II Economic Integration Between Hong Kong SAR and Mainland China

Tao Wang and Hong Liang

Hong Kong SAR’s economic ties with the mainland have strengthened since its return to Chinese sovereignty in 1997. Following the relocation of most of its manufacturing production to the mainland in the 1980s and early 1990s, Hong Kong SAR is going through another structural transformation as its economic integration with the mainland deepens in other dimensions. The recently signed Closer Economic Partnership Agreement (CEPA) has provided Hong Kong SAR-based businesses and professionals with access to mainland markets before broader market access to them is provided under China’s commitments to the World Trade Organization (WTO). Against this background, this section reviews the process of economic integration between Hong Kong SAR and the mainland, and the policy implications for Hong Kong SAR.

How Much Integration Has Taken Place?

Hong Kong SAR’s economic links with the mainland expanded rapidly in the 1980s and the first part of the 1990s, with Hong Kong SAR becoming the most important trade and international fund-raising center for the mainland. Since Hong Kong SAR’s return to Chinese sovereignty in 1997, integration between the two economies has deepened: mainland-related entrepôt trade has continued to increase; a large share of China’s foreign currency financing is raised in the Hong Kong SAR financial market; a growing range of economic activities are becoming integrated across the border; and business in Hong Kong SAR has increasingly become focused on China-related activities.

Trade

When China began opening up in the late 1970s, Hong Kong SAR’s role as an entrepôt was quickly revived, and it became the main intermediary of China’s external trade (Cheng and others, 1998). Despite a decline in recent years in the share of China’s external trade conducted through Hong Kong SAR, it is still around 40 percent.

As manufacturing activities moved across the border, Hong Kong SAR’s economy gravitated toward trade intermediation, and the value of its reexport trade, almost all of which is related to the mainland, is now larger than its GDP. After the mainland opened up, Hong Kong SAR businesses quickly moved their manufacturing bases to southern China while expanding their entrepôt activities. As a result, the share of manufacturing output in Hong Kong SAR’s GDP dropped sharply (to 5.2 percent in 2001 from 24.2 percent in 1984), while that of reexports in total exports more than doubled (to 91.6 percent in 2002 from 37.7 percent in 1984). Almost all of Hong Kong SAR’s reexports either originate in or are destined for the mainland. The ratio of reexports to GDP has more than tripled since 1984, to 113 percent in 2002.

Entrepôt trade with the mainland and related services are thus critically important to Hong Kong SAR’s economy. Total trade—excluding offshore trade—is equivalent to more than 250 percent of GDP, and its contribution to GDP is close to 10 percent (Figure 2.1). In addition, Hong Kong SAR is handling an increasing amount of offshore trade. A survey done in 2001 estimated that the volume of Hong Kong SAR’s offshore trade, which has doubled over the past decade, is about the same as that of reexports. More than one in six people employed in Hong Kong SAR are engaged in import and export trading, which contributed some 20 percent to GDP in 2001. This figure does not include trade-related services, such as insurance and financing, sea and air transport, freight forwarding, and advertising and marketing, that, if taken together, would significantly increase the contribution of trade-related activities to GDP.

1Defined as merchandise trade handled by Hong Kong SAR companies or their subsidiaries but not going through import-export declaration in Hong Kong SAR. It includes both “transshipment” and “offshore trade” as classified in the fifth edition of the IMF’s Balance of Payments Manual.
Finance

Hong Kong SAR has been the most important source of international capital for the mainland. This financing has come in the form of foreign direct investment (FDI), equity and bond financing, and bank lending. (See Section VII for a more detailed discussion of the points noted below.)

