



Europe and Hong Kong: Challenges in an Evolving Relationship

By Duncan Freeman

Issue Paper No. 25
23.2.2005

Contents

Executive Summary.....	2
1 Hong Kong and Europe: A Pragmatic Relationship.....	4
2 Hong Kong in European Trade.....	6
3 Hong Kong in European Investment.....	12
4 Hong Kong, Europe and China.....	14
5 Hong Kong and Europe: Partners Forever?.....	19
Conclusion.....	23
References.....	24

Introduction

For over 150 years Hong Kong has played a role in the interaction between Europe and China. In large part the relationship between Europe and Hong Kong is based on economics. Over the past 25 years Hong Kong has become a very important economic partner of Europe, especially as an intermediary in the economic relationship between Europe and China. Although this relationship has considerable depth, long-term trends indicate that the importance of Hong Kong to European business has been declining, as the internationalization of the Chinese economy continues. In recent years Hong Kong's share of European trade and investment has been falling, and its role as intermediary for doing business with China has been challenged as European companies choose to go directly to China. Hong Kong will face challenges in maintaining its past role and will need to once again re-orient its economy. Nevertheless, Hong Kong's established position will mean that it is likely to continue to remain an important partner of Europe in the foreseeable future.

1. Hong Kong and Europe: A Pragmatic Relationship

Hong Kong has been a significant point of interaction between China and Europe for over 150 years. In recent decades it has played a pivotal role in the expansion of economic exchange between China and the outside world, including Europe. As part of a dynamic region, in a changing world, it would be surprising if Hong Kong's relationship with Europe were to remain unchanged. This paper will consider some of the developments in the relationship between Europe and Hong Kong, largely focusing on business exchanges. By examining some of the trends that have emerged, it will offer some indications of how the relationship may continue to change.

The European Union as it is today has been only marginal in shaping Europe's relations with Hong Kong. The history of Europe in Hong Kong is, of course, largely the history of the UK in Hong Kong, even though other European nations have had significant business interests there. Still, since Hong Kong is no longer a British colony, and Europe as represented by the EU has some significance as an economic entity, both in the institutional and in the geographic sense, it is worth considering Hong Kong's economic relations with Europe as a whole. However, the reality is that the relationship is determined by national policies and above all by private actions that have little to do with the institutions of the EU. It is not the purpose here to offer a critique of the policy of the European Union towards Hong Kong, nor to provide in depth policy suggestions. It is in any case unclear that the EU in any real sense has, or even needs, a 'policy' on Hong Kong, apart from what might be called pragmatic engagement. Macau, historically the predecessor to Hong Kong as a point of contact between Europe and China as today it is of minor economic importance, is regarded in much the same way.

In the run-up to the return of Hong Kong to Chinese sovereignty and the creation of the new Special Administrative Region (SAR), the European Commission was committed to producing an annual report on the situation in Hong Kong and its relations with Europe. The 2004 Commission Report on Hong Kong¹ covers developments in Hong Kong for the year 2003. It consists in large part of a discussion of political developments within the SAR, other events such as the advent of SARS, and recites a few significant milestones in the relationship between Hong Kong and the EU. It is in large measure a recital of facts, notes concerns on a number of issues, and makes little in the way of recommendations.

The focus largely reflects a set of concerns arising from the return of Hong Kong to China in 1997 when Hong Kong's autonomy and political development under the arrangements agreed between the UK and China were high on the agenda. In as far as there has ever been a stated policy at EU level towards Hong Kong, it is has been defined by those concerns set out in a document issued by the Commission in 1997 titled "The European Union and

¹ Report from the Commission to the Council and the European Parliament Hong Kong Special Administrative Region: Annual report 2003.

Hong Kong: Beyond 1997.²” This document described in broad terms the existing relationship between Europe and Hong Kong and outlined areas in which Europe could continue to play a role there after the return to Chinese sovereignty, including support for political development. While the political development of Hong Kong was the main international concern in 1997, the role of the European institutions in this has been largely symbolic. In practice, cooperation between the two sides has been pragmatic in promoting matters of mutual interest and a number of bilateral agreements have been signed. Since the Hong Kong SAR retains control over most areas of policy and is a member of many international institutions, numerous areas where the two sides can continue to cooperate, at either the EU or Member State level still exist.

On the economic relationship between Hong Kong and Europe, the 2004 Commission Report offers little more than a brief overview. It highlights the importance of Europe in the Hong Kong economy in the following terms:

“The EU is well represented in various sectors of the Hong Kong economy. In terms of foreign investment, the EU was the third largest source of external direct investment for Hong Kong in 2002 after British Virgin Islands and Mainland China. The cumulative value of direct investment from the EU in that year amounted to HK\$ 304 billion (41.2 billion euro), accounting for 11.6% of the investment total, well ahead of the US (7.1%) and Japan (5.4%).

The EU was Hong Kong’s third largest supplier in 2003 after Mainland China and Japan, and was the third biggest market for Hong Kong’s exports, after Mainland China and the US. According to Eurostat, total bilateral trade between the EU and Hong Kong reached 27.3 billion euros (imports from Hong Kong to the EU: 9.34 billion euros; exports to Hong Kong from the EU: 17.96 billion euros), a slight decrease from 2002 (29.6 billion euros).”

This provides a single snapshot of a relationship, one that the Commission Report rightly points out has undergone some difficulty in the immediate past, but which nonetheless remains important to both sides. The business relationship with Europe is obviously a very substantial one. Hong Kong is a major supplier and market of European companies, and it is a centre from which many European companies do business in Asia, both trading and investment. This can be demonstrated in ways almost too numerous to list – by the absolute size of the trade between the two and the percentage of each partner’s trade that the other accounts for, the number of European companies that operate in Hong Kong or the number of Europeans that work there – and they are recited often, especially by Hong Kong government and business leaders, eager to demonstrate their continuing importance and attractiveness as a place to do business. But these bare facts, indisputable as they may be, do not tell the full story.

² Communication from the Commission to the Council The European Union and Hong Kong: Beyond 1997 Brussels 23.04.97 COMM (97) 171 final.

2. Hong Kong in European Trade

Despite the apparent strength of the relationship attested to by the commonly cited facts, the long-term trend is not quite so positive. True, there has been a huge increase in the level of trade between Europe and Hong Kong over the past two decades. Figures from the European side show that in 1980 EU15³ exports to Hong Kong were 2.2 billion euro and in 2003 they were 18.0 billion euro, and in the same period EU-15 imports from Hong Kong grew from 4 billion euro to 9.4 billion euro. But the figures also show that in recent years Hong Kong's trade with Europe appears to have peaked and then fallen both in relative and absolute terms. Hong Kong's share of Europe's external trade has fallen, and, perhaps of more concern for Hong Kong, there has been an absolute decline in trade recorded with Europe, although it is perhaps still unclear to what extent this reflects a general difficulty in trading conditions, especially in 2001.

