

Commission on Strategic Development
Executive Committee
Hong Kong's International Competitiveness

(Translation)

Introduction

This paper briefs Members on Hong Kong's strengths in international competitiveness, examines the challenges facing us as we develop these strengths, and sets out some strategic issues to facilitate Members' consideration of how to enhance Hong Kong's international competitiveness.

2. The international competitiveness of a country, territory or city generally reflects its overall capability to meet global competition and sustain its development. Since global competition is now predominantly economic, international competitiveness mainly refers to the economic performance of a place. Whether a place is internationally competitive is reflected in several aspects, including its attractiveness to international investors, to business people choosing a place to set up new businesses, and to talented individuals choosing a place to live and work.

Hong Kong's strengths in international competitiveness

3. Hong Kong is Asia's world city, a market-driven and open economy, a financial centre and an information and business hub. With our location at the heart of Asia, both geographically and economically, and with the Mainland as our hinterland, Hong Kong is one of the world's leading economic performers. Hong Kong is the 11th largest trading entity and exporter of services in the world. In terms of throughput, we

have the busiest international air-freight centre, the second busiest container port and the fifth busiest airport for international passenger traffic. In financial services, Hong Kong is a major international financial centre in the Asia-Pacific region: we run the sixth largest foreign exchange market, and our stock market is the eighth largest in market capitalisation. Last year, it raised more than HK\$300 billion, fourth most in the world and the most in Asia ahead of Japan.

4. In terms of inward investment, foreign direct investment (FDI) flows into Hong Kong increased from US\$9.7 billion in 2002 to US\$35.9 billion (increased by 2.7 times) in 2005 (preliminary figures), reflecting that Hong Kong continues to be a preferred destination for FDI. According to the World Investment Report 2005 released by the United Nations Conference on Trade and Development, Hong Kong ranked second in FDI flows in Asia, after the Mainland. In 2004, Hong Kong ranked seventh in FDI inflows in the world. Meanwhile, the number of regional headquarters, regional offices and local offices set up by overseas organisations in Hong Kong increased from 4,867 in 2002 to 6,272 in 2005. It all shows the increasing attractiveness of Hong Kong to international investors.

5. In the 2006 World Competitiveness Report released by the International Institute for Management Development in Lausanne, Switzerland, Hong Kong ranked second, after the United States. Hong Kong has been consistently ranked as the freest economy in the world by the Heritage Foundation of the US, the Cato Institute of the US and the Fraser Institute of Canada since the mid-1990s. However, Hong Kong was rated 28th in the Global Competitiveness Report 2005-06 published by the World Economic Forum (WEF), a ranking substantially lower than its 21st position in the previous year and far below those of comparable economies such as Taiwan (fifth), Singapore (sixth) and South Korea (17th). According to the WEF, the relatively low ranking of Hong Kong's competitiveness was attributed to, among other things, poor technological capability, inadequate drive for innovation and government inadequacy in handling matters impartially.

6. Well-established institutions and a business-friendly environment are among Hong Kong's strongest competitive strengths. Hong Kong has long been known for upholding the rule of law. Private property rights and contractual obligations are highly respected and legally protected. We have a clean and efficient government that practices a free market policy. We respect the freedom of enterprises to run their businesses and the principles of free trade, a free market and openness. There are basically no restrictions on the flow of tourists, goods, services or information. The same applies to foreign exchange and the movement of funds. Hong Kong is also equipped with a sound regulatory system. In the financial sector, for example, our corporate governance, accounting and financial regulatory frameworks are in line with international standards, protecting the interests of investors. Freedom of speech and expression has always been respected, and citizens' fundamental rights are fully protected by the Basic Law. In the face of economic globalisation and the increasing importance of corporate governance, these institutional strengths are Hong Kong's most crucial competitive edge.

7. A simple and low tax regime is another important strength of Hong Kong. Our profits and salaries tax rates are among the lowest in the world. We do not impose tax on capital gains, interest or dividends. This greatly reduces business and investment costs, which is crucial to maintaining Hong Kong's competitiveness. The recent measures to abolish estate duty and exempt offshore funds from profits tax help enhance Hong Kong's competitiveness as an international financial centre.

