

Executive Summary

**MADE IN
PRD**



**The Changing
Face of HK
Manufacturers**

Part II & Full Report



**Federation of
Hong Kong Industries**



香港工業總會
Federation of
Hong Kong Industries



創新科技署
Innovation and
Technology Commission

香港經濟研究中心

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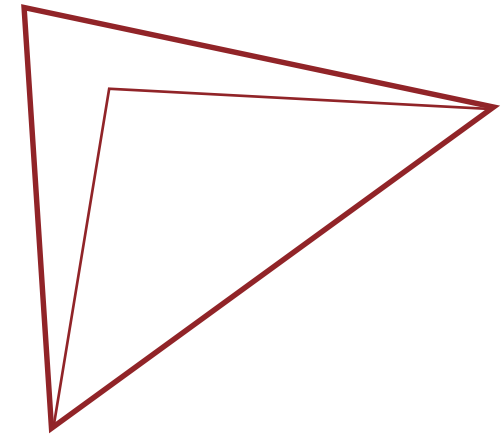
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MADE IN PRD



The Changing Face of HK Manufacturers

Part II & Full Report

The Changing Face of Hong Kong Manufacturers

Manufacturing is the largest and fastest growing economic activity in the Greater PRD.



Introduction

Hong Kong's rise as a service economy has led many people to mistakenly conclude that manufacturing has declined in Hong Kong. Following China's opening, Hong Kong manufacturing activities in Guangdong have expanded enormously over the past 20 years. Manufacturing is the largest and fastest growing economic activity in the Greater Pearl River Delta (PRD), comprising Guangdong, Hong Kong, and Macao.

A major part of Hong Kong's economy is tied to manufacturing activities across the border. Half a million workers in Hong Kong are employed in manufacturing or import-export companies that have production operations in the Mainland. Another one million workers are indirectly employed in producer services-related jobs that are linked to cross-border manufacturing activities.

The rapid growth of producer services in Hong Kong is a consequence of

industrialization across the border. Hong Kong must think of its service sectors from a regional perspective and not with a local mindset. Government industrial policy should therefore focus on enhancing the competitiveness of manufacturing-related activities in the region as a whole.

The PRD has been called the Fifth Asian Dragon, the other four Asian Dragons are Hong Kong, Singapore, South Korea, and Taiwan. All of these economies experienced rapid industrialization and sustained economic growth, and all are export oriented.

The partnership between Hong Kong and Guangdong has turned the latter into the Mainland's fastest industrializing province. Guangdong's relative share of industry value-added in the Mainland rose from 4.7 percent in 1978 to 11.4 percent in 2002. The partnership has transformed the Greater PRD into a highly integrated economic region despite administrative separation.

The Greater PRD is Asia's leading recipient of foreign direct investment (FDI) and the world's fastest-growing export-oriented manufacturing region. In 2001, the region was the recipient of more FDI than any other Southeast Asian economy. Hong Kong is the largest overseas investor in Guangdong, accounting for 71 percent of cumulative FDI, which totalled US\$79 billion at the end of 2001.

The total value of exports from the region in 2001 was higher than that for any other Southeast Asian economy other than Japan or the Mainland as a whole. The total value of exports from the Greater PRD in 2001 was US\$289 billion, representing 4.69 percent of total world merchandise trade. Total value of domestic exports (excluding re-exports but including earnings from re-exports) from the Greater PRD in 2001 was US\$152 billion, representing 2.56 percent of total world merchandise trade.

Hong Kong's Manufacturing Operations in Guangdong

According to our survey conducted in 2002, an estimated 63,000 companies, which comprise 52 percent of all Hong Kong based manufacturers and importers-exporters, are engaged in manufacturing activities in the Mainland.

Of these 63,000 companies, 7,000 are registered as manufacturers (they represent 35 percent of all manufacturers in Hong Kong), and 56,000 companies are registered as importers-exporters (they represent 55 percent of all importers-exporters in Hong Kong).

Twenty-seven thousand companies (22 percent) have invested in factory facilities, 32,000 companies (26 percent) have management and operation controls of factory facilities in the Mainland, and 28,000 companies (23 percent) have entered into sub-contracted processing arrangements with factories in the Mainland.

Of the 59,000 factory facilities that Hong Kong based companies operate in the Mainland, an estimated 53,300 are in Guangdong.

