

**"Hong Kong's Economic Integration with the Mainland:
The Opportunities, Challenges and Solutions"**

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To**

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Sir David and distinguished guests thank you for inviting me to speak before you on a topic that is aligned to our common goal of stability and prosperity for Hong Kong.

China - a global engine of economic growth

I'd like to begin with what Napoleon is reported to have said: "Let China sleep, for when she wakes, she will shake the world." That seems to be an accurate description of China at the time, and indeed two centuries later we are experiencing China's awakening.

China's resurgence must be seen not only as its embrace of globalisation, but also by the fact that the lid was taken off the Chinese entrepreneurial boiling pot. The last quarter-of-a-century is arguably the first time in China's modern history that the system of state governance has been aligned with entrepreneurship. The formula has resulted in the highest growth over the longest sustained period of time the world has ever seen. It has been an interactive process. Enterprises have thrived while the government has laid the domestic

institutional structure and physical infrastructure, and at the same time integrating China into the global market system.

The role of China as a global engine of economic growth cannot be underestimated. In 2007 while the US accounted for 21% of global GDP, it drove 15% of global GDP growth. In comparison, China accounted for 15% of global GDP, but for 31% of global GDP growth.

In this context, Hong Kong has an even greater role to play in China's economic development but that will only happen if we are geared up for what lies ahead.

Hong Kong's Role in China's Economic Development

In 1979, when China opened up, Hong Kong's own entrepreneurial spirit began the process of promoting closer links with the Mainland.

Our role as a centre for trade between China and the world became a critical foundation for our engagement in China's development. China's entry into the World Trade Organization at the end of 2001 further intensified the integration process.

In June 2003, the Closer Economic Participation Arrangement was signed between China and Hong Kong, which set a further important milestone in the process of economic integration. And these milestones are fuelled by the work of many organisations such as the Greater Pearl River Delta Business Council, the BPF and of course the regular exchanges that are now taking places at Government levels.

Hong Kong's Competitiveness

A key component of our economic integration with China is Hong Kong's future competitiveness.

We usually discuss Hong Kong's competitiveness in terms of what we have: our port, our airport, our geographic position, our legal and regulatory system, our people, and so on. These are our prized assets, our stocks, so to speak. These stocks are critical, but they are critical because they facilitate flows: flows of goods, flows of funds, flows of human resources, and flows of information. It is how we deal with these flows that will determine Hong Kong's competitiveness and further integration with China.

The Four Flows

Hong Kong's economy has always been built around flows: flows through our port and flows through our airport, including tourists particularly from China, flows through our stock market and banking sector – increasingly Chinese enterprises are listing in Hong Kong – flows of talented people from China and the rest of the world, information flows that have allowed Hong Kong to become a management and coordination center. It is these flows that have built our economy and it is these flows that sustain Hong Kong's prosperity.

When we deal with flows, for companies and for cities, we have to deal with capacity, constraints, frictions (by frictions I mean impediments that slow down the flows), and we need to deal with connectivity.

Historically, Hong Kong has benefited from investments in our port, our airport, our telecommunications system, and the rest of our infrastructure to ensure we have sufficient capacity to allow for growth. Historically, Hong Kong has benefited from the fact that we have had fewer constraints and frictions than most other economies in the region. Historically, Hong Kong has benefited because we have been better connected to the economically vibrant portions of the Chinese Mainland than the rest of the world and better connected to the rest of the world than the Chinese Mainland.

Today, we have to be more concerned about capacity, constraints and frictions, and connectivity perhaps than ever before. One reason is that Hong Kong is neither the source nor the destination of most of the flows that it relies upon. This means that Hong Kong is always going to face competition. A second reason is that China's development has changed the nature of the flows that Hong Kong relies upon.

The Changing Nature of Flows

Most of the flows that are important to Hong Kong have their source or their destination in the Chinese Mainland. The vast majority of goods flow through Hong Kong comes from or goes to the Chinese Mainland. The majority of our human resource inflows involve China as well. IPOs by Mainland companies and associated funds flows have made

Hong Kong a leading raiser of equity capital and a leading financial center. Hong Kong's role as a coordination and management center is closely linked to the information flows between Hong Kong and the Chinese Mainland.