- As of 2002, cumulative FDI into the mainland from Hong Kong SAR (from 1979 onward) was estimated at about US$205 billion, or about 45.9 percent of China’s total FDI. Although the share of FDI flows from Hong Kong SAR has decreased recently, it still accounted for more than one-third of total FDI flows to the mainland in 2002;
- All but one of the 58 Chinese state-owned enterprises (SOEs) listed abroad at the end of 2001 were listed in Hong Kong SAR, where they had raised a cumulative amount of US$16.6 billion. In 2000, China-related companies (both “red chips” and “H shares”) raised a record US$44 billion in the Hong Kong SAR market (Jiang and others, 2001);
- China has raised more than US$4 billion in the Hong Kong SAR bond market (out of $14 billion worth of bonds it has placed outside the mainland) in the last 10 years. Four issues of mainland sovereign bonds were carried out in Hong Kong SAR, and five mainland issues of nongovernment bonds were listed on the Hong Kong SAR exchange at the end of 2002;
- The stock of Hong Kong SAR banks’ direct lending to mainland entities totaled some US$37 billion, or about 70 percent of total foreign bank lending to the mainland, in 1999 (IMF, 2000 and 2001). Lending to the mainland by Hong Kong SAR banks has since declined, in part owing to the financial problems of some debtors;
- Hong Kong SAR banks have also been active in arranging syndicated loans and floating-rate notes for use on the mainland. At their peak in 1997, syndicated loans to the mainland arranged by Hong Kong SAR banks totaled US$6.1 billion.

The growing presence of mainland firms and their capital-raising activities has contributed to the development of Hong Kong SAR’s financial markets. For instance, the growing number of mainland firms in the equity market has attracted an increasing number of international funds to Hong Kong SAR, which earned good returns: during 1996–2000, the red chip index was up 36 percent, compared with 15 percent for the rest of the market.

Other Business Activities

Hong Kong SAR-funded firms now employ an estimated five million people in China, mostly in manufacturing. Some low-end services, such as retail trade, recreation and leisure, accounting and back-office operations of banks, and some trade-related services, have also started to relocate across the border (CLSA Emerging Markets, 2001). As a

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2Some of the FDI flows may be “round-tripping” from the mainland to take advantage of the preferential treatment of foreign investors in China.

3A number of them are also listed in New York.

4“H shares” are shares of mainland-incorporated companies listed in Hong Kong SAR, while “red chips” are shares of Hong Kong SAR-incorporated companies with a controlling stake held by state-owned organizations or provincial/municipal authorities on the mainland.

5Hong Kong SAR banks’ direct exposure to the mainland is relatively small, amounting to less than 3 percent of total assets of the banking sector, although their indirect exposure is likely to be higher, since a portion of loans booked for use in Hong Kong SAR are actually used by the borrowers for their mainland operations.

6In particular, the problems of international trust and investment corporations (ITICs). The net liabilities of Hong Kong SAR banks to mainland clients have recently increased sharply, largely reflecting the ample liquidity conditions on the mainland and the shrinking exposure of Hong Kong SAR banks to the mainland. There has also been increased lending—although from a very small base—by mainland banks to Hong Kong SAR companies, in part to finance the latter’s mainland operations.

7Excluding Hong Kong and Shanghai Banking Corporation (a large participant in the market that has seen its share price rise by more than 40 percent during this period).
result, the share of factor income that comes from the
mainland has almost tripled, to 23 percent in 2002
from 8 percent in 1995.

As the number of Hong Kong SAR residents vis-
itng Shenzhen and other nearby mainland cities for
shopping, entertainment, and leisure has increased,
the number of people who live and work on different
sides of the border has also increased. Between 1990
and 2002, the number of Hong Kong SAR residents
visiting the mainland more than tripled, to 56 million
departures (implying that Hong Kong SAR residents
averaged eight visits each in 2002). It is estimated
that Hong Kong SAR consumers spent HK$19.6 bil-
dlion in connection with personal travel in Guang-
dong, equivalent to 11 percent of Hong Kong SAR
retail sales, in 2002. Moreover, an estimated 198,100
Hong Kong SAR residents worked on the mainland
in 2002, up from 52,300 in 1988.