Table 1: Hong Kong Trade with EU15

	1980	1990	1999	2000	2001	2002	2003
EU exports to Hong Kong (Euro billion)	2.2	6.6	15.7	20.5	21.5	19.9	18.0
% of EU total	1	1.8	2	2.1	2.1	2	1.9
EU imports from Hong Kong (Euro billion)	4	5.9	10.7	11.6	10.3	9.7	9.4
% of EU total	1.4	1.4	1.3	1.1	0.9	1.0	1.0

Source: Eurostat

The Hong Kong economy is not isolated, and these changes do not just represent a shift in the bilateral trading relationship with Europe. Above all, they are the result of changes in the role that Hong Kong plays in Europe's trade with China. For many years Hong Kong was the main conduit for trade between China and the rest of the world. It is well known that Hong Kong's trade has been dominated by its re-exports and that its own domestic exports account for only a small percentage total trade. Hong Kong has imported goods, mostly parts and materials, re-exported them to China, usually to the Guangdong province, for manufacturing or assembly, then re-imported the finished product for re-export to the rest of the world, predominantly to markets in North America and Europe. Hong Kong also led the way as a trader in China for many European companies as the Chinese economy opened during the 1980s. It was a channel both for imports from, as well as exports to, China. But Hong Kong's once dominant role in Europe's China trade has fallen dramatically. As Table 2 demonstrates, EU statistics show that EU-15 exports

³ For convenience in dealing with historical and comparative data, the European Union will be taken to mean EU15 countries. Hong Kong's economic relations with the new accession countries have in any case been of generally minor importance.

to Hong Kong were consistently around 50% of combined total exports to Hong Kong and mainland China even until well into the second half of the 1990s. By 2003 the proportion had fallen rapidly to only 30.9% of the total. The situation for imports is even more dramatic. Imports from Hong Kong were only 8.9% of total imports from Hong Kong and mainland China in 2003, as against 65.5% in 1990. At least on the basis of these figures, Hong Kong has clearly lost its position as the key intermediary between China and Europe.

Table 2: EU15 Trade with China and Hong Kong

	1980	1990	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Exports													
China (Euro billion)	1.96	5.27	11.34	12.53	14.69	14.75	16.48	17.41	19.35	25.51	30.09	34.14	40.13
Hong Kong (Euro billion)	2.24	6.51	11.39	13.09	15.71	17.51	20.44	17.32	15.69	20.54	21.53	19.91	17.97
Hong Kong % of total (China + Hong Kong)	53.3	55.6	50.1	51.1	51.8	54.3	55.4	49.9	45.5	44.6	41.7	36.8	30.9
Imports													
China (Euro billion)	2.10	10.60	19.63	22.69	26.34	30.04	37.49	41.97	49.66	70.28	75.92	81.84	95.22
Hong Kong (Euro billion)	3.97	5.91	6.44	6.49	7.16	7.26	8.37	9.72	10.68	11.65	10.27	9.70	9.35
Hong Kong % of total (China + Hong Kong)	65.5	35.8	24.7	22.3	21.4	19.5	18.3	18.8	17.7	14.2	11.9	10.6	8.9

Source: Eurostat

This trend is apparent for every EU-15 Member State. Although the rate of decline varies, there is no exception. In the case of exports, it is apparent that the peak for the proportion of China trade conducted with Hong Kong was generally in the early to mid-1990s. The proportion of exports to Hong Kong then fell away quite rapidly as exports to the mainland began to take off. Historical and other ties to Hong Kong have little influence on the outcome. Trade between the UK, the former colonial power, and Hong Kong shows the same trend although it perhaps not surprising that the UK still retains a somewhat stronger bias towards trade with Hong Kong than other major European economies (Tables 3-7 show the breakdown for major EU trading partners with Hong Kong and China).

Table 3: Germany - Trade with China and Hong Kong Unit: Euro million

	Germany exports			Germany imports		
	China	Hong Kong	Hong Kong % of total (China + Hong Kong)	China	Hong Kong	Hong Kong % of total (China + Hong Kong)
1980	823	423	33.9	562	1,245	68.9
1990	1,892	1,533	44.7	3,539	2,340	39.8
1994	5,350	3,009	36.0	7,641	1,907	20.0
1995	5,756	3,083	34.9	8,066	1,802	18.3
1996	5,694	3,342	37.0	8,844	1,699	16.1
1997	5,406	4,022	42.7	10,277	1,686	14.1
1998	6,044	3,337	35.6	10,876	1,791	14.1
1999	6,949	3,307	32.2	12,799	1,866	12.7
2000	9,459	4,162	30.5	17,126	2,265	11.7
2001	12,118	4,235	25.9	18,110	2,171	10.7
2002	14,495	4,241	22.6	19,058	1,981	9.4

Source: Eurostat

Table 4: France - Trade with China and Hong Kong Unit: Euro million

	France exports			France imports		
	China	Hong Kong	Hong Kong % of total (China + Hong Kong)	China	Hong Kong	Hong Kong % of total (China + Hong Kong)
1980	219	199	47.6	308	240	43.8
1990	1,120	938	45.6	1,273	486	27.6
1994	1,831	1,980	51.9	2,649	393	12.9
1995	2,028	2,960	59.3	3,094	415	11.8
1996	1,981	2,802	58.6	3,713	419	10.1
1997	3,107	2,621	45.7	4,581	485	9.6
1998	3,043	2,880	48.6	5,054	545	9.7
1999	3,217	1,835	36.3	5,919	551	8.5
2000	3,424	2,382	41.0	8,158	593	6.8
2001	3,552	3,964	52.7	8,343	526	5.9
2002	3,708	2,764	42.7	8,572	436	4.8

Source: Eurostat

Table 5: Italy - Trade with China and Hong Kong

Unit: Euro million

	Italy exports			Italy imports		
	China	Hong Kong	Hong Kong % of total (China + Hong Kong)	China	Hong Kong	Hong Kong % of total (China + Hong Kong)
1980	185	194	51.2	315	207	39.7
1990	764	1,170	60.5	1,444	235	14.0
1994	1,921	2,637	57.9	2,627	191	6.8
1995	2,021	2,975	59.5	3,004	196	6.1
1996	2,209	3,451	61.0	3,175	166	5.0
1997	2,231	3,532	61.3	3,896	213	5.2
1998	1,835	2,750	60.0	4,325	267	5.8
1999	1,834	2,558	58.2	5,001	300	5.7
2000	2,380	3,269	57.9	7,028	398	5.4
2001	3,272	3,277	50.0	7,481	395	5.0
2002	4,018	3,089	43.5	8,307	427	4.9

