Economist Intelligence Unit

The Economist

Leaping dragon, trailing tigers?

Taiwan, Hong Kong and the challenge of mainland China

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Preface

Leaping dragon, trailing tigers? Taiwan, Hong Kong and the challenge of mainland China was written at a time of significant global volatility. Not only did the war in Iraq begin—and end—during the course of our research, but the SARS virus emerged as a new and unpredictable threat to the confidence of Asia as a whole, and of Hong Kong in particular.

This report from the Economist Intelligence Unit takes a deliberately longer view. The shifting economic relationships between Taiwan, Hong Kong and the mainland may attract fewer headlines but they are far likelier to determine the future prosperity of the two tiger economies and their hulking neighbour.

The research effort for this report comprised three key initiatives:

The Economist Intelligence Unit held dozens of one-on-one interviews with executives, policymakers, academics and analysts in Taiwan, Hong Kong and China.

The Economist Intelligence Unit conducted special surveys of senior executives in both Taiwan and Hong Kong to ascertain their views on the challenge of mainland China. Some 150 executives participated in the survey, which was conducted in March 2003.

Significant desk research drew on the resources and expertise of the Economist Intelligence Unit's team of analysts in Hong Kong and London.

The author of the report was Paul Cavey in Hong Kong. The editors of the report were Elisabeth Paulson, Charles Goddard and Graham Richardson.

Executive summary

Introduction

China's growing economic strength is seen as a threat to many countries. For Taiwan and Hong Kong, the challenges appear particularly acute. They are, after all, no ordinary neighbours of China. Their close geographical proximity and their historical and ethnic connections position them on the edge of China's lair. For many pessimists in both regions, this position poses many threats. The worry exists that China's continuing economic boom will harm, rather than aid, the economies of both Taiwan and Hong Kong. Their fears are misplaced. The challenge is to strengthen links with China, while at the same time carrying out domestic reforms that would be necessary in any case. If the development of stronger links with China is combined with domestic reforms, both former tiger economies will be well-placed to benefit from the emergence of the mainland dragon.

PART I **TAIWAN**

The investment tide

In recent years, Taiwan's government has begun to loosen some of the restrictions on investment in the mainland and to work towards the setting-up of direct cross-Strait transport links and the tentative loosening of direct financial links. Yet in most areas, economic links between China and Taiwan remain as restricted as ever. What is most notable about the battery of restrictions is its remarkable ineffectiveness in preventing Taiwan's economic integration with China. Investment in China by Taiwan companies has soared in recent years. Particularly alarming for some on the island is not the amount of mainland investment per se, but rather the rise in the proportion accounted for by firms from the island's high-profile information technology (IT) hardware industry.

The "hollowing out" myth

The political consequences of deepening cross-Strait economic ties are a growing concern for many on the island. Indeed it is exactly these political risks that the restraints on cross-Straits economic activities are aimed at heading off. The argument that these restrictions are needed to prevent a "hollowing out" of the domestic economy is harder to sustain. Manufacturing capacity has indeed moved to the mainland. But as certain processes move across the Strait, other more sophisticated activities emerge. Thus the domestic IT industry has upgraded in textbook fashion, creating a division of labour between manufacturing facilities in China and those in Taiwan.

The Taiwan advantage

The attractions of China for the island's manufacturing entrepreneurs seem almost overpowering. The range of incentives offered by local governments coupled with lower labour costs means that production can be undertaken at very low cost. In addition, for many manufacturers in Taiwan, investing in China also offers the opportunity to tap a bigger market and establish brands. But China's business environment is far from perfect, and Taiwan's offers advantages—especially as a location for higher-end activities such as research and development—that are too often overlooked. As a result, while basic manufacturing has moved to China, Taiwan remains at the core of the IT hardware development process.

The cost of economic constraints

The IT manufacturing sector seems to have thrived despite the restrictions imposed on interaction with China, not because of them. So do they have any economic utility? Probably not. In fact, it is possible that the welter of restrictions on cross-Strait links have forced activity away from the island. It has also increased costs to those companies that remain, thanks to the lack of transport links between Taiwan and the mainland and limits on the free flow of goods and people across the Taiwan Strait. And while there is much the government could do to improve the domestic operating environment for IT hardware firms, the health of the sector will ultimately depend on the opening of more direct links between headquarters on the island and the new manufacturing sector on the mainland.

The stifled service sector

Manufacturing is not the sector that has been hardest hit by the restrictions on cross-Strait economic links. The island's often-ignored services industry has been much more seriously affected. Taiwan firms' huge investments in China have been supported by foreign rather than local banks. Goods made in China have been transhipped through ports in Hong Kong and Korea rather than Taiwan. The tight restrictions that prevent all but a small number of mainlanders visiting Taiwan have locked the island's tourism industry out of an important market. By removing the barriers that have prevented its growth to date, the opening of full direct links with China would allow the service sector to become a new engine of growth for the economy.

PART II **HONG KONG**

The rise of services

Officials in Taiwan need look no further than Hong Kong for a model of just what a strong services sector can do for an economy—and for a lesson in how openness in China can offer rewards. The manufacturing sector, which was the engine of growth in the 1960s and 1970s, virtually disappeared in the following two decades as production moved to China. But this migration did not lead to a "hollowing out" of the Hong Kong economy. Rather, departed manufacturing capacity created demand at home for expanded support services. And by the 1990s Hong Kong had been transformed from one of the world's top makers of low-end manufactured goods to a global services centre

The Hong Kong advantage

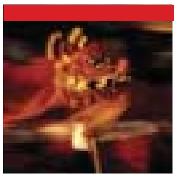
Hong Kong's smooth economic transformation seemed to come to a shuddering halt with the downturn of 1997, which has been followed by five years of economic misery. Contrary to the fears of many, these problems are not the result of closer integration or greater competition with China. Certainly, Hong Kong no longer holds the monopoly on service provision into the mainland that it once had. But there has been no simple outflow of activity to China. Rather, as with Taiwan's manufacturing sector, there is a developing division of labour, in which some lower-end processes move out, while higher-end ones remain and expand. In fact, Hong Kong's strengths will ensure that the service sector continues to grow—as long as the government manages to open up further to China while pushing through reforms that will prove unpopular with domestic vested interests.

The longevity of logistics

The logistics industry is a clear example of Hong Kong's comparative advantage. Seaports in China have been developing rapidly, but Hong Kong's port remains the region's largest. At the same time, the logistics industry in Hong Kong has been moving upscale, with air transport beginning to occupy a more important role. Hong Kong's sophisticated hard and soft infrastructure gives it an important competitive edge in both sea and air transport. The government seems to realise, however, that the territory's lead is not unassailable, and has been making important efforts both to improve transport links with China, and to liberalise the logistics sector at home.

Conclusion

Taiwan's president, Chen Shui-bian, has stated that closer links with China are no cure-all for the island's economy. This is undoubtedly true, and is equally pertinent for Hong Kong. But ignoring the challenge presented by greater economic integration with China will only harm both economies. Taiwan's government needs to realise that the absence of direct links could soon destroy certain industries—not protect them. Hong Kong's government is currently struggling to find a clear policy direction, but may be closer than Taiwan to understanding what the "three links" are really about—trusting in your own strengths, and not worrying over-much about the seemingly inexhaustible advantages enjoyed by the mainland. Closer links between China, Hong Kong and Taiwan will continue to present risks to certain sectors, but government policies—from all sides—should now focus on the rewards.



Introduction

To many in Taiwan and Hong Kong, it is no coincidence that recent economic problems have emerged just as both economies have become more closely entwined with an increasingly strong mainland China. The concern persists that China's gains will be at their expense. Their worries are misplaced.

Napoleon labelled China a "sleeping giant" that, once awoken, would shake the world. While Napoleon may have been more concerned with China's potential military prowess, these days it is China's burgeoning economic strength that is being closely watched.

One only has to look at China's recent economic performance to see why some countries are wary of China's seemingly unstoppable rise. In recent years, China's economic growth has soared, while most of the region has struggled to climb out of an economic slump. Foreign investment in China has risen, while some of its neighbours watch FDI levels flatten or fall. Even China's entry into the World Trade Organisation (WTO) in 2001 can seem a cause for concern. Some commentators heralded WTO membership as the country's coming of age, one that would also force Chinese industries to compete against new, foreign competition. But for its economic competitors, China's ascension to the global trade club also marks the country's real emergence as a major rival.

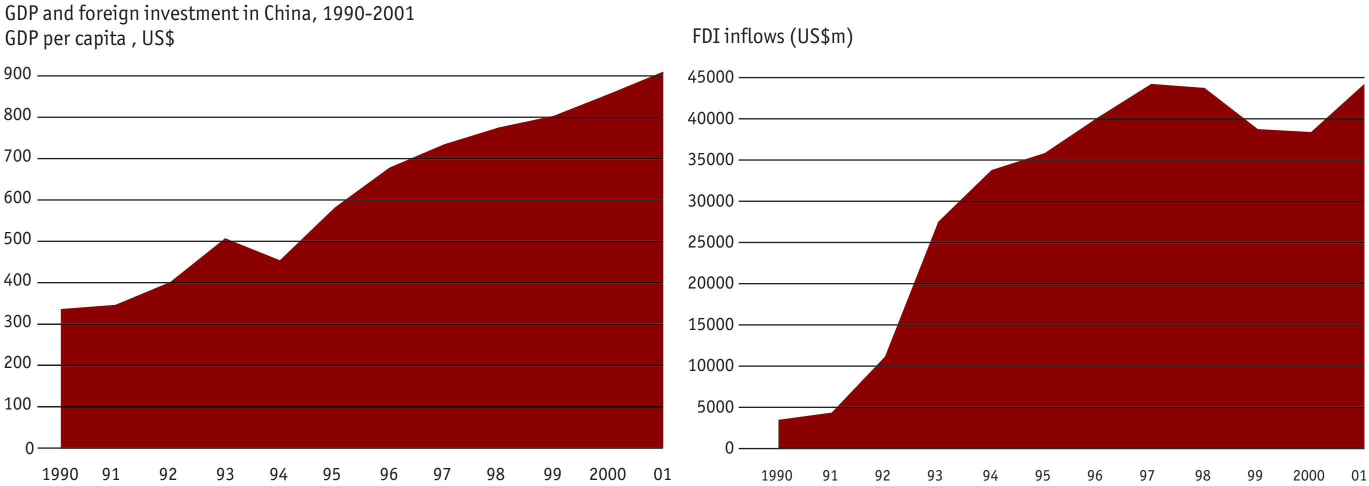
Much has been written about how China's economic awakening will affect Southeast Asia, whose economies—while much smaller than China's—tend to produce the same sorts of goods and services. Less has been written about the effect of China's emergence on the richer economies of Northeast Asia. Here, too, there is concern that foreign corporate interest will dry up. There is also a different worry, that the allure of China will lead domestic investors to ignore the home economy as well. With both domestic and foreign looking China's way, will the local economy begin to shrivel?

And for Taiwan and Hong Kong, in particular the challenges do not end there. They are, after all, no ordinary neighbours of China. In addition to their close geographical proximity, historical and ethnic connections position them on the edge of China's lair. This proximity should place Taiwan and Hong Kong in a perfect position to tag along on China's upward economic ride. But if the pessimists are to be believed, these connections may instead render Taiwan and Hong Kong more vulnerable to the sapping potential of China's economy. Will China's gains be at their expense?

For several decades, Taiwan's and Hong Kong's fortunes were divorced from economic developments on the mainland. Taiwan has been ruled as a separate entity since the losing Kuomintang (KMT) took refuge on the island after the end of the civil war on the mainland in 1949. For the following forty years, there was virtually no contact between the governments on either side of the Taiwan Strait, bar the occasional exchange of verbal insults and gunfire as both sought to establish themselves as the rightful government of China. Hong Kong's division from the mainland came even earlier, with the United Kingdom's annexation of the territory beginning in 1841. In the following 150 years, British officials oversaw the development of an economic and political system thoroughly distinct and separate from that of the mainland.

For the economies of Taiwan and Hong Kong, two of the original East Asian tigers, this alienation from China was probably more of a help than a hindrance. Between 1950 and late 1970s, when the mainland was itself isolated from the rest of the world, the economies of both Taiwan and Hong Kong prospered, driven by the development of world-beating, labour-intensive manufacturing industries. Living standards continued to grow rapidly even as China's economy began to reintegrate with the

The giant wakes
GDP and foreign investment in China, 1990-2001



Source: EIU

world economy in the 1980s and early 1990s. This was thanks to the movement of their economies into higher-value-added activities: the manufacture of hardware for the information technology (IT) industry in Taiwan, and service provision—particularly for the emerging mainland economy—in Hong Kong.

In recent years the political and economic circumstances of Taiwan and Hong Kong have shifted again. While on the one hand moving to promote the island as a political entity distinct from China, in the early 1990s the government in Taipei also started to ease its almost complete ban on contact with China, allowing limited movement of people, capital and goods across the Taiwan Strait. Both trends continued after the election in 2000 of Chen Shui-bian of the pro-independence Democratic Progressive Party (DPP) as president, an event that ended over 50 years of KMT rule, and also triggered a period of unprecedented political instability on the island.

Hong Kong, meanwhile, was returned to Chinese sovereignty in 1997, albeit as a Special Administrative Region (SAR)—an arrangement under which Hong Kong's previous way of life is supposed to be protected for a period of fifty years. Since the handover, contrary to the expectations of some, Hong Kong's distinct economic and legal systems have remained intact. Confidence in officialdom has, however, crumbled, with the government of the Beijing-selected chief executive, Tung Chee-hwa, seeming to stumble endlessly from one crisis to another.

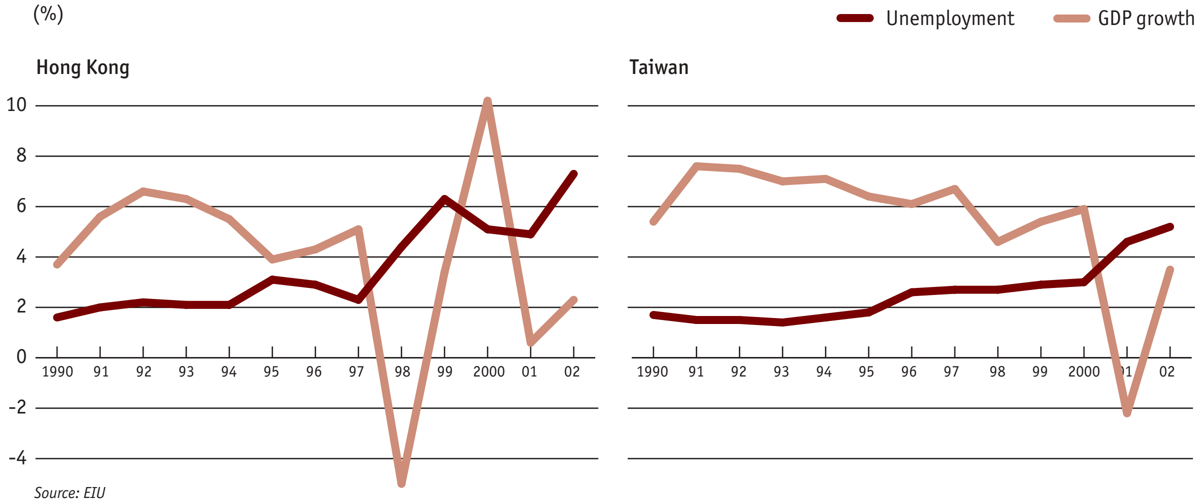
Adding to the malaise, the economies of both Taiwan and Hong Kong look their weakest in a generation. Taiwan suffered a searing recession in 2001 and even today unemployment, virtually unknown before the late 1990s, remains above 5%. Hong Kong's downturn was triggered by the 1997–98 Asian financial crisis which led to the thumping crash of the stock and property markets in 1997. This event has been followed by two technical recessions, an increase in unemployment from 2.2% to over 7%, a dramatic slide in the government's finances, and four full years of falling consumer prices and in a further blow to confidence, the territory is battling an outbreak of Severe Acute Respiratory Syndrome (SARS).

To many in Taiwan and Hong Kong, it is no coincidence that these severe domestic problems have emerged just as both have become more closely entwined with an increasingly strong mainland economy. Indeed, there is a palpable fear that the current downturns are not of a cyclical, temporary type, but are rather structural, directly caused by their changing relationship with an increasingly competitive China.

It is not necessary to spend long in either place to become aware of these fears. Newspapers in Taiwan talk of an exodus of investment and people to the other side of the Strait. Some estimates suggest investors from the island have spent more than US$100bn in the mainland during the last ten years, with perhaps 400,000 people from Taiwan—almost 2% of the domestic population—now living in the Shanghai area of China alone. (Another unofficial source placed the number of Taiwanese in the mainland on any given day at 3–4m.) To the south, meanwhile, figures showing increasing throughput in Shenzhen's ports are eagerly seized upon as evidence of Hong Kong's growing irrelevance as a transit point for mainland trade, while the decision of any foreign bank to establish an office in Shanghai is regarded as another nail in the coffin of the SAR's financial centre.

In this report, we hope to show that these fears are overdone. In the first instance, the macroeconomic problems currently being experienced in both Taiwan and Hong Kong are due less to China-related, structural factors than to the cyclical downturn of the global economy in 2001-02, aggravated by domestic political problems. Taiwan has also had to deal with a poorly-performing banking sector, while Hong Kong has struggled to recover from the bursting—in spectacular

From go-go to just so-so
Key economic indicators for Taiwan and Hong Kong
(%)



Source: EIU

style—of a property market bubble.

At the same time, while these developments have been accompanied by a movement of IT manufacturing capacity from Taiwan to China, and the growth in the mainland's capacity to deliver some of the services over which Hong Kong previously held a monopoly, there has been no simple outflow of corporate activity from either of the former tiger economies. Rather, for both Taiwan's manufacturing industry and Hong Kong's service sector, the picture is more one of a developing division of labour, in which some lower-end processes move out, while higher-end ones remain and indeed, more often than not, expand. Contrary to the fears of some, both Taiwan and Hong Kong have sophisticated industry clusters—manufacturing of IT hardware in one, services in the other—that will not be easily replicated on the mainland.

This is no excuse for complacency. Instead, the challenge, unsavoury as it may be to some, is actually to strengthen links with China, while at the same time carrying out domestic reforms that would be necessary in any case.

Take Taiwan. The island is well-placed to be a major centre not just for the manufacture of IT hardware, but for its development. Without, however, being more open to exchanges of people, resources and information with the mainland—an increasingly important location not only for the mass-production of IT goods but also for their sale—it will be difficult for the island to achieve this destiny. It is already arguable that the limits on economic ties with China have been responsible more for pushing manufacturing capacity out of Taiwan than keeping it in. Removing the restrictions would allow the island's service sector, which certainly has been crippled by the limits on cross-Strait economic ties, to become an alternative engine of growth.

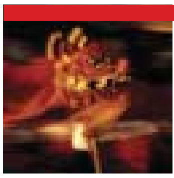
Hong Kong has clearly not been hobbled by the same kind of restrictions. Indeed, it is largely because of openness to China that the territory has evolved over the last twenty years from a world centre for low-end manufacturing to a global provider of high-end services (a pattern of development that Taiwan would be well-advised to take notice of). But while Hong Kong has always been open to capital movements, the interflow of goods and people has been less free. This did not matter when Hong Kong was the only city in China that offered an international-style airport, port and quality of life. But with the mainland's physical and policy infrastructure improving rapidly, this has now changed. Fortunately, the government realises this, and has been moving to improve transport links with the mainland, as well as easing barriers to mainland people entering Hong Kong.

Closer links with the mainland on their own are, however, insufficient to ensure continued prosperity. Taiwan and Hong Kong will profit not from being part of China's economy, but rather from being distinct and well-run entities with especially strong links to the mainland. Taiwan's government needs, for example, to encourage greater research and development activities, but must also implement much-needed improvements in the country's basic physical and regulatory structure. Officials in Hong Kong, on the other hand, need to strengthen the skills base of the economy, while taking on the vested interests that have prevented the territory's economy from being as competitive as is often claimed.

This two-pronged policy prescription presents difficulties for officials in both Taipei and Hong Kong. There is already concern in Taiwan about the leverage over the island's political future that the government in Beijing may gain through the island's growing investment in, and trade with, China. Admittedly, few governments would relish the idea of cozying up to a partner that maintains a standing threat to invade (See box on page 12). But this is at least a route lined with possible economic benefits for Taiwan. In any case, the alternative—economic irrelevance as China's economy becomes ever stronger—is hardly a palatable choice either.

Further integration does worry some in Hong Kong as well—property-owners (and developers) fear closer cross-boundary links will cause prospective homeowners to flee the territory in favour of cheaper investment opportunities in Shenzhen. If closer integration is combined with domestic reforms, however, Hong Kong would remain in demand—even if it is more expensive. The danger for Hong Kong is that while the government increasingly seems to accept the first part of this policy prescription—the chief executive, Tung Chee-hwa, devoted a whole chapter of his 2003 policy address to the subject—fear of vested interests will prevent it from implementing the second.

Taiwan's president, Chen Shui-bian, has said that direct links are no cure-all for the island's economy. This is undoubtedly true, and is equally valid for Hong Kong. But with the right domestic reforms, both former tiger economies have much to gain and little to lose from the leaping dragon.



PART I **TAIWAN**

The investment tide

Taiwan's battery of restrictions on transport, trade and communications with China remain tight. The rules governing investment, however, have been eased slightly, prompting the movement of more productive capacity to the mainland. And with much of the mainland investment centred on Taiwan's all-important IT sector, these changes are becoming ever more controversial on the island.

A "great sucking sound", predicted Ross Perot, would accompany a damaging migration of industry from the US to Mexico following the ratification of the North American Free Trade Agreement (NAFTA) in 1992. There are echoes of the same sentiment being heard throughout Taiwan. "If the government relentlessly opens investment to mainland China, it will exacerbate Taiwan's unemployment and worsen the situation of funds flowing out of Taiwan". While the language of Chen Chien-ming, a Taiwan Solidarity Union (TSU) legislator, may not have been as evocative as that of the former US presidential candidate, the underlying sentiment is the same. Just as Mr Perot expected the NAFTA agreement to drain the US economy, Chen thinks closer cross-Strait economic ties will produce a hollowing out of Taiwan's economy. And he is not alone.

The feeling that Taiwan's economy is being undermined by an apparently unstoppable "go west" trend became even more widespread in 2001-02. Taiwanese investment in the mainland appeared to pick up—it became almost impossible to open a local business magazine without seeing an article about "Shanghai fever"—just as the domestic economy fell into the worst slump in a generation.

Sceptics were not reassured by the government's decision to introduce a new approach to economic relations with the mainland. Launched by the government of president Chen Shui-bian, who took office in May 2000, the "active opening, effective, management" policy replaced the "less haste, be patient" principle that had guided policy in the 1990s. Under the new approach the number of sectors closed to mainland investment—which previously included, for example, the semiconductor and notebook industries—was eased, and the prohibition on participation on any project costing more than US$50m replaced with a case-by-case review for proposals worth more than US$20m. The most attention-grabbing part of the approach—and the component that prompted Mr Chen's comments—was the decision in 2002 to allow Taiwan firms to establish 8-inch semiconductor fabrication plants (fabs) on the mainland. The government also committed itself to working towards the establishment of direct cross-Strait transport links, and started to ease the ban on direct financial links between China and Taiwan.

Many industrialists in Taiwan doubted the sincerity of the latest opening, believing that "effective management" (which for many is indistinguishable from the "less haste, be patient" approach) rather than "active opening", is the guiding principle for the current government's mainland policies. In terms of investment policy, this is a little unfair. The 2001 liberalisation was hardly sweeping—Taiwan firms will, for example, be allowed to establish just three eight-inch semiconductor plants in China before 2005, and then only using depreciated equipment. But given that such factories are regarded as the crown jewels of the island's IT sector, that any at all were allowed to go did signify a real departure from previous policy.

Despite limited opening in areas such as these, economic links between China and Taiwan remain as restricted as ever. In recent years shipping links between the two sides have only gradually been expanded.

The three links fallacy

In this report we have not referred much to the so-called three links concept—a term commonly used to describe direct, cross-Strait links that are currently banned—for a number of reasons. First, the three links, which include transport, postal and trade links, really constitute only a single link. After all, with the advent of direct transport links, direct postal and trade links would naturally follow.

Furthermore, the ban on direct transport links has not been as watertight as is often assumed. Direct cross-Strait flights remain beyond the pale, but since 1997 ships have been passing directly between Kaohsiung in Taiwan and Xiamen and Fuzhou in China. Vessels plying this route have been prevented from carrying local cargo, but the same restriction has not applied to ships sailing between the mainland and Taiwan's offshore islands of Matsu and Kinmen—a route permitted since 2001. Even indirect links have been liberalised in recent years. Rather than having to stop and tranship cargo in a third area as was previously required, boats travelling between Taiwan and the mainland have increasingly been required only to pass through the waters of a third port, with a pilot boat coming out to sort the necessary paper work in good weather or via helicopter in adverse conditions.

Perhaps more importantly, the focus on the three links is also misleading because it excludes other types of ties that are equally important, such as financial transactions as well as the entry into Taiwan of mainland money, goods and people. Restrictions in these areas have been more watertight—and thus more damaging—than have the limits on cross-Strait transport links.

The government has moved in recent years to allow mainland investment in Taiwan's property market, but this limited concession is the only one that has been made. The island also retains a long-albeit shrinking-list of goods that cannot be imported from China. And it remains very difficult for mainland people to visit Taiwan.

