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Hot Topics for the Future of PRC and Hong Kong, China

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1. Snapshot of PRC's macro imbalance

At the end of 2004, the macroeconomic balance in the People's Republic of China (PRC) raises some interesting options. The external sector enjoys a huge surplus, with significant increases in the current and capital accounts (almost \$46 billion and \$53 bill. respectively, last year). Accordingly, foreign exchange reserves in 2003 amounted to a staggering \$400 billion. Turning to the domestic balance, the increase of fixed investment has been significant, although consumption is sluggish. (The ratio of fixed investments to GDP increased from 35% in the 1980s, and 39% for the 90s to 47% last year; while the consumption ratio, once more than 50% in the 80s, it is now at just 43%.) This indicates overinvestment in the external sector is offset by over saving domestically. However, since investment is overheating in some places and the government is running a budget deficit, only savings by individuals can absorb all of the overinvestment from external and domestic sectors.

Yet such structural imbalances are not sustainable over the long run. A large surplus in the current account combined with capital inflows puts appreciation pressures on the renminbi. Foreign reserves now far exceed the recommended optimal level of three months import requirements. The economy relies too much on investment and in some sectors, such as cement and steel, there are real concerns about overheating. Therefore, to address these structural imbalances, the main prescription comes down to how to stimulate individual consumption.

Economic theory teaches us that the propensity to consume by lower-income groups is generally greater than the rich. However, in the case of the PRC, the consumption rate of lower-income rural people, who account for a major part of the population, is strikingly low due to various factors, such as uncertainty of future income and a poor consumption environment. How to reduce the huge income disparities between urban and rural areas will be important for the PRC, not only from the standpoint of achieving social equality but also for ensuring a sustainable macroeconomic structure. Since the rural consumption market has enormous untapped potential, the PRC economy could eventually achieve sustainable economic growth led by domestic demand.

2. Reasons for Growing Pressure on the Renminbi

Many stories over the last year report that the United States, Japan and other countries have been applying persuasion on the PRC to appreciate the value of the renminbi (RMB). Washington has been asking Beijing to do this mainly to reduce its huge trade deficit with PRC, however, since the primary cause of that trade imbalance is structural (and not due to an overly cheap RMB), we doubt whether appreciation of the RMB can be expected to fix the U.S. trade deficit in the long run. (We recall that similar calls for adjusting the dollar-yen exchange rate in order to “correct” imbalanced trade were regularly heard throughout the late 80s and 90s.)

Japan also has run a trade deficit with the PRC in recent years. However, it seems that the true story behind this is not only a trade imbalance but also a capital account imbalance: in other words more Japanese manufacturing companies are transferring their production lines to the Mainland PRC. Concern over this so-called “hollowing out” of Japan’s manufacturing industry also triggers growing pressure on the RMB.

But will an appreciation of the RMB really address foreign direct investment (FDI) imbalances between Japan and the PRC? Certainly one of the main reasons for Japanese companies choosing to go to the Mainland is to hire cheap labor, therefore an appreciation of the RMB and consequent higher PRC labor costs might be expected to provide some negative impact on Japan’s FDI to PRC. However, we note that other locational factors such as skills and trainability, transparency, laws and regulation, governance, and most importantly, attractiveness of potentially huge consumer markets, have become more crucial when Japanese companies make their decisions on FDI. Accordingly, even if the RMB is appreciated, its impact on capital flows may be rather limited after all. As for trade imbalances, we observe that Japanese consumers are still more quality-sensitive than price conscious and so increases in import prices may not necessarily affect their behavior so drastically.

It seems that for the time being PRC expects that its new “go overseas” (zou chuqu) policy as well as the planned reduction of export tax rebates will mitigate most of the international pressure on the RMB. However, we consider that floating and full convertibility of the RMB is inevitable in the

medium run and that will only contribute to further economic reform and development. PRC itself seems to be aware of this. We hope that the recent discussions on the appreciation of RMB have turned out to be a good opportunity for PRC to reflect more deeply on how it will pursue its structural reforms.