Source: Eurostat

Table 6: Netherlands - Trade with China and Hong Kong

Unit: Euro million

	Netherlands exports			Netherlands imports		
	China	Hong Kong	Hong Kong % of total (China + Hong Kong)	China	Hong Kong	Hong Kong % of total (China + Hong Kong)
1980	107	97	47.5	197	255	56.4
1990	189	321	62.9	1,046	494	32.1
1994	574	793	58.0	1,709	1,589	48.2
1995	635	907	58.8	1,908	1,734	47.6
1996	609	925	60.3	2,272	1,956	46.3
1997	758	1,026	57.5	3,148	2,396	43.2
1998	693	800	53.6	3,991	2,829	41.5
1999	767	887	53.6	4,651	3,235	41.0
2000	1,116	1,071	49.0	8,705	2,129	19.7
2001	1,238	1,018	45.1	10,440	1,543	12.9
2002	1,574	999	38.8	12,000	1,500	11.1

Source: Eurostat

Table 7: UK - Trade with China and Hong Kong

Unit: Euro million

	UK exports			UK imports		
	China	Hong Kong	Hong Kong % of total (China + Hong Kong)	China	Hong Kong	Hong Kong % of total (China + Hong Kong)
1980	282	904	76.2	288	1,349	82.4
1990	654	1,769	73.0	1,713	1,701	49.8
1994	1,085	2,814	72.2	4,280	1,750	29.0
1995	979	2,996	75.4	4,551	1,780	28.1
1996	905	3,454	79.2	5,593	1,832	24.7
1997	1,322	4,600	77.6	7,340	2,192	23.0
1998	1,271	3,910	75.5	8,504	2,751	24.4
1999	1,838	3,543	65.8	10,170	2,902	22.2
2000	2,391	4,380	64.7	14,077	3,706	20.8
2001	2,744	4,311	61.1	15,530	3,198	17.1
2002	2,364	3,766	61.4	16,811	3,038	15.3

Source: Eurostat

In fact, the EU figures do some injustice to Hong Kong since they tend to exaggerate the degree to which Hong Kong has declined as a European trade partner because they do not fully capture the extent of trade between the two.⁴ There is a significant discrepancy between EU figures for imports from Hong Kong and Hong Kong's own figures for total exports to Europe. In large part this is accounted for by European imports from Hong Kong that are actually re-exports sourced from China. In EU trade statistics these should be accounted for simply as exports from China since this will be their country of origin, while in Hong Kong they are included in the total export figures as re-exports. Thus, the EU figures tend not to reflect one of the most important elements in Hong Kong's trade. Nevertheless, even if we take account of re-exports, the overall trend is the same, although their inclusion shows that Hong Kong still has a more significant role in China's trade with Europe than the European statistics would suggest. After peaking in 2000, Hong Kong total exports to Europe dropped sharply, before recovering again in 2003. It is noticeable that Europe's share of Hong Kong's exports has been generally declining over the past decade. At the same time, China's own exports directly to the EU continued to grow more strongly. Between 1999 and 2003 China's exports to the EU almost doubled from 49.7 billion euro to 95.2 billion euro, while Hong

⁴ It should be noted that there is considerable debate over the precise meaning of statistics relating to China's foreign trade, and particularly the role of Hong Kong in this trade. Most of this discussion has arisen as a result of argument over the size of China's trade surplus with the United States. In simple terms, China counts only trade carried out directly with the US, while the US includes trade with China carried out through Hong Kong, which, because of Hong Kong re-exports gives a much larger figure for China's trade surplus with the US. From the statistical point of view, similar points are relevant to the overall question of China's trade with Europe, but is unlikely that any of them would significantly affect the apparent trend.

Kong's total exports to Europe including re-exports increased by only 6.5%. The competitive pressure on Hong Kong as its share of Chinese trade has fallen as is demonstrated by the fact that Hong Kong statistics tend to show that the trade margin on re-exports has been falling in recent years.

Table 8: Hong Kong Total Exports to EU15

	Value (HK\$)	Share of Hong Kong exports (%)	Change (%)
1982	24,608	19.3	-1
1983	28,157	17.5	14
1984	34,529	15.6	23
1985	31,718	13.5	-8
1986	43,960	15.9	39
1987	65,315	17.3	49
1988	83,922	17	28
1989	95,100	16.7	13
1990	118,641	18.5	25
1991	144,068	18.8	21
1992	157,895	17.1	10
1993	168,032	16.1	6
1994	177,026	15.1	5
1995	200,821	14.9	13
1996	207,796	14.9	3
1997	214,238	14.7	3
1998	211,720	15.7	-1
1999	216,875	16.1	2
2000	239,778	15.2	11
2001	213,711	14.4	-11
2002	206,736	13.2	-3
2003	231,033	13.3	12

Source: Hong Kong Census and Statistics Department.

It could be argued that that Hong Kong's role in trade is actually greater than even the re-export figures demonstrate. The Hong Kong government points to the rapid growth of trade services or offshore trade – goods that are traded by Hong Kong entities, but do not actually pass through Hong Kong. This type of activity has indeed been growing significantly, and it now accounts for large amounts of trade between Europe and Hong Kong. But the figures show that Hong Kong's margins in this form of service are significantly lower than for traditional re-exports, and it might also be argued that such services may be replicated elsewhere and may also eventually be eroded by competition from other entrants. In some respects they represent a reduction in Hong Kong's past role, a pure middleman, adding little value. Whether such activities can help to counter the challenge which Hong Kong faces is questionable.

3. Hong Kong in European Investment

Hong Kong is more than a trading centre. The promoters of Hong Kong like to point out that many international, including European, companies set up regional headquarters and offices in the SAR from which they operate a full range of business activities. The figures in Tables 9 and 10 would suggest that Hong Kong is holding its own in this regard as a centre for the regional activities of European companies.