Although boats have been allowed to pass directly across the Taiwan Strait since 1997, they are only allowed to sail between one of the island's ports, Kaohsiung, and two harbours in China, Xiamen and Fuzhou. Moreover, cross-Strait cargo carried on this route cannot pass through customs in either Taiwan or China; the route is only for transhipment to third destinations. In recent years some vessels have been allowed to sail between Taiwan and China without, as was previously required, having to tranship cargo onto a second boat at a third port during the voyage. These vessels still, however, have to pass through the waters of a third port on route, most commonly the Japanese port of Ishigaki.

True direct sailings were established in 2001, but only between mainland China and Taiwan's outlying islands of Kinmen and Matsu. And as with both the transhipment and "direct shipment through a third area" services, only Taiwan or mainland Chinese vessels (albeit sailing under a flag of convenience) can plough the Kinmen-Matsu-China route. Foreign shipping companies wishing to carry cargo across the Strait must still transfer it en-route onto a second vessel, a change-over which usually happens in Hong Kong, but which may also take place in ports in Korea or Japan.

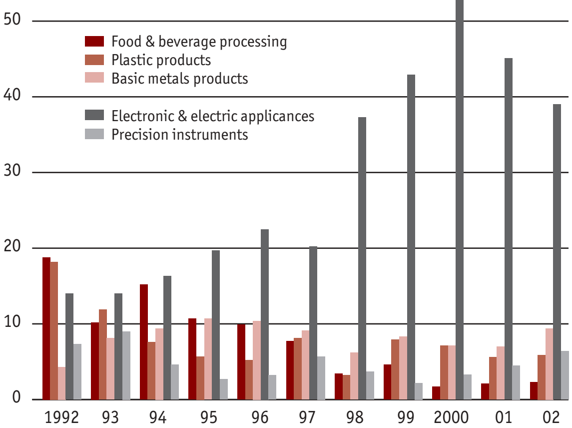
Air links between Taiwan and China are even less developed. All passengers passing between Taiwan and China must touch down en route in a third destination, either Hong Kong or, since 1996, Macau. The most seamless services are provided by the Hong Kong carrier, Dragonair, and Air Macau, which are the only two airlines with permission to fly to Taiwan and to cities in the mainland as well. The other airlines flying between Hong Kong or Macau and Taiwan have teamed up with third carriers to shorten transit stops. In 2003 commercial airlines from Taiwan were allowed to fly to the mainland for the first time since the end of the civil war, but they still had to land in Hong Kong or Macau en route, and this charter flight service was only offered during the Chinese New Year period.

Direct financial links between Taiwan and China are also all but non-existent. As part of the 2001 opening to the mainland, larger local banks were allowed to apply to establish representative offices in the mainland. Since 2002 local banks have also for the first time been able to remit money directly across the Taiwan Strait. Such remittances can only occur, however, through offshore banking units (OBUs), which are restricted from dealing with domestic firms or individuals. The former minister of finance, Lee Yong-san, planned to extend this opening to domestic banking units (DBUs), and allowing OBUs to lend to Taiwan firms in the mainland. This proposal was unpopular with Taiwan's pro-independence politicians, and was one of the factors that led to Mr Lee's resignation in November 2002.

Taiwan keeps close tabs and many limitations on the outflow to China of capital, goods and people. But the government retains even stricter controls on the movement of resources to the island from China. In recent

Investment surge

Approved mainland investment by Taiwan companies
(% of total)



Source: Ministry of Economic Affairs, Taiwan

years officials have allowed the import of a growing list of goods from the mainland—in 2002 the sale of China's best-known beer, Qingdao, was allowed for the first time on the island. But the government still retains a list of 2,621 prohibited items, which includes a broad range of agricultural, textile and steel products, together with things like washing machines and cars. Restrictions on the inflow of people and capital are even stricter. The only mainland tourists currently allowed to visit Taiwan are those currently residing outside of China, and even they can only enter as part of a tour group. And mainland investment remains virtually prohibited in Taiwan.

The most notable aspect of this battery of restrictions is that it has proved remarkably ineffective at dissuading Taiwan firms from investing in China. Taiwan's government approved mainland investment projects worth US$26.4bn in 1992-2002. Mainland investment approved in 2002, at US$6.7bn, was more than half as much again as the previous record-high recorded in 1997.

And these figures are universally regarded as understating the true level of local investment in China. Rather than seeking government approval that may not have been forthcoming, many local firms have invested in China without the knowledge of Taiwan's government. Statistics from the mainland government show that Taiwan investment totalled US$31.2bn between the beginning of 1992 and the end of September 2002. Even this figure is likely to be below the real total. With direct inflows from Taiwan banned, all investment in the mainland from the island's firms has been routed through third destinations, most commonly Hong Kong, Singapore and the tax havens of the British Virgin Islands (BVI) and the Cayman Islands.

What has attracted more attention in Taiwan in recent

Between a rock and a hard place?

The debate over the establishment of economic links with China often becomes subsumed in politics. Those in Taiwan from the pro-independence camp, who want no political relationship with mainland China, tend on principle to be against closer economic links. Meanwhile, pro-unificationists, who hope for the eventual creation of a pan-Chinese entity embracing both mainland China and Taiwan, generally take the opposite view. The bottom line? When it comes to dealings with China, it is nearly impossible to divorce politics from economics.

After all, ties between Taiwan and China are not all about computer chips. Whether it is bluff or bravado, China's government has a standing threat to invade Taiwan—rhetoric backed up with high military spending and the build-up of a large arsenal of missiles directed at the island. It is difficult to argue that Taiwan's government would be best serving its people by ignoring these threats when creating its economic policy towards China. At the same time, however, those opposed to links need to accept that the main effect of the current regime of restrictions has not been to prevent Taiwan's economy becoming more closely integrated with the mainland, but rather to stop the island's economy benefiting fully from the broad links that have developed.

In recent years the issue of direct links with China has been attracting more and more attention on the island. This is a result both of Taiwan's own economic difficulties, and ever-increasing local investment in the mainland. It is also owing to developments in China itself, where the government appears—somewhat uncharacteristically—to be ready to offer concessions in order to achieve closer economic ties with Taiwan. Mainland officials seem to believe that in so doing, they are in a win-win situation. The opening of direct links would be portrayed as a first step towards unification—China's stated goal. Mainland officials presumably also hope that a softly-softly approach will marginalise Taiwan's president, Chen Shuibian, whose pro-independence stance causes distrust in Beijing, and also appears to make him reluctant to work—as he has formally pledged to do—towards the establishment of closer cross-Strait economic ties.

Supporters of closer links hope that the presidential election in 2004 will bring a breakthrough. Mr Chen, much criticised during his first term in power, might advance cross-Strait links in an effort to secure a second. If he loses in March 2004, the opposing team of Lien Chan and James Soong are committed to opening direct links. Even so, don't expect regular direct flights between Taiwan and China anytime soon. A wild and reckless opening to China would likely prove no less controversial than a stalled one.

years is not the amount of mainland investment *per se*, but rather the rise in the proportion accounted for by firms from the island's high-profile information technology (IT) hardware industry. From under 20% in the early- to mid-1990s, the proportion of approved mainland investment accounted for by the electronic and electric appliances sector rose to more than 50% in 2000. The proportion has dropped off since then, but in 2002 was still at nearly 40% of approved mainland investment.

The heavy mainland investment of the electronics industry quickly becomes apparent in any tour of the Kunshan-Suzhou-Wujiang region in China, the area lying to the west of Shanghai that in recent years has become the focus of investment by Taiwan firms in the mainland. According to Taiwan engineers in this area, it is a recreation of the island's own Taipei-Hsinchu electronics corridor. (Hsinchu, the home of Taiwan's famous science-based manufacturing park, is the cradle of the island's technology industry). Sure enough, most of the big names in the island's electronics industry—such as the notebook computer maker Compal (Kunshan), the producer of computer peripherals BenQ (Suzhou), and the manufacturer of scanners Microtek (Wujiang)—have facilities in the region.

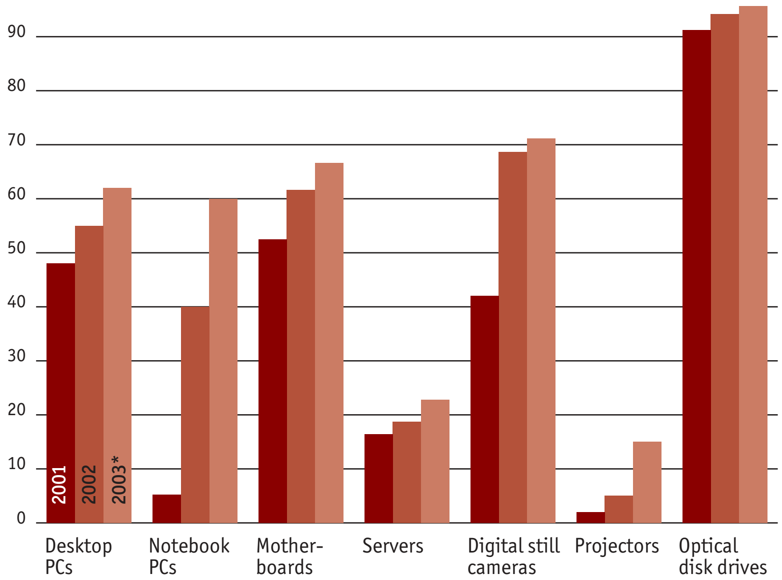
Some of Taiwan's IT investments in China are booming. In recent years, the level and range of output of the mainland facilities of Taiwan firms has expanded steadily—in line both with rising investment levels as well as changes in the nature of the IT hardware industry. In 2001 the mainland factory of one Taiwan notebook manufacturer was producing just 100,000 notebook computers a month, less than the 250,000 monthly output from its facility on the island. In 2002, however, mainland production surpassed that in Taiwan, rising to 350,000 units a month. This expansion is far from complete. With the building of a new factory, the company expects to be making 600,000 notebook computers every month in China by the end of 2003, by which time production in Taiwan would have fallen to 200,000 a month.

The evolution of BenQ's operations on the mainland tells a similar story. The company's mainland manufacturing operation opened in 1995, employing 56 staff. The next year production of cathode ray tube (CRT) monitors began, and in 1998 the mainland factory began to make CD-Roms. By 2002 the mainland factory was manufacturing goods including communication products, LCD monitors, digital cameras and colour laser printers, and mainland employment had risen to more than 7,000. BenQ expects to shift further production to China from Taiwan in 2003.

These trends are usefully illustrated by figures from the Market Intelligence Centre (MIC), based in Taipei.

Made in Taiwan... and China

China-based production as a % of Taiwanese electronic firms total production



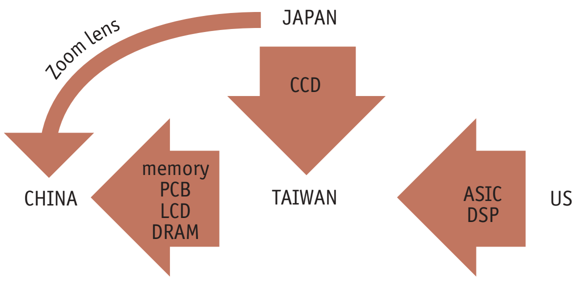
* Forecast   *Source: Market Intelligence Centre, Taiwan*

According to the MIC, of the total desktop computer production of Taiwan firms, the proportion made on the mainland rose from 48% in 2001 to 55% in 2002, and is expected to rise further, to 60%, in 2003. With the easing of restrictions on investment in notebook computer manufacturing on the mainland, the proportion of Taiwan production made in China jumped from 5.2% in 2001 to 40% in 2002. The MIC expects it to rise further to 60% in 2003. The movement of production capacity from Taiwan to China is visible from statistics for a range of other products, from motherboards to digital still cameras and projectors. Overall, MIC statistics show that of the total IT production of Taiwan firms, the proportion produced in factories on the mainland rose from 37% in 2001 to an estimated 47% in 2002, and is expected to increase to more than 50% in 2003.

This movement of productive capacity to the mainland has been controversial, for a number of reasons. Taiwan investment in the IT sector is, for one thing, clearly supporting the growth of the mainland economy. According to the mainland's State Economic and Trade Commission (SETC), China's output of electronic goods (in constant price terms) grew by 23.8% in 2002. And Taiwan firms were responsible for much of this growth: MIC figures show that 64% of the mainland's 2002 IT output was produced by Taiwan firms. (The MIC expects this proportion to rise to more than 70% in 2003.)

The increasing investment in the mainland by the island's electronics firms is also driving increased interaction—which some interpret as dependence—between Taiwan's economy and that of China. According to the

Tangled web
The sourcing of materials for a Taiwanese optical device factory in China

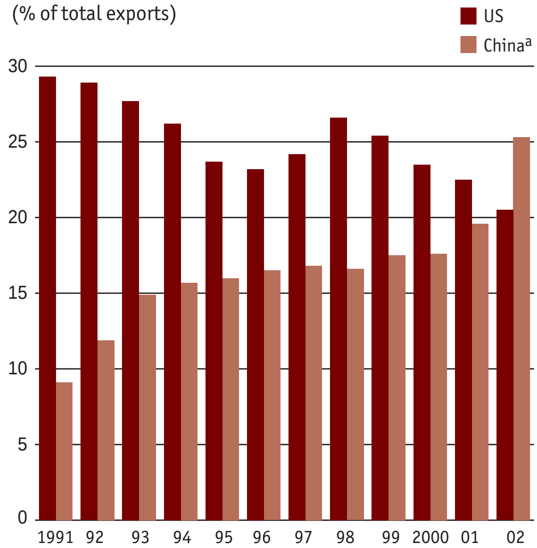


Purchased locally in China:
metal cases,
plastic cases,
electronic parts

CCD charge-coupled device
ASIC application-specific integrated circuits
DSP digital signal processing devices
PCB printed circuit board
LCD liquid crystal display
DRAM dynamic random access memory

Source: Industry sources, Taiwan

Trading places?
Taiwan's exports to China and the US
(% of total exports)



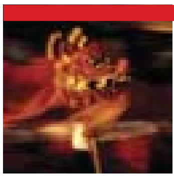
a Government exports, calculated by (1) exports to mainland China according to Taiwan's customs, (2) exports to mainland China through Hong Kong, according to Hong Kong's customs, and (3) 80% of the difference between exports to Hong Kong according to Taiwan's customs and imports from Taiwan according to Hong Kong's customs.
Source: Board of Foreign Trade, Taiwan

former head of the government's Council for Economic Planning and Development (CEPD), Chen Po-chih, while investment by US and Japanese firms in China is equivalent to just 1/1000th of the size of their respective countries' economies, Taiwan firms' mainland investment amounts to 2% of the island's GDP.

Apart from an expansion in investment, the migration of industrial capacity from Taiwan to China has also driven a rapid increase in cross-Strait trade. (For an example of how an investment in China can drive cross-Strait trade, see the chart above.) Yet as with the island's investment in the mainland, the restrictions imposed on direct cross-Strait contact have made it difficult to record accurately the amount of goods that passes between Taiwan and China. Fearing inquisitiveness from the government, some exporters have not been willing to report China as the final destination for their goods—and they have been aided in this common deceit by the rule that all exports bound for the mainland must first pass through a third destination, usually Hong Kong. Disingenuousness is not the only issue clouding trade statistics. Trading companies based in Hong Kong are big buyers of goods from Taiwan, but these goods are ultimately bound not for the SAR but rather for factories in the mainland. In addition, it is common for goods from everywhere in the world—not just Taiwan—that are destined for southern China to be exported in the first instance to Hong Kong, from where they enter the mainland by road

The quality of the island's data on exports to China trade is improving, thanks to development in recent years of "direct shipping through a third destination," as well as attempts by Taiwan's government to reassure companies that they are free to export to the mainland. Still, they are clearly deficient: while the proportion has risen steadily in recent years, in 2002 Taiwan's recorded exports to the mainland were still only 32% of the value of those sent to the much smaller economy of Hong Kong. Aware of this problem, officials in Taiwan produce estimates for trade with China, which splice together the island's own trade data with those produced by Hong Kong's government. According to these, Taiwan's exports to China rose by 37.4% in 2002 to US$33.1bn. This rapid growth was driven by exports of inputs for the IT industry, with the value of shipments to China of electrical machinery, equipment and parts surging by 75.2% last year to US$10.5bn, or 31.6% of the total. As a result of this rapid growth, China in 2002 overtook the US to become Taiwan's largest single export market.

Trade ties are growing. Investment ties are growing. And yet many of the barriers to cross-Strait ties are still in place. This situation would provide sufficient fodder for a rivetting policy debate. But of greater concern to the island is the flow of its precious IT sector to China. Is there cause for worry? In the next chapter we address the "hollowing out" fear.



PART I **TAIWAN**

The "hollowing out" myth

There's little evidence to support the worry that trade and investment with China is "hollowing out" Taiwan's economy, particularly in the all-important IT sector. Sure, IT manufacturing has moved across the Strait, but only as the domestic manufacturing base has upgraded, in textbook fashion.

The political consequences of the rapidly deepening cross-Strait economic relationship are a growing concern for many on the island. The pro-independence camp fears that businessmen with large investments in China will become more supportive of unification with the mainland than they otherwise would be. Even less radical groups worry about the leverage over Taiwan's political future that the government in Beijing may gain through the island's growing investment in, and trade with, China. Indeed it would be unreasonable for the government to ignore the possible political consequences of the deepening economic integration.

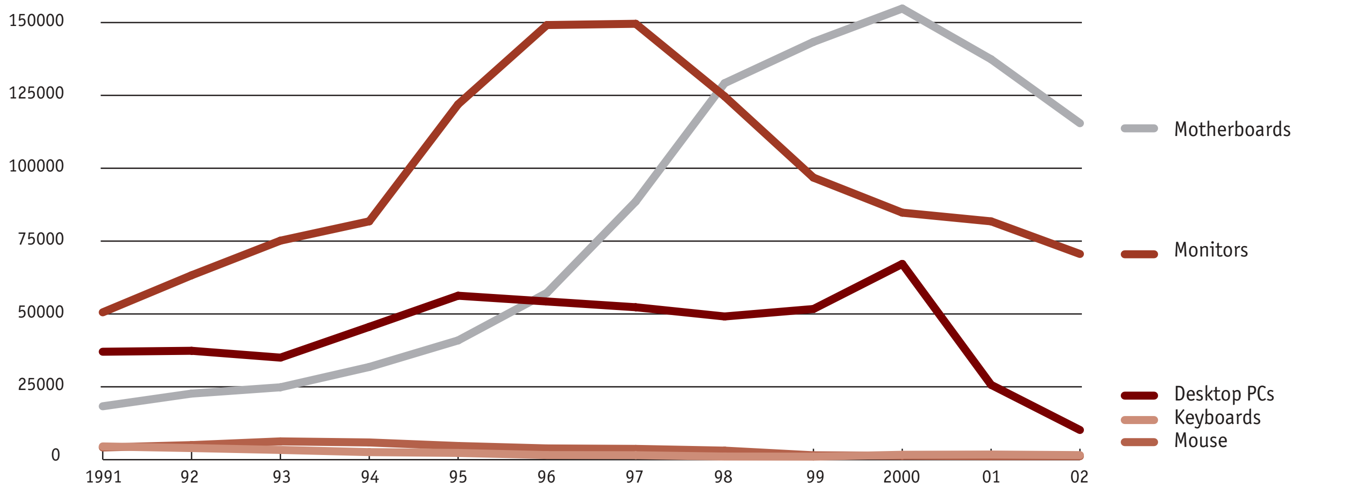
But the argument often made in Taiwan that these restrictions are also needed to prevent the hollowing out of the domestic economy is harder to sustain. In the first place, it is not at all clear that Taiwan's links with China are leading to the "hollowing out" of the island's industrial sector at all. Taiwan investment in China has only been permitted since 1990, but since then domestic investment has averaged more than 22% of GDP, above the average 19.8% recorded in the second half of the 1980s. Admittedly, during the first half of the 1990s investment was held up by increased capital spending by the government. But when public-sector investment fell-off during the second half of the decade, it was replaced by capital spending by the manufacturing sector, which rose from 5.5% of GDP in 1993 to 10% in 2000. Manufacturing investment in real terms rose by 18.1% a year in 1996-2000, a faster rate of average annual growth than in any five-year period since 1971-75.

Manufacturing output has shrunk relative to the economy as a whole in recent years. But the manufacturing sector has hardly shrivelled away. In 2001 manufacturing still accounted for a significant 26.4% of GDP. And while this was below the 33.3% recorded in 1990, the shrinkage recorded in the 1990s was of a moderate scale. In fact the relative size of the manufacturing sector had contracted much more sharply in the second half of the 1980s—in 1986 manufacturing had accounted for almost 40% of GDP. Moreover, while overall manufacturing output has grown relatively slowly in recently years, the high-profile electronics sector has continued to expand rapidly. Overall manufacturing output grew by an average of 6% a year in 1996-2000, but in the same period production of the information and electronic sector (comprising electrical and electronic machinery and precision instruments) rose by an average of almost 15%. Between 1996 and 2000 the value of Taiwan's exports of electronic products rose from US$16.6bn to US$31.7bn.

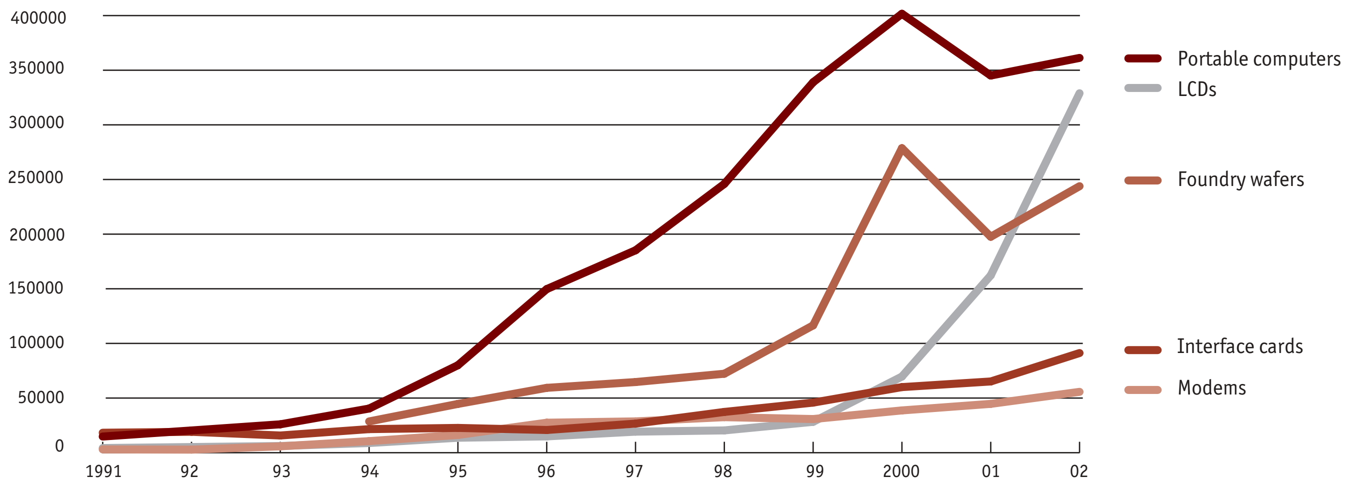
Of course, there's no doubt that Taiwan's good fortune during that period owed much to the well-documented IT bubble in the US, which spurred the stunning growth of the electronics sector. Thus when this bubble burst, as it did in spectacular fashion in late 2000, Taiwan was hit by a searing recession. The island's GDP contracted by 2.2% in 2001, with manufacturing investment plummeting by 34%. But the growth potential is far from exhausted. In 2002 the output of the domestic information and electronic industry, which had contracted by 9.6% in 2001, grew by 11%.

So no signs in electronics output numbers of the widely feared "hollowing out," despite the tangible increase in domestic interest in China in 2001-02. How then did production of the domestic electronics sector continue to grow so strongly in the second half of the 1990s, given that such large amounts of investment were

Sunset...
Taiwan's production of selected electronics manufactures
(NT$m)



...and sunrise



Source: Taiwan Ministry of Economic Affairs

going to mainland China? Simple: Taiwan's IT industry upgraded in textbook fashion. As production of a particular IT product peaks and then falls, new products take its place in the output hierarchy until they too are replaced by something smaller, faster or more sophisticated.

Earlier in the decade Taiwan's IT industry was based on the manufacture of products such as monitors, desktop personal computers (PCs) and motherboards. The value of domestic production of computer monitors peaked at NT$149.6bn (US$5.2bn) in 1997, and has fallen steadily ever since. Domestic production of desktop PCs and motherboards did not peak until 2000, but fell consistently in the following two years. The fall-off in manufacture of desktop PCs has been particularly dramatic, with production values dropping from NT$67.2bn in 2000 to just NT$10.2bn in 2002.

One does not need to be a gadget geek to know that monitors and desktop PCs are no longer at the cutting edge of the IT revolution. These products have been succeeded in the market place by items that are more compact, portable and functional, and domestic production of these more sophisticated products continues to rise in Taiwan—at least until something better comes along. For example, the value of notebook computers produced in Taiwan rose consistently from 1991 to peak at NT$401.6bn in 2000. Dragged down by the global economic downturn of 2001 domestic production fell back

Taiwan's semiconductor industry

The development of Taiwan's semiconductor industry has been a major success story. Formed as spin-offs from the government's Industrial Technology Research Institute (ITRI), United Microelectronics (UMC) and Taiwan Semiconductor Manufacturing (TSMC) are now the world's dominant foundry producers of microchips. (A foundry is a semiconductor manufacturing plant that makes chips under brand for other companies.) According to figures from Taiwan's National Chiao-Tung University (NCTU), between 1995 and 2000, Taiwan's share of the global foundry market grew from 21% to 70%, a period during which worldwide foundry revenue more than doubled, from US$5.1bn to US$12.9bn. The global market shrank in 2001, but Taiwan was less seriously affected than some, with the island's market share growing further to 73%.