8. In terms of physical infrastructure, Hong Kong has a modern international airport. We are well connected by global aviation and shipping networks. We have an extensive road system, a world-class financial infrastructure and a sophisticated communications system. All these are important in increasing efficiency and reducing costs for business.

9. Given the high mobility of talent worldwide, any successful effort to create a talent pool will strengthen our technical and management capabilities and expand our global networking. To attract top-notch talent from around the world to settle and work in Hong Kong, the Government will launch the "Quality Migrant Admission Scheme" in mid-2006,

targeting people who have both established track records and potential to continue to develop in their careers or professions. The new admission scheme will facilitate local economic development and enhance Hong Kong's competitiveness in the global market. In addition, starting from this academic year, the Administration has increased the number of education institutions and programmes that are open to non-local students. It will also allow non-local students to stay in Hong Kong for employment upon graduation.

10. To nurture local talent, the Government is taking action on two fronts. Efforts are being made to raise the overall education level of our population by increasing the opportunities for education, including senior secondary and tertiary education, and providing opportunities and resources for the workforce to pursue further education. And, to meet society's development needs, school education is being revamped to focus more on values and attitude, as well as students' communication skills and critical thinking. Measures have been taken to improve the quality of learning and teaching (such as full-scale implementation of whole-day primary schooling, enhancement of teachers' professionalism, improvement of the teacher-to-student ratio in primary schools to enable specialised teaching, and promotion of language education). Diverse learning opportunities and progression pathways are also provided to cater to individual differences in learning so that youths can develop to their full potential. In addition, the Government has established the Continuing Education Fund and the Qualifications Framework to promote lifelong learning in the community.

11. Compared with most places in Southeast Asia, Hong Kong has a stable political environment. This is an edge crucial to the development of Hong Kong in various aspects. A stable political environment also increases Hong Kong's attractiveness and competitiveness by reducing the political risks faced by overseas investors.

12. As regards international networking, the Government has set up a number of Economic and Trade Offices (ETOs) abroad. These ETOs maintain liaison with the political and business communities, think-tanks and the media in their host countries, with a view to safeguarding and

promoting the economic and trade interests of Hong Kong. They also serve to enhance local understanding of Hong Kong and promote the image of Hong Kong through various channels. In addition, Invest Hong Kong has established more than 10 regional representative units to promote Hong Kong. The Hong Kong Trade Development Council and the Hong Kong Tourism Board have also set up offices in major overseas cities, providing Hong Kong with an established channel for overseas business and trade contacts, information and cultural exchanges. In addition to the efforts made by these official and semi-official organisations, our voluntary and non-governmental organisations also play an important role in fostering links between Hong Kong and the international community.

13. The booming Mainland economy has huge potential for further development. With the implementation of the Mainland's 11th Five-Year Plan, the economy of our country will continue to develop rapidly, creating lots of business opportunities. More and more enterprises are keen to tap the Mainland market, and Hong Kong has naturally become a major foothold from which foreign enterprises and investors can venture into the Mainland. Many multinational companies engaged in China trade choose to establish themselves in Hong Kong as a bridgehead for development in the Mainland. "Leveraging on the Mainland and engaging ourselves globally" is our unique advantage, enabling us to enjoy enormous business opportunities. This is also an important reason for Hong Kong's success in attracting investors. To strengthen co-operation and exchanges with the Mainland in various areas, and to better coordinate the promotion of closer ties with the Mainland, the SAR Government will set up ETOs in Shanghai and Chengdu, in addition to its office in Beijing. The Shanghai ETO will cover the Municipality of Shanghai and the four provinces of Jiangsu, Zhejiang, Anhui and Hubei, while the Chengdu ETO will cover the provinces of Sichuan, Yunnan, Guizhou, Hunan and Shaanxi and the Municipality of Chongqing. In addition, coverage of the Guangdong ETO will be expanded to include Guangdong, Guangxi, Fujian, Jiangxi and Hainan, so as to strengthen the close ties between Hong Kong and the Mainland.