3. Northern Economy of PRC: its Bright and Dark Sides

Although many Sinologists focus on the regional imbalance between coastal and inland areas, the northern part of PRC is actually more interesting. GDP there roughly accounts for one-fourth of the country's GDP and other economic indicators, such as GDP per capita and growth rates are more or less the same as the national average. Many state-owned-enterprises (SOEs) are located in the northern region and most of them are heavy industries, including steel, autos and oil refining. But unlike the south, it does not receive much in the way of FDI and lacks many export industries. The northern region used to be a relatively developed area due to its large-scale SOEs and heavy industry. However, after the opening up of the PRC economy, the north has been left behind, as it has had to rely too much on yesterday's SOEs and sunset heavy industries.

By contrast, other areas—coastal and southern regions in particular—have attracted FDI and succeeded in developing IT-related industries. In this sense, it's obvious that the economic woes of the north are nothing but the problems of SOEs: poor management and governance and excessive labor forces (xia gang). SOE reform still has a long way to go and PRC's entry into the WTO is expected to have an adverse impact on internationally less competitive SOE heavy industries. So much for the 'dark side' of the northern economy.

However, reports from the Development Bank of Japan Singapore Office paint a brighter picture. "Zhong guan cun", which is located near Beijing has now become a center for hi-tech industries in the northern region. Many joint ventures by enterprises and universities have been set up, which rapidly develop hi-tech industries for the region. In the northern region, Japan and Korea have been recognized as one regional economic zone and the relationships among them are becoming closer.

Development of the northern region is expected to become one of the top policy agenda in the next 10-year economic plan, similar to the well-known “Xi bu da kaifa” (“Go West” policy). And investment totaling 280 billion RMB to prepare for the 2008 Beijing Olympics is expected to stimulate the northern economy, particularly tourism and transportation infrastructure. Regardless of its strengths or weaknesses, the northern economy must play its full role to achieve a smooth transition after WTO opening. So in our view it becomes all the more important for the authorities to attract FDI, develop PRC-foreign joint ownership and restructure corporate governance in order to realize the promise of the great north.

4. Predicting the Future of Southern PRC

There are four main competing models which seek to explain how a so-called greater southern China zone might come about. Hong Kong, China (HKC) could become the center of such a zone, relegating other regions, including the bustling Pearl River delta, to the sidelines. Or Guangzhou might maintain its historical political, economic and social lead to become the undisputed center. The zone could also comprise three relatively equal clusters: central urban Guangzhou (with industry and transport), east urban Shenzhen and HKC (international finance, trade and high-tech), and west coastal Zhuhai and Macau (possibly tourism). Finally, each city might simply preserve its own specialized role within a flat administrative relationship, along the lines of the Netherlands model. Interestingly, all these models stress the importance of strengthening ties and cooperation i.e. linkage—among the southern cities and agree that it would be hard for the region to thrive in the face of a power grab by any one city.

What is crucial to know is that the HKC-centric version was (not surprisingly) originally put forward by academics from there, while the Guangzhou prediction is the brainchild of mainland scholars. (The other two models being obvious compromises.) Many of the experts in HKC who advocate a closer partnership between HKC and the other southern regions, take pains to stress that closer linkages do not have to mean that HKC will necessarily become a part of Guangdong province or that it is effectively absorbed into the Mainland. But these experts also anticipate that a closer

linkage might have some adverse impact on HKC's economy in the short run. For instance, salary levels might decline, employment opportunities may be lost or property markets may drop further during any adjustment periods. However, the linkage modelers always stress that closer ties will definitely contribute to the future of HKC and southern PRC as well in the long run. Right now, they just have to concentrate on mitigating the possible counterarguments to the closer linkage model.