It is, however, not just production has grown. Again, according to NCTU, Taiwan is ranked number one in the world for semiconductor testing and packaging, with a market share of 35%. Taiwan's semiconductor design capability has also expanded rapidly. Revenue of Taiwan's fabless companies—which design and sell chips, but do not manufacture them—grew from US$700m in 1995 to US$3.6bn in 2001, with its share of the world market rising from 12% to 26% during the same period. Taiwan's semiconductor design industry is now ranked second in the world, trailing only that of the US. There have even been some reports of US semiconductor design firms moving to Taiwan.

After apparently tortuous debate, Taiwan's government in 2003 finally granted permission for TSMC to establish a fab in China. This will not open up a stampede across the Taiwan Strait. Before 2005 the government will allow only three current industry-standard 200mm wafer fabs using depreciated equipment to set up on the mainland. Moreover, local firms will only be able to apply for permission to relocate 200mm plants after they pour in "considerable" investment in Taiwan to upgrade their technological levels; specifically, local firms must show their they have been producing the more advanced 300mm wafers in Taiwan for at least six months.

Even if these restrictions were not in place, the semiconductor industry would not move wholesale from Taiwan. The attraction for semiconductor firms of manufacturing in China is neither lower wages—the industry is heavily capital-intensive—nor transport costs—semiconductors are small, light and very valuable. Rather, firms such as TSMC want to be in China to sell in the local market without attracting the value-added tax that is levied on imported components.

Investments by Taiwan's well-known semiconductor firms will undoubtedly give a boost to the mainland. It will, however, be some time before China's industry is in a position to rival that of Taiwan. According to a semiconductor market research firm, IC Insights, based on current plans China could have 25 new fabs by 2005, only a handful of these will be making 300mm wafers. By contrast, Taiwan already has five working 300mm fabs, and a further six are likely to come on line before the end of 2003.

to NT$345bn. But despite the sharp rise in mainland production of notebook computers by Taiwan firms in 2002, production on the island also increased, to NT$361bn.

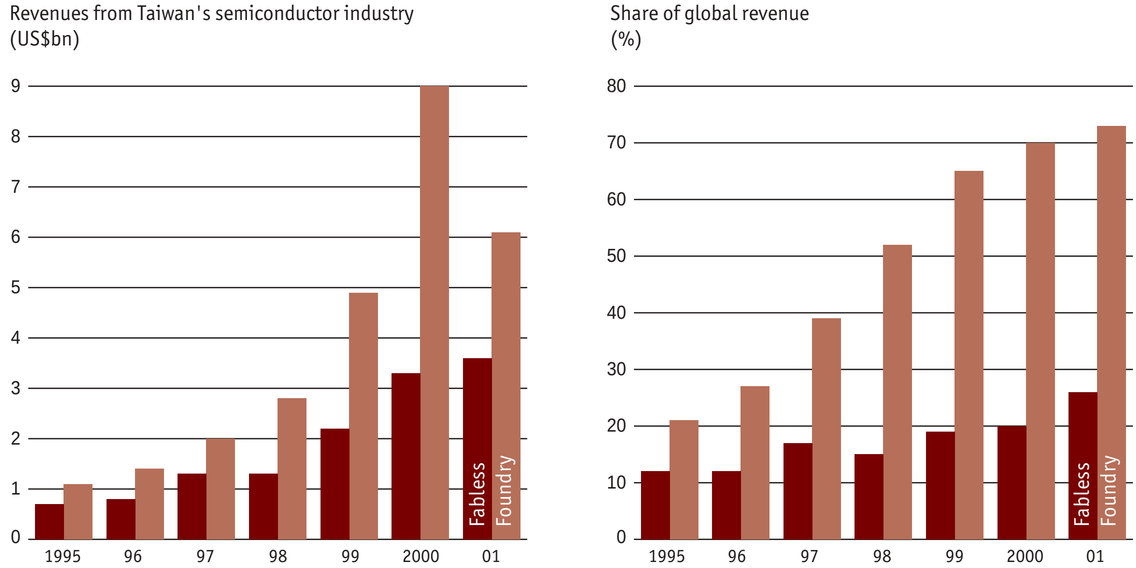
While serving as the main source of sales growth in the world computer market in recent years, notebook computers themselves are no longer the leading IT product that they once were. Although production of notebook computers clearly remains important in Taiwan, the domestic IT industry does not currently rely on this activity. For one thing, in recent years domestic production of Internet devices has expanded rapidly. The value of modems produced on the island has risen in almost every year since 1992, reaching NT$55.7bn in 2002. Between 1996 and 2002 production of interface cards more than quadrupled, rising from NT$20.8bn to NT$91.2bn.

Revenue generated through the manufacture of Internet-related devices is rising quickly. However, it remains much smaller than the production value of the semiconductor and display (flat panel and liquid crystal display—LCD) industries. Under the Two Trillion programme, officials hope that by 2006 production value of the two sectors will have grown to NT$1.5trn and NT$1.3trn respectively.

Production of both technology-intensive sectors has been rising rapidly in recent years. Taiwan is the home to the world's two largest foundry producers of semiconductor wafers, Taiwan Semiconductor Manufacturing (TSMC) and United Microelectronics (UMC). The domestic output value of the foundry industry increased more than five times between 1996 and 2000. Output declined in 2001—although, in a reflection of the strength of Taiwan in this sector, Taiwan's share of worldwide semiconductor foundry revenue rose from 70% to 73%—but then increased again in 2002 to NT$243.9bn. The growth of the LCD industry has been even more rapid. Domestic output value was just NT$20.4bn in 1998, but by 2002 had jumped to NT$328.9bn.

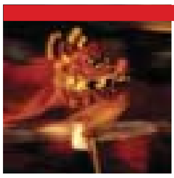
The picture painted by all these statistics is clearly not

When the chips are up...



Source: National Chiaotung University, Taiwan

one of an electronics sector that is rapidly being hollowed out, to China or anywhere else. Instead, these figures suggest that while much capacity is indeed being moved to mainland China, it is being replaced in Taiwan by the expansion of existing activities or the development of new ones. This story is confirmed by interviews with managers from some of Taiwan's leading IT companies, both on the island itself and in their facilities on the mainland. While some could foresee all production being moving to the mainland, most executives said that a division of labour existed between manufacturing facilities in China and those in Taiwan, which is determined by the maturity, labour and value-added content, and scale of production of any particular product.



PART I **TAIWAN**

The Taiwan advantage

Lower labour costs in China are a draw for Taiwan's manufacturers, as is the opportunity to tap a bigger market and establish brands. But Taiwan's advantages—and China's weaknesses—will anchor most manufacturers on the island for sometime to come.

The attractions of China for the island's manufacturing entrepreneurs might seem almost overpowering, even for those most strongly committed to the cause of Taiwan independence, and so reluctant to contribute in any way to the strengthening of the mainland's economy. Local governments in China are falling over themselves to attract foreign investors. Granting generous tax breaks to Taiwan companies is one common way to attract investment. But these are, perhaps, not the most important incentives. According to one company that spoke to the EIU, local officials are willing to consent to "almost anything" that is requested. Certainly land is routinely provided either for free or at very low rates, but the EIU was also told of examples of local governments investing in roads and water treatment plants on request. Taiwan companies have also frequently been granted special permission to build dormitories, used to house the cheaper workers who come from China's inland provinces .

These incentives can add up. The result? Production can be undertaken at very low cost and very quickly. The EIU has found cases in which production began just a year after a Taiwan firm expressed initial interest in a particular investment project, even if the preferred site was previously farmland unconnected to a road network.

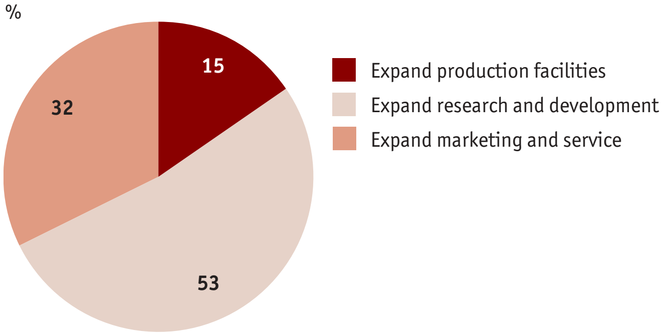
It is labour, however, that remains the most important factor behind China's appeal as an investment site. Some companies in China report paying assembly workers standard wages of just Rmb400 (US$48) a month. Other firms are more generous, but even for them the total cost of a production-line worker, after associated payments such as dormitory provision and social insurance are added in, is unlikely to exceed Rmb1,000 a month. This is an amount far below the basic NT$18,000 (US$518) basic monthly wage received by a worker on an electronics production line in Taiwan. Moreover, wages for assembly workers in China do not appear to be rising: while more and more foreign companies are establishing manufacturing facilities in the mainland, it will be some time yet before demand catches up with the supply of low-skilled labourers from China's 500m rural workforce. One manager in Guangdong did tell the EIU that, in the aftermath of the 16th National Congress of the Chinese Communist Party (CCP) in November 2002, he was instructed by local officials to raise wages. (The manager attributed the directive to the 16th Congress, which called for the "building of an affluent society" in China.) Even so, the minimum wage will have to be increased at a very rapid rate indeed if China is to lose its competitiveness to Taiwan in basic manufacturing any time soon.

Suppose Taiwan manufacturers could resist the very low labour costs and generous incentive packages offered by local authorities in the mainland. Other, less obvious, reasons exist for establishing a presence on the other side of the Strait. Most Taiwan manufacturing companies do not sell finished products under their own name, but instead produce under contract for other companies. It is a business model which, depending on the research, development and planning input supplied by the end-client, is known varyingly as original equipment manufacturing (OEM) or original design manufacturing (ODM). In this way many of the goods sold by such well-known companies as Dell, Motorola and Sanyo, are in fact made by much less famous firms from Taiwan including Quanta, BenQ and Premier.

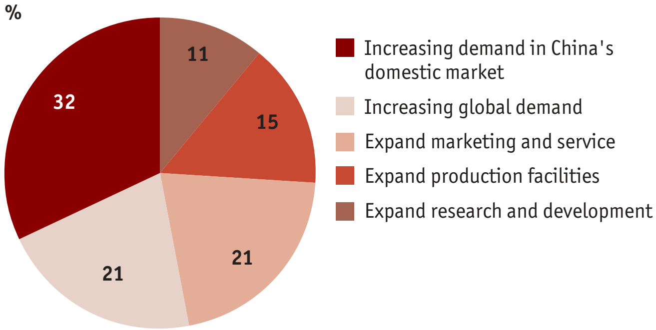
These end-clients know that upstream production costs—and therefore their own procurement prices—can be lowered if manufacturing is moved from Taiwan to China. Naturally then, these big brand name companies have been pressuring the smaller, largely anonymous manufacturers of their finished products to make this move. These Taiwanese firms, not wanting to carry excess inventory or incure import duties, have in turn requested their own suppliers to establish production facilities in China. The result is that entire supply chains have been moving from Taiwan to the mainland, resulting in an across-the-board increase in the purchase of local raw materials and components. Managers of all the factories visited by the EIU on the mainland reported that the proportion of components purchased locally had risen consistently in recent years. In a typical example one firm, a manufacturer of scanners, told us that when their company first started production in China, 70% of inputs were imported from Taiwan. Now, all but 10% of their inputs is procured locally.

Lower production costs are not the only reason that China is looming larger in the minds of the big, brand-name electronics companies. For many of these firms the mainland is also becoming an increasingly important end-market—a trend corroborated by the results of the survey conducted for this report of senior executives at some 550 of Taiwan's top companies. Indeed, in our survey, the most common reason cited by firms already invested in China for increasing investment in China over the next three years was to take advantage of opportunities in the mainland's domestic market.

If you plan to increase investment in Taiwan, why?
%



If you plan to increase investment in China, why?
%



Source: Economist Intelligence Unit executive survey, March 2003

Accessing China's domestic consumers can be difficult, however. Many foreign manufacturing firms in China have export processing contracts that, in theory at least, prohibit them from selling domestically. Even if this rule does not apply, or can be circumvented, imported components that are used in the production of goods sold domestically attract high rates of value-added tax.

Other companies see the potential to tap China's massive market not through the consumer's pocketbook, but though the government's. The semiconductor industry, for example, is interested in the opportunities arising from China's introduction of a new national "smart" identity card sometime in the next few years. With each card having its own chip, this development offers a potentially lucrative sales opportunity for semiconductor manufacturers—although at the very least China's government is likely to impose local content requirements on the manufacture of the card, citing national security concerns.

Such business-to-business selling has long been the mainstay of Taiwan's contract-based manufacturing industry. But some local companies also see the mainland as their chance to move away from the generally low-margin OEM and ODM work and towards the production and sale of goods under their own brand—the so-called own brand manufacturing (OBM) model. A handful of companies from the island have tried to make this leap in the past and some, notably top bicycle maker Giant, have succeeded. But most companies—including Acer, a computer company—have struggled to establish themselves with end-consumers.

Once again, China looks attractive. Many of the world's best-known brands are working to establish a presence in China, but few have sewn up any one market. And in developing the China market, Taiwan companies, see themselves as having unique competitive strengths over these other foreign brands. Executives we spoke to, citing their cultural and linguistic similarities with the mainland, referred to China as their true "home market". Certainly, some local firms appear to be succeeding in breaking into the China market. Giant, for, instance, is the number one bicycle brand in the mainland, with a market share of around 4%. Some firms are even using China to establish a brand for the first time. One Taiwan firm, DBTel, claims it now has a 5% share of China's GSM mobile telephone market. And Chengshin Rubber's Maxxis brand of tire is now China's number one.

The mainland's drawback

Given the strength of the factors pressuring local firms to move to China, it may seem surprising that anything at all is produced in Taiwan. But the attractions of the mainland are not all-pervasive. From the EIU's interviews with company executives, it is clear that doing business in China remains difficult and risky. The export-processing contracts that govern the activities of many Taiwan firms in the mainland are restrictive and inflexible—manufacturers have to report in advance, for example, what materials in what quantities will be used to make a particular item. In addition, while Taiwan itself is hardly a paragon of virtue with respect to protection of intellectual property rights (IPR), China is even worse. The ability of mainland China firms quickly to copy products and manufacturing processes has always been a concern for Taiwan firms. But IPR considerations are becoming even more important as companies from the island invest more in research and development (R&D) and brand-building in an attempt to migrate from the basic OEM model of production to ODM, and even OBM.

Another frequently cited drawback of China's business environment is the prevalence of job-hopping. The willingness of a low-skilled assembly worker to jump ship when offered Rmb50 a month to work somewhere else may not cause much of a hiccup: such people receive little training and are easily replaced. The lack of corporate loyalty is, however, more of a problem when it comes from skilled staff, people who tend to have positions of greater responsibility, but who are also in short supply. While Taiwan managers have much praise for the strong fundamental knowledge of graduates in the mainland, they complain about the supply of engineers with applied skills, particularly those with experience. The shortage of such workers is becoming more severe as more and more foreign firms establish manufacturing capability in the mainland. Wages for skilled workers are thus being bid up, a process which not only fuels the job-hopping phenomenon, but also cuts China's cost competitiveness. According to one executive that spoke to the EIU, an engineer with two to three years experience in Kunshan could earn as much as Rmb8,000 a month, which, once indirect costs are included, is little different from the NT$42,000 a month a similarly-skilled person would be earning in Taiwan.

The executives that spoke to the EIU all had a consistent story to tell. While well-developed products manufactured in large numbers and requiring heavy labour input, such as scanners, are likely to be made in China, more sophisticated, newer, higher value-added products such as, say, projectors, tend to be manufactured in Taiwan. This division of labour does not just characterise the electronics sector across the Taiwan Strait. Textiles and garment manufacturers told the EIU a similar story. And the point is perhaps illustrated most graphically by a local firm, Giant, which is one of the world's leading manufacturers of bicycles. The average price of a Giant bicycle made in Taiwan is US$240, whereas in China it is just US$70.

Admittedly, this price difference partly reflects local demand considerations, with the cheaper bike made for the mainland market. But this is not the only reason for the disparity, since Giant's facilities in China also produce for export. Instead this suggests that for Giant, as well as for many electronics firms, Taiwan offers advantages over China in the production of higher-end products.

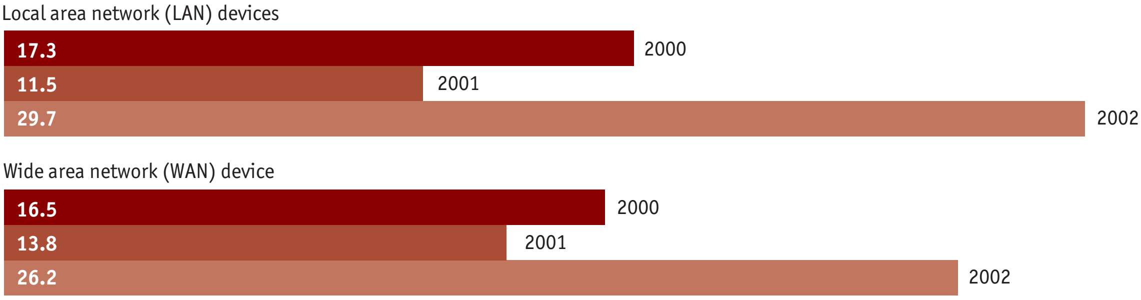
Taiwan's lures

Clearly, greater freedom from government interference in the production process, as well as simpler import and export regulations and Taiwan's better transport and communication links with the rest of the world, are factors that cannot be ignored. More important, however, is that the main R&D activities of Taiwan firms continue to be located not in China, but on the island. What is more, it seems unlikely that this division of labour will change any time soon. Expanding R&D activities was the least common motivation cited by companies in our survey as a reason for increasing investment in the mainland during the next three years. By contrast, of the factors given by those companies that said they planned to increase investment in Taiwan, expanding R&D activities was by far the most common.

Openness to the rest of the world is one reason why most R&D activity continues to occur in Taiwan rather than the mainland. Engineers on the island are better exposed to international trends in consumer technology markets than they would be if they were based in China. The standard of living and education system also seem to help: corporate loyalty is stronger in Taiwan, and managers generally feel that workers on the island are better able to work in a team than is the case on the mainland. Taiwan's competitive strength in this regard is also related to the depth and breadth of its IT sector, which has been built up during a period of twenty years. According to one executive, this background gives Taiwan a particular efficiency in R&D activity that would not be found elsewhere; another said it had imbued the island's engineers with a regard for quality that is absent in the mainland.

R&D activities also need to be near a web of supporting businesses, many of which do not exist in force on the mainland. In Taiwan, where firms have traditionally been OEM manufacturers and so less involved in cutting-edge research, R&D engineering activity has been

Early adopter
% of LAN and WAN device production of Taiwan firms made overseas



Source: Market Intelligence Centre, Taiwan

focused on the testing of new products and associated production processes—technically speaking, the engineering, design and production validation tests (PVT). Rolling out these new items of IT hardware and their associated manufacturing process is no simple task. It cannot be done without R&D engineers, together with an accumulated infrastructure of suppliers and other expertise, on hand to correct any problems.

So while much production has been moved to the mainland, followed more recently by later stages of the R&D process such as the PVT, Taiwan remains at the core of the IT hardware development process. This is clearly illustrated by the product lifecycle of the rapidly developing local area network (LAN) and wide area network (WAN) technology sector. In 2000, 17.3% of the LAN production of Taiwan companies was manufactured outside of the island. In 2001, however, new products and processes—developed in Taiwan—came on stream, so the proportion of offshore LAN manufacturing fell to 11.5%. As this technology matured production was moved away from Taiwan to save costs, and in 2002 the proportion of LAN goods made outside of Taiwan rose to almost 30%. It is for similar reasons, and not primarily the continued restrictions on investment in the mainland, that the island's semiconductor and LCD companies have been rolling out their latest manufacturing facilities—300mm wafer and 5th generation fabrication plants respectively—in Taiwan, not in mainland China.

Taiwan's R&D vision

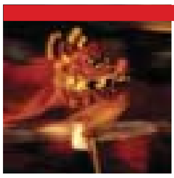
Taiwan has never been as "high-tech" as might be supposed from its dominance over the production of many IT hardware products. Traditionally, the technology and design input has been provided to Taiwan manufacturers on an Original Equipment Manufacturing (OEM) basis. As late as 1999 research and development spending in Taiwan accounted for only 2% of GDP, which is well below the spending level reached in the US (2.7%) and Japan (3%) in 2000.

The government wants to raise R&D spending to 3% of GDP within six years. To achieve this goal, officials are planning initiatives such as the establishment of a semiconductor design academy and setting aside capital to fund soft loans to R&D activities.

The government is also trying to attract major foreign multinationals to establish R&D centres in Taiwan. The usual range of incentives—financial start-up support and tax holidays—are available, but so is talent support: engineers who have just left university may be permitted to take up a four-year contract with an R&D centre rather than enrol in compulsory national service.

According to the Market Intelligence Centre, at least ten foreign firms have already applied to the Ministry of Economic Affairs to establish R&D centres on the island. The list of applicants includes such well-known names as IBM, Dell, Hewlett Packard, Sony and Intel. Sony's R&D centre, which already employs 30 people and will involve investment of NT$3bn over a three-year period, is focusing on semiconductors, as well as consumer products such as notebook computers and game machines. Intel, meanwhile, which has long based engineers in Taiwan to provide technical support to its many customers on the island, is establishing an R&D facility to work on network communications.

The influx of foreign companies to Taiwan is undoubtedly welcome. But more important in determining whether the government achieves its R&D target will be the decisions of local firms. Here as well there have been signs of improvement in recent years, with Taiwan companies becoming more involved in the "concept" phase of product development. Although R&D spending has risen it is still below target.



PART I **TAIWAN**

The cost of economic constraints

The restrictions on shipping and air links, as well as on labour mobility, imposed by Taiwan's government may have forced some manufacturing business out of Taiwan and increased costs to those that remain. At what cost to domestic industry do these barriers remain?

Analysis of Taiwan's electronics sector does not reveal a simple picture of an industry hollowing out to China, but one in which low-end activities are being relocated in the mainland, while higher value added processes remain—and often thrive—on the island. So are the limitations Taiwan imposes on cross-Strait investment of any economic use? Superficially, they might seem to have played a part in keeping Taiwan's manufacturing at home: after investment restrictions were eased in 2001, for example, the proportion of notebook computers produced by Taiwan firms in the mainland leaped. And they might reassure those with concerns about the political implications of greater economic ties. But in the electronics sector at least, they have become almost an irrelevance in terms of the health of the domestic industry. The industry has developed at an impressive pace, checked from time to time by bursting bubbles and fast-changing markets. But there is little chance that the Taipei-Hsinchu corridor will become a series of ghost towns anytime soon.

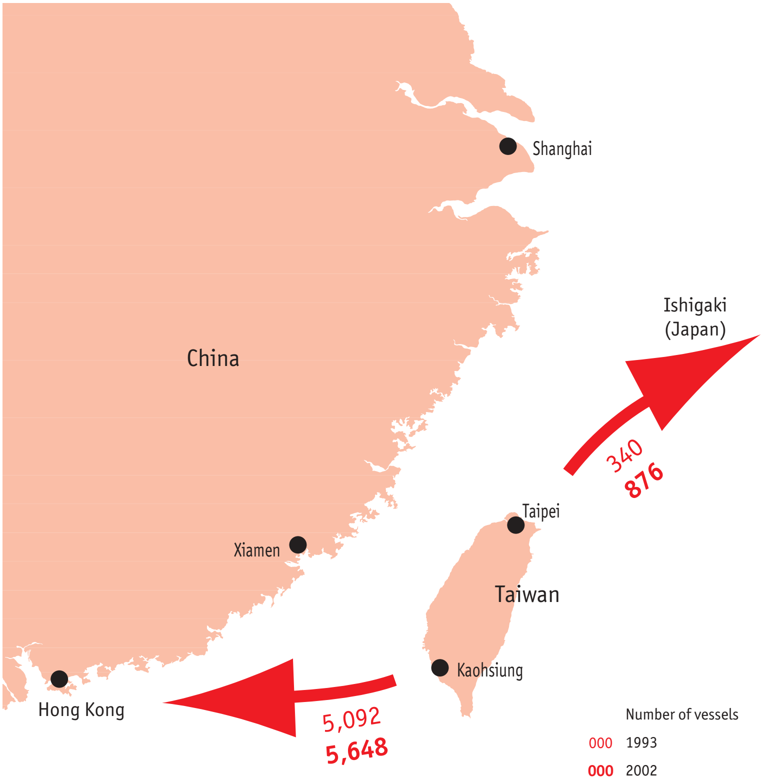
Investment rules form only one part of the government's attempts to restrict economic links with the mainland, however. It is at least arguable that the other restrictions, such as the lack of transport links between Taiwan and the mainland and limits on the free flow of goods and people across the Taiwan Strait, have forced as much manufacturing activity out of Taiwan as investment restrictions have kept in and increased costs to those that remain.

At the simplest level, the restrictions on direct cross-Strait shipping and air links clearly add to the operational costs of the many Taiwan companies that have invested in China. Nobody knows just how much cheaper cross-Strait transport links will be if ships and planes were permitted to travel directly between Taiwan and China. Much will depend on how direct links are opened up, both in terms of the number of landing points opened on either side of the Strait, and the number of firms allowed to operate such routes. Savings will in any case vary between companies: those firms that currently need to send cargo or passengers between Taiwan and Shanghai will clearly benefit more from direct links than will those companies that have their primary China base in Guangdong.

Still, it is clear that direct transport links will generate cost savings for Taiwan firms. Lee-in Chen Chiu, a scholar from Taiwan's well-respected Chung-Hwa Institute for Economic Research, has found that cargo transport costs for manufacturing firms in Taiwan would fall by 14.6% with the establishment of direct transport links; passenger transport costs would fall even further, by 27.1%. Dr Chen found that the savings for the electrical and electronic equipment sector would be 15.8% and 25.5% respectively. While not as much as some—Dr Chen found that direct links would cut the material and passenger transport costs faced by the rubber industry by 23% and 50% respectively—the savings are still significant.