Mainland’s Presence in Hong Kong SAR

The mainland of China has become a major source
of FDI for Hong Kong SAR. By the end of 2001, the
mainland had invested US$123 billion in Hong Kong
SAR (29.3 percent of its total inward FDI). Many
firms and government entities have set up offices in
Hong Kong SAR to gain international exposure and
market opportunities. An estimated 2000 mainland-
related companies are currently operating in Hong
Kong SAR, with an important presence in the trad-
ing, real estate, insurance, transport, finance, and
construction sectors. At the end of 2000, 24 branches
of mainland banks accounted for 16 percent of total
assets and 21 percent of deposits in the Hong Kong
SAR banking system (Hong Kong SAR Census and
Statistics Department, 2001).

A rising number of visitors from the mainland has
helped sustain the Hong Kong SAR tourist industry.
In 2001, mainland visitors contributed 37 percent of
Hong Kong SAR’s tourist receipts, and the number
of visitors increased by another 53.4 percent in
2002.

Correlations of Economic and Financial
Developments

Hong Kong SAR’s economy is increasingly corre-
lated with the mainland’s external sector, though not
its overall economy. On the one hand, the correlation
between Hong Kong SAR’s GDP and China’s exter-
nal trade has been strong and has tended to increase
in recent years (Figure 2.2).8 On the other hand, since integration of other sectors is still at an early

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8Measured by the correlation of estimated deviations from
trends over moving subperiods.

Figure 2.2. Correlation of Hong Kong SAR’s
GDP and China’s Trade Growth1
(Correlation coefficient)

Source: IMF staff estimates.
1A 20-quarter rolling correlation, based on data from 1994 to
2003.

Outlook for Further Integration with
the Mainland

Hong Kong SAR’s integration with the mainland
will deepen in the coming years, with the mainland
economy opening up further following WTO acces-
sion (Aziz and others, 2000; and Hong Kong SAR
General Chamber of Commerce, 2000). This process
is expected to spur additional realignment of output,
trade, and investment patterns, and financial flows in
the region. In the near term, Hong Kong SAR is
likely to benefit from increased trade and investment
activities between the mainland and the rest of the
world, given the excellent “starting position” that
Hong Kong SAR companies have in intermediating those activities. The zero-import-tariff preference and the WTO-plus market-liberalization measures for trade in services would give companies in Hong Kong SAR a further advantage. In the longer run, however, Hong Kong SAR’s traditional role as a middleman will likely diminish, with sources of growth shifting increasingly to higher-value-added service sectors.

**Trade**

In the next few years, Hong Kong SAR will benefit from increased trade between the mainland and the rest of the world. Even after two decades of rapid growth, China’s exports still account for only about 5 percent of world exports. Given China’s large labor supply and cost competitiveness, as well as its rising domestic demand, significant scope remains for continued strong expansion of China’s trade. (See Rumbaugh and Blancher, 2004.)

Hong Kong SAR’s efficient port facilities, trading experience, global logistics network, and agglomeration of trading activities will be hard to rival in the near future. Hong Kong SAR is endowed with a natural deepwater, silt-free harbor, strategically located on major sea routes and with China’s export growth engine, the Pearl River delta, as its hinterland. Nearby ports of the mainland do not yet pose a serious challenge; rather, the about twenty small-to-medium-sized ports in the region could complement Hong Kong SAR’s port services, helping to lower their overall costs. Hong Kong SAR also has the advantage of major port agglomeration with extensive port and freight-management experience, permitting it to provide complete services, including insurance and finance. A new terminal (to be phased in beginning in 2003) will add significant capacity, providing a solid basis for handling additional trade with China.

Nonetheless, mainland port facilities are improving, and the economy of the Yangtze River basin is gaining in importance. Ports in southern China have expanded rapidly, and mainland exports handled by Hong Kong SAR companies are increasingly shipped directly from the mainland rather than through Hong Kong SAR. Growing competition will come, especially from Shanghai and its surrounding ports, which are situated in the middle of China’s coastline, with easy access to the large economic zone along the Yangtze River. Given its location and large industrial base, the Yangtze River region will likely gain further importance as a major engine of growth and exports (Box 2.1).