5. Will South China Realize its Dream to Overtake HKC?

The three economic standouts of the People's Republic of China—Shanghai-Suzhou, outer environs of Beijing and Southern China—are at a crossroads. What role can they best play to complement each other? This policy question is challenging the leaders of Guangdong province as they compete to supplant Hong Kong, China. For the moment they seem to be concentrating on high-value added and high-tech products, which are made by the many foreign firms that want to set up their operations there. According to official sources, the South might also be the first region to get Beijing's permission to deregulate their services sector, as promised in the WTO commitments. Their other top priority is improvement of human and physical infrastructure (e.g. new Baiyun International Airport), so as to attract foreign companies away from HKC as their first choice.

Now for the reality check. Labor costs in the South are rising rapidly in comparison with other areas of the mainland and even local firms are joining the exodus of foreign companies moving inland so as to reduce their costs. Southern China's approach to urban planning is still decidedly "car-friendly", which relegates the importance of environmental protection and clean air. At present few seem to care about this problem anyway. And society is becoming increasingly unsafe for those workers on the margins: young jobseekers from the countryside and foreign immigrant workers are falling prey to the grey economy. For twenty years now, Guangdong and South China have enjoyed faster growth than the rest of the country. With this precocious development come problems of maturity that can no longer be ignored.

6. A Mixed Future for the Economy of Hong Kong, China

The economy of Hong Kong, China (HKC) fortunately showed signs of recovery and improving confidence throughout 2004. However, HKC is still undergoing structural adjustment and it seems that experts' views on the medium and long-term are sharply divided. Optimists stress these factors. First, although private consumption and investment are still sluggish, the economy is now on an export-driven growth path, especially export of services. This suggests that HKC has probably succeeded in turning itself into a high value-added economy and is starting to play the role of an international hub.

Second, current deflation is not structural, like pressure of downward price adjustment from Southern China, but more cyclical. Pessimists worry that more HKC residents will go to Shenzhen and other cities of Southern China for shopping or purchasing property, but in fact their amount of consumption in Southern China is less than 1 percent of HKC's GDP and its impact should be negligible.

Be that as it may, we still need to remember the following. First, HKC's external demand is largely supported by the increase in trade with the Mainland after PRC's entry into the WTO. Infrastructure at the other ports of Southern China is lagging behind HKC and has not yet caught up with the increases in trade. Quite simply, that is why HKC still enjoys the role of gateway between PRC and other countries.

But port infrastructure in Southern China is quickly improving and, in our opinion, it is too early to judge if HKC has succeeded in achieving a high value-added economy and firmly established itself as an entrenched international business hub. Second, even if the current economic situation can be explained by cyclical factors, we need to understand why HKC cannot get out of cyclical deflation for so long. Third, although the current amount of consumption is still small, what is important here is not the absolute amount but its direction of change. Ultimately, whether you are an optimist or pessimist about the economy, all of us can agree the very real difficulties HKC is now facing and appreciate that it is probably a wise course for HKC to pursue closer cooperation with Southern China whatever its future may hold.

7. Prospects for the Pegged HK Dollar Hinge on Renminbi

The HK\$ has been basically pegged to the US\$ since 1983 under a currency board system, and it is allowed to fluctuate within a narrow range of between 7.7 to 7.9 HK\$. The debate on the appropriateness of a currency board system for Hong Kong, China (HKC) re-emerged in late 2003 and quite a few economists have pointed out that a domestic price downward adjustment under a fixed exchange system is a primary cause of a continuing deflationary spiral. Therefore, the sooner HKC abandons its currency board, the sooner it can get rid of its current economic difficulties. While others defend the currency board system by saying that since HKC is a small economy, it is fragile to any external shocks under a floating exchange regime.

While the argument that under a fixed exchange rate regime domestic equilibrium is sacrificed through a domestic price adjustment process is nothing special—it seems to us that there are now at least two new aspects worth considering. First, many experts, regardless of whether they are for or against the currency board system, predict that in 5 to 10 years the convertibility of PRC's RMB will be achieved and it is likely then that HK\$ will be re-pegged to the RMB. Put simply, whether US\$ peg can survive largely depends on when Beijing decides to make the RMB convertible. And there might not be much room left for HKC to take its own decision on this issue any longer.