In recent years, limited quasi-direct cross-Strait shipping links have developed. True direct links would, however, still make a difference. While Ishigaki is not that far out of the way for a vessel passing from, say, Kaohsiung to Shanghai, the detour to the waters around the Japanese island adds perhaps a day to the total length of the journey. Cash outlays are also involved. Shipping lines that spoke to the EIU said payment of US$3,000 a vessel

Direct links, Taiwan style
Vessel departures from Taiwan



Source: Ministry of Transport and Communications, Taiwan

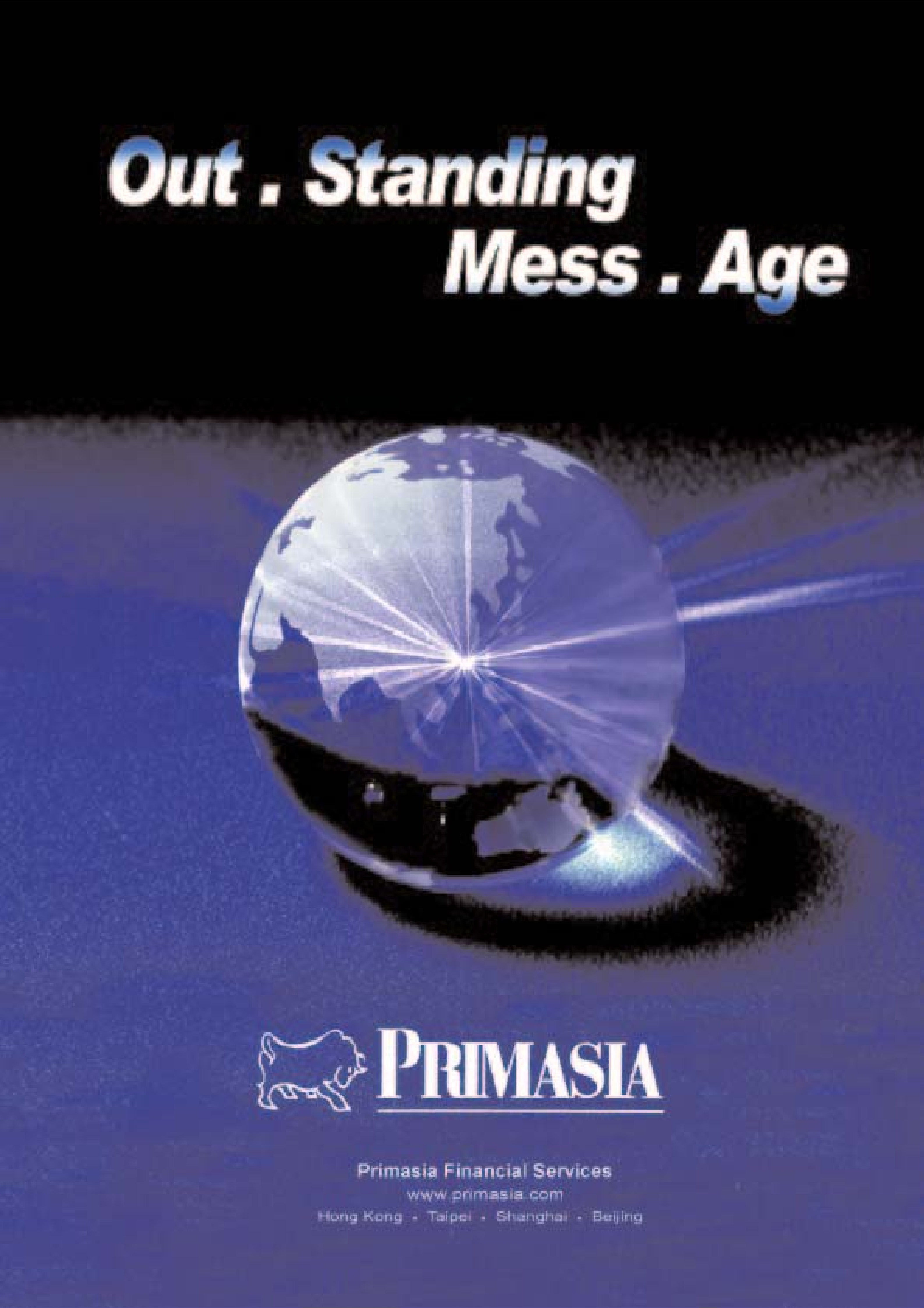
is required for port clearance in Ishigaki, considerably lower than the US$5,000 reportedly charged in Hong Kong; if cargo has to be offloaded en-route, the cost is higher still. Altogether, the current cost of shipping a twenty-foot equivalent unit (TEU) container on a continuous voyage between Kaohsiung and Shanghai ranges from US$250 (if the carrying vessel passes through the waters off Ishigaki) to US$350 (Hong Kong). These costs could fall by 10% and 30% respectively with the introduction of direct links.

Comparable data for air cargo costs is more difficult to obtain. But industry experts that spoke to the EIU thought a reasonable charge for a passenger flying directly between Taipei and Shanghai would be around NT$8,000-NT$10,000; currently, the cost of flying between these cities via Hong Kong or Macau is typically NT$16,000. This saving is clearly significant, but is perhaps not as important as the reduction in journey time that would be the result of direct links. A direct flight between Taiwan and Shanghai would take around 90 minutes, much shorter than the six hours needed for the current indirect route. Direct links would, in fact, free up even more productive time for business people than the 270 minutes saved. As one executive explained to us, the current journey, consisting of two flights and a stop off, really is wasted time, good for neither working—nor sleeping.

It is inconceivable that these costs have not had an effect on the division of labour between Taiwan and China. But while advocates might argue that the ban on direct cross-Strait transport links has kept companies in Taiwan, it is in fact just as likely that the associated costs in terms of both money and time have pushed firms out to China. Admittedly, transport generally accounts for only a small proportion of the final price of a good, so it seems unlikely that the extra costs associated with indirect cross-Strait transport alone would have forced many facilities on the mainland to buy from a local supplier rather than one still based in Taiwan. In any case, the ban on direct links causes other costs: longer lead times resulting from indirect links may cause mainland factories to hold greater inventories from suppliers based in Taiwan than would otherwise be the case.

With the journey for passengers travelling between Taiwan and anywhere but the south of China currently being so long—and so inconvenient—it is not a trip that anyone wants to make too frequently. As a result, it is more difficult for, say, engineers to be based in Taiwan but still oversee effectively operations in China. In theory, this could have two results: some manufacturing that would otherwise move to the mainland remains in Taiwan, or engineers who would commute from the island instead live and work in China. With more and more manufacturing capacity being based in the mainland it seems likely that the pendulum will swing increasingly towards the second outcome. This will not just lead to a "brain drain" of skilled workers from Taiwan to China. With more skilled engineers living in the mainland, upstream stages of the R&D process will be able to move there as well.

It is not just the ban on direct transport links that causes difficulties for the island's manufacturing indus-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try. Many electronics firms told the EIU that the tight restrictions on mainland people coming to Taiwan made it very difficult for them to bring employees from China to headquarters on the island for training. The result: experienced people from Taiwan had to go to the mainland instead. With the promise of time overseas being one of the major non-monetary perks offered by foreign companies to mainland employees, these restrictions may also affect the ability of Taiwan firms in China to prevent job-hopping. In addition, while it was not a complaint heard from electronics companies, some textiles and garments companies that spoke to the EIU said the continued ban on the imports of certain types of goods from the mainland affected their ability to produce in Taiwan.

Speaking in October 2002, Taiwan's president, Chen Shui-bian, said that the opening of direct links with China was not a "cure-all" for the island's economy. This is undoubtedly true. Indeed, most of the companies who responded to our survey said that of the different policy initiatives needed to ensure Taiwan's continued economic growth, improved domestic infrastructure was the most important.

But while direct links are no panacea, they are important for Taiwan's economy. While 39 companies that responded to our survey thought continued economic growth needed improved domestic infrastructure, 35 also said the establishment of direct links was necessary. And it would seem that Taiwan's all-important IT sector has little to fear from the opening of direct links with the mainland. Contrary to what is increasingly becoming established wisdom, Taiwan's IT hardware industry has not been hollowing out to China—though this is less because of investment restrictions than because of the pull of the mature IT sector that has developed on the island over the last twenty years. Indeed, it is more likely that the future of Taiwan's IT hardware sector will be secured through the opening of more direct links between headquarters on the island and the manufacturing base that is rapidly developing on the mainland, rather than the preservation of the current system of ineffective controls on cross-Strait economic ties.

What policy initiatives are needed to ensure Taiwan's economic growth?
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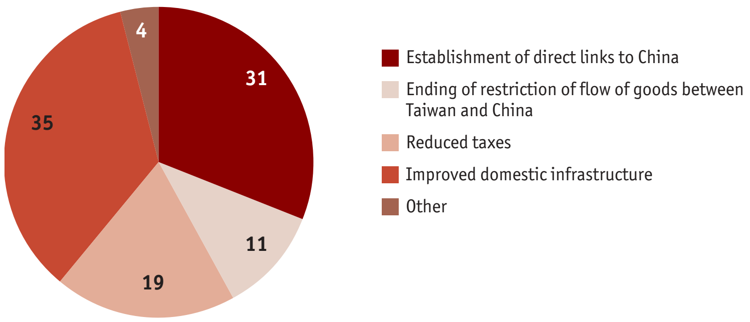
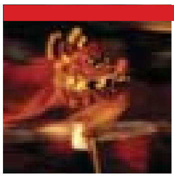


Source: Economist Intelligence Unit executive survey, March 2003



PART I **TAIWAN**

The stifled service sector

The ban on links with China has clearly stunted the development of Taiwan's services sector. Taiwan's banks have missed out on considerable business because they have not been allowed to provide services for their clients investing in China. It was largely because of the ban on direct links with China that Kaohsiung lost its position as East Asia's major port. And the island's tourism industry would be far larger if mainland residents were allowed to visit.

Taiwan's powerful IT sector has managed to thrive despite the battery of restrictions imposed by Taiwan's government on cross-Strait links. Yet, as this report has argued, the sector may have performed even more strongly had some of these constraints been eased sooner or more broadly.

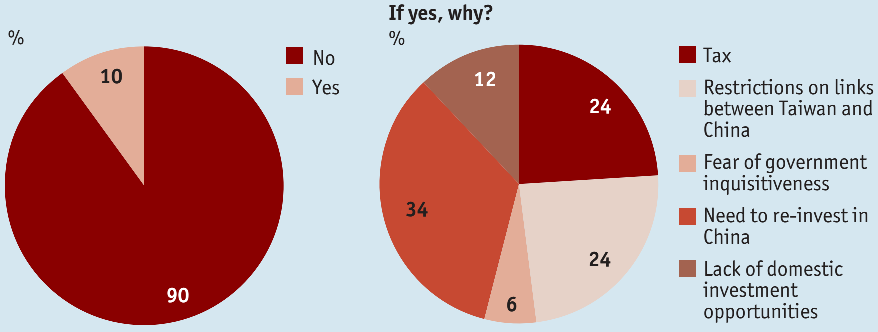
And these policies have had other side-effects on Taiwan's economy. The government's cold attitude towards mainland investment by local firms, for example, has forced much corporate activity offshore. Firms that did not want to bother with the government's approval process set up foreign subsidiaries for secrecy; even those that did gain official permission were banned from investing in China directly. Partly as a result, many Taiwan firms have offshore subsidiaries. Paper companies in the British Virgin Islands or Cayman Islands are the easiest to establish. Incorporating in Hong Kong or Singapore is more involved but has advantages in terms of investor perception. Still, whichever location is chosen, the network of offshore subsidiaries clearly affects corporate transparency. It also reduces employment in Taiwan. According to Hong Kong's Census and Statistics Department, 121 Taiwan companies had regional offices in the territory in June 2002. A survey by the TDC found that 59.9% and 29.6% of Taiwan companies in south China and the Shanghai area respectively had offices in Hong Kong. According to the Taipei Trade Centre in Hong Kong, more than 3,000 Taiwan firms maintained an active presence in the territory. Taiwan companies have also set up over 10,000 paper companies in Hong Kong.

Yet it is the island's financial service sector which has probably felt the effects of the government's restrictions most intensely. Of the firms surveyed by the TDC, over 80% said they used Hong Kong banks for transferring funds between Taiwan and China. This is partly out convenience. Until recently, for example, Taiwan banks have been prohibited from setting up branches in the mainland. The domestic banking units (DBUs) of Taiwan banks have also been banned from dealing with mainland banks. Overseas branches and OBUs have been less restricted, but even these have been not been able to deal directly with entities in mainland China but only, for example, with the overseas branches of mainland banks. It thus made sense for local companies to try to avoid using Taiwan banks for their mainland financing requirements. Each stage in the elongated process added costs and caused delays. A local company was much better off using a foreign bank—although these could not deal directly with entities in the mainland either, their branches in Hong Kong could. Banks on the island have been almost completely excluded from doing business with the mainland.

Banks complain that, being more closely supervised, they have not been able to circumvent these restrictions in the same way that manufacturing companies, for example, have been able to evade the limits that have sought to dissuade them from investing in China. This is not strictly true. Taiwan's Shanghai Commercial and Savings Bank, through its Hong Kong-owned subsidiary, Bank of Shanghai (which is co-owned by the mainland's own Bank of Shanghai) established a representative office in China without needing the permission of the

Does money come back to Taiwan?

Is there truth to the perception that Taiwanese companies do not bring profits earned in China back to Taiwan?



Source: Economist Intelligence Unit executive survey, March 2003

The debate over Taiwan's economic links with China is clouded by the perception that large amounts of investment flow out to the mainland, while little of the resultant profit returns to Taiwan. In a sense, this complaint is not without basis. While according to figures from the Central Bank of China (CBC), Taiwan in recent years has consistently recorded a net outflow of foreign direct investment (FDI), it has perversely also recorded a large net outflow of resultant incomes.

At the same time, however, the vast majority of the respondents to our survey reported that the perception that profits do not return to Taiwan was false. One reason for this difference is that the government's restrictions on investment in China have forced companies to hide the true state of their mainland operations from the government.

It is interesting to note, for example, that the CBC statistics indicate Taiwan firms re-invest none of the income they earn abroad, when local firms report that this is a common way that their mainland units fund expansion. And that this method is used is no surprise. With China's system of capital controls, Taiwan firms are no keener on having their capital tied up on the mainland than is their government.

To avoid these capital controls, Taiwan firms also usually try to ensure profits earned from mainland operations are not booked in China. For export-oriented firms, a commonly used method of achieving this is transfer pricing. Imagine a parent company in Taiwan receives an order from a US customer for 1,000 notebook computers at, say US$700 each. Assume also that the computers cost US$600 a unit. Typically, the parent company would then sub-contract its factory in China to produce this order, and pays it US$610 for each unit. This is the value of the export from China, although a change of invoice on route means it enters the US at US$700, which is the price the US customer pays directly to the parent company in Taiwan.

In this way, the Taiwan-owned factory in China makes profit sufficient enough to avoid the unwanted attention of the mainland tax authorities, while the parent company ensures most earnings are kept outside of the mainland. Such revenue from China-made exports that is booked directly in Taiwan would represent a return of profits, although it would not show up in the CBC's direct investment income statistics.

This kind of financial trickery is unavailable for those firms that are selling to China's domestic market. Those firms that want to pay dividends to shareholders at home can take profits out of China once they pay relevant mainland taxes. Until recently, however, even these profits were not coming back to Taiwan: with the island lacking any kind of double-tax arrangement with the mainland, these funds would have been taxed again as soon as they entered Taiwan. The government has been pledging to end the double taxation of mainland profits, but so far only appears to be doing so on a company-by-company basis.

Still, while earnings generated through transfer pricing may return to Taiwan, it is unlikely they all do. Furthermore, while progress on the double tax issue would lead to some more profits being repatriated to Taiwan, it is likely even then that a large proportion would continue to be kept offshore. This is because the main obstacle to money flows back to Taiwan is not the island's strained relationship with China, but rather the immature nature of the island's capital markets. In Taiwan, for example, annual inward and outward remittances are limited to US$5m a year for individuals, and US$50m for companies. and standards of corporate governance are below international best-practice. Hong Kong, by contrast, offers free, unfettered capital flows, and, by virtue of its deep and sophisticated financial markets, a wide range of investment options.

island's government. And First Sino Bank, also based in Shanghai, has a "special strategic relationship" with the Far East National Bank, a US institution owned by one of Taiwan's leading private financial-services groups, Sinopac Financial Holdings.

Still, these *de facto* breaches of the ban have required a fair degree of ingenuity, and have been few and far between. The banking sector has thus for some time been lobbying for an easing of the restrictions. In 2001 the government reacted by allowing Taiwan's largest banks to establish representative offices in China. It also allowed banks to deal directly with entities in the mainland. This latter concession almost came to nothing after one of China's big four commercial banks said it would only deal with Taiwan banks that first accepted the "One China" principle. This insistence was soon dropped, but even after these changes Taiwan's banking sector will still find it hard to win business from Taiwan companies in China. Under mainland regulations, a foreign bank can only open a branch two years after it established a representative office. And it is only the OBUs, not DBUs, that can deal directly with entities in the mainland, and then only to remit money, not to issue loans.

Taiwan banks will therefore continue to be left out of the loop. But while the biggest beneficiaries will continue to be Hong Kong and foreign banks, mainland banks will also play an increasingly important role. During the 1980s and 1990s Taiwan companies found it very difficult to borrow money from mainland banks. But recently this situation has changed. China's banks are keen to strengthen weak balance sheets and lending to large firms from Taiwan and elsewhere—which are seen as better credit risks than local companies—is a favoured method. Reports also suggest that China's big four banks have been instructed to forge relationships with Taiwan's top 300 firms as part of the mainland government's strategy of using stronger economic ties to achieve unification with the island.

Whatever the reason, according to both Taiwan manufacturers and bankers, mainland banks are falling over themselves to lend to firms from the island. We heard one story of a Taiwan firm receiving an unsecured loan of Rmb60m, together with a stand-by support facility, before its mainland factory had even been built. One banker told us that if the Agricultural bank of China knows a Taiwan firm in the mainland is listed at home—which indicates a degree of accounting transparency—it would provide a line of credit within a month. For their part, borrowing funds from a mainland bank also helps build political goodwill with local officials. Of the companies we surveyed, 64% reported their subsidiary in China already had a relationship with a mainland bank.

The restrictions on direct cross-Strait financial links have not only cost Taiwan banks revenue; the limits have also robbed the island's banking industry of an important mechanism of upgrading. As they ventured into China, Hong Kong firms maintained close relationships with local banks in Hong Kong, which were then forced to adapt to the increasing scale and sophistication of their clients. Taiwan banks have not had the same opportunity. Partly as a result, Taiwan's bigger, global firms now complain that the island's banking sector cannot offer the services they need.

The opening of direct links will not make either the superior services provided by Hong Kong's financial sector, or the lower prices offered by mainland Chinese banks, disappear. But the island's bankers are confident that direct links would give a great boost to their business. Taiwan firms are not known for their profligacy, and often complain about high-priced Hong Kong. Local banks are also confident that with their deeper understanding of the needs of Taiwan firms, with easier access they would be able to win back business from mainland rivals. Furthermore, the linguistic and cultural advantages that give Taiwan firms in the mainland a competitive edge in other industries are just as relevant to the banking sector. By allowing local banks to expand in scale and sophistication, direct links would also help resolve the formidable domestic challenges faced by Taiwan's banks: weak balance sheets, heavy government interference and cut-throat competition.

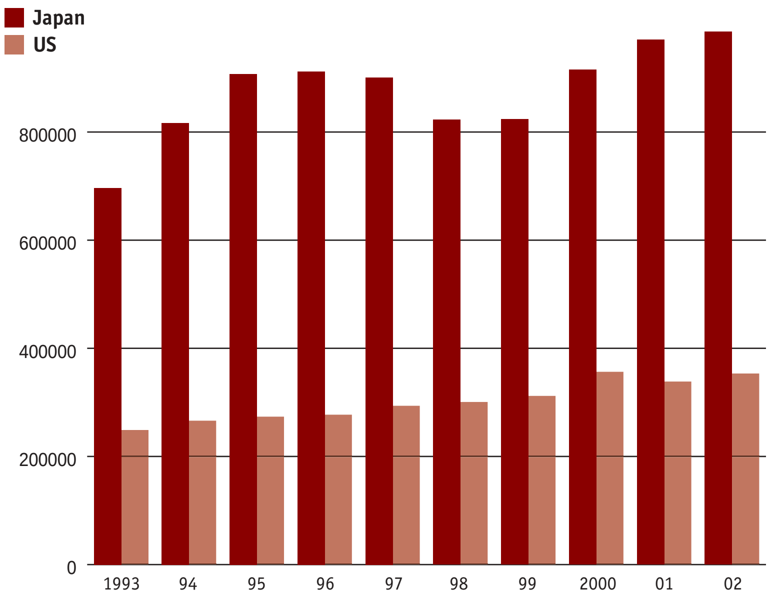
Easing restrictions on direct cross-Strait financial flows would clearly be helpful for the development of the island's financial sector. It would not, however, be a panacea. There is much else Taiwan's government needs to do to raise the quality of the island's financial sector. Ending state involvement in the banking sector is one. (In 2001 the government owned stakes in 17 banks in Taiwan, which together had a market share of more than 50%). Relaxing the restrictions on general inflows and outflows of capital, as discussed earlier, is another. Officials also need to address generally poor standards of corporate governance on the island. These measures would help improve the international competitiveness and relevance of the island's capital markets and ensure that Taiwan firms, while perhaps eventually issuing IPOs for their growing mainland businesses in Shanghai, keep their main listing in Taipei.

Taiwan's transport sector

While the ban on direct transport links has attracted more attention, it has perhaps not been as harmful. After all, unlike banks on the island, Taiwan transport firms have not been completely left out of the loop: local shipping lines and airline companies are involved in indirect transport links, and the flow of goods and people has been an important source of business for the island's sea and air ports. Still, the ban has clearly been damaging. For one thing, Hong Kong, not Taiwan, has become Asia's leading transportation hub. This was not inevitable. While geographically Hong Kong is well-positioned to be a transport hub, so is Taiwan. And, even without links Kaohsiung, Taiwan's largest port, is today the fifth largest port in the world, and the island is the home to two of the world's largest shipping lines, Evergreen and Yang Ming, as well as the biggest intra-Asia carrier, Wan Hai.

In recent years Kaohsiung has, however, been slipping down the global league tables, and this is largely because of the ban on direct cross-Strait shipping links. Between 1999 and 2001 Kaohsiung's throughput grew from 6.3m to 7.5m TEUs. But in 2002 throughput in Pusan in Korea reached 9.3m TEUs, up from 4.5m TEUs seven years earlier, boosted in part by trans-shipment from ports in northern China. Of more symbolic importance, in 2002 Kaohsiung was overtaken by Shanghai, where the port handled 8.6m TEUs up from just 3.1m TEUs in 1998. These numbers do not even tell the whole story. The ban on direct links does not only make it costly to trans-ship China cargo through Taiwan. Given the increasing importance of mainland China, it also risks leaving Taiwan left out as international shipping routes develop.

Do drop in... more often
Foreign visitor arrivals in Taiwan



Source: Taiwan Ministry of Transport and Communications

The airline industry is in a similar position. After increasing rapidly in the first half of the 1990s, the number of arrivals at Taiwan's main Chiang Kai-Shek (CKS) International Airport near Taipei rose from 54,473 in 1997 to 66,224 in 2002. Taiwan aircraft have traditionally been banned from flying over the mainland's airspace, pushing up travel times for airlines flying from Europe. The same delays do not affect passengers flying from the US, but they are then faced with a long, inconvenient flight if they want to go on to visit mainland China. This is not an abstract issue. One US airline we spoke to reported seeing signs of a change in travel patterns, as executives from high-tech firms on the west coast of the US opt to visit China only, rather than stopping off in Taiwan and then travelling to the mainland.

Taiwan has lost its chance to establish a formidable lead as Asia's leading transport hub. But the island could still become important in this respect if direct links were opened soon. In the both the sea and air business, Taiwan has some notable competitive strengths over Hong Kong. Kaohsiung has 25 container berths—more than the 24 Hong Kong will have even after the completion of CT9. Furthermore, unlike the facilities at Kwai Chung in Hong Kong, Kaohsiung's port has been built by the government, and is managed by the Kaohsiung Harbour Authority (KHA). The KHA runs two container berths itself, and leases—at "reasonable rents" according to industry insiders—the remaining 23 out to shipping lines. In addition to Taiwan's own companies, tenants include foreign industry leaders such as Maersk Sealand. With direct cross-Strait links these firms would start to he opportunity to trans-ship cargo through their own specialised berths in Kaohsiung rather than having to use Hong Kong's expensive terminal operators.

Similarly, airlines may prefer to use Taiwan over Hong Kong as a hub: unlike Hong Kong, Taiwan has an open skies agreement with the US. One barrier to this is the poorer quality of Taiwan's physical infrastructure. Terminal One at CKS opened 23 years ago. While airlines acknowledge Terminal Two, which opened only in 2000, is much better, they complain that the length of the time between its planning and completion makes it too feel old-fashioned in some respects. Taiwan also still lacks a rail link between the airport and the city. Still, none of this negates the strength of the case for direct links. It just means that Taiwan's economic future will not be secured by a breakthrough in this area alone; better domestic infrastructure is needed as well.