14. Hong Kong's world-class experience and expertise in finance and marketing and its well-developed infrastructure, combined with the

rapid economic growth of the Mainland, will create a win-win situation. The Mainland is Hong Kong's largest trading partner. Under the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA), eligible enterprises run by Hong Kong or foreign businessmen have preferential access to the Mainland market, enjoying zero tariff and other preferential treatment for designated products and services. This helps consolidate Hong Kong's position as the premier conduit for doing business with the Mainland, while highlighting the important role of Hong Kong as an international trade and business centre. And, with Mainland enterprises taking progressive steps to establish their presence outside China, Hong Kong naturally becomes their springboard.

Challenges to our international competitiveness

15. Although Hong Kong has many strengths in international competitiveness, the globalisation of economies and the Mainland's opening-up policy and rapid growth in recent years have brought about challenges.

16. The challenges we face include:

- (i) Global migration to free market economy gradually reducing the strengths of Hong Kong

Since the 1970s and 1980s, it has become a trend for economies to migrate from interventionism and protectionism to market economies. It has become an emerging consensus among governments worldwide over the past 20 to 30 years that competitiveness should be improved by more open markets, lower taxes, minimum government intervention, greater government efficiency and an improved business environment. As a result, Hong Kong's traditional advantage as a free market economy over other places is gradually diminishing. Our branding as a free market has also lost its uniqueness.

- (ii) Factors determining competitiveness have changed gradually with economic development

In the early stage of economic development, physical infrastructure is an essential element of competitiveness. As an economy develops, the importance of market performance and government efficiency increases. In a more advanced stage of development, factors such as innovation and invention, corporate governance or cultural heritage become more important in determining the competitiveness of an economy.

At present, scientific inventions or technological industries are the source of competitiveness for some countries or regions (e.g., the United States, South Korea, Taiwan and some Scandinavian countries like Finland). For cities such as London and New York, their competitiveness hinges largely on the size and maturity of their financial markets. A fresh and pleasant environment or a rich and unique culture are the special qualities of certain places. Global economic development in recent years has again made natural resources a competitive strength for some countries.

Hong Kong has reached its current state of development after years of economic development. In the absence of natural resources, the quest for a new breakthrough in raising our competitiveness has become an issue.

(iii) Opportunities, competition and risks arising from the Mainland's continued economic growth

The rapid economic growth of the Mainland has created more room for Hong Kong to expand its market and ride on its institutional strengths. Market expansion and enhancement have also created many business opportunities for sectors such as financial services, professional services and trade. However, the Mainland's development has also brought about greater competition. Issues being widely discussed include whether Shanghai will replace Hong Kong as a financial centre, whether Shenzhen will replace Hong Kong as a major container port, or whether Baiyun Airport in Guangzhou will replace Hong Kong

International Airport as a regional aviation hub. Political and business circles in foreign communities have paid less attention to Hong Kong because of “China fever”.

The Mainland’s rapid economic development requires various types of risk management. Moreover, the Mainland could encounter fluctuations or doldrums in its economic development, or even financial or social unrest in the longer term. New challenges and concerns for Hong Kong include maintaining our competitiveness by exploiting our experience in risk management and handling market crises, and helping Mainland enterprises and our country manage various risks in the course of China’s development.

(iv) Human capital

The attractiveness of a place to outside talent is an important factor in determining its competitiveness. In the face of globalisation, Hong Kong needs a sufficient talent pool to support the development of high value-added industries and a knowledge-based economy. Although an international outlook and proficiency in English are our strengths, many in the business community think the English and Chinese language standards of our young people have shown signs of decline in recent years. As Mainland residents have rapidly caught up in this respect, they pose a threat to our edge in language proficiency. In addition, compared with other developed economies and major cities around the world, the percentage of Hong Kong people who have attained a university-level education or above is still low, and there is a trend of local young talent leaving the territory for good. With a low fertility rate and longer life expectancy, Hong Kong is facing the problem of an ageing population. Many new arrivals from the Mainland under the One Way Permit Scheme are not highly educated. How all these factors will affect the quality of Hong Kong’s population and its impact on our development to a

knowledge-based economy has attracted greater attention in the community.