Second, the argument this time around had been started during a deflationary spiral of the HKC economy. The cause, however, is structural and there is no clear mid and long-term strategy for overcoming it. In this sense, unlike before, calls to review the US\$ peg won't go away. Market interventions may also be expected to continue if the US\$ weakens further. The debate about the appropriateness of a US\$ peg will persist unless the HKC economy overcome its structural problems, at the same time the end game is steadily approaching (i.e. with RMB convertibility) and the initiative will continue to slip away into the hands of Beijing.

8. HKC's Closer Social Linkage with Mainland PRC

After the reunification of Hong Kong, China with PRC, economic ties with the mainland, in particular the Southern region, have become noticeably closer. High-profile examples of this are the signing and broadening of the Closer Economic Partnership Arrangement (CEPA), plans to build a bridge that connects HKC with Macau and Zhuhai, and the lifting of restrictions on mainlanders when they visit HKC. Now we can also see two phenomena starting emerging in the area of social development and cooperation.

First, more HKC people, especially young students, have started to learn Putonghua (Mandarin) with community encouragement (e.g. annual "Putonghua Campaign"). HKC universities are introducing special Putonghua courses for seniors who are about to graduate. The reason is obvious: with the HKC economy in a deflationary spiral, graduates with Putonghua can more easily find good jobs in HKC or the mainland.

Second, HKC's historical comparative advantage for Putonghua education appears to be waning vis-à-vis the mainland. Foreign students who used to study Putonghua in HKC, are now leaving and flocking to the mainland. We are aware of 3 main reasons: education is much cheaper on the mainland (fees and costs of living are less than a third or more of HKC); outside the classroom opportunities to practice Putonghua are less in Cantonese-speaking HKC; and living conditions on the mainland have improved dramatically. (In the recent past, even if foreign students appreciated the low cost of living and superior learning environment, they hesitated to study on the mainland because of various inconveniences of residing there.) Individually these phenomena may not appear so important, but taken together their implications could be profound. Although HKC prides itself on its autonomy, we should keep watching its ties with the Southern mainland which are being strengthened both economically and socially.

9. Is HKC's Fiscal Deficit Merely Cyclical or Structural?

In a major policy address at the start of 2004, the Chief Executive of Hong Kong, China, highlighted two pressing problems: deflation and the fiscal deficit. The fiscal balance of HKC has been steadily worsening since the end of 1990s. The ratio of fiscal balance to GDP in 2000, 2001, 2002 and 2003 was Δ 0.6, Δ 4.9, Δ 4.8, and Δ 6.0 respectively. An unexpected increase in spending in 2003 is explainable by a temporary factor—the outbreak of SARS. But this cannot explain the whole picture. In our view, there are two main underlying factors behind the fiscal deficit deterioration. First, income from real estate, which once accounted for 40% of total revenues, began to decline sharply by the end of the 1990s due to the bursting of the real estate bubble.

Surprisingly, there has been no significant tax reform in HKC for the past sixty years! (In the 1970s and 1980s HKC considered introducing a consumption tax but this was postponed due to the hyperinflation of the late 1980s.) In the first half of the 1990s, HKC enjoyed an increase in property tax revenues thanks to the real estate bubble, but concealing the underlying structural problem of a simple tax system, which lacked a stable base and relied too heavily on real estate. This structural problem became painfully apparent with the bursting of the bubble. (In fact, there are echoes of Japan's experience in the mid-1990s.)

Second, despite the decrease in revenue, spending has been growing at a rapid pace. To some extent, this reflects increasing needs for social security and education. However the underlying factor is that despite general impressions, the size of the HKC administration is not necessarily small in terms of its administrative expenditures. This is primarily due to the high level of remuneration of public servants, which accounts for almost 70 % of total expenditures.