By encouraging more people from the US and Europe to visit Taiwan, direct links might thus help the government to achieve its target of doubling the number of tourists by 2008. This goal would not only be achieved, but would almost certainly be surpassed, if an easing of the ban on direct links was accompanied by a relaxation of the limits that currently prevent all but a small number of mainlanders visiting Taiwan each year. It is highly likely that with such a liberalisation Taiwan would prove an even more attractive destination for mainland travellers than Hong Kong. Taiwan’s urban areas cannot compete with the skyline of Hong Kong island. But the unpopulated east coast of Taiwan is beautiful, and the island has a justified reputation for good food. That Taiwan is a democracy with politicians willing to stand up to leaders in Beijing makes the fascination only greater.

For a glimpse at how the local economy might be missing out from the battery of restrictions on cross-Strait links, officials in Taiwan need look no further than Hong Kong. The former UK colony has benefited more than any other from Taiwan’s restrictions on links with mainland China. Boats unable to sail directly across the Taiwan Strait traditionally instead pass first through Hong Kong. People from Taiwan wishing to visit the mainland similarly have had to touch down en route in a third area, and Hong Kong has been the most popular stopping-off point. Taiwan companies, prohibited from investing directly in the mainland, have established subsidiaries in Hong Kong. Restricted from offering services to clients from domestic banking units (DBUs) in Taiwan, local banks set up busy offshore branches in Hong Kong. In short, Hong Kong provides many of the services for Taiwan firms in China that could presumably be supplied by Taiwan’s economy itself. Taiwan's bans have been Hong Kong's boons.

But that is not the only salutary lesson from the Hong Kong experience. In the next few chapters of this report, the EIU will look how the growth of Hong Kong’s service sector over the last twenty years has in fact been driven in large part by the territory’s openness to China. The same fears of "hollowing out" persist in Hong Kong too. Yet while the territory does indeed lose certain sections of its economic base across the boundary with the mainland, this report will again show how new sectors develop in their place and some old ones continue to deepen.

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> Resulting market threats and opportunities
> Your current and new potential partners
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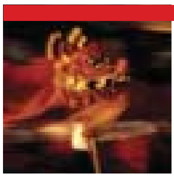
> Restructuring potential and cost-cutting necessities

Contact:

Shanghai Office
Dr. Eugen von Keller
23 Floor Shanghai Kerry Center
1515 Nanjing West Road
Shanghai 200040, P.R.C.
Phone +86-21-52 98 66 77
Fax +86-21-52 98 66 60
eugen_vonkeller@cn.rolandberger.com

Beijing Office
Hartmut Schnabel
6 Floor East Lake Villas Office Building
35 Dongzhimenwai Street
Beijing 100027, P.R.C.
Phone +86-10-64 67 70 93/94
Fax +86-10-64 67 76 28
hartmut_schnabel@cn.rolandberger.com



Leaping dragon, trailing tigers?

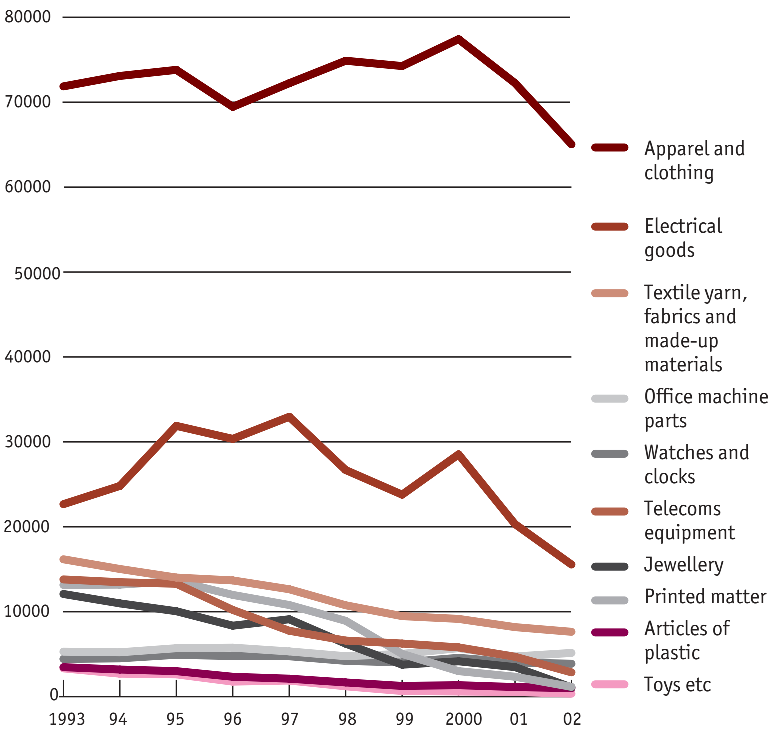
PART II **HONG KONG**

The rise of services

A booming manufacturing sector ignited Hong Kong's economy in the 1960s and 1970s. The sector virtually disappeared in the late 1970s as production moved to China. But this migration has not lead to a "hollowing out" of the Hong Kong economy. Instead, the economy has transformed from one of the world's best-known producers of low-end manufactured products to one of the world's major international services centres.

During the 1960s and 1970s Hong Kong, a city with less than 5m people, became one of the manufacturing powerhouses of the world. Leveraging cheap labour costs and entrepreneurial ability, Hong Kong companies led the world in the export of labour-intensive goods such as toys, plastic watches and clocks. Hong Kong was even more dominant in the production of textiles and garments, becoming the world's largest textile producer in the 1960s and 1970s.

"Made in Hong Kong" no more?
Hong Kong's domestic exports
(HK$ bn)



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

In these years Hong Kong's manufacturing enterprises generated around 30% of Hong Kong's GDP, and provided work for almost 50% of the workforce.

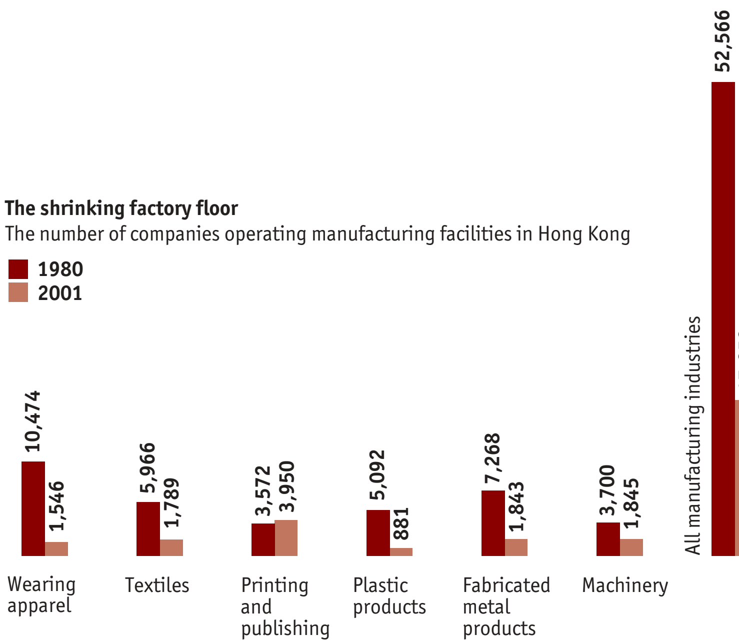
Since then the "Made in Hong Kong" label has become harder to find. With the opening of China to foreign investment in the late 1970s, Hong Kong companies began to move their manufacturing operations across the border. By 2001 the number of manufacturing firms had fallen to just 17,258, which generated 5% of GDP and employed 190,000 people, around 8% of the total workforce.

In many ways the manufacturing sector was a victim of its own success. The rapid economic growth generated by the success of Hong Kong's exporters of garments, plastic flowers and toys in the 1960s and 1970s pushed up wage and other production costs in Hong Kong. To remain competitive, local entrepreneurs began thinking about moving their factories elsewhere. With China opening up to foreign investment in the late 1970s, their gaze increasingly turned northwards.

At that time, Hong Kong manufacturers relocated to China for the same reason that drove Taiwan's IT hardware firms there in the 1990s: geographical and cultural proximity, generous incentives offered by the Chinese government, and cheap wages for assembly workers. The pull was perhaps even stronger for Hong Kong investors because a larger proportion had relatives in the mainland, particularly in the neighbouring province of Guangdong. It is perhaps no surprise that this region, which also shares the same Cantonese dialect of Chinese that is spoken in Hong Kong, has been by far the most popular destination in China for Hong Kong investors. According to some reports, Guangdong has received 70% of the total mainland investments made by firms from the territory. No more surprising, the attention of Hong Kong investors have been focused on the area of Guangdong closest to the territory, the so-called Pearl River Delta.

The shrinking factory floor

The number of companies operating manufacturing facilities in Hong Kong



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

During the next twenty years, some manufacturing industries almost disappeared in Hong Kong: for example, by 2001 the plastic products sector employed just 4,353 workers, down from 85,595 in 1980. The combined textile and garments industry seems to have bucked the trend, remaining the biggest domestic manufacturing sector and accounting for around 25% of manufacturing employment and a similar proportion of gross output. The size of this sector is, however, less a reflection of Hong Kong's continued comparative advantage in textiles production than the result of the quantitative quotas imposed by industrialised economies against textile and garment imports from particular countries notably China.

Previously known as the Multi-Fibre Agreement, the trade restrictions are now under the auspices of the World Trade Organisation (WTO) in the form of the Agreement on Textiles and Clothing (ATC). These quotas have not been as restrictive as they might have been for Hong Kong companies. With the consent of the US government Hong Kong firms have been allowed to establish Outward Processing Arrangements (OPAs) in which some parts of the production chain have been relocated to China. Nonetheless, in order to gain the all-important "Made in Hong Kong" label, it has still been necessary for the finished good to be produced in the territory. At the same time, with quota in individual countries being limited, Hong Kong firms had to look beyond China as a location for garment factories with local entrepreneurs consequently investing in Southeast Asia, Africa and South America.

Under the ATC, the system of quantitative restrictions on imports of textiles and garments is being phased out, and is scheduled for complete removal by 2005. Many apparel manufacturers are, however, sceptical that this schedule will be met. The ATC was back-loaded: the first three stages of the process, in 1995, 1998 and 2002, involved the removal of not less than 16%, 17% and 18% respectively of the 1990 clothing and textile imports

Pearl River Delta

The Pearl River Delta (PRD) has become a frequently used term. Not many people who use it, however, could define exactly the area it describes. A recent study published by a non-profit institution in Hong Kong, The 2022 Foundation, tried to set the record straight. The report, "Hong Kong and the Pearl River Delta: The Economic Integration" used the definition of the PRD Economic Zone set out by the Guangdong provincial government in 1987. This includes the capital of Guandong province, Guangzhou, together with two of China's original Special Economic Zones (SEZs), Shenzhen and Zhuhai, and Dongguan, Foshan, Jiangmen, and Zhongshan, and the urban areas of Huizhou and Zhaoqing.

According to the report, this region attracted US$80.4bn in foreign direct investment (FDI) in the period 1985-1999, 70.8% of which was supplied by companies in Hong Kong and Macau. Another study, "Made in PRD: The Changing Face of Hong Kong Manufacturers", published by the Hong Kong Federation of Industries, found that the areas of the PRD most favoured by Hong Kong firms are Dongguan, Shenzhen and Guangzhou. According to this study, of the estimated 59,000 factories in China that in 2001 were producing for manufacturing and trading firms registered in Hong Kong, almost 90% were in five PRC cities: Dongguan, Shenzhen, Zhongshan, Guangzhou and Huizhou.

Main jurisdictions in the Greater Pearl River Delta region

covered by the ATC; the remaining amount, likely for most countries to be 49% of 1990 imports, is supposed to be liberalised in one fell swoop on January 1, 2005. Even the limited removal that has occurred to date has triggered complaints from OECD manufacturers (see box: Less support for bras). And the US and other countries have several ways of trying to clamp down on imports from China (see box: Less support for bras). The ATC provides for a special transitional safeguard mechanism that allows countries to impose quota restrictions for up to three years on imports which cause "serious damage, or actual threat thereof", to its domestic industry. Furthermore, the agreement under which China gained membership of the WTO in 2001 includes a special textiles provision that can be used until the end of 2008 against all products subject to the ATC. The WTO agreement also included a China-specific safeguard, effective until 2013, allowing countries to take action against any import from China causing market disruption.

If quotas were removed, it is likely that Hong Kong's manufacturing sector would contract further: as one local manufacturer put it, with the removal of quotas Hong Kong's remaining garment producers would "roll-up their tents" and move to China. Such a development would make life very difficult for those made unemployed. With the unemployment rate among low-skilled workers in Hong Kong rising rapidly in recent years—joblessness among those educated only to primary school level rose from 2.5% in 1997 to 9.8% at the end of 2002—assembly labourers laid-off from the garment industry would struggle to find new jobs in a sector that comprised only 2.2% of total employment in 2001. And with much of the flow of garments between Hong Kong and China related to OPAs that would be made obsolete with the phasing out of quotas, cross-boundary trade would also be affected. (The border between Hong Kong and China officially became the boundary with the return of Hong Kong to Chinese sovereignty in 1997.)

The further migration of the textile and garment industry would not, however, sound the death knell for Hong Kong's economy; nor would it much reduce the importance of the garment and textile industry to Hong Kong. This is because the marked deindustrialisation of the last twenty years has been accompanied by the rapid development of a related service industry in its wake. As one industry participant put it, whereas twenty years ago he managed a 10-storey garment factory in the territory, he now runs a 10-storey office. According to the Hong Kong Trade Development Council (TDC), by 2002, more than 15,000 companies in Hong Kong, employing over 90,000 workers, were involved in textile import-export\ trade. While far fewer than the 300,000–plus people employed in garment manufacturing factories in 1980, positions in areas such as buying and sales tend to be better paid than basic assembly jobs.

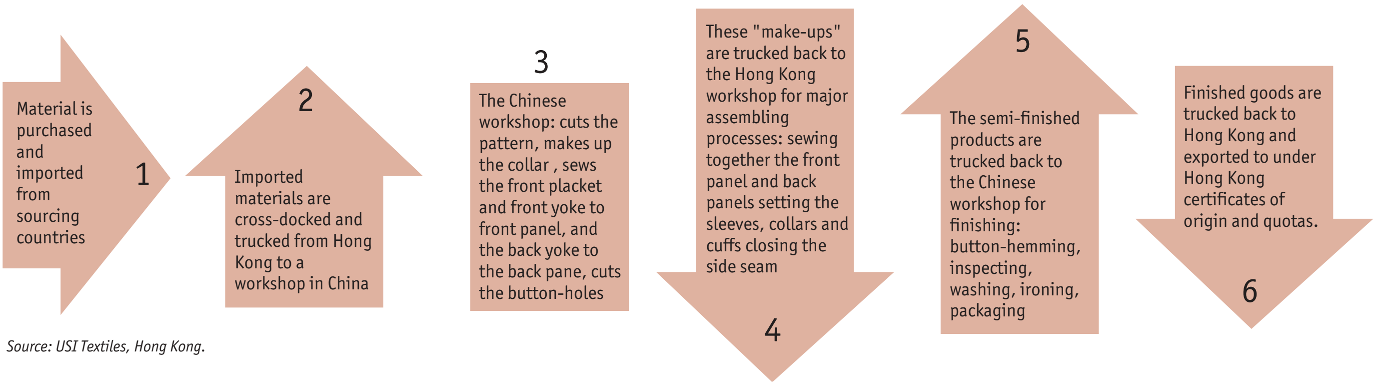
That the service sector has grown so quickly should not be surprising. During the last twenty years the average Hong Kong company in the textiles and garment industry has become immeasurably more sophisticated. Running both the OPA chains and global manufacturing facilities that have appeared in response to the system of export quotas maintained in industrialised countries has, for example, been no simple business (OPA chains in particular have developed into very complex animals—

Less support for bras

In 2002 women's bras attracted more than the usual amount of attention in the US. As part of the implementation of the third phase of the WTO's Agreement on Textiles and Clothing, on January 1st 2002 the US government removed quota restrictions on the import of certain types of bras. In the following twelve months the value of bras imported to the US from China more than doubled, to US$289.8m. As a result, China leapt from being the fourth largest supplier of bras to the US in 2001, with an 8.7% share of the import market, to being the largest in 2002, with a market share of almost 20%. China won market share largely through low prices. According to the industry group, the American Textile Manufacturers Institute (ATMI), the price of bras imported from China fell to US$29 per dozen last year, "by far the lowest of any major supplier".

Such rapid sales growth undoubtedly boosted China's economy. Many US women have also presumably welcomed the availability of cheap underwear of increasingly high quality. China's export success has not, however, pleased everyone. In September last year, the ATMI called on the US government to impose special quotas on exports of a selected number of goods from China, arguing that "imports of Chinese textile products are currently experiencing their greatest surge in history". Apart from bras, the ATMI called for restrictions to be imposed on imports from China of knitted fabrics (which according to the ATMI rose by 22,000% in the first six months of 2002), gloves (up 300%) nightwear/dressing gowns (up 400%), and textile luggage (up 400%).

The garment game
The processing of a woven shirt exported under a Hong Kong certificate of origin



Source: USI Textiles, Hong Kong.

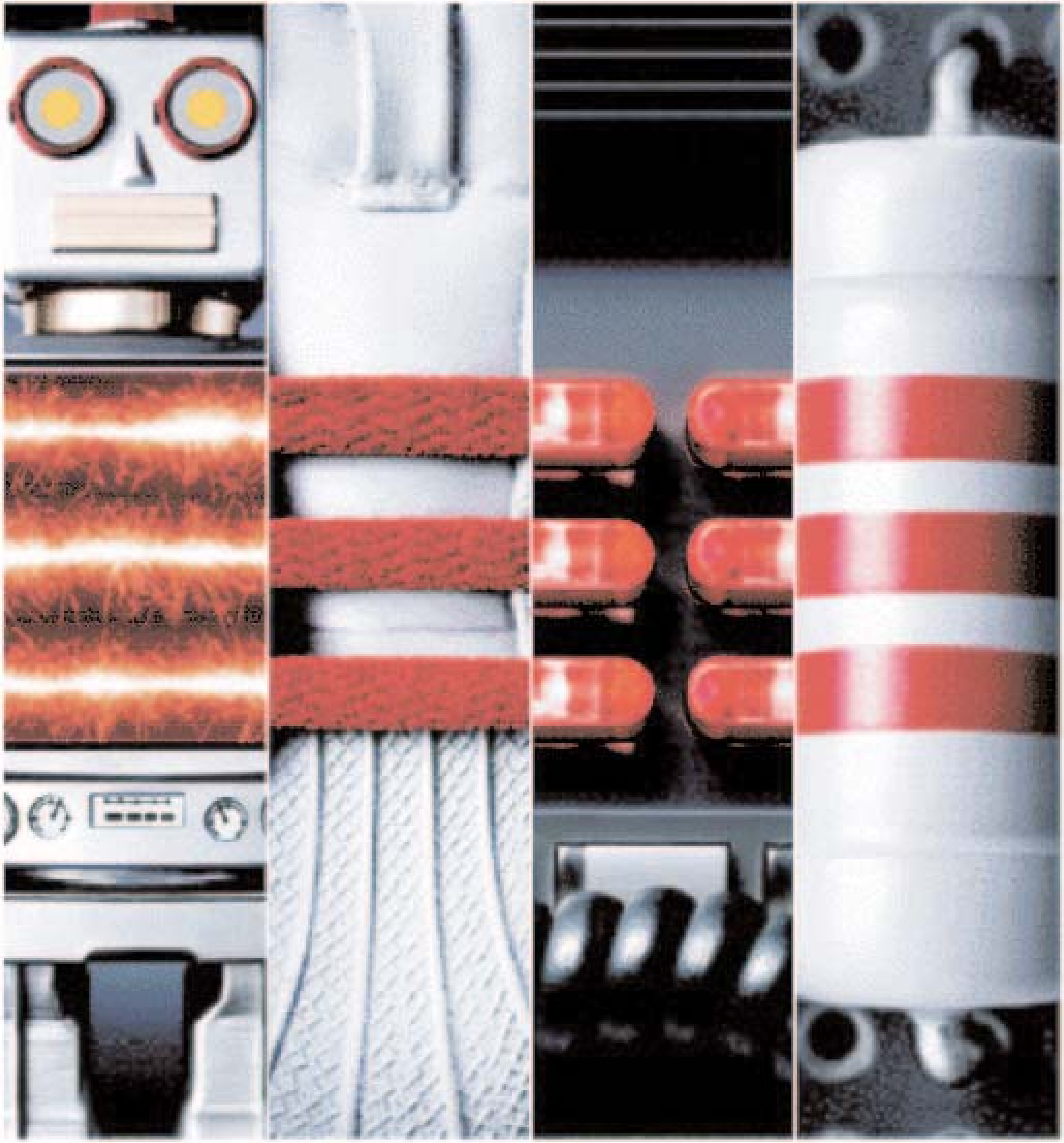
see the chart The garment game). Expansion overseas has also meant an increase in production scale: while even at its peak total manufacturing employment in Hong Kong never exceeded 1m, most surveys estimate that firms in the territory now employ around 10-11m workers in China. This has increased demand for workers such as accountants, buyers and sales staff. At the same time, while many Hong Kong companies have continued to manufacture for other firms under the OEM model, during the last twenty years others have started to develop their own brand names. Examples include the chain stores Espirit, Baleno, Bossini, Giordano, Jean West and Moiselle.

These changes at the company level have promoted Hong Kong's transition from a garment-manufacturing centre to a global sourcing hub for the apparel sector.

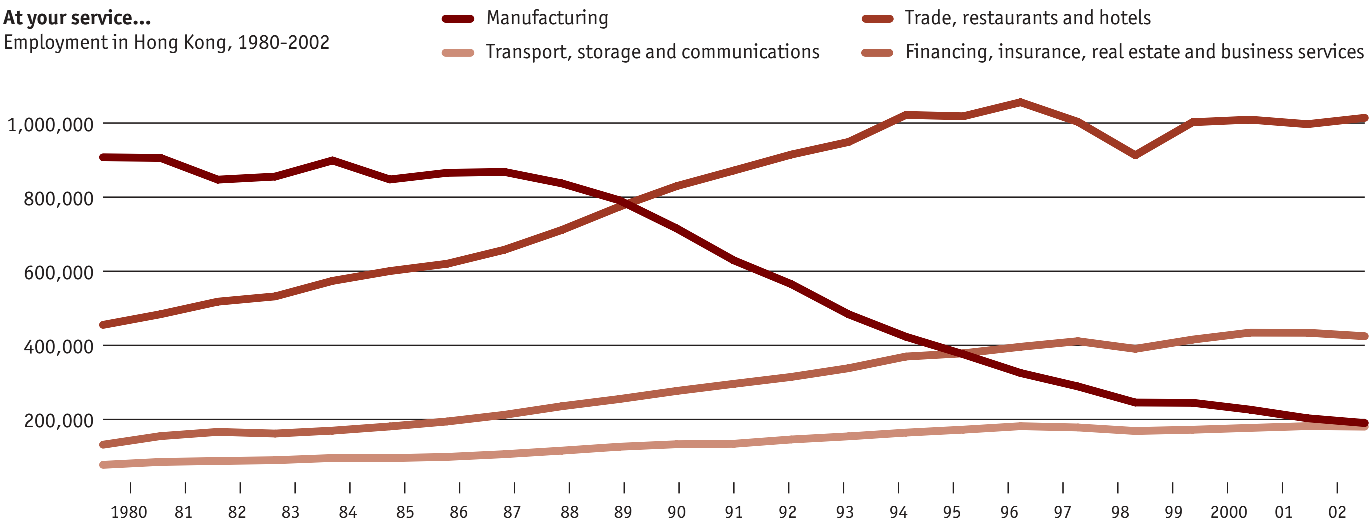
This pattern—the partial replacement of departed manufacturing capacity with expanded support services—has been replicated in other sectors. While the number of manufacturing firms in Hong Kong has fallen dramatically during the last twenty years, not all of these companies have shut down completely. Indeed, after shifting all their manufacturing operations to the mainland, some have merely been reclassified in Hong Kong as trading rather than manufacturing firms. Other companies have grown up with the sole purpose of intermediating production from the mainland. As a result, paralleling the fall in the number of manufacturing firms in Hong Kong has been a rise in the number of import and export companies, from under 18,000 in 1980 to a peak of more than 100,000 in 1994-96, at which time they employed over 500,000 people. The importance of mainland manufacturing as a source for economic activity in Hong Kong was further illustrated by a report published in November 2002 by the Hong Kong Federation of Industries, "Made in PRD: The Changing Face of Hong Kong Manufacturers". This study found that the 63,000 local manufacturing and trading companies economically active in the mainland in 2001—defined as firms with investments in, management control over, or sub-contracting arrangements with manufacturing facilities in China—employed around 477,000 people in Hong Kong.

It is not only the evolution of local firms that has pushed Hong Kong's economy into the service sector. The willingness of foreign firms to use the territory as a base from which to develop markets in the wider Asian region—particular China—has also been an important factor. Hong Kong's pre-1997 status as a British colony which, at least for firms from the OECD economies, afforded it a "safeness" often considered lacking in other Asian cities, was one reason for the territory's attractiveness to foreign firms. In concrete terms this related to the strength of the rule of law, the wide use of English, and the availability of western-style social amenities not available elsewhere. The quality of Hong Kong's transport infrastructure was another attraction—although feelings towards the skyscraper-skimming flight into the old Kai Tak airport were mixed, ranging from exhilaration to pure fright. Pulled in by these factors, foreign firms established regional and China offices in Hong Kong, employing accountants and sales and marketing professionals. According to the government's Census and Statistics Department (CSD), of the 948 regional headquarters and 2,171 regional offices in Hong Kong on 1st June 2002, which altogether employed more than 160,000 people, around two-thirds belonged to companies from the US, Japan and five western European countries.