Table 9: Hong Kong Regional Headquarters by Country of Parent Company Incorporation

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
UK	81	91	94	90	84	95	82	81	90	80	86	106
Germany	26	35	33	40	51	59	55	50	56	52	56	67
Netherlands	26	22	28	30	25	27	32	31	48	39	38	46
France	21	26	28	26	35	38	36	28	43	35	44	47

Source: Hong Kong Census and Statistics Department

Table 10: Hong Kong Regional Offices by Country of Parent Company Incorporation

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
UK	102	107	132	123	130	128	124	155	163	163	196	211
Germany	35	52	48	85	78	74	76	93	108	96	122	135
Netherlands	22	46	42	48	47	46	48	65	62	57	55	52
France	20	25	26	31	65	76	74	88	88	91	101	106

Source: Hong Kong Census and Statistics Department

But the trade and investment statistics suggest that despite this, many companies are bypassing Hong Kong. Very many European companies now run their regional (China or Greater China) operations from locations in the mainland, and in some cases their Hong Kong office may now be subordinate to the China headquarters. A few hundred regional offices are only a minor factor in the larger business equation when thousands of European companies now deal directly with China. It is true that Hong Kong has played a huge role in the influx of foreign investment into China over the past 25 years. Indeed, it has been the greatest single source of foreign direct investment (FDI) in China. Not only have Hong Kong companies invested massively in China, but it has also been a preferred conduit for many Western companies investing in China. Nevertheless, there are indications that as with trade, this role is in relative, if not absolute, decline. The evidence suggests that Hong Kong's once dominant role in China's FDI is a thing of the past. Even the UK, not surprisingly by far the largest European investor in Hong Kong historically, now appears to be shifting increasingly to direct investment in China. For European companies, the direct route is increasingly preferred. The following tables show that investment by European countries in mainland China has tended to surpass that in Hong Kong over the past decade.

Table 11: EU Investment in Hong Kong

Unit: Euro million

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Germany	228	48	117	142	-6	74	692	824	-96	285	26
France					77	243	163	208	93	254	123
Netherlands	117	133	204	100	83	-104	-30	194	281	-301	601
UK	588	143	887	897	-519	2272	474	-5429	949	1484	-572

Source: Eurostat

Table 12: EU Investment in China

Unit: Euro million

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Germany	93	212	409	797	1014	574	631	889	1091	943	1573
France					148	116	200	369	169	599	196
Netherlands	-14		79	151	185	-19	246	30	437	171	-220
UK	27	10		251	103	-352	917	673	1065	na	na

na: not available

Source: Eurostat

There is an element of uncertainty in these figures, since it is difficult to track exactly where investment is sourced, and where it ends up. In recent times much inward investment in Hong Kong has actually be re-used in China, or even other parts of Asia. It should also be noted that for both Hong Kong and China, tax havens, most notably the British Virgin Isles, are now leading sources of foreign investment. It is not clear to what extent European companies use these. However, it is known that many Hong Kong companies, including many leading ones, are officially domiciled in tax havens, hence a large proportion of Hong Kong's recorded FDI flows are in fact merely internal movements of funds by local companies. It is also believed that many Taiwan companies use tax havens to invest in China, sometimes through Hong Kong, in order to evade domestic restrictions on investment on the mainland. Given this, the FDI figures are likely to be representative, while failing to provide the full picture. Hong Kong's own figures for FDI inflows show that European investment is relatively small. Although the Hong Kong figures do not fully mirror those of the EU, the trend in the amount of investment is similar. It is worth noting that, in so far as it can be determined, China is by far the largest source of FDI in Hong Kong.

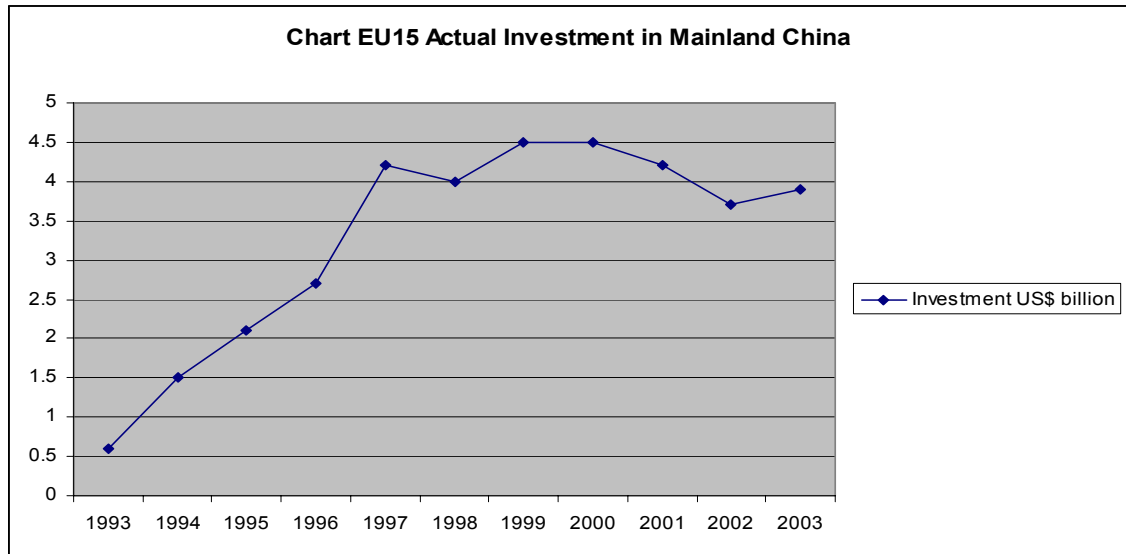
Table 13 Hong Kong Inward FDI

Unit: HK\$ billion

	1998	1999	2000	2001	2002
BVI	30.3	48.8	238.4	74.9	79
China	20.2	38.6	110.7	38.5	32.7
Bermuda	20.7	24.6	36.9	9.9	2.1
Netherlands	13.2	24.3	7.4	-2.3	10.3
USA	6.6	19.1	18.8	11.8	-10.8
Japan	0.6	6.7	25.1	8.5	15.3
Singapore	0.5	5.9	60.2	11.4	6.4
UK	8.3	2	-41.5	7.2	8.6
Cayman Isl.		1.3	11.1	10.9	-68.7
Australia				2.3	0.7
Panama	0.8	1.4	0.4		
Others	7.9	17.9	14.7	12.6	24.3
Total	114.4	190.8	482.2	185.4	99.8

Source: Hong Kong Census and Statistics Department

The EU and Hong Kong FDI statistics shown here are recorded on a net basis, which accounts for some of the sharp swings and negative amounts. On the other hand, Chinese statistics on foreign direct investment (so called ‘actual investment’), which are not recorded in the same way, show that, European investment going directly into China grew consistently throughout the 1990s and, while below its peak of a few years ago, remains strong even when taking into account the decline in global FDI activity that occurred after the boom in the late 1990s.