At first glance, the fiscal balance deterioration in HKC seems to be attributable to cyclical macroeconomic conditions. However, upon deeper investigation, we realize that the fundamental problem is really a mismatch between “small government” on the revenue side and “big government” on the expenditure side. To solve that problem, it seems advisable to us to widen the stable tax base by introducing, for example, a consumption tax

and by cutting the excessive salary levels of public servants, as well as promoting the privatization of public facilities, such as airports and railways.

10. Governance of PRC's Banking Sector

It seems that many China experts in the international community agree that how to improve the governance structure and how to address huge amounts of non-performing loans (NPLs) are two major challenges which the banking sector in PRC is now facing. But what is the Chinese people's view on these issues? International conferences to discuss these issues are frequently held in the PRC, which attract the attention of Chinese local press specializing in economic and financial matters. Their reports may give us a hint in this regard. These newspapers are all in Chinese and their targeted readers are local people, which tells us that policymakers as well as business people in the financial sector of PRC are now paying more attention to the importance of these issues. Looking back over these reports filed by local press, a couple of points are worth commenting upon.

First, the local business media try hard to understand both sides of the international and local experts. It appears to us that some of the local press possibly tries to minimize the importance of the diversification of ownership in banking sector. For instance, Economic Daily once stressed in its article that the linkage between shareholding structure and efficiency of banking business is weak. China Economic News and Financial News comment that there are differing views about ownership diversification, and points out firmly that while diversification may be one of the solutions, it is by no means the only one.

In connection with this, some press emphasize so-called 'Chinese uniqueness' and also endorsed the 'step-by step approach' as we have observed from time to time in other cases. For example, both Economic News and Financial News quote Chinese experts' views: 'We should take account of special Chinese characteristics', 'Banking sector in PRC has its own uniqueness', or 'Diversification should be pursued step by step'. While they all agree that NPLs are the most urgent issue to be addressed for the banking sector in PRC, at the same time they tend to talk down the seriousness of the NPL problem (which continues to worry many

international commentators). To wit, Economic Daily and Security Times once highlighted an optimistic view of the People's Bank of China on NPLs (i.e. that they've already hit a peak), and China Securities Journal quotes a Chinese expert's view that 'most NPLs are attributable to social costs arising from PRC's historical transition'. In other words their message appears to be this is basically a phenomenon which cannot be avoided.

11. Foreign Banks may Shake up PRC's Financial Market

As part of its accession commitments to the WTO, the PRC has introduced many new measures making it easier for foreign banks, such as HSBC and CitiHK, to set up renminbi operations in attractive mainland locations. But some vocal commentators worry that local Chinese banks will suffer from the foreign banks' entry due to their endemic NPL and governance problems. Most experts, however, think that won't be the case, and we agree. Chinese local banks and foreign banks each have their own comparative advantage. Foreign banks can provide a wide variety of sophisticated financial instruments for their new Chinese customers, and also they normally bring good and sound governance, and high quality of risk management skills. These are just what local Chinese banks are eager to pick up.

What then is the local banks' comparative advantage? Many PRC enterprises, in particular SOEs, are still loss makers and foreign banks would need to look long and hard at their real performance before doing business with them. However, due to a lack of transparency, it is often difficult for foreign banks to get sufficient and precise information; while local banks benefit from strong connections and appreciation of local enterprises. And local banks usually enjoy a solid nationwide branch network, which foreign banks do not yet have. (Although more cities are being opened to foreign banks—after taking account of cost effectiveness—it is not certain that foreign banks will wish to go to the trouble of setting up a lot of branches around the countryside.)

We expect that during the course of PRC's liberalization of the financial sector, close cooperation or alliances, as well as competition, will probably emerge among local banks and foreign entrant banks. Perhaps a

more profound implication of foreign entry would be: first the possibility of a huge brain drain from local to foreign banks which can offer higher salaries, as one observer recently suggested. And second, given the situation that local banks are still reluctant to provide services to the PRC private sector, if foreign banks aggressively seek to do business with that sector and then do well, this might have a tremendous impact on PRC's "market socialism economy" one way or the other.