The transition of the average business in the territory



At your service...
Employment in Hong Kong, 1980-2002



Source: Census and Statistics Department, Hong Kong Special Adminstrative Region

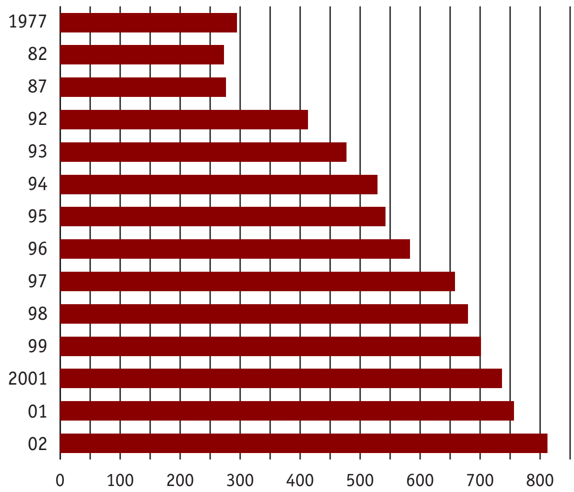
from a local factory making goods to an office dealing with larger manufacturing facilities in China, as well as the development of Hong Kong as a regional centre for foreign firms, have contributed to the growth of a specialist services industry. The overall services industry now accounts for 82% of GDP, up from 65% of GDP in 1981. Within that sector, the contribution of the financial services and insurance sector to the overall economy grew to an all-time high of 12.1% in 2000, up from a low of 6.1% in 1985; from just 66,467 in 1981, employment in this sector rose to 136,340 at the end of September 2001. Between 1981 and 2001 the business services sector expanded from 2.1% to 4.4% of GDP. According to the Law Society of Hong Kong, between 1992 and 2002 the number of law firms in Hong Kong rose from 427 to 682, with the number of lawyers increasing from 2,720 to 5,957. Similarly, the number of accountants registered with the Hong Kong Society of Accountants rose from 1,924 in 1982 to 6,032 in 1992, and to almost 20,000 ten years later. Finally, the transport and storage sector, which includes activity at Hong Kong's sea and air ports, expanded from 5.6% of GDP in 1980 to a high of 7.6% of GDP in 2000.

As well as having expanded in size during the last twenty years, the services industry has grown in sophistication. In the late 1970s, for example, the financial services sector in Hong Kong was centred on the commercial banking industry. It was not, however, until 1981 that the government allowed foreign-based banks to operate in Hong Kong. They jumped at the chance: by the end of 2002, 107 licensed banks in the territory—80% of the total—were incorporated overseas. The internationalisation of the banking sector has not, however, just involved foreign banks coming into the territory. Local institutions have also been looking out.The proportion of funds lent by authorised institutions for use outside the territory rose from 30% in 1981 to a peak of almost 60% in 1992–95.

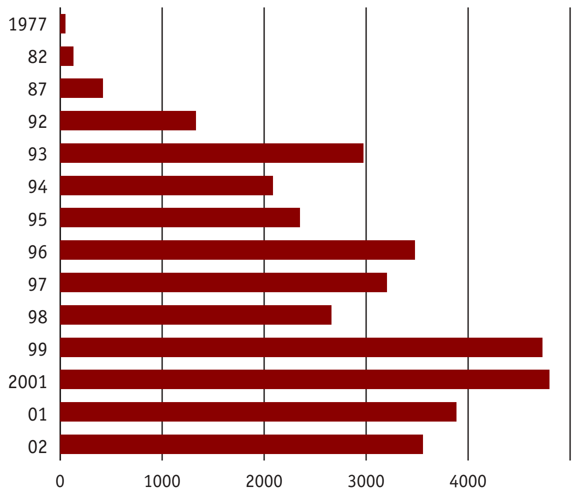
The breadth of the financial services industry has also expanded over the last twenty years. The Stock Exchange of Hong Kong (HKSE) was formed in 1986, following the merger of four existing stock exchange companies. It was then merged with the Hong Kong Futures Exchange in March 2000 to become part of Hong Kong Exchanges and Clearing (HKEx). In the twenty years from 1982 the number of firms listed in Hong Kong almost tripled, rising from 273 to more than 812, with capitalisation expanding from HK$131.6bn (US$21.7bn, 68% of GDP) to a peak of HK$4.8trn (US$615bn, 372% of GDP) in 2000, before falling back to HK$3.6trn (280% of GDP) in 2002. As a result of this expansion the HKSE consequently became the second largest stockmarket in the region. The value of outstanding bonds (other than the Exchange Fund Bills and Notes issued by the Hong Kong Monetary Authority, HKMA) meanwhile, has grown from just 13.3% of GDP in 1991 to 32.6% in 2002. The variety of debt instruments has also expanded, with the HKMA's Hong Kong Mortgage Corporation, for example, beginning to sell mortgage-backed securities.

The development of the financial sector has added impetus to changes that were happening anyway in the professional services sector. In the 1970s, the average accountant in the territory would have doing simple audit and Hong Kong tax work. Today, according to industry insiders, the same accountant must address issues related to China tax, the management of finances between Hong Kong, China and possibly a third country, and might also give advice on the structuring of busi-

Market maker
Selected indicators, Hong Kong stock exchange
Number of listed companies



Market capitalisation
(HK$bn)



Source: Hong Kong Exchanges and Clearing

ness. With Hong Kong becoming a major centre for financing and mergers and acquisitions (M&A), demand for accountancy services such as due diligence has also increased. By 2002 there were 38 foreign law firms in Hong Kong and 750 overseas lawyers; a top law firm, Clifford Chance, had 89 lawyers in 1996 rising to 134 in 2000. Lawyers speak of a great expansion in the breadth and depth of work being done in Hong Kong. As with accountancy, this evolution has been driven by a general increase in the size and sophistication of client companies, as well as by the development of Hong Kong as a financial services centre.

Trade-related services also boomed. Much of Hong Kong's manufacturing industry moved out to China during the 1980s and 1990s. But most of the goods were still transported back to the territory to be exported out to the rest of the world: as late as 1994, 40% of the goods sold by China to the rest of the world were re-exported through Hong Kong. During that period, goods were brought back to Hong Kong for inspection or packaging, or for consolidation, tasks which even now can be difficult in China because of the mainland's more restrictive customs requirements. Goods were also attracted back by Hong Kong's developed transport links with the rest of the world. The territory's deep-water container port at Kwai Chung has 18 berths. The sometimes hair-raising flight into the old airport did not prevent Hong Kong enjoying air connections to most places in the world, with the number of flight departures rising from 27,000 in 1980-1981 (April-March) to over 82,000 in 1997-98. This connectivity was complemented in 1998 with the opening at Chek Lap Kok of a new airport, which has come to be regarded as one of the best in the world.

The final ingredient in the rapid development of Hong Kong as a service economy has been the growth of the tourism industry. Between 1981 and 1990 the number of foreign visitors (excluding those from China) to Hong Kong grew from 2.5m to 5.9m. In 1992 the government started to include mainland Chinese residents in its statistics, and the total number of tourists reached 13m in 1996. The number fell back to 10.2m in 1998, but increased again in the following years to reach a new record of 16.7m in 2002. This drove directly an increase in the value-added by hotels and boarding houses, from HK$1.3bn in 1980 to an all-time high of HK$14.1bn in 1996. Value-added shrank in the next few years, but at HK$8.7bn in 2001, the sector was still much more significant than it had been twenty years before. Total tourism receipts followed a similar pattern, rising from HK$6.5bn in 1980 to an all-time high of HK$93.6bn. In 2001 tourism spending in Hong Kong totalled HK$64.3bn (4.9% of GDP).

As the product offering of Hong Kong's service sector widened and deepened during the 1980s and 1990s, its customer profile also changed. Hong Kong's stand-alone service sector established more of a regional role, selling to firms in Korea and South-east Asia and, as restrictions on cross-Strait social and economic contact were eased in the 1990s, Taiwan. In fact, Hong Kong has benefited more from Taiwan's restrictions on links with mainland China than any other place. Boats unable to sail directly across the Taiwan Strait traditionally have first passed instead first through Hong Kong. People from Taiwan wishing to visit the mainland similarly have had to touch down en route in a third area, and Hong Kong has been the most popular stopping-off point. Taiwan companies, prohibited from investing directly in the mainland, have established subsidiaries in Hong Kong. Restricted from offering

services to clients from domestic banking units (DBUs) in Taiwan, local banks set up busy offshore branches in Hong Kong. In short, Hong Kong provides many of the services for Taiwan firms in China that could presumably have been supplied by Taiwan's economy itself.

New clients in China

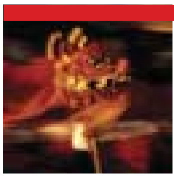
And now demand from China itself is growing. According to the Census and Statistics Department, Hong Kong's service exports to the mainland grew from 16.6% of the total in 1995 to 24.9% in 1998, before falling back to a still-high 22.9% in 2000. A 2002 survey by the HKTDC found that 14.4% of private-sector enterprises in the mainland provinces of Guangdong, Jiangsu and Zhejiang had already established an office in Hong Kong. The CSD survey found that by June 2002, 96 mainland firms had established regional headquarters in Hong Kong, with a further 170 having offices in the territory.

The increasing importance of demand from mainland firms for Hong Kong's services industry has perhaps been most obvious in the financial sector. According to the HKMA, for example, at the end of September 1998, local banks in Hong Kong had outstanding loans to non-bank Chinese entities of HK$75.9bn, equivalent to 4.5% of total assets. Hong Kong's capital markets have also benefited, with Chinese-controlled companies incorporated in Hong Kong—"red chips"—starting to list on HKSE in 1986. Only five red chips went to the market in the following six years, but seven listed in 1992, and twenty the next year, when they were also joined by "H-shares", or China-incorporated companies. By the end of 2002, 72 red chip and 76 H-share companies were listed in Hong Kong. In 1998-2002 these firms raised HK$520.5bn, equivalent to two-thirds of the total equity funds raised on the territory's stockmarket during this period.

Some of these IPOs have involved state-owned giants from the mainland such as the telecoms companies China Mobile (1997), China Unicom (2000) and China Telecom (2002), the oil firms PetroChina (2000), China Petroleum and Chemical Corp (Sinopec, 2000) and China National Offshore Oil Corporation (2001), and one of the mainland's big four banks, Bank of China (2002). These listings have not only been large, they have been very complex affairs, generating much work for the investment banks, lawyers and accountants in Hong Kong involved in advising on the corporate restructuring and financial reforms necessary to allow these former state-owned enterprises to come to the market.

China has generated work for Hong Kong's legal industry is another way. Many foreign firms sign contracts on the mainland not under China but rather foreign—most commonly New York, London or Hong Kong—law. Disputes that arise can then be heard in an overseas court. Of course, in some cases firms may shy away from litigation. Going to court is expensive, and enforcement of foreign judgements in China can anyway be difficult, given the absence of legal instruments such as bilateral treaties of enforcement. Companies do, however, have another option: arbitration. This is a cheaper route, and can be more effective in producing results because China is a signatory to the UN Convention on arbitration. (In legal speak: the UN Convention on Acknowledgement and Enforcement of Foreign Arbitral Awards). Regardless of whether arbitration or litigation is chosen, Hong Kong is a popular venue. Its geographical position helps, but it also has a generally well-respected legal system, as well as a supply of skilled arbitrators.

The mainland has also been becoming an increasingly important market for Hong Kong's tourism industry. Between 1992 and 2001 the number of visitors from the mainland rose from 1.1m to 4.4m to account for more than 50% of the total increase in tourist arrivals during this period. The number jumped again in 2002, rising by 53.4% to 6.8m, boosted by an easing of restrictions on mainland residents visiting the territory. Perhaps surprisingly, mainland tourists have also individually been spending large amounts of money in Hong Kong. During 2001 mainland tourists to Hong Kong spent an average of HK$5,169 (US$660) per head, more than all other visitors except those from the US. Interestingly, mainland residents were particularly heavy shoppers. While hotel bills accounted for nearly 50% of spending by US visitors in 2001, for example, mainlanders blew more than 60% of their cumulative HK$23bn expenditure in Hong Kong's shops.



Leaping dragon, trailing tigers?

PART II **HONG KONG**

The Hong Kong advantage

Structural factors, namely the growing capacity of cities in mainland China to provide many of the services that are currently supplied by Hong Kong, are being blamed by some for Hong Kong's current economic slump. In fact Hong Kong's strengths will ensure the robustness of the services sector for a long time to come—as long as the government pushes reforms that will ward against complacency.

Hong Kong's smooth economic transformation from manufacturing to services seemed to come to a shuddering halt with the sharp downturn of 1997—the year in which Hong Kong also happened to return to Chinese sovereignty. In October that year, the stock market crashed, with the benchmark Hang Seng Index falling from over 15,000 in early October to under 10,000 at the end of the month, and the bubble in the property market burst, precipitating a 40% fall in average real estate prices during the following 12 months. These events contributed to the economy slumping into a severe recession. The economy started to grow again in 1999, and expanded by a robust 10.2% the following year, but then fell back into recession in 2001, when the territory's economy, which is heavily geared towards trade and related services, was badly affected by extremely sluggish growth in world trade.

Since then many questions have been asked about the future direction of the economy. Is Hong Kong's economy beginning to lose out from the migration of business to China? Is it losing its edge against its traditional rival, Singapore and its new competitor, Shanghai? Has Hong Kong seen its best days?

Some of this pessimism is overdone, though it is not difficult to see why some in Hong Kong might point a finger at the 1997 handover as a possible cause of the malaise. The return to Chinese sovereignty in 1997 was accompanied by some disturbing political and economic reverberations. It can be argued that Hong Kong's autonomy from China is being eroded, but if it is, the process is slow, and for the moment at least the territory's special political position remains largely preserved. Hong Kong's transition to a Special Administrative Region (SAR) of China has, however, been far from smooth, with the last six years being marked by an extraordinary number of crises and controversies. Some of these have been purely man-made. Quarrels between the UK and China led to the mainland replacing the sitting Legislative Council (Legco) in 1997 with an appointed Provisional Legislative Council, thereby derailing the political through-train that was supposed to carry Hong Kong though the 1997 handover. In 1999 the government decided to invite China's legislature to overturn a 1999 right of abode ruling issued by the territory's Court of Final Appeal. More recently there has been the push to fulfil Article 23 of the Basic Law, which calls for the Hong Kong authorities to enact legislation prohibiting acts of "treason, secession, sedition, and subversion" against the central government (the Basic Law is Hong Kong's mini constitution). But even the non man-made crises, such as the first outbreak of avian influenza in late 1997 and the 2003 spread of Severe Acute Respiratory Syndrome (SARS, an acronym that bears an uncanny resemblance to that of the SAR), have been marked by a high level of government bungling.

The handover also produced some economic phenomena that were not conducive to steady rates of GDP growth. There was a rush of tourism in 1995 and 1996, fuelled in part by the desire of some foreigners to see Hong Kong as a British colony. This motivation came to an end in 1997, with the inevitable fall-of in tourism then exacerbated by high prices and rumours of full hotels for the period of the transition itself, as well as damaging revelations that Japanese tourists were being singled out for uniquely high charges in Hong Kong. Optimism surrounding the transition also fuelled a real estate investment boom, pumped up by capital from both Hong Kong and mainland China. Rather than cooling this over-heated market, monetary policy in Hong Kong added fuel to the flames. With the Hong Kong dollar being fixed to the US dollar at HK$7.8: US$1, local interest rates are in effect set by the US Federal Reserve rather than by the HKMA. Pre-1997 inflation was much higher in Hong Kong than the US, so real interest rates in the territory were low or even negative as the bubble was inflating. And then, with prime interest rates (the lending rates banks charge their best customers) remaining at 8% in the following three years but consumer prices starting to fall, high real interest rates reinforced the scale of the subsequent crash.

Of course, Hong Kong's lifeblood is international trade—in recent years exports and imports of goods and services have amounted to more than 250% of GDP. And after growing by an average of 8.7% a year in 1993-97, exports of goods and services expanded by a much more moderate 4.8% in 1998-2002. But did this have anything to go with the return of Hong Kong to Chinese sovereignty? Probably not. This poorer performance was in large part due to the depression in external demand caused by the Asian crisis of 1998-99 and the more globalised slump of 2001-02.

Despite these arguments, a growing perception exists in Hong Kong that these cyclical factors alone do not explain Hong Kong's economic malaise. Serious structural challenges do, in fact, exist. The chief concern is that the rapid development of physical infrastructure and the general business environment in China is gradually robbing Hong Kong of its position as the monopoly supplier of services into the mainland. The monopolistic position that Hong Kong has enjoyed for the last twenty years has contributed to the development of significant

Shanghai vs Hong Kong

For years, the rivalry between Hong Kong and Singapore was the headline-grabber. Denizens of both cities kept an eye on the number of cranes, the arrival of new banks and the proliferation of trendy restaurants in an attempt to gauge who was winning the contest to be Asia's number two (after Tokyo) financial centre. Now, for Hong Kong at least, there is a new kid on the block and a new rivalry to contest. Shanghai is on the ascendant and if the administrators are to be believed, anxious to reclaim its crown as China's main commercial centre.

In contrast to many other great cities of the world, both Shanghai and Hong Kong have had rather short lives. Both were sleepy fishing towns until the middle of the nineteenth century when both came under strong—and uninvited—foreign influence. After China's defeat to Britain in the Opium Wars, China gave up its sovereignty to Hong Kong, Shanghai and other treaty ports. Both cities began to develop as important trading centres but it was Shanghai that really began to boom. And by the turn of the century and the first few decades thereafter, Shanghai shone as the most cultured city in China—and arguably Asia—as well as the country's commercial centre.

That was soon to end. The emergence of the People's Republic of China in 1949 ended Shanghai's reign as the country's most sophisticated city. And Shanghai's loss was to be Hong Kong's gain. Businessmen fled Shanghai in their thousands in the first few years after the communist revolution, setting up shop in Hong Kong instead. Already a steadily growing trading city, this influx was one of many factors that helped ignite the city's manufacturing boom in the coming decades.

Now Shanghai is back on the scene and here is much talk about the return of the old "Paris of the East." The city government—and their bosses higher up the chain—are keen to build Shanghai into a showcase city, shining up the old buildings and building glittering, new towers and shops. Shanghai has closer links—and boundary-free travel—with the Chinese interior and closer ties with the government in Beijing. And it is the new natural destination for challenge-seeking expatriates, in the way Hong Kong once was.

Talk like that has some in Hong Kong worried that Hong Kong will then become the new Venice, a reference to the another trading powerhouse that declined after losing its monopoly on trade with Asia in the 1400s. That analogy glosses over some of Hong Kong strengths. The territory offers a stronger legal system, deeper financial and business services, a lack of capital controls, wider use of English and decades of experience as a modern business hub. It will take more than a coat of paint for Shanghai to catch up with all these qualities. What Shanghai lacks in polish it is gaining in brute, economic strength. Many economists believe that Shanghai's GDP has been growing faster than Hong Kong's and may catch-up with its old rival very soon—if it has not already.

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depth in particular industry sectors, from fashion to financial services, which will be difficult to replicate anytime soon. At the same time, monopolies are rarely efficient, and the rapid growth of the 1980s and early 1990s generated considerable complacency that may render some industries vulnerable to more nimble and less protected competition.

One of the most noticeable threats to Hong Kong's position has been the rise of Shanghai. Few doubt that the northern city's leaders want to reclaim the mantle of the financial and commercial capital of China, a title lost to Hong Kong after the Chinese Communist Party (CCP) took power in the mainland in 1949. And the rate of development of Shanghai over the last ten years certainly makes it difficult to doubt that this is anything but a completely plausible goal. The glittering skyline of Pudong and the rapidly improving transport infrastructure are just the most visible signs of this. A survey of North American, European and Japanese multinationals in 2000, conducted by a professor from the University of Hong Kong, Michael Enright, found that 3% of firms had regional headquarters in Shanghai; not a large number, but significant considering ten years earlier it would probably have been zero. The number of foreign banks with offices in the city has grown rapidly, to 48 in 2002. In 1991 only eight firms were listed on the Shanghai stockmarket, but there are now 646, and in the intervening period the market's capitalisation grew from Rmb2.9bn (US$545m, or 0.1% of GDP), to Rmb2.7trn (US$333bn or 28.8% of GDP).

Professional services firms reveal that Shanghai, previously the favoured destination only for China hands, is fast becoming the place to be for young and ambitious people from all over the world, including those from Hong Kong and those who have never picked up a copy of *Red Star Over China* (see box Shanghai vs China). Shanghai's growing popularity is partly a result of the increase in sophistication of work to be done—the time when the only work to be done in China was plain vanilla FDI deals for naïve incoming foreign multinationals is fast coming

Funds of knowledge

Hong Kong's asset management industry has grown rapidly over the past two decades. In the late 1970s the sector was dominated by just three firms, but there are now more than 150 that at the end of 2001 were responsible for managing almost US$190bn in assets. In a reflection of Hong Kong's role as an international financial centre, more than two-thirds of these funds were sourced by non-Hong Kong investors.

In asset management as in other industries, however, there are worries about Hong Kong's ability to compete. Singapore's aspirations as a regional centre for the fund management industry are a particular threat. The government there retains a range of incentives to attract foreign fund managers, such as tax holidays and subsidies of up to 50% on staff salaries. And according to Fund Management in Hong Kong and Singapore, a paper by Matthew Harrison of Hong Kong Exchanges and Clearing, assets under management (AUM) in Singapore have increased steadily from S$37bn (US$21bn) in 1992 to S$307bn (US$173bn) in 2001.

So far, Hong Kong's government has been less pro-active than Singapore's. In a reflection of their attitude towards foreign investment in general, officials have tended to prioritise the provision of an attractive overall business environment rather than specific incentives for the fund management industry. Although Hong Kong remains a larger fund management centre, its lead over Singapore has narrowed in recent years as its AUM has fallen from an estimated HK$3.5trn (US$448bn) in 1999 to HK$1.5trn (US$188bn) in 2001.

But the territory still has considerable strengths. The recent fall in AUM is somewhat misleading—restructuring at one large fund management firm played a large part. Fund managers in Hong Kong praise the government's non-interventionist approach, and have few policy requests to make of officials. They also note that the territory's industry is benefiting from the establishment in 2000 of a compulsory old-age savings scheme, the Mandatory Provident Fund (MPF). The scheme currently generates a stream of around US$2bn a year in new assets for the fund management industry, and MPF funds are expected to total US$123bn in 30 years' time.

There is also the small matter of China, of course. Thanks to exchange controls on the renminbi, mainland residents are generally prohibited from investing abroad. Chinese officials have talked, however, of allowing residents to invest in closed-end funds in Hong Kong. Even if they do not receive such a fillip, fund managers in Hong Kong still think the territory will be well-placed to benefit when China's capital controls do begin to fall. Shanghai, of course, will want a piece of this pie. But Hong Kong fund managers think the territory's oft-cited advantages—rule of law and so on—put it in a strong position to compete effectively with mainland rivals.

to an end. The quality of life for foreign residents in Shanghai has also improved markedly in recent years, with the creation, for example, of many more international bars and restaurants.

It is not only the take-off of Shanghai that is causing concern in Hong Kong; developments in neighbouring Shenzhen, notably the rapid growth in its port, are also generating ripples of concern. In 1998-2002 container throughput in Hong Kong's ocean and river ports grew by an average of 6% a year, much slower than the 47% annual growth achieved in the same period by Shenzhen's largest port, Yantian (Shenzhen's other two ports are Shekou and Chiwan). Furthermore, it appears that there is almost insatiable demand for the services of these ports. Throughput at Shenzhen's largest port, Yantian, grew by more than 55% last year as new capacity came on stream; even then there were reports of severe congestion as trucks waited to enter the port. It thus seems likely that use of Shenzhen's ports will grow as fast as new capacity can be rolled out. Phase III of Yantian's expansion plan, which involves the addition of 4 berths to the existing 6, raising total designed annual capacity from 3.9m to 6.5m TEUs, is expected to be completed by the end of 2005. Phase II of the expansion of Shekou, which will double the number of berths to 4 and annual designed capacity to 1.8m TEUs, will be completed by the end of 2003. Media reports have suggested that Shenzhen's local government plans to increase port handling capacity to 11m TEUs by 2005 and to 18m by 2010.

The situation in Hong Kong appears far different. Capacity at the territory's ocean port of Kwai Chung will increase by 33% in the next few years as the delayed six-berth Container Terminal 9 (CT9) is finally completed. In contrast to China, this new capacity will take some years before it is fully utilised: the EIU spoke to the three of Hong Kong's four terminal operators, the private firms that run the territory's port facilities, none of whom expressed any expectation that this development would lead to a one-off increase in overall throughput at Kwai Chung. Indeed, CT9 was not mentioned as a determinant in the latest port throughput forecast published by the Hong Kong Port and Maritime Board for the 2000/01 period.

So are Hong Kong's service sectors losing out to the mainland's evolving industry? Looking at the headlines, one could be forgiven for thinking that Hong Kong is quickly fading from the map. Such a conclusion would, however, be misguided. Take the support-service side of the garment and apparel business. Executives in a number of textile firms did tell us that to save costs they had already moved back-office positions, such as clerical officers, across the border. One firm even told us that in the next few years their mainland office would become larger than the Hong Kong one.

