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Clouded Destiny

How Hong Kong is losing its edge.

By Friedrich Wu, Philipp Martin Dingeldey, and Wan Tin Wai

With the recent rejection by the Hong Kong legislature of Beijing's proposed election reform plan for the Special Administrative Region, China's "one country, two systems" model for Hong Kong is now facing the greatest challenge ever. The legislative veto is bound to create a prolonged period of political stalemate, deepening the divide between democracy advocates and the pro-China camp, as well as ushering in an era of economic uncertainty for the territory. However, even without this latest political blowup, the "Umbrella Revolution," which erupted last October and spurred thousands of protestors to occupy public areas over a three-month period, was already a clear manifestation of the local people's long-standing discontent with what they perceive as an unresponsive and unrepresentative SAR government. They hold this government responsible for the development of several economic and social "fault lines" that have negatively affected their livelihoods.

Hong Kong's "fault lines" stem from chronic income stagnation and growing inequality, the soaring cost of living driven by ever-rising housing prices, and depressing employment prospects for the young, especially

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those without a university education. According to the Census and Statistics Department, the real wage index for non-professional and non-managerial employees has been on a secular downward trend for several years. Even university graduates in Hong Kong are facing increasingly bleak employment prospects due to oversupply by eight government-funded academies plus a myriad of privately funded post-secondary institutions, as well as a mismatch between salary expectations and skills. Meanwhile, the city's Gini coefficient has climbed to a record high, from 0.518 in 1996 to 0.537 in 2014. According to the Economist Intelligence Unit, Hong Kong's prices for general basic groceries are 31 percent higher than those in New York, making it the most expensive city for expatriates in Asia. Likewise, housing prices are severely unaffordable, with the city's median household income (US$34,834) being one-fifteenth of the city's median home price (US$518,653).

In a startling report in August 2014, two months before the widespread street protests, Trigger Trend, a research firm based in Guangzhou, contended that "Hong Kong is losing its edge as a global financial and commercial center, and the territory's economic clout will be overshadowed by China's major cities by 2022." Hong Kong's eroding competitiveness is a result of government inaction as well as rapid economic progress in China.

The root causes of the "fault lines" originate from the government's fiscal dependence on high land prices through its continued collusion with real estate developers, which have sent housing prices skyrocketing in recent years. The "Crony Capitalism Index," constructed by *The Economist* (15 March 2014), which measures the extent of business tycoons profiting from close relationships with government officials, placed Hong Kong in the very top position in 2014.

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Besides alleged business-government collusion, the city suffers from an unsustainable economic structure which deepens the "fault lines." Until the late 1980s, Hong Kong's economy had four industry pillars consisting of finance, trade and logistics, regional headquarters services for multinationals (professional services), and manufacturing. The four pillars have been reduced to three in the last two decades, as the manufacturing sector has completely migrated to China. But the remaining three pillars are further shrinking since the city's cost competitiveness continues to erode without a corresponding increase in efficiency and productivity.

Hong Kong is now facing several risks that may threaten its leading position as an international financial hub in Asia. The financial sector mainly generates its revenue via the stock market by trading shares and launching mainland Chinese initial public offerings, as well as through its international banking sector. Nevertheless, in November 2014, a *Financial Times* article named Hong Kong as the worst place to invest in Chinese IPOs, with transactions in the territory recording lower-than-average returns and a higher chance of losses compared to the Shanghai or New York Stock Exchange. Alibaba, for example, chose to list on the New York Stock Exchange in 2014, despite stating earlier that HKEx was its preferred stock exchange. HKEx was unable to change its shareholders' rules to accommodate the listing, missing out on the high-profile IPO, which could have greatly boosted its IPO volume and total revenues. Fundraising is also increasingly being diverted from Hong Kong, with Deloitte reporting that for the first three months in 2015, the Shanghai Stock Exchange surpassed HKEx and New York Stock Exchange for the first time in IPO fundraising. This development was mainly caused by the increased effort of the China Securities Regulatory Commission to reduce the required procedures to list new shares, although this policy has been reversed since July when Shanghai and Shenzhen have fallen into bear markets.

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The establishment of the Shanghai Free Trade Zone in 2013, set to become the "global center of yuan trading, clearing, and pricing," poses a significant and inescapable threat to Hong Kong. The renminbi's progressive internationalization and China's impending capital account liberalization will facilitate the rise of Shanghai as financial center. The unreserved backing and commitment of the Chinese government toward the development of the Shanghai Free Trade Zone, in sharp contrast with the Hong Kong government's dearth of policy direction, are bound to give Shanghai a competitive edge in the long run. Offshore RMB payments are increasingly handled by centers beyond Hong Kong, with the share of these centers growing from 17 percent in 2013 to 25 percent in 2015. This is clear evidence that Hong Kong is losing its edge as the premier offshore RMB center. In short, facing multiple challenges, Hong Kong's status as a financial hub will be less than secure going forward.