Source: Ministry of Commerce, PRC

4. Hong Kong, Europe and China

Of course, none of this is really new, or very surprising. What is perhaps more surprising is the degree to which the perception of Hong Kong’s importance to China held sway for so long. Some of the statistics would suggest that by the mid-1990s, at least in some respects, Hong Kong’s role in the Chinese economy had already peaked. As we know, when China opened its economy Hong Kong was able to take advantage. In the late 1970’s Hong Kong’s economic strength in large measure rested on its own manufacturing base which had been built up since the 1950s. It exported its goods all over the world, but its role in trade with China was still relatively limited. Indeed China’s own foreign trade was very small. As China opened its economy in the 1980s, Hong Kong companies expanded their trading activities in China, and also quickly began investing in production facilities, especially in Guangdong province, or more specifically the Pear River Delta. Guangdong province was the recipient of most of China’s inward foreign investment and came to dominate China’s foreign trade, mainly as a result of export processing carried out through Hong Kong. Hong Kong’s own manufacturing base was in large part quickly moved to China where it was able to benefit from the cheap land and labour to enormously expand its activities in a way that would not have otherwise been possible. Hong Kong and its partner Guangdong province came to have a dominant role in China’s foreign trade and investment.

This situation has been changing. The recent huge investment by foreign companies in the Shanghai region, otherwise known as the Yangtze River Delta, is well known. As the following table shows, the foreign trade of Shanghai and the neighbouring provinces of Jiangsu and Zhejiang has been growing much faster than that of Guangdong province, although Guangdong's foreign trade momentarily still outstrips other regions in China. Like Guangdong before it, much of the trade growth in the Shanghai region is being driven by foreign investors and the region has now overtaken Guangdong as a recipient of foreign investment. In 2002, Shanghai municipality accounted for 8.1% of China's actually used FDI, Jiangsu accounted for 19.3% and Zhejiang 5.8%; a total of 33.2% for the three together. Guangdong accounted for 21.5% of FDI in 2002. Only a few years earlier in 1998, however, Guangdong received 26.4% of China's total actually used FDI, whereas Shanghai accounted for 7.9%, Jiangsu only 14.6% and Zhejiang a mere 0.03% (a combined total of only 22.5% for the three). A decade earlier in 1992 Guangdong accounted for 32.8% of FDI in China, and in 1991 for 41.6%.⁵

Table 15 Regional Growth of China's Foreign Trade

	2001		2002		2003	
	Imports	Exports	Imports	Exports	Imports	Exports
Guangdong amount (US\$ billion)	8.1	9.5	10.3	11.8	13.1	15.3
% growth	3.7	3.8	26.6	24.2	27.3	29.1
Jiangsu amount (US\$ billion)	2.2	2.9	3.2	3.8	5.5	5.9
% growth	13.1	12.1	41.6	33.3	71.3	53.7
Shanghai amount (US\$ billion)	3.3	2.7	4.1	3.2	6.4	4.8
% growth	13.3	9.0	22.0	16.0	57.4	51.3
Zhejiang amount (US\$ billion)	1.0	2.3	1.3	2.9	2.0	4.2
% growth	17.1	18.2	27.7	28.0	58.0	41.5
Total China	24.4	26.6	29.5	32.6	41.3	43.8
% growth	8.2	6.8	21.2	22.3	39.9	34.6

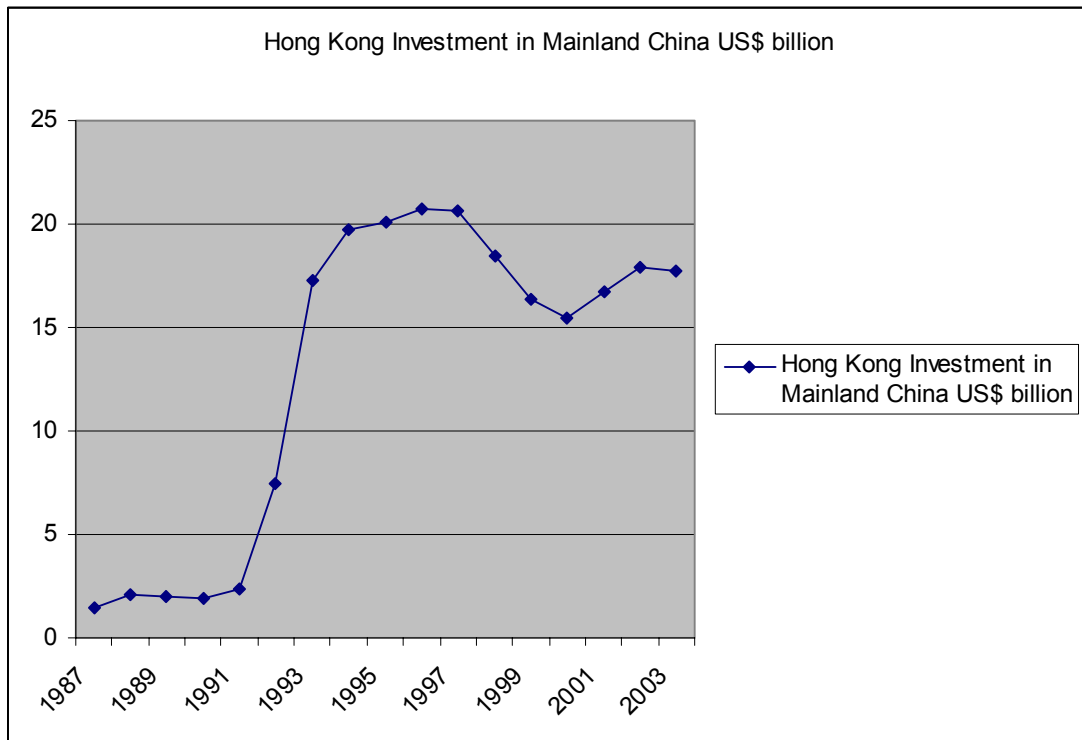
Source: PRC Customs

The mainland is also becoming less reliant on Hong Kong as the main trade intermediary with the outside world. Mainland China's trade with Hong Kong has been declining as a percentage of its total foreign trade as other regions and ports have developed. For instance, in 1991 Hong Kong received 44.7% of China's exports, but by 1999 the figure was only 18.9%, although this was obviously of a much higher total amount of exports.⁶