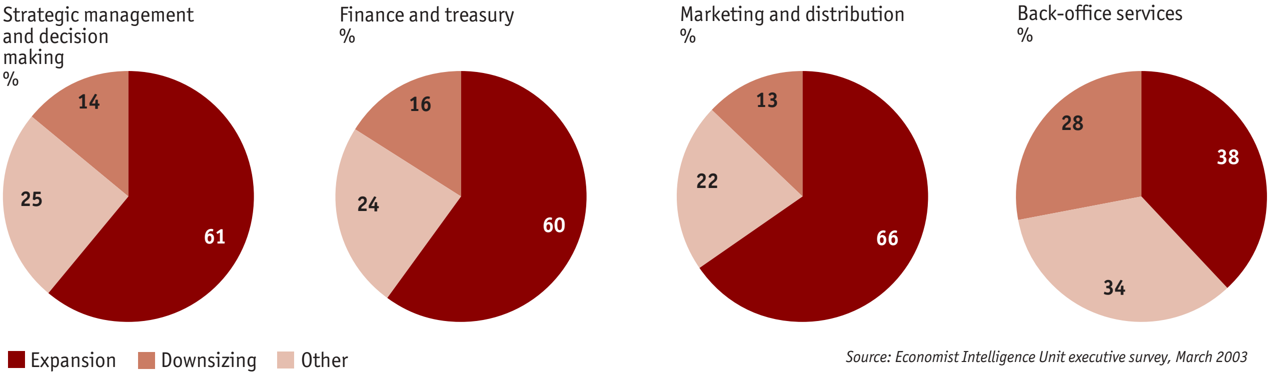
But most industry participants tended to think the territory's position as an international centre for the textile and garment industry will prove rather durable. Largely because of quality of life issues, companies we met with were confident that for some time to come the majority of foreign buyers would prefer to do business in Hong Kong rather than in the Pearl River Delta. They also noted that English-language skills, an attribute considered essential for the sales and marketing activities of Hong Kong's internationally-oriented firms, were better in the territory than on the other side of the boundary. Hong Kong's internationalisation, both in terms of the city's exposure to trends from the rest of the world, and the ability of local people to travel without the procedures that encumber mainland residents, was considered a further competitive strength.

This nuanced picture is not unique to the garment and textile industry. Regular TDC surveys of Hong Kong's trade and trade supporting services have found that in recent years the proportion of firms planning to locate different functions in China rather than Hong Kong has shown an across-the-board increase. And the latest survey, carried out in the first quarter of 2001, found that in the next five years some functions will be located overwhelmingly in the mainland, such as manufacturing/packaging (86.3% of surveyed firms), quality control (78%), sample-making (73.4%) and material sourcing (71.9%). These activities are, however, lower-end ones that are closely related to the production process itself. Higher-end activities, on the other hand, are continuing to be located in Hong Kong. Thus, the 2001 survey found that the vast majority of firms would in the next five years still retain in the territory functions such as regional headquarters (85.4% of surveyed firms), business negotiation (72.4%), trade financing (90.1%) and insurance (84.9%). In addition, for those firms planning to locate higher-end functions in Hong Kong during the next five years, more planned to expand the scope of these activities than to downsize them; the opposite was true for lower-end activities.

The TDC's surveys look mainly at local small- and medium-sized enterprises (SMEs). This is an important sector: it is after all local manufacturing and trading SMEs that form the bedrock of Hong Kong's economy. Still, it can be argued that such firms are less footloose than most—home and family ties might be sufficient to keep a firm in Hong Kong even though financially it would be better off moving to China.

These conclusions were corroborated by our own survey of Economist Intelligence Unit clients in Hong Kong, which tend to be multinational companies. (Complete survey results are printed after page 53.) Conducted

What trends characterise changes in your strategic management and decision making activities in Hong Kong over the last three years?



Source: Economist Intelligence Unit executive survey, March 2003

specifically for this report, our survey did not reveal a picture of a simple outflow of corporate activity from Hong Kong. The results of this exercise did suggest that in the areas surveyed—strategic management and decision-making, finance and treasury, marketing and distribution, and back office services—all but back office services reported an expansion in Hong Kong activities. For those companies that reported that business activity had left the territory, Shanghai was the most likely recipient of new business. This movement was the result of a shift in corporate focus from Southeast to Northeast Asia in general, and to China in particular.

For companies that reported a consolidation of business in Hong Kong, most firms reported that back office services in Hong Kong would be further downsized during the next three years. But a clear majority of firms reported that finance and treasury activities in Hong Kong would be expanded in 2003-05. And in both strategic management and decision-making and marketing and distribution, as many firms reported they would expand activity in Hong Kong over the next three years as reduce it.

These results should not be surprising. Hong Kong's business environment remains highly regarded by multinational businesses, and not just relative to that in China. The number of companies reporting China's business environment as "reasonable", "poor" or "very poor" outweighed decisively the number thinking it "good" or "very good" in all but two categories. The exceptions were low property, utility and staffing costs, and ease of access to the national market. The low cost category was, by contrast, one of the only two in which the number of "reasonable" and "poor" responses outnumbered the "good" for Hong Kong. The other was not ease of access to the national market; interestingly, the proportion of respondents thinking Hong Kong rated "good" or "very good" in this category was larger than for China. Rather, the other outlier in Hong Kong was the availability of English-language skills (and even in this area Hong Kong scored better than China).

None of this suggests Hong Kong is becoming irrelevant as a location for the offices of local and foreign companies. Far from it. Despite the economic difficulties of the last five years, the number of lawyers registered with the Law Society of Hong Kong rose by almost 1,000 between 1997 and 2002, with the number of foreign lawyers increasing by almost two-thirds. During the same period the number of accountants on the books of the Hong Kong Society of Accountants rose by more than 6,000. Foreign professional services firms do report expanding offices on the mainland. But in general this appears to be in addition to, rather than at the expense of, capacity in Hong Kong. Furthermore, while the functional ability of offices on the mainland is growing, the deepest pool of expertise in the region remains in Hong Kong.

Admittedly, the financial-services sector has shrunk in recent years, with output falling by 2.7% in 2001. As a major financial centre, however, Hong Kong could hardly remain immune from the consequences of the ending of the great US bull market in 2000. Furthermore, even in 2001 the gross output of the sector, at HK$146.9bn in 2001, was still the second-highest on record, and larger than any other sector in Hong Kong except import/export trade. Few other cities in the region, and nowhere in China, are able to compete with the depth and breadth of financial services available in Hong Kong.

This is not to suggest that Hong Kong's prosperity is pre-ordained. There are concerns about the declining standard of English in Hong Kong; if the territory wants to continue to be a major business centre for China, the government also needs to work to improve the general standard of Mandarin. Language skills are not, however, the only problem. Indeed, historically the overall education system in Hong Kong has been poorly funded: government spending on education in 1990–95 averaged

Deflation in Hong Kong

Since 1997 property prices in Hong Kong have fallen by around 60%. In 1998–2002 consumer prices fell by 10%. Some believe that this process of deflation is being driven by deepening integration with China, as improvements in cross-boundary immigration procedures and transport links allow local people easier access to the property and consumer markets in cheaper Shenzhen.

This theory is simplistic at best, and erroneous at worst. There has indeed been an outflow of capital and goods from Hong Kong to the mainland. According to one article cited in the recent 2022 Foundation report on the PRD, people from Hong Kong purchased 6.1m square feet of housing in Shenzhen in 2001. The government's Census and Statistics Department found that Hong Kong residents travelling for reasons other than business made 35.7m person-trips to the mainland in 2001, spending HK$27.6bn in the process. According to the planning department, 211,000 people, equivalent to 8% of the workforce, travelled frequently to China for business in 2001.

The adverse effect of such flows on Hong Kong's economy are, however, questionable. The Foundation 2022 report claims that property in the PRD serves distinct categories of demand, such as weekend and holiday homes or residences for the elderly. The report also cited information from the Hong Kong Business Professionals Association (HKBPA), that in 2001 only 1.4% of people living in Hong Kong had purchased a property in Shenzhen. In addition, while the number of personal trips to the mainland did rise in 2001 from the 33.8m recorded the previous year, related expenditure fell from HK$29.4bn.

In any case, as far as price movements in the territory go, the tendency of Hong Kong people to buy property and goods in China is only half of the story—just as important is the willingness of mainland people to spend in Hong Kong. And there has indeed been a strong inflow of resources from China. This is most obvious in terms of tourism: expenditure of mainland tourists visiting the territory rose from HK$18.3bn in 2000 to HK$23bn in 2001. People from the mainland have also become more important investors in Hong Kong's property market.

Supporters of the China-causes-deflation theory might still argue that the outflow will grow as boundary restrictions are eased further. But the HKBPA survey found that only 8.3% of people would consider living in Shenzhen if the boundary was open 24 hours a day, and crossing time was cut to 15 minutes or less. And while more Hong Kong people might go out to China, there are still many changes that can be made to encourage more mainlanders to visit Hong Kong. Visa restrictions on tourists can be eased further, for example, as can the strict limits that prevent all but a couple of hundred mainland people every year from gaining permission to live and work in the territory.

If integration with China cannot explain deflation in Hong Kong, what can? The most important factor is the exchange rate. With the Hong Kong dollar fixed to the US dollar, local interest rates have been determined more by economic conditions in the US than in the territory. As a result, real interest rates in Hong Kong were too low during the mid-1990s—which helped fuel an unsustainable property investment splurge—and too high afterwards—exacerbating the pain of the inevitable downturn.

just 2.9% of GDP, compared with 5.3% in Taiwan. Given this, it is welcome that government spending on education has been ramped up in recent years, to 18.9% of total public spending in 1996–2001, from 17.5% in the preceeding six-year period.

The shortage of skilled local workers has not prevented the economy moving into higher value-added activities. This is because Hong Kong has traditionally made it easy for skilled people from North America, Europe and Japan to live and work in the territory. The territory's rulers have, however, never been as welcoming for skilled workers from the mainland. An effort was made to change the admission of mainland professionals programme (first introduced in 1994, and again in 2001 after being discontinued in 1997) and the admission of talents scheme (established in 1999). But with neither could the government be accused of opening the floodgates. The first, nicknamed the "Einstein" scheme by Hong Kong's chief secretary for administration, Donald Tsang, was limited to mainlanders with doctorates; the second was restricted to workers in the IT and finance sectors, who were not allowed to take their families with them to Hong Kong. Given these strict rules, it should not be surprising that between 1997 and 2001 an average of 16,700 foreign professionals a year arrived to work in Hong Kong, but by the end of 2002 the Einstein scheme had attracted just 256 people, and the professionals scheme just 12 more.

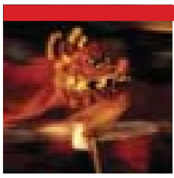
In a major review of Hong Kong's population policy released in early 2003, the government sought to end this inequality. Announcing the new stance, Mr Tsang said for "any particular jobs that the local employer cannot fill, we can contemplate importing from all over the world now, including the mainland of China". The shift in attitude is important, and not just because it will increase the supply of skilled workers in Hong Kong. The presence of large numbers of western and Japanese professionals has been an important factor in the growth of Hong Kong as an international services centre. It is difficult to imagine a Hong Kong closed to skilled workers from China maintaining the same relevance as the mainland's economy becomes more powerful. The change is also important as Hong Kong seeks to attract mainland firms to establish regional offices in Hong Kong, a flow that will help to offset any movement of local and foreign workers to China.

Perhaps the most obvious threat posed by Shanghai to Hong Kong is in the financial services sector. Hong Kong's importance in this area is partly a result of its regime of free capital flows—a policy that will not be replicated on the mainland for many years to come. Superior financial regulation has also been a factor. But while regulation in Hong Kong is perhaps the best in Asia, it is far from perfect, and there is much that can be done to ensure the SEHK remains the market of choice in the region for top-class firms wishing to raise capital. Officials already have a blueprint for some of the reforms that need to be made in the form of a report issued in March 2003 by the government-appointed Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure. As the well-known editor of a corporate governance website, David Webb, wrote, "While the name of the group may have lacked punch, the report certainly did not." Its central recommendation was that regulatory power over listings should be taken away from HKEx, itself a listed company, and invested in a new Hong Kong Listing Authority under the main capital markets regulator, the Securities and Futures Commission (SFC). In Mr Webb's words, the proposals would "establish a regulatory framework which is a necessary part of the improvements needed to raise Hong Kong to international standards".

On the same day the report was released, the government announced that it had accepted the recommendations. Whether it implements them, however, remains to be seen. While HKEx initially announced it would cooperate with the government in making the changes, a few days later the exchange's chairman, Charles Lee, said he would send a letter to officials opposing them. This is worrying, mainly because the government has a record of not taking on vested interests. This reticence does not just affect the standard of regulation in Hong Kong. It is also responsible in part for the high costs that our survey suggested form the main deficiency in the territory's business environment. Thus, faced with fierce opposition from small brokers, the government has failed on several occasions to abolish minimum broker fees. The distinction between barristers and solicitor pushes up the costs of commercial litigation in Hong Kong (particularly because most barristers in the territory are skilled in criminal rather than commercial law).

Brokers and barristers are small fry. Far more powerful are the conglomerates that dominate many sectors of the economy, from the property market to supermarkets. Critics allege that the influence of these companies has prevented the government from introducing the legislative and institutional measures that are used elsewhere to encourage competition. The conglomerates reject charges of anti-competitive behaviour, as do officials, who say that as a small, extremely open economy, Hong Kong is competitive enough without burdensome legislation. In a sense both the government and its critics are right. According to an IMF working report issued in August 2000, Hong Kong's economy is "neither significantly more nor significantly less competitive than the average OECD country". Nevertheless, officials have not simply dismissed the allegations that Hong Kong's economy is not as competitive as it could be. In 1997 they established a competition policy advisory group (CPAG), and in the following years moved to promote greater competition in areas such as telecoms and banking.

The government has also made efforts to liberalise the air services industry. Since the new airport opened in 1998, Asia Airfreight Terminals has been offering cargo-handling services, breaking the monopoly previously enjoyed by Hong Kong Air Cargo Terminals Limited (HACTL). A third company will soon join the fray: in October 2002 the Airport Authority awarded the express delivery company, DHL, a franchise to develop an express cargo terminal. In June last year the government moved away from its previous policy of allowing only one local carrier to fly any given route, with Dragon Air being allowed to join the larger Cathay Pacific in flying to Taipei. This was followed four months later by the signing of a new US-Hong Kong aviation agreement. While not enshrining "open skies", the new accord did give US carriers expanded fifth-freedom rights in Hong Kong. This will perhaps be painful for the Cathay and Dragon, but it is likely to prove useful in bolstering the territory's position as a hub for the air industry. Reform of the Hong Kong's financial markets will provide a further test of whether the government's ability to put the interests of the economy above those of individual companies is limited to selected industries only.



PART II **HONG KONG**

The longevity of logistics

Hong Kong's role as a gateway for goods and peoples—by sea, land and air—is also facing new challengers from China. But, again, the statistics don't point to an exodus. And Hong Kong's strengths make a major migration of traffic unlikely.

The development of Hong Kong's services sector has been promoted by the territory's position as an all-purpose gateway, both for China and for the wider Asian region. This role has taken many forms. This report has already discussed Hong Kong's important role as a intermediary for services between China and the rest of the world, Taiwan and China as well as a favoured base for foreign firms venturing into mainland China and the wider Asia region.

Of course Hong Kong's original strength lay in its role as a trading entrepôt—a role it still plays today. Ports in China are clearly growing quickly. But even today, Hong Kong remains the largest port in the world. In this light, double-digit throughput growth in two of the last five years, and a further 7.4% expansion in 2002, might be considered impressive. Still, in some ways, it should not be surprising that port business is being diverted away from Hong Kong. The phasing out of apparel quotas under the ATC and the gradual liberalisation of China's customs regulations—which is allowing larger foreign firms, for example, the unprecedented freedom to consolidate cargo before shipment from the mainland—are just some of the recent developments that have reduced the need to re-export goods through Hong Kong.

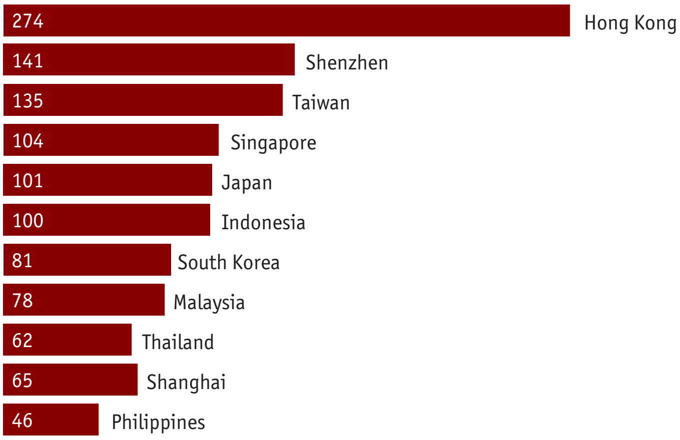
And shipping through China can be an attractive option. Hong Kong, for one thing, is further away than Shenzhen from factories in the Pearl River Delta. To be shipped from Kwai Chung, cargo also has to pass through controls on the China-Hong Kong boundary. This not only adds to direct costs. It also causes delays: a government-sponsored study to produce a Master Plan for Hong Kong's logistics development, issued in December 2002, found that a truck travelling from Kwai Chung to Dongguan would take 7 hours under good circumstances, and more than 15 under bad a considerable length of time for a 100-kilometre journey. Thus, the cost of trucking a Forty-foot Equivalent Unit (FEU) from Dongguan to Yantian is around US$180, far below the US$490 needed to send the container by road to Hong Kong. There is a cheaper option: barging. But while barging an FEU to Kwai Chung only costs around US$300, it is less convenient. While trucks can ship one container when it is ready, a barge needs to wait for other boxes before it can move.

The costs of transporting cargo from factories to ports are not the only ones faced by exporters. They also have to pay terminal handling charges (THCs), which are levied by shipping lines supposedly to recover the costs imposed by the terminal operators who load and unload containers. While there is little transparency on the issue, it is common knowledge that THCs are high in Hong Kong, not just in comparison with China, but compared with the rest of the world: according to the Economic Services Bureau, in 2001 the THC for sending an FEU to the US was US$274 from Hong Kong, much more than Shenzhen (US$141), Taiwan (US$135), Japan (US$126), and Shanghai (US$88). It is difficult to determine precisely how this situation has come about. The exporters and shipping lines we spoke to attributed some of the responsibility to the oligopolistic power of Hong Kong's four terminal operators. These firms, for their part, claim that the charges they levy for use of their facilities (which they call container terminal charges—CTCs) do not tally with the THCs that the shipping lines charge exporters. And all players accept that in any case, Hong Kong's unique port structure, in which port development—from the purchase of land to the building of infrastructure—is financed entirely by the private sector, would probably make port facilities in the territory more expensive to use than would be the case with government-funded facilities elsewhere.

Shenzhen's cost advantage does appear to be narrowing however. The ESB says that between 1995 and 2001 the cost of trucking cargo across the boundary from China fell by around 30%. The gap in THCs also appears to be narrowing. According to the Hong Kong Port and Maritime Board, while average charges in Hong Kong have not fallen in recent years, they have not risen either. At the same time, THCs in Shenzhen do appear to be increasing. Ports in southern China are not monopolised by the government. Rather, Shenzhen has copied the private-sector model of port development from Hong Kong: indeed, Hutchison International Terminals (HIT), which independently operates 10 of Kwai Chung's existing 18 berths and has an interest in two more, also operates the container port at Yantian, in which it has a 48% stake. Admittedly, land costs are not as high in China, but they appear to be rising; in any case, it would be surprising if a private company faced with an excess of demand over fixed supply on the scale of that currently in evidence at Yantian did not respond by hiking prices.

Hong Kong will not price itself out of the market. While being more expensive than ports across the border, Hong Kong's port has other strengths, such as deep water (its only competitor in the region in this respect is Yantian), more efficient document handling services, streamlined customs procedures, and the availability of

Floating your boat
Terminal handling charges for sending a Forty-foot Equivalent Unit to US (HK$), 2001

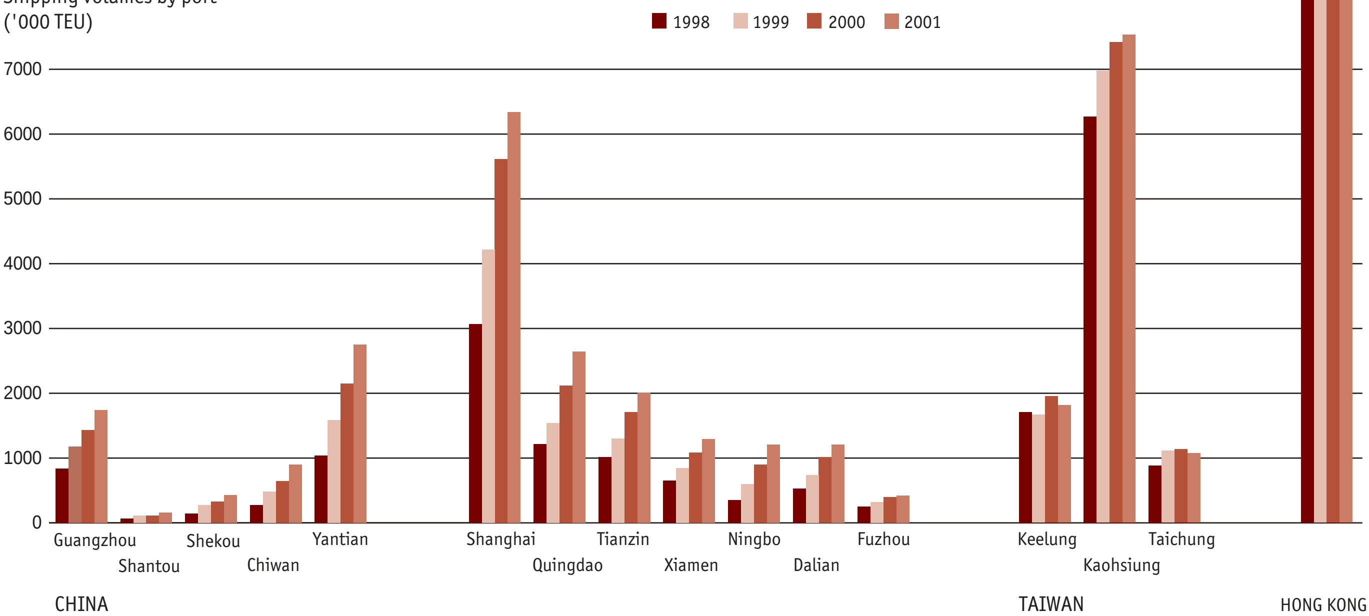


Source: Economic Services Bureau, Hong Kong Special Administrative Region

a sophisticated range of supporting services, from trade finance to insurance. Importantly, it also has better connectivity. In 2002 Hong Kong had more than 160 ocean-going sailings per week, compared with just 60 in Shenzhen. A total of 700 vessels, or approximately two a day, arrived in Hong Kong from the US during 2002. This is important: a container which misses a sailing to the US from Shenzhen may have to wait a costly couple of days for the next one; the delay in Hong Kong, by contrast, would be a matter of hours. This appears to keep freight rates from Hong Kong down: according to the Economic Services Bureau, the ocean freight charge in 2001 for a consignee in the US would have been US$2,110 for an FEU shipped from Yantian, but US$1,810 for one sent from Hong Kong.

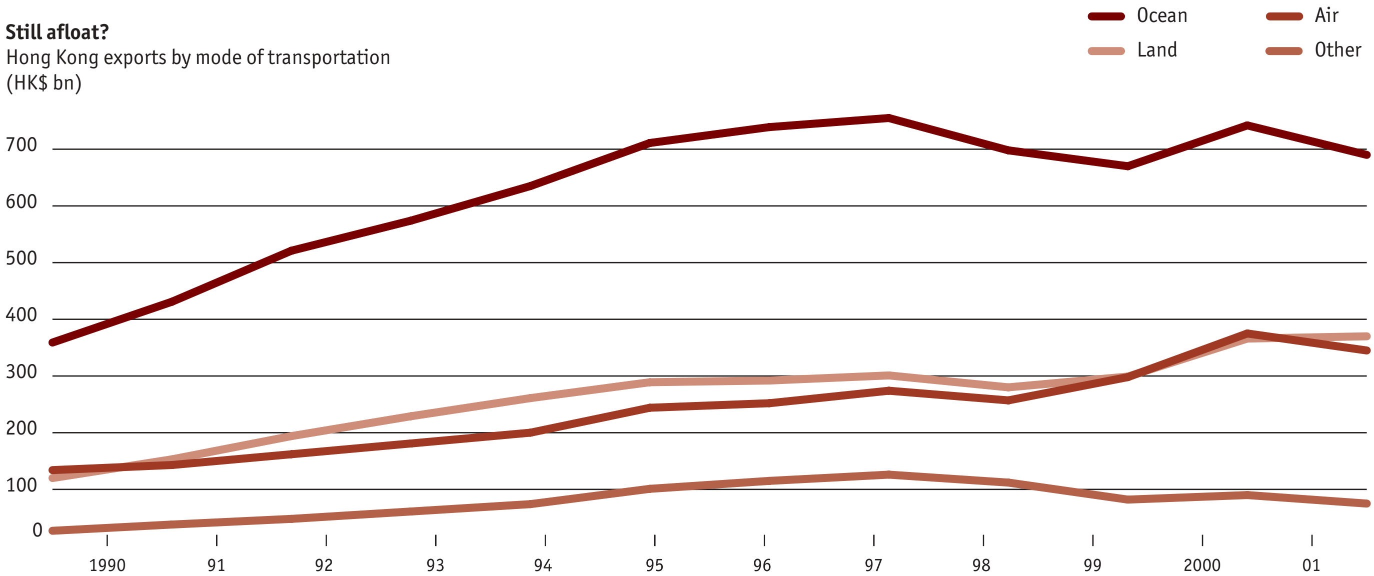
Clearly, connectivity and documentation procedures

Shipshape
Shipping volumes by port
('000 TEU)



Source: Hong Kong Port and Maritime Board, Taiwan Ministry of Transport and Communications, Guangdong/Shanghai Statistical Yearbook, The Report on China's Shipping Development.