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Hong Kong's position as an international trade hub is at stake with its logistics sector facing increasing competition from southern China. Since 2000, Hong Kong Port's business has continuously shifted from handling direct cargo to transshipment cargo, and since 2008 overall container throughput has been in relative decline. In the past, Hong Kong's location was its main advantage for shippers to get cargo in and out of China. However, over the years, Chinese ports have caught up fast in areas that once made the port of Hong Kong attractive, making it less and less advantageous for shippers to directly ship to Hong Kong.

For example, Shanghai's port is becoming a tough competitor as it offers a vast hinterland economy and improved maritime services in its free trade zone. As a result, Hong Kong's importance for handling direct cargo intended for southern China is in secular decline, decreasing from 76 percent to 39 percent between 2001 and 2011, and translating into its growing dependency on transshipment cargo. Unfortunately, transshipment cargo is less profitable than direct cargo since transshipment operations require logistical adjustments such as onsite storage facilities. Such adjustments have not been implemented at the port of Hong Kong, resulting in more time taken in cargo handling and dwelling, decreasing overall efficiency.

This, coupled with higher handling charges compared to its southern Chinese competitors, makes Hong Kong not only less efficient but also more expensive. For example, Hong Kong charges US$276 per twenty-foot equivalent unit, whereas Shanghai's port only charges US$185 per TEU. BMT Asia-Pacific recently forecast that international transshipment will constitute the lion's share of overall throughput growth for Hong Kong until 2030, thus further increasing its vulnerability to international trade shocks.

Last but not least, Hong Kong also faces mounting challenges to its attractiveness as a hub for multinational corporations' regional headquarters. The costs of living for expatriates and for doing business have increased vastly, the city's pollution is nearly on par with that of mainland cities, fiscal incentive packages *vis-à-vis* other mainland cities are lacking, and the influence of Beijing in the city's political landscape is rising.

At first glance, the number of regional headquarters in Hong Kong has grown constantly since 2010, mainly due to its competitive tax system. Nevertheless, of the 1,389 multinational corporation regional headquarters reported by Invest Hong Kong, more than half employ less than twenty workers, thus inflating the overall number of regional headquarters and their ostensibly regional functions.

Hong Kong's high cost of living and employment and soaring rents, as well as a shortage of locals with appropriate skills, translate into high operating costs for multinational corporations. Mercer rated Hong Kong as the most expensive location in the Asia-Pacific region for expatriates in 2014. According to a mid-2015 survey by CBRE Research on global prime office occupancy costs, Hong Kong's prime office market is ranked the most expensive in Asia. At an estimated average of US$254 per square foot, it is more than double Shanghai's US$118 per square foot. Shanghai, on the other hand, offers close proximity to Chinese clients and the world's largest consumer market, direct access to distribution channels and production facilities, lower operating costs and cost of living, as well as comprehensive incentive packages.

Moreover, in Shanghai's favor, once granted the status of newly established regional headquarters by the city's municipal government, multinational corporations enjoy a myriad of benefits which include financial bonuses, subsidies, and eased immigration procedures. In 2014, Shanghai had nearly five hundred multinational corporations' regional headquarters, including the likes of Acer, FedEx, General Electric, and Roche. Short of government action to counteract these challenges, Hong Kong will gradually lose its attractiveness as a hub for regional headquarters compared to other cities in the region including Shanghai and Singapore, thus further undermining its economic future.

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With the steady erosion of competitive advantages of Hong Kong's main industry pillars, a fractured government which espouses an archaic policy of "positive non-interventionism," and an economy dominated by self-serving crony capitalists, Hong Kong's decline seems as inevitable as it is inexorable. Last year's popular Umbrella Revolution may thus be seen as a manifestation of the people's desire to directly elect a more responsive and activist government that can help reverse Hong Kong's declining economic fortunes. Businessmen and investors do not seem to fear the protests *per se,* but are more concerned with the weakening of the city's policy environment, which may in turn affect the business environment. However, with the recent rejection of Beijing's proposed election-reform plan but without a second option, the city's Legislative Council will become even more divisive, creating political gridlock and policy uncertainty going forward. With the Hong Kong government in limbo, unable to secure policy consensus, the territory's "fault lines" will only deepen and widen. Meanwhile, as more disaffected residents take their issues to the streets, business confidence will turn more fragile, when political and social strife inevitably spreads and shakes the foundation of Hong Kong as a preferred business location in the Asia-Pacific. The once-vaunted "Pearl of the Orient" now faces a clouded destiny. ◆