As China continues to liberalize trade and investment, direct access between the mainland and the rest of the world will increase, potentially bypassing Hong Kong SAR. Under China’s WTO commitments, more Chinese firms will be allowed to engage in direct external trade, distribution, and transportation services. At the same time, restrictions on foreign companies are being reduced or abolished. Although Hong Kong SAR companies are also expected to benefit from such liberalization, they

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9A recent survey by the Trade Development Council shows that such direct shipments doubled between 1994 and 2000.
Outlook for Further Integration with the Mainland

will face intensified competition from both mainland and foreign firms. Hong Kong SAR’s traditional role as a middleman for mainland trade is therefore likely to diminish over time. Reexports are likely to increasingly shift to offshore trade (Table 2.1) or bypass the Hong Kong SAR connection altogether. Although the initial increase in the mainland’s overall trade will likely dominate the trade-diversion effects, Hong Kong SAR will eventually have to reduce its reliance on entrepôt trade for the mainland.

**Financial Services**

With the mainland opening up its financial sector, some foreign financial institutions are likely to relocate their China-related activities from Hong Kong SAR to the mainland, especially Shanghai. Lower business costs and proximity to business and clients

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Box 2.1. Hong Kong SAR and Shanghai: A Comparative Perspective

**Hinterland**

Narrowly defined, Hong Kong SAR’s hinterland is the Pearl River delta; more broadly, it could be viewed to include the whole of Guangdong province. Shanghai’s hinterland is the Yangtze River delta or, viewed more broadly, may include Jiangsu and Zhejiang provinces. Guangdong province has been the main export engine of China, but Jiangsu and Zhejiang have the potential to catch up, given their large populations and industrial bases and vibrant nonstate sectors. Moreover, goods from other provinces along the Yangtze River could easily reach Shanghai via the river and its extensive branch network. This area would include much of Anhui, Hubei, and Hunan provinces, which have a total population of 285 million.

**Comparison of Ports, 2000**

<table>
<thead>
<tr>
<th>Port</th>
<th>Cargo Volume (millions of tons)</th>
<th>Container Traffic (million TEUs)</th>
<th>New Construction</th>
<th>Hinterland</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong SAR</td>
<td>175, of which 69 percent containerized</td>
<td>18.1, busiest in the world</td>
<td>Terminal 9 will add 2.6 million TEUs capacity</td>
<td>Pearl River delta</td>
</tr>
<tr>
<td>Shanghai</td>
<td>204, largest port in China. 25 percent growth per annum in past 10 years</td>
<td>5.6</td>
<td>Deep-sea port being built on outskirt island</td>
<td>Yangtze River delta</td>
</tr>
</tbody>
</table>

Sources: China, Ministry of Communication; and IMF staff estimates. 1 TEUs= 20-foot equivalent units.

**Comparison of Guangdong and Jiangsu Plus Zhejiang, 2001**

(In percent of mainland total, unless otherwise noted)

<table>
<thead>
<tr>
<th></th>
<th>Guangdong</th>
<th>Jiangsu Plus Zhejiang</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>11.1</td>
<td>16.9</td>
</tr>
<tr>
<td>Exports</td>
<td>36.0</td>
<td>20.2</td>
</tr>
<tr>
<td>Population</td>
<td>6.1</td>
<td>9.4</td>
</tr>
<tr>
<td>People with college degree or higher education (millions)</td>
<td>1.5</td>
<td>2.1</td>
</tr>
<tr>
<td>Industrial production</td>
<td>14.7</td>
<td>20.6</td>
</tr>
<tr>
<td>Share of non-state-owned enterprises in total number of industrial enterprises of region</td>
<td>86.5</td>
<td>91.7</td>
</tr>
</tbody>
</table>

would be the main attractions of moving to the mainland. Shanghai is an industrial and commercial center where many foreign production facilities are located, and it has an ample supply of relatively well-educated labor. In addition, the government has continued to invest heavily in Shanghai’s infrastructure, and the city is gaining expertise as a financial center.