Still afloat?
Hong Kong exports by mode of transportation
(HK$ bn)



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

are improving in China. But it will take years for China to develop the depth and breadth of supporting services that has been a critical factor in Hong Kong's strength as a shipping hub. In any case, even if Hong Kong's non-cost lead does eventually disappear, its port operators have every incentive to cut THCs to ensure Kwai Chung retains a role: these private firms have, after all invested huge amounts in the development of the port infrastructure. Hong Kong will not retain its position as the world's busiest port forever, but it will remain an important shipping hub for sometime to come.

In some ways, the focus on water port TEU throughput is unhelpful. As one port operator explained to us, some ports have recorded increases in throughput that were not organic, but rather merely the result of expansion in the geographical scope of a particular port authority, motivated by a desire to appear on the list of the world's top ten container ports. More seriously for Hong Kong, the attention given to the issue of port throughput growth risks detracting from the territory's expansion as an air hub in recent years. In 2001 the Hong Kong International Airport (HKIA) at Chek Lap Kok was the fifth busiest in the world in terms of international passenger throughput, with 32m travellers using its facilities; the airport was even busier in 2002, recording passenger throughput of 33.5m. The airport is also the world's largest hub for international air cargo. The weight of cargo moved might sound small: in 2002 just 2.5 tons in 2002, compared with the 190,000 tons handled by Hong Kong's sea ports. But air cargo is much more valuable. Air trade in 2001 amounted to HK$824.1bn, not much less than the HK$1.3trn of water-borne cargo. Air cargo has also been growing robustly. After growing by 6% a year in 1995-98, the volume of air cargo handled expanded by 12% a year in 1999-2002. The proportion of Hong Kong's total international trade carried by air has increased steadily in recent years, rising from 17.7% in 1992 to 27% in 2001.

As in the container port industry, it is indisputable that Hong Kong's position as a pre-eminent air hub has been partly due to the low level of development of the mainland's airport infrastructure. And as with sea ports, the mainland is now beginning to catch up. A new, modern terminal in Beijing and the flashy Shanghai Pudong airport both opened in 1999. There are also four international airports within 100km of Hong Kong, in Macau, Zhuhai, Shenzhen and Guangzhou. The largest, the overcrowded Guanzhou Baiyun Airport, recorded passenger and cargo throughput of 12.8m and 0.5m tons respectively in 2001. A new airport is, however, being built which will have the capacity to handle 25m passengers and 1m tons of cargo a year. Airports in China also enjoy a considerable price advantage over the HKIA: Hong Kong has a higher cost base in any case, a situation that may have been exacerbated by the dominance of cargo handling in the territory by one company, Hong Kong Air Cargo Terminals Limited (HACTL). China's air connections with the rest of the world have also improved markedly in recent years: the number of weekly international departures from Shanghai rose from 41 in 1985 to 554 in 2002, and from Beijing, from 44 to 405.

Still, Hong Kong's competitive position as an air hub remains strong. This is partly because of the availability of the same supporting services that make it such an important place for the shipping industry. The physical infrastructure is also excellent: the HKIA, which cur-

Direct links and Hong Kong

Hong Kong is the favoured stopping-off point for cargo and passengers travelling between Taiwan and China. The territory will therefore be hurt when direct cross-Strait transport links are finally established. Hong Kong's Airport Authority thinks direct links would affect 8% of the current passenger flow through HKIA. In 2001, air cargo to and from Taiwan generated 13% of total throughput at Chek Lap Kok. In terms of ocean freight, the Hong Kong Port and Maritime Board (PMB) thinks that in 2001 cross-Strait trade via Hong Kong accounted for 1.1m TEUs, or 5.9% of Hong Kong's total throughput.

Not all of this business will, however, be lost. It is difficult to believe that cargo and people wishing to travel between Taipei and, say, Shanghai, would first pass through Hong Kong if they could possibly avoid doing so. But with Taiwan businesses having invested so heavily in Guangdong province, it is clear that much of the cross-Strait trade passing through Hong Kong is actually bound for southern China. In an apparent indication of this, only 20% of the Taiwan-related cargo handled by HACTL in 2002 was in direct transit (although some of the remainder could have been destined for northern China after consolidation by a local importer in Hong Kong). The PMB estimates around 60% of the cross-Strait TEU's passing through Hong Kong is related to southern China. If, as we have suggested likely, Hong Kong manages to remain competitive vis-à-vis the sea and air ports in Guangdong, it is likely to retain a large portion of South China-related cross-Strait trade.

Hong Kong could even continue to remain an important hub for cross-Strait trade that is not related to southern China, thanks to political semantics from Beijing. China has traditionally defined cross-Strait transport links as "domestic." Therefore only local firms are allowed to provide transport services. This policy already affects the conduct of cross-Strait trade. While single vessels from Taiwan and China (albeit sailing under flags of convenience and via the waters of a third destination) can already carry local cargo between the two sides, foreign ships have to trans-ship such goods en route, usually in Hong Kong but sometimes in Korea. In recent months leaders in Beijing have suggested an easing of the "domestic" definition. It is not clear, however, what practical significance is heralded by this change in rhetoric. A failure to grant foreign players so-called cabotage rights would help Hong Kong remain an important hub for cross-Strait trade.

In any case, do not expect a "big bang" opening of direct links. Ports and airports in China are likely to be opened up to links with Taiwan on a selected basis. While public opinion in Taiwan appears broadly in favour of direct links with China, a wild and reckless opening would be unpopular. With direct links in the first instance being limited, there will still be demand for the Taiwan-Hong Kong-China route. Moreover, China's government could select to open areas for links in a way that limits the impact on Hong Kong, in particular by excluding Guangdong. This would not be without precedent. One industry participant told us that all ports in China are open for "direct links via a third area" except those in Guangdong.

Big bang or not, visitor numbers to Hong Kong are still likely to be hurt by this change in policy, although the effect on the broader economy would be muted. Visitors from Taiwan to Hong Kong are outnumbered only by those from mainland China. Taiwan visitors are, however, the shortest staying—in 2002 almost 80% left the same the day as arriving—and consequently do not spend much—a modest HK$4,422 a head in 2001, less than visitors from all regions except non-China Asia. Much will depend on whether the opening of direct transport links will be accompanied by an easing of restrictions on direct cross-Strait financial flows. Without the latter, many Taiwan managers of mainland-based businesses will continue to visit the territory to do their banking.

Whatever happens, Hong Kong won't be as hard hit by the establishment of direct transport links as some other areas. Around 60% of the passengers passing through Macau's airport, for example, are flying either to or from Taiwan. The Japanese island of Ishigaki would also be affected. The island has become an important transit point for local vessels passing indirectly across the Taiwan Strait. According to the Ishigaki branch of the Okinawa Regional Customs Clearance Office, 3,265 boats called at Ishigaki for clearance in 2002, accounting for 93% of all visits registered by the port. With each boat paying around US$3,000 in port fees, this business provides a significant source of business for the local community.

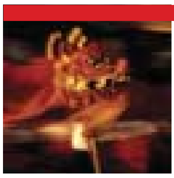
rently has the capacity to handle 45m passengers and 3m tons of cargo a year, is generally regarded as one of the best airports in the world. Progress has also been made in reducing transit times to and from China. Under HACTL's branded SuperLink China Direct service, launched in 2000, cargo arriving at HKIA is carried in sealed trucks across the Hong Kong-mainland boundary, with final China customs clearance not happening until the goods reach the final destination in the PRD. With these streamlined customs procedures, trucks can make the trip between HKIA and Dongguan in just four hours. In 2001 a Marine Cargo Terminal was opened, linking the airport to 20 river ports in the Pearl River Delta. Finally, Hong Kong also still enjoys a wide lead over the mainland in terms of connectivity with the rest of the world. In 2001 the airport was serviced by more than 65 airlines flying to 90 international destinations (and 40 in mainland China). Between April 2001 and March 2002, HKIA registered over 84,000 passenger plane landings, up from 68,000 in the same period four years earlier.

It should be clear then that Hong Kong's strength as a hub for the sea cargo and air industries is based not just on physical infrastructure, but also on streamlined procedures and the availability of a wide range of supporting services. This is important: while it is relatively straightforward for the authorities in China to build sea ports and airports, creating an advanced soft infrastructure is a much more complicated and lengthy affair.

Hong Kong cannot rest on its laurels. With a large proportion of cross-Strait cargo and passenger flows being routed through Hong Kong, the territory will clearly be adversely affected when direct transport links between China and Taiwan are finally established (the impact is, however, likely to be smaller than commonly thought). And while development of the necessary infrastructure will not be completed overnight, it is clear that cities on the other side of the boundary have ambitions to serve as major hubs for the cargo and people that originate in the Pearl River Delta.

Hong Kong authorities cannot do much about the first development but a two-pronged approach can be used to used to address the second: cutting the cost of cross-boundary transport, and improving Hong Kong's soft infrastructure. The government has been moving ahead on both fronts. For example, the Western Crossing, a 5.1km dual three-lane bridge linking Hong Kong with Shenzhen, is due to be opened in 2005. Transport links will be further enhanced if proposals laid out in the December 2002 Master Plan, such as new rail and road logistics pipelines linking Hong Kong to the east of the PRD, and a new sea link to the west, are implemented. Proposals have also been revived for a bridge linking Hong Kong with the western side of the PRD. This would seem to make sense from Hong Kong's point of view: it would make the territory the geographic focal point of the region. It could also be good for China. The 2022 Foundation report on the PRD argues that, by opening up the west of the delta for investment by Hong Kong firms, the bridge would trigger a similar process of development to one that occurred in the east after local companies started to move there in 1978. In terms of soft infrastructure, significant steps have been taken in recent years to liberalise the both air cargo handling and the airline industry itself. These changes will introduce more competition, and will bolster Hong Kong's position as an air services hub.

The recent SARS outbreak in Hong Kong and China has thrown Hong Kong's tourist industry into a tailspin. Prior to this worrying development, Hong Kong's continued status as an important air hub looked certain to support future growth in the local tourism industry. According to the World Tourist Organisation, China will become the world's most visited country by 2020. An increasing proportion of these people will fly directly to and from China, but the numbers being hubbed through Hong Kong could continue to grow even as the territory loses market share; in any case, Hong Kong's peculiar history and spectacular skyline are likely to continue to prompt people visiting China to include the territory as an add-on. Hong Kong's attractiveness will also grow once the territory's Disneyland opens in 2005. This theme park will also pull in more people from the mainland, especially from the south who, with easing visa restrictions, will anyway find it easier to visit Hong Kong.



Conclusion

Ignoring the challenge presented by greater economic integration will only harm the economies of Taiwan and Hong Kong. The challenge is to strengthen links while introducing reforms at home. There are risks.

At moments of great change, risk and reward can be difficult to balance. The rapid development of economic links between China, Taiwan and Hong Kong has been driven by businessmen seeking substantial future financial rewards. Against this, links have frequently, been held back by politicians or other groups worried about real or imaginary risks—about the "hollowing out" of Taiwan or Hong Kong industry, for example.

The good news is that optimism has so far triumphed over caution. As discussed above, Taiwan's extensive regulations about investing in the mainland have failed to control Taiwanese firm's investment on the mainland. At the same time Taiwan's industrial base has not been destroyed, as some had feared, but has had to upgrade—in textbook fashion. In a rather different way, Hong Kong firms have replaced domestic production capacity with trading and intermediation with production on the mainland—to both sides' substantial benefit.

The bad news is that governments have yet to catch up completely with reality. This will limit their ability to capitalise on future gains.

Taiwan's government has yet to grasp all the implications of integration. President Chen is right to say that establishment of direct links would not be a "cure-all" for the economy. The development of a better infrastructure is also key, if Taiwan is to benefit fully from direct links. But President Chen and others need to realise that the absence of direct links could soon destroy certain industries—not protect them. Service sector development has undoubtedly already been badly damaged by restrictions on trade with the mainland.

Hong Kong's government is currently struggling to find a clear policy direction, buffeted by troubles not all of its own making. But, despite its fumblings, Hong Kong may be close than Taiwan to understanding what the "three links" are really about—trusting in your own strengths, and not worrying over-much about the seemingly inexhaustible advantages enjoyed by the mainland. Recent moves to reduce the cost of cross-boundary transport and improve its "soft" infrastructure indicate a desire to deal with problems, not ignore them.

Closer links between China, Hong Kong and Taiwan will continue to present risks to certain sectors. But government policies—from all sides—should now focus on the rewards.

Appendix: EIU survey results

The Economist Intelligence Unit conducted two surveys for this report, one targeted at major companies in Taiwan the other at senior executives of multinational companies with a base in Hong Kong. The broad aim of the surveys was to elicit responses on whether and if so, how, the respondents' businesses are adapting to the surge in growth of the mainland China economy. The two surveys differ, of course, in their substance. The issue for Taiwan is to determine to what degree Taiwan corporate investment in mainland China is having an impact on the island's economy. Is it contributing to the "hollowing out" of the economy, as some believe, or is it, to take the opposite view, a healthy indication of comparative advantage at work as Taiwan moves itself upwards on the economic ladder into higher value-added manufacturing and services? Additionally, the Taiwan survey sought to understand to what extent the lack of direct links (transport, human and capital) between Taiwan and China is having an impact on cross-Strait investment and economic activity, and whether a lifting of restrictions on direct links would be advantageous, or otherwise, for Taiwan's businesses and economy.

Our Hong Kong survey had different antecedents. As an international services centre, Hong Kong's evolving inter-dependence with China requires us to understand the dynamics of regional management structures and headquarters, an issue central to the territory's present economic structure and strengths; in particular we have sought to determine to what degree China's economic emergence, among other things, is affecting the location strategies of global corporations and their regional operations.

Methodology

Both surveys were conducted in March 2003 via email and the Internet. Additional follow-up was provided by trained telephone surveyors. Results were compiled, and conclusions drawn, by analysts at the Economist Intelligence Unit in Hong Kong.

The Hong Kong survey was distributed electronically to some 1,000 multinationals. Of the total of 84 responses, six were declared null and void, and the remaining 78 (just under 8%) viable and usable.

The Taiwan survey, conducted in Chinese, was distributed electronically to some 550 Taiwan "Innovalue" firms, so designated by the China External Trade Development Council (CETRA) for their innovative products and trading and investment practices. Innovalue firms represent, by and large, the biggest and most successful companies in Taiwan, many of them IT manufacturers (chip-maker TSMC, computer peripherals producer BenQ and notebook computer maker Compal among them). A total of 77 responses were received (a roughly 12.6% response rate), with 69 being viable and usable.

Taiwan survey

Companies already invested in China

What are your investment plans over the next 3 years?

	Taiwan	China
Increase	27	43
No change	15	3
Decrease	2	1

If you plan to increase investment in China, why?

	respondents
Because of increasing global demand	23
Increasing demand in China's domestic market	36
Expand production facilities	17
Expand research and development	13
Expand marketing and service	23
Other	0

If you plan to increase investment in Taiwan, why?

	respondents
Expand production facilities	10
Expand research and development	34
expand marketing and service	21

Since investing in China have staff nos./the wage bill:

	staff nos.	wage bills
Increase	14	20
No change	17	14
Decrease	16	15

How much of a hindrance to your business is the lack of direct cross-strait links with China?

	air	sea
No effect	9	12
Inconvenient	17	18
Very inconvenient	23	19

If direct cross-strait links were established, which would be most important to your business?

	total
Freer movement of people	5
Time saved travelling	7
Costs saved travelling	1
All of above	36

Assuming full air and sea direct links are established in 2003, how would your investment plans be effected?

	Taiwan	China
Increase	16	28
No change	29	20
Decrease	1	1

Is there truth to the perception that Taiwan companies do not bring profits earned in China back to Taiwan? And if yes, why?

	yes	no
Total	5	45
Tax	4	
Restrictions on links between Taiwan and China	4	
Fear of government inquisitiveness	1	
Need to re-invest in China	6	
Lack of domestic investment opportunities	2	

What does the government need to do to encourage the return of profits:

	respondents
1. More incentives made available	7
2. Improve investing environment for businesses in Taiwan	4
3. Stabilise the financial policy	3
4. Solve the tax problem	4
5. Facilitate production upgrade	1

Does your mainland subsidiary have a banking relationship with a Chinese bank?

	respondents
Yes	32
No	18

How big a hindrance to big business is the absence of functioning Taiwan banks on the mainland?

1. Very significant/inconvenient	10
3. Quite significant	4
2. Not significant. At present Taiwan banks are establishing a presence in China	10
4. An obstacle to sales expansion	1

Are you optimistic or pessimistic about Taiwan's economic future?

	respondents
Optimistic	24
Pessimistic	26

What policy initiatives are needed to ensure Taiwan's economic growth?

Establishment of direct links to China	35
Ending of restriction of flow of goods between Taiwan and China	14
Reduced taxes	22
Improved domestic infrastructure	39
Other	8

If you think direct links are essential, please rank the following according to their importance to your business

	Most important	2nd most	least
Transport: direct sea and air links	28	15	3
Financial: a loosening of restrictions on capital flows	17	20	9
People: a loosening of restrictions on mainland people travelling to work in Taiwan	2	10	34

Companies not yet invested in China

Why have you not invested in China?

	respondents
Government restrictions	6
Concerns over IPR	6
Lack of direct transport links between Taiwan and China	14
Financing difficulties due to lack of Taiwan banks on the mainland	8
Other	7

Do you plan to invest in China in the next 3 years? If yes, why?

	yes	*no*
Total	13	10
Increasing need to tap domestic China market	12	
Hope that direct cross-strait transport links will be established	7	
Hope that direct cross-strait financial links will be established	6	
Improvement in China's business environment	8	
Other	2	
Other specified	0	

Q.2.4
After investing in China do you: expect staff nos. in Taiwan to

	respondents
Increase	5
No change	10
Decrease	5

Q.2.5
Are you optimistic about Taiwan's economic future?

	respondents
Optimistic	9
Pessimistic	13

Q.2.6
What policy initiatives are needed to ensure Taiwan's economic future?

	respondents
Establishment of direct links with China	18
Reduced taxes	13
Improved domestic infrastructure	15
Other	3

If you think direct links are essential please rank the following according to their importance to your business

	Most important	*2nd most*	*3rd*	*Least*
Transport:direct sea and air links	11	7	2	1
Financial: a loosening of restrictions on capital flows	8	6	6	0
People: a loosening of restrictions on travel	1	6	12	0

Hong Kong survey

Location status

What is the present status of your office in Hong Kong?

	respondents
Asia-Pacific regional HQ	42
North-east Asia regional HQ	5
China/greater China HQ	18
Other	13

How long have you had an office in Hong Kong?

	respondents
Less than three years	3
Between three and six years	6
More than six years	69

Strategic management and decision making

What trends characterise changes in your strategic management and decision making activities in Hong Kong over the last three years? (you may choose more than one)

	respondents
Expansion due to increase in size of Asia Pacific business	23
Expansion due to increase in size of China business	33
Expansion due to consolidation in Hong Kong of activities previously undertaken elsewhere in the region	11
Downsizing due to reduction in size of Asia Pacific business	5
Downsizing due to reduction in size of China business	0
Downsizing due to migration to elsewhere in the region of activities previously undertaken in Hong Kong	22
Other	15

If strategic management and decision-making activities have been consolidated in Hong Kong, where have they moved from?

	respondents
Beijing	2
Shanghai	3
Singapore	10
Tokyo	3
Other	17

Why?

	respondents
Shift of corporate focus from SE Asia to NE Asia in general	8
Shift of corporate focus from SE Asia to China in particular	17
Other	15

If strategic management and decision-making activities have been moved away from Hong Kong, where have they been relocated to?

	respondents
Beijing	5
Shanghai	16
Singapore	3
Tokyo	0
Other	13

Why?

	respondents
Need to be closer to major market	23
To save on labour and property costs	4
Other	8

What is likely to happen to your strategic management and decision-making activities in Hong Kong over the next three years?

	respondents
Expansion	31
Downsizing	35

Finance and treasury

What trends characterise changes in your finance and treasury activities in Hong Kong over the last three years (you may choose more than one option)

	respondents
Expansion due to increase in size of Asia Pacific business	18
Expansion due to increase in size of China business	26
Expansion due to consolidationin HK of activities previously undertaken elsewhere in the region	9
Downsizing due to reduction in size of Asia Pacific business	6
Downsizing due to reduction in size of China business	1
Downsizing due to migrationto elsewhere in the region of	14
Corporate activites previously undertaken in HK	
Other	14

If finance and treasury activities have been consolidated in Hong Kong where have they moved from?

	respondents
Beijing	2
Shanghai	2
Singapore	6
Tokyo	3
Other	14

Why have they moved?

	respondents
Shift of corporate focus from SE Asia to NE Asia in general	5
Shift of corporate focus from SE Asia to China in general	12
Other	8

If finance and treasury activities have moved away from Hong Kong, where have they been relocated to?

	respondents
Beijing	3
Shanghai	11
Singapore	5
Tokyo	0
Other	12

Why?

	respondents
To be closer to major market	14
To save costs	6
Other	10

What is likely to happen to your finance and treasury activities in Hong Kong over the next three years?

	respondents
Expansion	27
Downsizing	24

Marketing and distribution

What trends characterise changes in the nature of your marketing and distribution activities in Hong Kong over the last three years? (you may choose more than one)

	respondents
Expansion due to increase in size of Asia Pacific business	22
Expansion due to increase in size of China business	31
Expansion due to consolidation in Hong Kong of activities previously undertaken elsewhere in the region	7
Downsizing due to reduction in size of Asia Pacific business	4
Downsizing due to reduction in size of China business	2
Downsizing due to migration to elsewhere in the region of corporate activities previously undertaken in Hong Kong	13
Other	12

If marketing and distribution activities have been consolidated in Hong Kong where have they moved from?

	respondents
Beijing	0
Shanghai	4
Singapore	4
Tokyo	4
Other	15

Why?

	respondents
Shift of corporate focus from SE Asia to NE Asia in general	3
Shift of corporate focus from SE Asia to China in particular	19
Other	6

If marketing and distribution activities have moved away from Hong Kong where have they been relocated to?

	respondents
Beijing	5
Shanghai	16
Singapore	1
Tokyo	0
Other	11

Why?

	respondents
To be closer to major market	26
To save costs	3
Other	3

What is likely to happen to your marketing and distribution activities in Hong Kong over the next three years?

	respondents
Expansion	26
Downsizing	25

Back-office services

What trends characterise changes in the nature of your back-office activities in Hong Kong over the last three years? (you may choose more than one)

	respondents
Expansion due to increase in size of Asia Pacific business	12
Expansion due to increase in size of China business	14
Expansion due to consolidation in Hong Kong of activities previously undertaken elsewhere in the region	3
Downsizing due to reduction in size of Asia Pacific business	4
Downsizing due to reduction in size of China business	2
Downsizing due to migration to elsewhere in the region of corporate activities previously undertaken in Hong Kong	20
Other	22

If back-office have been consolidated in Hong Kong, where have they moved from?

	respondents
Beijing	0
Shanghai	5
Singapore	5
Tokyo	2
Other	11

Why

	respondents
Shift of corporate focus from SE Asia to NE Asia in general	3
Shift of corporate focus from SE Asia to China in particular	15
Other	6

If back-office activities have moved away from Hong Kong, where have they been moved to?

	respondents
Beijing	1
Shanghai	14
Singapore	3
Tokyo	0
Other	11

Why?

	respondents
To be closer to major market	14
To save costs	13
Other	6

What is likely to happen to your marketing and distribution activities in Hong Kong over the next three years?

	respondents
Expansion	10
Downsizing	36

General

Are you optimistic or pessimistic about Hong Kong's economic future?

	respondents
Optimistic	34
Pessimistic	27
Other	10

What policy initiatives are need to secure Hong Kong's economic future?

	respondents
More efficient transport and communication links with mainland China	43
Improved domestic infrastructure	14
Reduced taxes	19
Political reform	31
Action to increase competition in the domestic economy	43
Other	15

How important are the following factors in the decision as to where to locate corporate activities (please indicate on a scale of 1:5, with 5 being the most important)

	1	*2*	*3*	*4*	*5*
Availability of skilled managers/support staff	3	5	9	16	35
Availability of English-language skills	3	7	12	26	16
Availability of professional support services	2	3	18	25	14
Transport and communications infrastucture	6	2	16	30	15
Low property, utility and staffing cost	5	6	27	17	11
Political stability	0	6	11	21	28
Stable economic policy environment	0	3	14	22	26
Benign tax regime	3	8	12	30	14
Ease of access to national market	3	7	12	24	19
Ease of access to regional markets	1	3	15	22	22
Transparent legal and regulatory environment	0	2	10	24	31
Other	0	0	0	2	5

How does Hong Kong rate in these areas?

	1	*2*	*3*	*4*	*5*
Availability of skilled managers/support staff	2	7	15	23	24
Availability of English-language skills	1	8	27	24	7
Availability of professional support services	2	1	11	23	28
Transport and communications infrastucture	1	1	3	22	43
Low property, utility and staffing cost	16	23	21	4	0
Political stability	2	2	16	28	19
Stable economic policy environment	2	7	16	33	7
Benign tax regime	23	3	6	25	30
Ease of access to national market	5	4	14	20	22
Ease of access to regional markets	2	2	9	31	24
Transparent legal and regulatory environment	1	0	6	30	33
Other	1	1	0	1	1

How does mainland China rate in these areas?

	1	*2*	*3*	*4*	*5*
Availability of skilled managers/support staff	2	21	31	11	3
Availability of English-language skills	4	25	30	5	1
Availability of professional support services	3	24	26	9	0
Transport and communications infrastucture	4	17	39	6	1
Low property, utility and staffing cost	0	3	18	27	19
Political stability	5	4	35	17	6
Stable economic policy environment	1	9	34	17	3
Benign tax regime	12	16	27	10	0
Ease of access to national market	1	7	21	16	20
Ease of access to regional markets	7	20	20	13	4
Transparent legal and regulatory environment	16	26	16	3	2
Other	1	1	0	0	2