(v) Mismatch of skills

Hong Kong is an international financial centre providing services such as financing, asset management, banking and insurance. We are also an international business services centre offering a wide range of high value-added professional services including brand building, cultural creativity, corporate headquarters services and other related professional services. Meanwhile, low value-added industries have limited scope for development in Hong Kong. The phenomenon of industries relocating across the border has spread from the manufacturing industry to certain service industries, resulting in a mismatch of skills and a widened income gap. This has generated social conflict and confrontation in Hong Kong.

(vi) Environmental problems

Owing to rapid economic development in the Pearl River Delta, Hong Kong and other places in the region are facing serious pollution problems. Environmental problems have a direct impact on Hong Kong's attractiveness to tourists, talent and foreign investment and undermine our international competitiveness.

(vii) Political situation

Since reunification, the SAR Government has faced challenges to its governance. At the same time, the relationship between the executive and the legislature has remained rather tense. And development of the political structure will continue to be a controversial issue in the community.

Enhancing Hong Kong's competitiveness

17. In consolidating and strengthening Hong Kong's international competitiveness, the following strategic issues should be considered:

(i) Consolidating institutional strengths

Our institutional strengths are the cornerstones of the stability and prosperity of Hong Kong. The prerequisite for Hong Kong to attract overseas investors and entrepreneurs to conduct business here, and for our residents to live and work satisfactorily, is to excel in institutional strengths. The Government should spare no effort in safeguarding these strengths and improving the existing systems.

For example, Hong Kong has long been regarded as the world's freest economy. The international community has high regard for Hong Kong's fair competitive environment. Since introduction of the Statement on Competition Policy in 1998, the Government has gained much experience from the implementation of sector-specific competition policies. However, as Hong Kong enterprises grow in strength, with some reaching world-class standard, coupled with an increased presence of multinational enterprises, it is possible that forces capable of manipulating the market may emerge in Hong Kong.

To ensure that the competition policy continues to serve the public interest and support a business-friendly environment, the Government should consider the need to introduce cross-sector legislation to tackle anti-competitive practices so as to encourage fair competition, enhance market efficiency and reduce disruption to the operation and development of small and medium enterprises. The Government appointed a Competition Policy Review Committee in June last year. The Committee is chaired by an independent and non-official member, with members drawn from different sectors. It is

tasked to conduct a review on the existing policy and is expected to complete the review by mid-2006.

Moreover, because of the narrow tax base, government revenue is highly sensitive to economic fluctuations and market changes. This leads to occasional fluctuations in the stability of the Government's financial position. In this regard, the Government should consider introducing revenue items that are less sensitive to economic fluctuations to stabilise our revenue and financial position.

(ii) Strengthening and upgrading the core industries

Financial services, business services, logistics and tourism are the four pillar industries in Hong Kong. We should take proactive measures to strengthen them. As an international financial centre, Hong Kong ranks first in investment and financing capabilities in Asia. Hong Kong's sophisticated financial market is built on a sound and fair legal system, a reliable and transparent regulatory regime, the free flow of information and compatibility with international practices. On this foundation, the Government should consider how to seize the opportunities presented by accelerated liberalisation and development of the Mainland economy to enhance Hong Kong's role as an international financial centre. In particular, it should tap into the huge potential of renminbi business, the bond market and asset management services. At the same time, the Government should continue to improve the quality and stability of our financial market and align our legal and regulatory framework with the best international practices by drawing reference to the standards of other major financial centres. Efforts should also be made to strengthen the regulation of listed companies and enhance the standard of corporate governance, so that we have a quality financial market that will attract local and overseas investors.

As regards business services, we should encourage wider application of new technology and innovation. We should strengthen design, research and development and brand-building activities to promote trading services. Leveraging on the Mainland market, the business services sector in Hong Kong will have more opportunities for expansion. On the logistics front, the Government has worked to strengthen Hong Kong's competitiveness (including that of the container freight industry) through discussions with the Guangdong authorities and co-operation with the industry. Such efforts have begun to deliver results. The "4-up-4-down" and "1-truck-1-driver" requirements imposed on cross-boundary container trucks have been relaxed. The attractiveness of our port has also been enhanced with the reduction of dues for port facilities and lighting, and anchorage charges for vessels. Given the broad spectrum of services provided by the logistics sector, the SAR Government should capitalise on the opportunities brought by the Mainland's accelerating economic and trade growth and liaise closely with the industry to formulate comprehensive measures to improve the competitiveness of Hong Kong's aviation, container freight and maritime transport services, with a view to maintaining our position as a logistics, air-freight and maritime transport centre in the region. On tourism, with the growth of tourism in the Mainland and worldwide, active measures have to be taken to develop resources for Hong Kong's tourism and improve support facilities to consolidate existing advantages and further develop our potential.