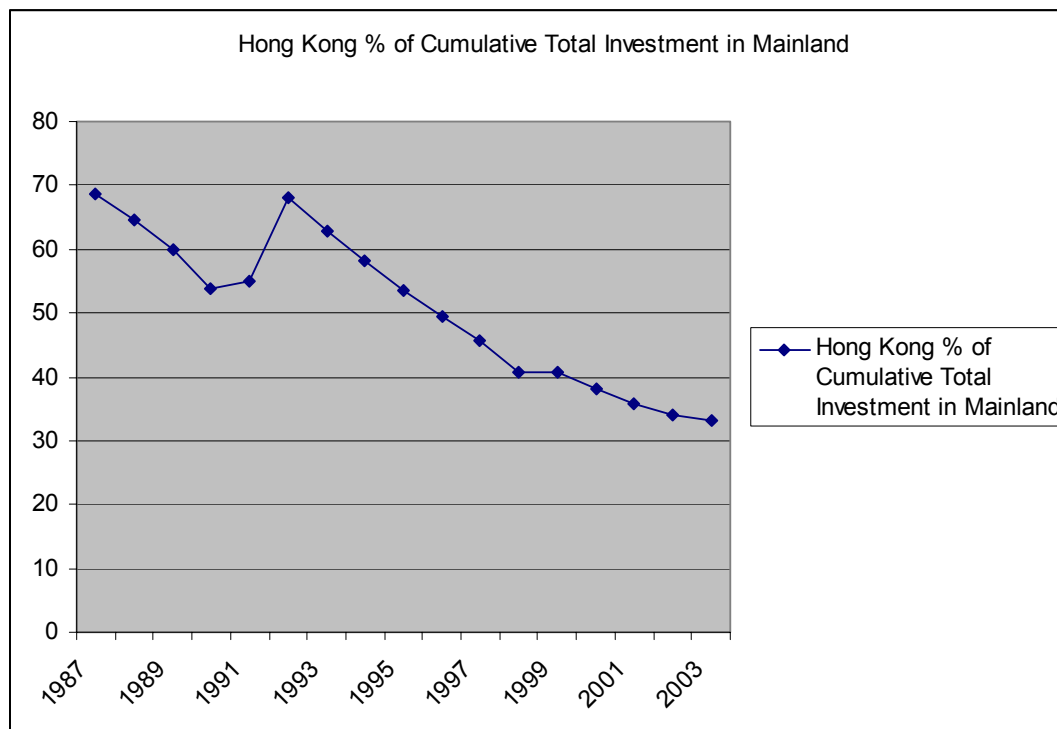
⁵ PRC, Ministry of Commerce.

⁶ PRC Customs.

The relative decline in Hong Kong’s role in the Chinese economy can also be seen from the inward investment statistics, although as we have seen the widespread use of tax havens and the problem of ‘roundtripping’ makes it difficult to estimate exactly what the source of much FDI in China actually is. Until the mid 1990s Hong Kong continued to account for over 50% of the total cumulative actually used foreign investment in China, but since then its share has fallen to about one third. The question of round tripping, mainland funds that are transferred to Hong Kong and then reinvested in the mainland, has long confused the issue of exactly how much investment from Hong Kong is real FDI. Estimates vary, but the consensus is that the level of such roundtripping is likely to have declined as some of the incentives to foreign investors in China have begun to be reduced in recent years. This might in part explain both the relative and absolute declines in the level of Hong Kong investment in the mainland. Even the popularity of using the BVI and other tax havens indicates that at least for some investors this is preferable to routing their investment through Hong Kong, as once might have been the case. But it would not completely explain the fact that while Hong Kong investment in the mainland remains large, its importance has decreased and that investment from elsewhere has become more important for China.



Source: Ministry of Commerce, PRC



Source: Ministry of Commerce, PRC

While Hong Kong had already become an important manufacturing and trading centre before China began its process of opening in the late 1970s, the subsequent changes gave it an enormously enhanced role. Hong Kong became the most important intermediary between China and the rest of the world. Trade and investment flowed through Hong Kong, most of its manufacturing industry moved across the border into Guangdong province, allowing Hong Kong companies to expand to a degree that would have otherwise been very difficult, with the result that the Hong Kong economy enjoyed enormous success. European companies have enjoyed great benefits from Hong Kong. Not only British, but also many other European companies have used Hong Kong as a conduit for business to China and other parts of Asia.

Both the British colonial government and the current SAR administration have said often that Hong Kong's success has been built on a foundation of free markets, rule of law, low taxes limited government intervention. These form the core of the Hong Kong 'advantages' that the SAR now uses as its sales pitch to the rest of the world in order to attract companies to locate there. History, however, would suggest that Hong Kong's success owes as much to consequences of actions by the Chinese Communist Party as it does to a commitment to free markets.

When Hong Kong was returned to China in 1997 it was the single most important colonial remnant of the British Empire, far outweighing the importance of any of Britain's other remaining colonial possessions. At the end of British colonial rule Hong Kong was, and remains, a major international economic centre. This has probably created a misperception of its real historical importance to both Britain and China, and the nature of its role in

mediating between China and the world. Until the World War II Hong Kong was something of a colonial backwater. Even for Britain, Shanghai was of far greater importance as a centre of manufacturing, trade and financial interests in China than Hong Kong. Shanghai was the entry point to the heart of the Chinese economy, whereas Hong Kong, bordering Guangdong province, itself geographically isolated from the centre of the China, was on the periphery.

Events following World War II began the transformation of a relatively minor colonial outpost to a major international economic centre. Rather than commitment to free markets or the rule of law, it was the advent of a successful Communist revolution in China that was the making of Hong Kong. The revolution, by causing many industrialists and financiers to flee Shanghai and many poor farmers to flee Guangdong for the relative safety of a British colony, provided Hong Kong with the capital, skills and labour force which it had lacked before. These allowed Hong Kong to create its first real manufacturing base and the export industries which formed the early foundations for later economic success of the 1960s and 1970s. Hong Kong also had a new role, tolerated by the Communist rulers in Beijing, as a commercial intermediary between China and the outside world. The destruction of Shanghai as a major international commercial and financial centre by the Chinese Communist Party created a new space for the British colony to operate in.

By the 1970s Hong Kong had become a manufacturing and trading centre of considerable significance, and to a lesser extent a financial centre as well. However, it was the decision of the Chinese Communist Party under Deng Xiaoping to embark on economic reform and opening that was to allow Hong Kong to transform itself into the primary point of contact between the Chinese and world economies. From the earliest establishment of the Special Economic Zones and the promulgation of the first joint venture laws Hong Kong has benefited from this process. By the 1990s Hong Kong, it seemed, had discovered a magic formula for economic success. The illusion was perhaps all the more dangerous for having being based on the enormous achievements of the people of Hong Kong and their undoubted economic successes. Business boomed, many people, though not everybody, got rich, and the Hong Kong economy was transformed.