12. Long March to Privatization

The Chinese Communist Party at its 2003 fall meeting accepted that the property rights of private enterprises should be protected under the constitution. This little-noticed decision at the time was, in fact, an epoch-making event in PRC's economic history. In truth, PRC has been gradually pursuing economic transition and liberalization for over 20 years. Now PRC is strengthening its efforts around the principles of "san ge daibiao" or "three representations": i.e. the Party must represent the most advanced economic forces in society; the most advanced elements of Chinese culture; and the basic interests of the people. In 1999 private enterprises were given certain formal legal status under the constitution, a number of private enterprises were also given "trade rights", and in 2002 the Party allowed membership of private entrepreneurs.

It seems to us that the underlying driving factor for PRC embracing privatization is concern over growing unemployment. Despite good macroeconomic performance, the number of workers who are losing their jobs is steadily increasing, not only in rural areas but also in urban areas due to the deepening of state-owned enterprise (SOE) reform. This naturally gives rise to worries about social stability.

According to official figures, while the number of employees working for SOEs in 2003 was 68.8 million—a sharp decline compared with 112.6 million in 1995—workers in private sector in 2003 were 89.5 million, which surpass SOEs and a big increase over 55.7 million in 1995. Although the Party wishes to maintain its basic political framework, it cannot help but rely on private enterprises to create job opportunities: in other words, economic logic is gradually overtaking political logic. We need to watch in the near

future if these developments will give rise to some contradiction (maodun) or conflict between the Party's political bureaucracy (zhengzhi guanliao) and market mechanisms (shichang yunzuo).

There is no doubt that this is still a sensitive issue to the PRC government. We anticipate that they will basically continue with the "parallel privatization approach"; that is, keeping the existing SOE sector intact and letting private enterprises be developed in the new areas, such as high-tech R&D or financial consulting, exactly those kinds of knowledge-intensive industries which are expected to play the role of an engine for further economic structural reforms.

13. Doing business in the PRC from a Japanese perspective

In recent years, rapid economic growth and the expansion of markets in the PRC means more foreign companies are headed to the mainland to try their luck. Despite a lucrative market outlook, foreign companies are still facing a hard time in dealing with various business problems, frequently related to unclear laws or regulations. For many foreign businesses, differences in mindset, shared expectations or business practices are causing trouble as well.

One Chinese attorney frequently working on PRC-Japan business transactions recounts three differences in the so-called mindsets of business people from Japan and the PRC. Japanese apparently value morale and prefer long-term relationships, while the Chinese are more attracted to windfall profits and short-term interests. Japanese consult lawyers only after trouble occurs, but Chinese will usually consult on legal questions as a normal course of business. Many Japanese expect their business counterparts to agree without the need for a contract or any formal written document (often even without saying so verbally!), while Chinese businesspeople will not feel committed unless they are formally informed, preferably in writing. The lawyer concluded that despite their geographic proximity, Japanese and Chinese businesspeople cannot be said to share a common business sense and so this makes for many misunderstandings.

Leaving aside its merits, Japan's traditional way of doing business in the PRC (and the rest of the world for that matter) continues to be a

competitive disadvantage, although this is gradually diminishing. Particularly unfortunate, Japanese businesses wrongly assume that working in PRC as opposed to the U.S. or Europe must necessarily be closer to their own ways of thinking and doing. Whether Chinese market or business practices are fully in conformity with preferred “global standards” is another issue. It is widely believed that in PRC informal, personal connections, networks or backroom talks remain more important to doing successful deals than relying upon laws. Nevertheless, PRC is moving steadily toward becoming a fully lawful business society.

Many multinationals share the expectation that whoever can dominate the PRC market will eventually become a major player in world markets. From this perspective, then, it is all the more important for them, when doing business in the PRC market, to keep thinking about what really constitutes any “PRC uniqueness” and whether there is really any such uniqueness on their side as well.