Hong Kong used to have more capacity to interact with the rest of the world than cities in the Mainland.

If we look at the investments that Mainland cities are making in their ports, airports, and communications systems, we can see that that is not going to be the case in the future. Hong Kong has benefited from fewer constraints and frictions than Mainland cities in terms of goods flows, human resource flows, fund flows, and information flows. Hong Kong still has an important advantage here, particularly in terms of fund flows and information flows, but increasingly China is becoming more efficient in transportation and customs systems. In terms of human resources, the most important new source of talent for Hong Kong is the Chinese Mainland and many talented people from the rest of the world are gravitating to cities in the Mainland rather than to Hong Kong. Thus any advantage that Hong Kong has had in terms of fewer frictions and constraints on human resource flows is starting to diminish.

Better Connectivity

China's development also is changing the nature of the connectivity that is important to Hong Kong. It used to be that Hong Kong could benefit from China's economic development by having good

connectivity to the manufacturing base of the Pearl River Delta and to service sectors of the first tier cities of Shanghai and Beijing. But high caliber manufacturing operations are spreading into other parts of China and the bulk of China's development in the next decade will take place in the second tier cities.

If Hong Kong is going to be able to benefit from the bulk of China's economic development in the future, it is going to have much better connectivity to the vast majority of the 105 cities in China that have a population greater than one million today. This means pushing beyond the Pearl River Delta to link with cities in the Pan-Pearl River Delta with their more than 450 million people and GDP approaching one trillion US dollars. It means pushing beyond Shanghai and Beijing to connect directly to the second tier cities in the Yangtze River Delta and the Bohai Region, which include many of the most dynamic cities in China. It means better connectivity to emerging centers in the west and the northeast as well. This means better connectivity for goods flow, people flow, funds flow, and information flow.

So what does a focus on the critical flows mean for Hong Kong's future?

Sufficient Capacity

The first conclusion is that Hong Kong needs to have sufficient capacity to manage the critical flows. Today, we are facing a number of capacity constraints. One only has to read the job listings in the

newspapers to know that we face severe capacity constraints in highly skilled human resources. At Hong Kong International Airport, stronger than expected growth on the Chinese Mainland, a rapidly expanding proportion of transfer passengers and higher transshipment volumes have created capacity constraints well ahead of schedule. We are going to have to make decisions soon about when and how to expand capacity at the airport. A study is now underway to evaluate the potential benefits that a new runway will bring and another study is being commissioned to assess the engineering and environmental feasibilities of building a new runway at the airport. Such infrastructure projects take years to build and we must start the planning process now in order to safeguard the airport's future viability. Meanwhile, we are working closely with the Civil Aviation Department to maximise existing runway capacity and we are supporting the creation of an integrated Pearl River Delta airport system that will make optimal use of available airspace and other resources. With respect to fund and information flows, we have the hardware to meet expanding demands. The question is whether we will have all the software and enhanced capabilities in place to meet this demand.

Reducing Frictions and Constraints

The second conclusion is that we need to reduce the frictions and constraints associated with these critical flows. CEPA is a good start in reducing the frictions for Hong Kong companies doing business in the Mainland. We need to reduce the constraints and frictions associated with human resources, particularly with respect to talented people from

the Chinese Mainland. We also need to deal with pollution that is reducing the quality of life and are making Hong Kong less attractive for mobile professionals.

We need to have a broad enough outlook to ensure that information flows to and from the rest of the world and to and from numerous Chinese cities are as dense as possible. We also need to ensure that our regulatory and political processes do not create unnecessary delays and hence slower cycle times in our decisions concerning needed infrastructure projects.