The Hong Kong economy has not performed well in recent years, especially when compared with the decade from the mid-1980s to mid-1990s. True, there are a number of explanations for this: the Asian Financial Crisis, indifferent world economic performance and SARS, have all played a role. Nevertheless, while these specific events have been challenging, the real challenge for Hong Kong is a long-term one. The question for Hong Kong now is whether it can meet the challenges of its changing environment and once again refocus its economy as it has done in the past to meet new needs.

Before 1997, many observers foresaw problems for the Hong Kong economy, but contrary to almost all predictions made then, and sometimes even after, the difficulties of Hong Kong have had little to do with the return to Chinese sovereignty. The real sources of Hong Kong's difficulties were largely

unforeseen. The aura of success, and the approaching resumption of Chinese sovereignty perhaps blinded Hong Kong, including its government, political and business leaders, to the real the challenges around them. For most people in Hong Kong during the 1990s the only measure of their own and Hong Kong's economic success that really mattered was the value of real estate, not economic performance in relation to the region in which it was situated. As a result, few in Hong Kong appreciated the changes that were occurring around them.

5. Hong Kong and Europe: Partners Forever?

Hong Kong still promotes itself as the strategic location for doing business in China, and this is the pitch its government and business community make in Europe and elsewhere. Nevertheless, it is now facing new challenges. The boom in China trade and investment and the opening of the Chinese economy in which Hong Kong led the way has also been to some extent its undoing. Hong Kong now has to compete in a way that it did not have to in the past. Thousands of European companies, not just major multinationals, have been investing in and trading with China for many years. They are experienced, have built up their own presence in China, and learned how to do business there. Fifteen or twenty years ago a major European company entering China would almost certainly have first considered setting up an office or finding an agent in Hong Kong. Although Hong Kong boasts a great fund of expertise in dealing with China, today even small European companies with little or no experience of China go straight to Beijing, Shanghai or even more remote parts of the mainland to set up their businesses or find local Chinese partners. The process has accelerated since China joined the WTO and opened its economy even further. The implications of China's accession to the WTO were a matter of debate in Hong Kong between pessimists who argued that it would undermine the SAR's position and the optimists who believed that it would create new opportunities. While WTO membership has undoubtedly accelerated trade and investment flows to China, it is as yet unclear what the full impact on Hong Kong will be.

Not only have Europeans learned how to do business with China, but the reverse is also true. China has now much greater capacity to deal with the outside world. Tens of thousands of Chinese have worked with and for foreign companies and tens of thousands have studied abroad and then returned to China. It is no longer clear that Hong Kong offers any particular advantage as an intermediary. While Beijing was willing to allow Hong Kong to act as a useful middleman, it was never its intention for a British colony or even a Special Administrative Region of the People's Republic to be the arbiter of, or to dominate, its business dealings with the rest of the world. Similarly, many Chinese companies clearly have ambitions to become major international players and will not be satisfied to allow middlemen to come between them and the outside world. The next stage of economic relations between China and Europe may very well be the expansion of Chinese investment in the EU, and in this it is unclear what role, if any, Hong Kong could play.

Hong Kong has sold itself partly on its linguistic and cultural affinity to the rest of China. Even this is not necessarily all that it might seem. While the citizens of Guangdong may admire and wish to emulate their cousins in Hong Kong, these are not sentiments widely shared in other parts of China. Hong Kong's history and culture are separate from the mainland, and apart a certain facility with the Chinese language, the Hong Kong Chinese do not necessarily hold any particular advantages over businessmen from most other parts of the world when dealing with their mainland counterparts.

China is made up of regional economies. The Pearl River Delta is in many ways as isolated from the rest of the Chinese economy as it was when the British first seized Hong Kong. The old geographic barriers between Guangdong and the north remain. Its location on the periphery, which favoured Hong Kong when the first experiments with foreign investment and Special Economic Zones were launched in the late 1970s, makes it less attractive today. The geographic barriers are reinforced by the localism and the regional barriers that have resulted out of 50 years of a planned economy and 20 years where each province has sought to promote its own economy without any effort at rationalisation at the national level. The Pearl River Delta is in many ways more integrated into the world economy with the rest of the Chinese economy. Economic development in China depends as much on political influence as it does on competitive advantage, and Hong Kong has no real political weight in China. Unlike Shanghai, which benefited from the support of the central government throughout the 1990s, Hong Kong has no 'faction' in Beijing play favourites with.

One great advantage that Hong Kong has that it did not have a hundred, or even 50 years ago, is a developed economic hinterland that certainly in some sectors has achieved world class levels. The regional integration of the Pearl River Delta continues apace. Coordination of infrastructure projects will increase the ability of Hong Kong to exploit its advantages in the region. But even here Hong Kong cannot necessarily expect any favours. Mainland China has a system of bureaucratic economic competition, with governments at provincial, city and local levels promoting their own economies. Each of these aims to capture the maximum economic advantage for their own region without considering the wider economic rationality. While the authorities in Guangzhou are happy to cooperate with Hong Kong if it is to their own advantage, they will also continue promote their own plans, including port, airport and other infrastructure projects that compete with Hong Kong, if they believe it hold a greater benefit for them. Even within the Pearl River Delta, Hong Kong will have to compete to stay in the game. Many European companies doing business in that region, for instance, now settle in Guangdong rather than Hong Kong.

Since 1997, Hong Kong has largely slipped out the international consciousness except during various, usually political, crises. Indeed, ever since the build up to 1997, for most people in the West, Hong Kong has been a political rather than an economic story. Prior to 1997, many observers predicted that Beijing's control of Hong Kong would be largely felt in the political arena, and that such control would also lead to damage to the Hong Kong economy, especially since

it was believed that the new SAR would be engulfed in a wave of corruption emanating from the mainland.

In fact, although there have been conflicts between the aspirations of most people in Hong Kong for greater democracy, and the conservative instincts of most of the business and government leadership, the resumption of Chinese sovereignty has had less of a direct impact on the Hong Kong economy than many predicted. Hong Kong has not fallen under the sway of Communist Party bureaucrats, nor, apart from a few well publicised scares, has it become particularly more corrupt than before 1997. The central political problem for Hong Kong is the stasis of the partly democratic system that creates an opposition with a democratic mandate and the freedom to criticise but no prospect of responsible power and an executive with freedom to act but little authority. The political paralysis in Hong Kong, compounded by the lack of dynamism and leadership of the Chief Executive and many figures in his administration, has not necessarily helped the cause of the Hong Kong economy.