Nonetheless, Hong Kong SAR has advantages that will likely preserve its role as a center for China’s international capital-raising activities for the foreseeable future:

- A sound legal framework and an independent and efficient judiciary;
- Free flow of capital and information; and
- A mature financial market and sound banking system.

These factors will make it difficult for Shanghai or other cities on the mainland to rival Hong Kong SAR as a major international financial center in the near future.

Growing financing needs on the mainland will likely benefit Hong Kong SAR in its role as an international financial center. Given China’s high saving rate, much of the financing needed for the expansion of domestic investment will be raised domestically. Nonetheless, a significant part will be raised abroad, and Hong Kong SAR—with its well-developed market infrastructure and experience—could benefit in the following areas:

- Increasing placements by large Chinese state-owned enterprises and private firms in the Hong Kong SAR stock market;
- Restructuring and infrastructure projects on the mainland should help boost Hong Kong SAR’s debt market (A 1996 World Bank report estimated that China’s infrastructure-related spending could exceed US$700 billion over 10 years, and preparation for the 2008 Olympics may require additional infrastructure spending.);
- Growing corporate debt financing by mainland firms (If China’s corporate debt-to-GDP ratio were to reach 4 percent—the level in Thailand before the crisis—by 2010, corporate bonds outstanding could total more than $120 billion, compared with the current $10 billion.);
- FDI flows to China will likely increase with WTO-related liberalization of the services sector and the elimination of textile export quotas in 2005. Some of this FDI is likely to continue to be channeled through Hong Kong SAR.

Hong Kong SAR firms could benefit from the opening up of China’s financial sector, although they will face competition from international firms. Under China’s WTO commitments, mainland banking, insurance, and asset-management industries will gradually open up to foreign firms. The Closer Economic Partnership Agreement (CEPA) between Hong Kong SAR and the mainland, which went into effect on January 1, 2003, will give Hong Kong SAR firms access to these sectors two years before foreign firms and with lower entrance requirements. Hong Kong SAR firms could potentially benefit from this liberalization, given their extensive experience in these areas. However, Hong Kong SAR firms will eventually have to compete with much larger and well-established international firms.

**Business Services**

Migration of certain trade-related services to the mainland is likely to continue. A survey by Hong Kong SAR’s Trade Development Council indicates that more than three-fourths of Chinese exports handled by Hong Kong SAR now have freight forwarding and consolidation arranged on the mainland, and over half of the testing and certification is also conducted there. As China opens up its services sector further, this trend is likely to continue.

Nevertheless, although some foreign companies may relocate to the mainland, Hong Kong SAR is still very attractive as a business center. As foreign businesses’ presence on the mainland expands, cheaper labor and office space may induce regional offices and China-related operations to move from Hong Kong SAR across the border. Hong Kong SAR could gradually lose its predominance as a center for China-related foreign businesses. Hong Kong SAR, however, still has many advantages (described in Section III) that seem to justify a significant cost premium. The number of regional headquarters and offices in Hong Kong SAR increased by 24 percent between 1997 and 2002, to over 3,000 (Table 2.2), and the presence of Chinese firms, which declined during 1998–99, has started to grow again.

The Hong Kong SAR tourism industry, although still relatively small, could be an important source of

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**Table 2.1. Survey of Traders on Prospects of Different Shipping Arrangements for China Trade**

(Views expressed, percentages of total)

<table>
<thead>
<tr>
<th></th>
<th>Growth</th>
<th>No Change</th>
<th>Decline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reexports</td>
<td>18.5</td>
<td>32.5</td>
<td>49.1</td>
</tr>
<tr>
<td>Transshipments via Hong Kong SAR</td>
<td>37.2</td>
<td>36.8</td>
<td>26.0</td>
</tr>
<tr>
<td>Direct shipment</td>
<td>76.7</td>
<td>17.9</td>
<td>5.4</td>
</tr>
</tbody>
</table>

Source: Hong Kong SAR, Trade Development Council.
growth in the future. Tourism receipts were equivalent to 4.9 percent of its GDP in 2001, with 37 percent coming from mainland Chinese visitors. Further relaxation of restrictions on visas/quotas for mainland visitors to Hong Kong SAR could boost tourism significantly in the coming years.