(iii) Ties and co-operation with the Mainland

While rapid development in the Mainland may lead to regional competition, it may also provide greater opportunities for Hong Kong. On this premise, we should consolidate our strengths while co-operating with Mainland cities to support each other's development. Only in this way can we complement each other and achieve a "win-win" situation.

The Outline of the 11th Five-Year Plan adopted by the National People's Congress in March 2006 stresses that support will be given to Hong Kong's development in finance, logistics, tourism and information services, and to maintain Hong Kong's status as an international financial, trading and shipping centre. We should seize the opportunity and play a positive role in supporting the development of the Mainland, including the Pan-Pearl River Delta region, so as to maintain and enhance Hong Kong's competitiveness.

The Government should also actively promote regional co-operation with the Mainland, such as co-operation with Guangdong and other parts of the Pan-Pearl River Delta region, to enhance co-ordination and support between the two sides, in particular with the Pearl River Delta region and neighbouring provinces and areas. We can forge closer ties with provinces and areas in the east and southwest through the ETOs to be established soon in Chengdu and Shanghai, to strengthen our co-operation with the Mainland. In addition, we should step up integration of our transport infrastructure with neighbouring areas, pushing ahead with major infrastructure projects, such as construction of the Guangzhou-Shenzhen-Hong Kong Express Rail Link and the Hong Kong-Zhuhai-Macao Bridge, to facilitate the smoother flow of goods and people.

(iv) Manpower policy

Regarding the development of local talent, the Government should actively increase the opportunities for education, including senior secondary and tertiary education, and continue to provide opportunities and resources for the workforce to pursue further education. This will help raise the overall education level of our people, broaden their international outlook, and boost their proficiency in both Chinese and English. We should also provide diversified learning opportunities and advancement ladders to promote lifelong learning in the community.

The Government should also continue its efforts to help the local workforce upgrade their skills with a view to improving the quality of our human capital. In fact, a number of initiatives have been launched to enhance the competitiveness and employability of workers. These include the Skills Upgrading Scheme, the Employees Retraining Scheme and the Continuing Education Fund, which will provide employees of different sectors with focused training and continuing education. The Government is rolling out a Qualifications Framework to promote lifelong learning.

On efforts to attract non-local talent, the Government should consider introducing a more flexible admission scheme to attract the best brains from around the world to live, work and study in Hong Kong.

(v) Improving the living environment

Hong Kong must improve its air quality and deal with the smog issue. The Government should keep up liaison and co-operation with the Guangdong Government to achieve the target of reducing the emission of pollutants in the Pearl River Delta region by 2010 as scheduled. At the same time, the Government should introduce more measures to reduce environmental pollution caused by the local power plants, and control the pollutants emitted from local vehicles as well as products containing volatile organic compounds.

(vi) Promoting political and social stability

The Government should work with all sectors of the community as closely as possible to strengthen the implementation of “people-based” governance and actively foster a harmonious society. As regards our political structure, the Government should continue to develop a democratic political system in a gradual and orderly manner in accordance with the Basic Law,

and strive to improve the relationship between the executive and the legislature.

Summary of strategic issues

18. To sum up, when we work out ways to enhance Hong Kong's competitiveness, we should consider:

- (i) How to enhance and improve existing institutional strengths.
- (ii) How to strengthen and upgrade the core industries and develop new ones.
- (iii) How to strengthen ties and co-operation with the Mainland. In particular, how do we capitalise on the opportunities presented by the 11th Five-Year Plan?
- (iv) How to improve the quality of local talent and attract more talent from outside.
- (v) How to effectively improve the living environment and especially the air quality of Hong Kong.
- (vi) How to improve political and social stability.

Secretariat to the Commission on Strategic Development
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