Not surprisingly, the SAR government has been criticised from almost all sides in Hong Kong in the past few years for its policy failures, especially in the face of the crises that have occurred. Clearly, the government has failed to get to grips with many of the problems that Hong Kong has faced in recent years, not least those of the economy. It has struggled to react to events, some beyond its control, others not, rather than pursuing any clear strategy. As we have seen, Hong Kong is to a large extent at the mercy of forces beyond its control. Even with the best of strategies, it is unclear that it would have completely escaped the effects of external economic and political events. Hong Kong has attempted to address some of the issues related to its own productivity or competitiveness, and in this it has been aided by several years of deflation and falling real estate values. While the Hong Kong government attempts to redress some of the previous domestic policy failings it also promotes closer economic integration by such means as infrastructure development and the recent Closer Economic Partnership Arrangement (CEPA) which allows certain Hong Kong products and services preferential access to the mainland. This has been hailed by the Hong Kong authorities as a major step in regaining Hong Kong's leading position for doing business in China. On the surface this might appear to allow Hong Kong companies, including those set up by foreign investors, great advantages in doing business there, but in the post WTO China, the advantages offered by this agreement are unlikely to fundamentally alter the equation for most European companies looking at where to conduct their business in China.

Hong Kong today needs to promote itself in a way that would have been unthinkable a decade ago. The efforts of Hong Kong to promote itself range from the pragmatic (Hong Kong as a key location in the Pearl River Delta) to controversial (Cyberport) to the fanciful (Hong Kong as 'Asia's World City'). For Hong Kong to continue to count in Europe, it will have to convince European companies that it has something to offer them. While the Hong Kong government attempts to present the advantages that it offers to companies operating there, the fact is that many businesses no longer rate these advantages highly enough to outweigh the benefits of bypassing it.

Some European companies are still willing to work through Hong Kong. For certain sectors, Hong Kong certainly retains advantages. Over the past two decades Hong Kong has grown into a significant financial centre, and for the moment the banking and finance sectors remain unchallenged in China, despite the emergence of Shanghai. The Hong Kong government is eager to promote the service economy, and for some sectors the Hong Kong 'advantages' will remain critical, but for many they will not. The Hong Kong government hopes that the traditional trade in merchandise will be supplemented by trade in services. While these sectors have been undoubtedly growing, it is not clear that this will be a successful strategy in the long term. On the other hand, China's economic development will not bring an end to Hong Kong's prosperity or its role as an intermediary, as some of the more dire predictions might imply. For instance, it should not be assumed that Hong Kong is competing against Shanghai to be the single international business centre in China and that the success of one means the death of the other. On the contrary they will play complementary roles. But it will mean a diminished role for Hong Kong, one which will require it to undergo a measure of transformation.

Some outside Europe who feel that 'Europe' is paying them insufficient attention point to enlargement as the reason for their being ignored – the argument being that Europe's self-preoccupation has diverted attention that should be spent on the world at large. Europe's internal preoccupation, or the idea of a 'fortress Europe' is sometimes used in Hong Kong to explain the fact that Europeans fail to appreciate what is happening on the other side of the world. While this may be true in the institutional sense in that for Member State governments and the European institutions the question of enlargement has been an enormous preoccupation, it is not true in a wider sense. European media, business circles and the public demonstrate a fascination with developments in China. Unfortunately, today this rarely encompasses Hong Kong. European enlargement itself, while it has greatly enlarged the internal market, has apparently made little difference to trade and investment with China and Hong Kong, for the moment. The new Member States so far have only a minor role in exchanges with either Hong Kong or China, although one possible effect of enlargement may be to divert some investment that would otherwise go to China in search of lower costs to Member States closer to home.

In a world where enormous European interest is focused on mainland China, Hong Kong will struggle to be noticed. Perceptions have changed over the past few years. Despite the fact that Hong Kong and Europe are both important to each other, it is probably true that Hong Kong needs Europe today more than Europe needs Hong Kong. Whereas Europe continues to be perceived as an important economic partner by Hong Kong, for Europeans the reverse is no longer always the case. The European Union and individual Member States continue to have an interest in Hong Kong, and will ensure that their interests are advanced. Given the role that the EU now plays in the economic sphere, the actions it takes towards Hong Kong may even be, on occasion, more important than those taken by Member States. But the economic relationships will largely be determined by actions outside the purview of these actors. Hong Kong has

attempted to redress some of issues of concern for European companies, but the jury is out on whether any policies so far adopted will really permit it to recapture past glories.

Conclusion

The improved performance of the Hong Kong economy in 2004 gives some sign of hope that it has finally begun to return to the path of success, but it will still have to work hard to sustain the momentum. Europe retains a strong presence in Hong Kong, but that presence, and the relationship it represents, is undergoing a change. Relatively speaking, it is certain that the relationship is becoming less significant, as European companies increasingly deal directly with China. Even in absolute terms there are indications that the Hong Kong is becoming less important to Europe as a place of business. How far this process will go, and the future direction it may take is difficult to predict. For Hong Kong this is part of a wider challenge to once again reposition its economy.

At the European level Hong Kong is a relatively minor consideration when compared with the other actors in Asia, notably China. For Hong Kong, however, the ability to continue to attract foreign companies, including those from Europe, to doing business there is vital. While Hong Kong attempts to sell itself and to address some of the problems facing its economy, it is unclear to what extent long- term success can be assured. Hong Kong will continue to attract the admiration and sympathy of many in Europe, but it also need to sway hard nosed decision makers in business.

References

Statistics on China's foreign trade and investment can be found at:

Ministry of Commerce <http://www.mofcom.gov.cn/tjzl.shtml>

Statistics on Hong Kong can be found at:

Hong Kong Trade Development Council <http://stat.tdctrade.com/>

Hong Kong Census and Statistic Department <http://www.info.gov.hk/censtatd/>

Hong Kong Monetary Authority <http://www.info.gov.hk/hkma/>

Information on Hong Kong's efforts to promote itself can be found at the following official websites:

<http://www.firstchoicehongkong.gov.hk/>

<http://www.investhk.gov.hk/>

<http://cepa.tdctrade.com/>

EU statistics on trade and investment with Hong Kong and China can be found at:

http://epp.eurostat.cec.eu.int/portal/page?_pageid=1090,1137397&_dad=portal&_schema=PORTAL

Background on the EU and Hong Kong can be found at:

Office of the European Commission in Hong Kong and Macau
<http://www.delhkg.cec.eu.int/en/>