Challenges of Integration

To meet the challenges of integration, Hong Kong SAR must continue to enhance its competitive advantage and attract higher-value-added business activities. As an advanced, relatively high-wage economy, Hong Kong SAR cannot compete with the mainland in activities such as labor-intensive manufacturing and low-end services. It will have to “move up the value chain,” following the examples of some companies that have successfully adjusted their business structures (Box 2.2). As noted, China’s growth, increasing financing needs, and further liberalization offer great opportunities for Hong Kong SAR—with such a vast and vibrant hinterland, Hong Kong SAR can further develop what it does best and consolidate its role as a major international financial, trade, and business center.

A recent survey on trade and trade-related services shows that many Hong Kong SAR companies are planning to change their business operations along these lines. Table 2.3 shows that companies plan to move lower-value-added trade-related services to the mainland while focusing Hong Kong SAR operations on higher-value-added activities.

To take full advantage of this structural shift, Hong Kong SAR will need to further enhance its comparative advantage. A survey of foreign companies with regional representation in Hong Kong SAR identified the following major advantages that it possesses (in decreasing order of importance): (1) low tax rates and a simple tax system; (2) free flow of information; (3) political stability and security; (4) corruption-free government; (5) up-to-date communications, transport, and other infrastructure; (6) rule of law and independent judiciary; (7) business-friendly government economic policy; (8) absence of exchange controls; (9) free-port status; and (10) level playing field.

The structural changes resulting from integration could lead to higher structural unemployment and a shortage of skilled workers. A recent study by the Hong Kong Monetary Authority (Peng, Cheung, and Fan, 2001) finds that the natural rate of unemployment has risen modestly in recent years, and there is evidence of an increased skills mismatch in the ser-

### Table 2.2. Hong Kong SAR as a Regional Headquarters for Multinational Companies

<table>
<thead>
<tr>
<th>Year</th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of regional headquarters and offices in Hong Kong SAR</td>
<td>2,514</td>
<td>2,449</td>
<td>2,490</td>
<td>3,001</td>
<td>3,237</td>
<td>3,119</td>
</tr>
<tr>
<td>Of which: those with parent companies incorporated on the mainland</td>
<td>243</td>
<td>205</td>
<td>205</td>
<td>229</td>
<td>242</td>
<td>266</td>
</tr>
<tr>
<td>Number of persons engaged in regional headquarters and offices in Hong Kong SAR (in thousands)</td>
<td>...</td>
<td>136</td>
<td>114</td>
<td>133</td>
<td>173</td>
<td>165</td>
</tr>
<tr>
<td>Of which: those with parent companies incorporated on the mainland</td>
<td>...</td>
<td>7.6</td>
<td>7.3</td>
<td>9.2</td>
<td>7.2</td>
<td>6.6</td>
</tr>
</tbody>
</table>

Source: Hong Kong SAR, Census and Statistics Department.

Excluding those who did not respond.

