude a country like China with such huge potential. The cautious, mainly from the U.S., say that if a country like China were to be accepted in WTO, they would be faced with the problem of dealing with intellectual property rights and other issues. It may be closer to the truth to say that they are concerned about the amount of domestic industry protection that should be approved for China as a developing country, given its enormous market.

China has stated that it should be allowed some prescribed protective tariffs, and has come out by strongly saying that, as long as these principles are not acknowledged, it will not join WTO. Regardless of whether China or the U.S. is right, for the time being, China will foster its five industries – automobiles, machinery, electronics, petrochemicals and construction – as the mainstay of its domestic industries, and will continue to protect them until they acquire international competitiveness.

In the future, China will be exposed to this type of international bargaining, while developing its industries under the principles of protectionism, regulation and encouragement of competition. Regions will keep this government policy in mind when considering their actions. Guangdong, Shanghai, Beijing, Tianjin and other cities will all react in the same manner. Table 3-1 gives total import and export figures and the percentage of foreign direct investment accounted for by each province of China. Looking at the figures per capita of population, Shanghai leads the nation in import and export totals and in foreign investment in actual use. With the combination of its manufacturing strength, the financial facilities to be built in Pudong and an international airport, Shanghai will become the economic center of China.

Table 3-1 Economic power of the provinces (1995)

(Unit: $100 million)

	Import and export total		Direct investment total	
	Total	Share (percentage)	Total	Share (percentage)
Nationwide	2808	100.00	378.1	100.00
Guangdong	1039	37.00	102.6	27.14
Beijing	370	13.18	10.8	2.85
Shanghai	243	8.65	28.9	7.64
Jiangsu	163	5.80	51.9	13.73
Fujian	144	5.13	40.4	10.68
Shandong	139	4.95	26.9	7.83
Liaoning	132	4.70	14.2	3.75
Zhejiang	115	4.09	12.6	3.33
Tianjin	80	2.85	15.2	4.02

Note: Only the leading nine regions have been cited.
Source: *China Statistical Yearbook*, 1996

What will then happen to Hong Kong? The development of China into a market economy will allow Chinese firms to conduct business directly with overseas organizations without going through Hong Kong, and Shanghai and the north China region will be able to procure funds from the international finance market independently. Hong Kong will become one of many financial centers in the south China region, rather than remain an international financial center.

Notes:

(1) John Wong, *Nihon Keizai Shimbun*, 25 November 1996

(2) *Asahi Shimbun*, 30 November 1996

(3) The China Institute of Economic Reform, *Economic Boom in Southeast Coast of China* (China Reform and Development Report 1996), published by Shanghai Yuan dong Publishing, 1996, p. 54

(4) *Economic Daily*, 28 August 1996

(5) *China's Custom Statistics*, July 1996

(6) *China Statistical Yearbook*, 1995

(7) See (2)

(8) Yang Yonghua, *A Model of Chinese Economic Development – Guangdong Industrialization Model*, edited by Ma Hong and Sun Shangqing, China Development Company, 1996

(9) *Asahi Shimbun*, 25 May 1996