Expanding Connectivity

The third conclusion is that capacity is not enough. We have to have sufficient connectivity to the right places to ensure that we are plugged into the sources and destinations of the critical flows. This means extending our connectivity to the rest of the world, but it also means dramatically expanding our connectivity to cities in the Pearl River Delta and in the rest of the Chinese Mainland. The vast majority of the trips between Hong Kong and the Pearl River Delta are to the eastern portion of the Delta. That is why we need to move forward with the Hong Kong - Zhuhai - Macau bridge. It is also why we need to think about linking our road systems and our rail systems to those of the Mainland. This will expand the “Magic Three Hour Zone”, the area that can be reached by land from Hong Kong in three hours. This is the Zone in which it is easiest for Hong Kong companies to invest, for Hong Kong sourcing and trading offices to access, for Hong Kong

service providers to serve, and for Hong Kong firms and offices to manage.

Today, Hong Kong International Airport has flights to 118 international destinations, compared to 96 for Shanghai, 92 for Beijing, 43 for Guangzhou, and 19 for Shenzhen. It is expected that the international connectivity of China's airports will increase dramatically over the next decade. Hong Kong has flights to 36 destinations in the Chinese Mainland. Shanghai has flights to 77 destinations; Beijing to 89 destinations; Guangzhou to 87 destinations; and Shenzhen to 59 destinations. And these cities have far greater flight frequency to many second tier cities than Hong Kong. As the second tier cities in China become more important production locations and markets, Hong Kong's disadvantage in China connectivity could become substantial for both local companies and overseas companies that use Hong Kong as a base for accessing China. *(Source: OAG week 3 Dec 2007 obtained on-line on 12 Nov 2007)*

For many companies, connectivity to China's second tier cities could become an important consideration in determining where to place vital activities.

Connectivity is not just a question of competition between Hong Kong and cities in the Chinese Mainland. It is also by far the best way to facilitate cooperation and complementarity between Hong Kong and other Chinese cities of the sort that has benefited Hong Kong greatly in the past.

Strengthening Information Flows

The fourth conclusion is that information flows about developments and plans in the Mainland are of critical importance to Hong Kong's future. This is a part of information flow and our knowledge base in Hong Kong. The latest Five-Year Programs of China, Guangdong, and major cities in China reflect a new stage in China's development in terms of economic diversification, innovation-based business, regional development, and concern about sustainability. The more Hong Kong and Hong Kong-based business people know about these plans, the better able we will be to grasp new opportunities associated with China's development. If we wish to improve connectivity with Chinese Mainland, we need to work with the Central Government, Guangdong, Shenzhen, and other cities in China. We need to know how better connectivity fits into their plans and can help them reach their goals. We need to work with them to ensure that the roads and railway lines link up and so planes that take off have places to land. The Economic Summit on China's latest Five-Year Program held in earlier this year is absolutely critical to Hong Kong's ability to do what it has been doing all along, managing flows of goods, flows of funds, flows of human resources, and flows of information.

Conclusion

Improving our ability to manage these flows will require sustained effort over time. They also require immediate attention. Increasing our

capacity, reducing constraints and frictions, and improving our connectivity all take a long time.

For example, some of the options that might be considered for expanding the capacity and improving the connectivity of our airport, such as a third runway, could take years to bear fruit. As we have seen, steps to better integrate our land transportation network with that of the PRD through the Western link, the Hong Kong – Zhuhai – Macau bridge across the Pearl River Delta, and new rail lines, have similar lead times. New policies on education and training and on improving human resource flows will take time to have a major impact. Ensuring the right balance in our financial regulatory structures and further building our capabilities to manage fund flows is an ongoing effort. Ensuring that Hong Kong and Hong Kong-based business people have the best information available on policies, plans, and developments in the PRD, in Guangdong, and in China as a whole requires sustained investment and attention.

In some cases, what this means is that decisions that we make, or fail to make, in the months and years ahead, could influence our competitiveness for years to come. In other cases, it is more a matter of many smaller decisions that we must make over time. I would suggest that if we focus on the importance of flows of goods, flows of human resources, flows of funds, and flows of information, then we are more likely to make the right decisions.

Thank you