### Table 2.3. Location of Major Operations of Hong Kong SAR Companies in Next Five Years

<table>
<thead>
<tr>
<th>Operation</th>
<th>Hong Kong SAR</th>
<th>Mainland</th>
<th>China</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade financing/documentation</td>
<td>90.1</td>
<td>16.1</td>
<td>4.4</td>
<td></td>
</tr>
<tr>
<td>Regional headquarters/offices</td>
<td>85.4</td>
<td>18.8</td>
<td>5.0</td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>84.9</td>
<td>19.5</td>
<td>6.9</td>
<td></td>
</tr>
<tr>
<td>Business negotiation</td>
<td>72.4</td>
<td>39.7</td>
<td>18.5</td>
<td></td>
</tr>
<tr>
<td>Arbitration</td>
<td>71.5</td>
<td>35.0</td>
<td>9.6</td>
<td></td>
</tr>
<tr>
<td>Marketing</td>
<td>58.1</td>
<td>37.6</td>
<td>30.5</td>
<td></td>
</tr>
<tr>
<td>Freight forwarding and consolidation</td>
<td>55.3</td>
<td>58.5</td>
<td>9.0</td>
<td></td>
</tr>
<tr>
<td>Production development/design</td>
<td>53.4</td>
<td>46.6</td>
<td>16.2</td>
<td></td>
</tr>
<tr>
<td>Testing/certification</td>
<td>46.2</td>
<td>59.1</td>
<td>12.0</td>
<td></td>
</tr>
<tr>
<td>Material sourcing</td>
<td>38.3</td>
<td>71.9</td>
<td>20.2</td>
<td></td>
</tr>
<tr>
<td>Warehousing/inventory control</td>
<td>30.6</td>
<td>77.8</td>
<td>5.9</td>
<td></td>
</tr>
<tr>
<td>Sample making/prototyping</td>
<td>27.2</td>
<td>73.4</td>
<td>11.0</td>
<td></td>
</tr>
<tr>
<td>Quality control</td>
<td>25.9</td>
<td>78.0</td>
<td>10.5</td>
<td></td>
</tr>
<tr>
<td>Manufacturing/packaging</td>
<td>14.4</td>
<td>86.3</td>
<td>10.8</td>
<td></td>
</tr>
</tbody>
</table>

Source: Hong Kong SAR, Trade Development Council.
II ECONOMIC INTEGRATION BETWEEN HONG KONG SAR AND MAINLAND CHINA

vices sector. The government’s 2001 manpower projection report estimates that by 2007, Hong Kong SAR will have a shortage of some 99,000 people with higher education and a surplus of about a quarter of a million people with a secondary-school education or less (Table 2.4).

These labor-market pressures will continue to challenge education and other social policies. As is discussed in more detail in Section VI, structural change is the main factor behind the increase in income inequality over the last two decades. To meet the growing demand for highly skilled workers, Hong Kong SAR will have to further strengthen its education and training programs, and may also need to adjust its immigration policies. In this vein, a new Admission for Mainland Talents and Professionals Scheme took effect in July 2003. The scheme aims to attract skilled workers and professionals from the mainland to work in Hong Kong SAR in order to meet local manpower needs and enhance Hong Kong SAR’s competitiveness in the global market.

Meeting the challenges of integration will also have fiscal implications. Upgrading the education system, infrastructure development, and higher unemployment could create pressures for higher public expenditures, leading to measures to contain costs and/or obtain offsetting savings elsewhere. At the same time, relocation of more economic activities from Hong Kong SAR to the mainland could result in lower revenues, given the territorial-source principle of income taxation, thereby pointing to the need for measures to strengthen the revenue base.11

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Table 2.4. Projected Manpower Resource Balance in 2005

<table>
<thead>
<tr>
<th>Education Attainment</th>
<th>Projected Manpower Resource Balance (persons)</th>
<th>(percentage of supply)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower secondary and below</td>
<td>133,500</td>
<td>11.8</td>
</tr>
<tr>
<td>Upper secondary</td>
<td>82,500</td>
<td>8.6</td>
</tr>
<tr>
<td>Craft</td>
<td>15,600</td>
<td>51.7</td>
</tr>
<tr>
<td>Postsecondary</td>
<td>−62,600</td>
<td>−32.9</td>
</tr>
<tr>
<td>First degree and above</td>
<td>−36,500</td>
<td>−5.8</td>
</tr>
</tbody>
</table>

Source: Hong Kong SAR government (2003).

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11Hong Kong SAR, Task Force on Review of Public Finances, 2002.