Out of the 53,300 factory facilities in Guangdong, 21,300 are foreign-funded enterprises (FFE), and 32,000 are other contractual forms (OCFs). The OCFs include those classified as other foreign investments (OFIs) and those under other arrangements (OTHs). OFIs are predominantly enterprises engaged in "three forms of processing/assembly operations and compensatory trade." OTHs are other contractual arrangements that allow Hong Kong based companies to manage and control Mainland factory facilities. The geographic distribution of these factory facilities in Guangdong is as follows:

Dongguan	18,100
Shenzhen	15,700
Guangzhou	4,900
Huizhou	3,500
Zhongshan	3,000
Others	8,100

An estimated 10 million workers in Guangdong are employed in manufacturing operations of Hong Kong based companies (4.75 million in FFEs, 5.04 million in OFIs, and 0.55 in OTHs). The geographic distribution of these workers in Guangdong is as follows:

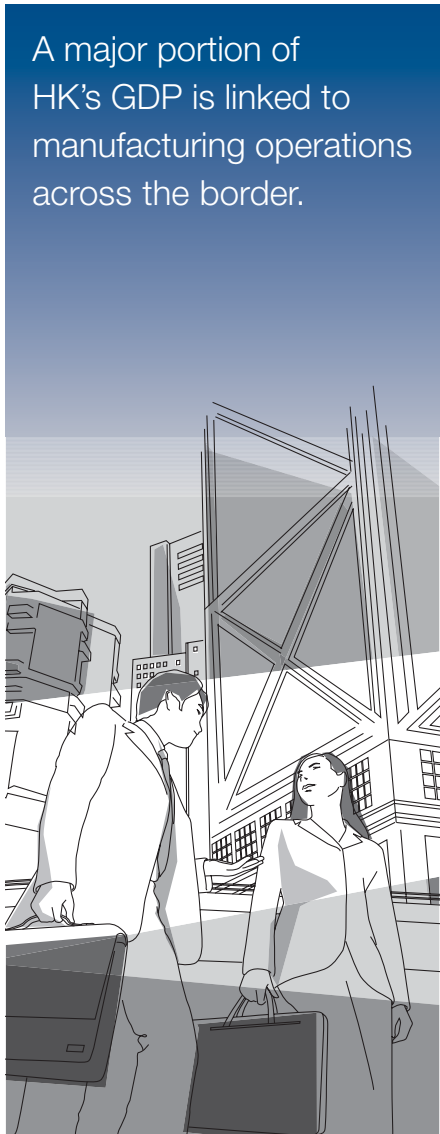
Dongguan	4.02 million
Shenzhen	2.58 million
Guangzhou	0.92 million
Huizhou	0.87 million
Zhongshan	0.61 million
Others	1.34 million

The 63,000 Hong Kong based manufacturers and importers-exporters that were economically active in the Mainland employed 477,000 workers in Hong Kong. For every employee engaged in Hong Kong, 23.5 were employed in the Mainland.

Out of these 63,000 companies, a total of 46,000 had either invested in factory facilities or had management and operation control of factory facilities in the Mainland. They employed 389,000 workers in Hong Kong.

Among the companies surveyed, an estimated 80 percent of the value of their exports and 50 percent of the value of their imported materials was transported through Hong Kong. The massive movement of goods in the PRD supports Hong Kong's logistics industry. Hong Kong Port will continue to perform an important role in serving the region. For the future, some 37 percent of the surveyed companies indicate that they are likely to rely more on ports in the Mainland.

In 2001, 64 percent of the companies had experienced incidents of and incurred financial losses due to traffic congestion and customs delays while transporting goods across the Hong Kong and Shenzhen border. Three-quarters of the companies reported that



they had experienced one to five incidents in that year and the other quarter reported six or more incidents. The median value of the financial loss incurred from such incidents was estimated at HK\$100,000. This means billions of dollars are lost each year because of such incidents.

One of the critical strengths of manufacturing in the Greater PRD is its rapid response capability. The role performed by Hong Kong Port in supporting industries in Guangdong is enormous and will remain so for the foreseeable future. The region's competitiveness in the future will depend on the smooth functioning of global product supply chains managed out of Hong Kong.

An Evolving Partnership – Guangdong and Hong Kong

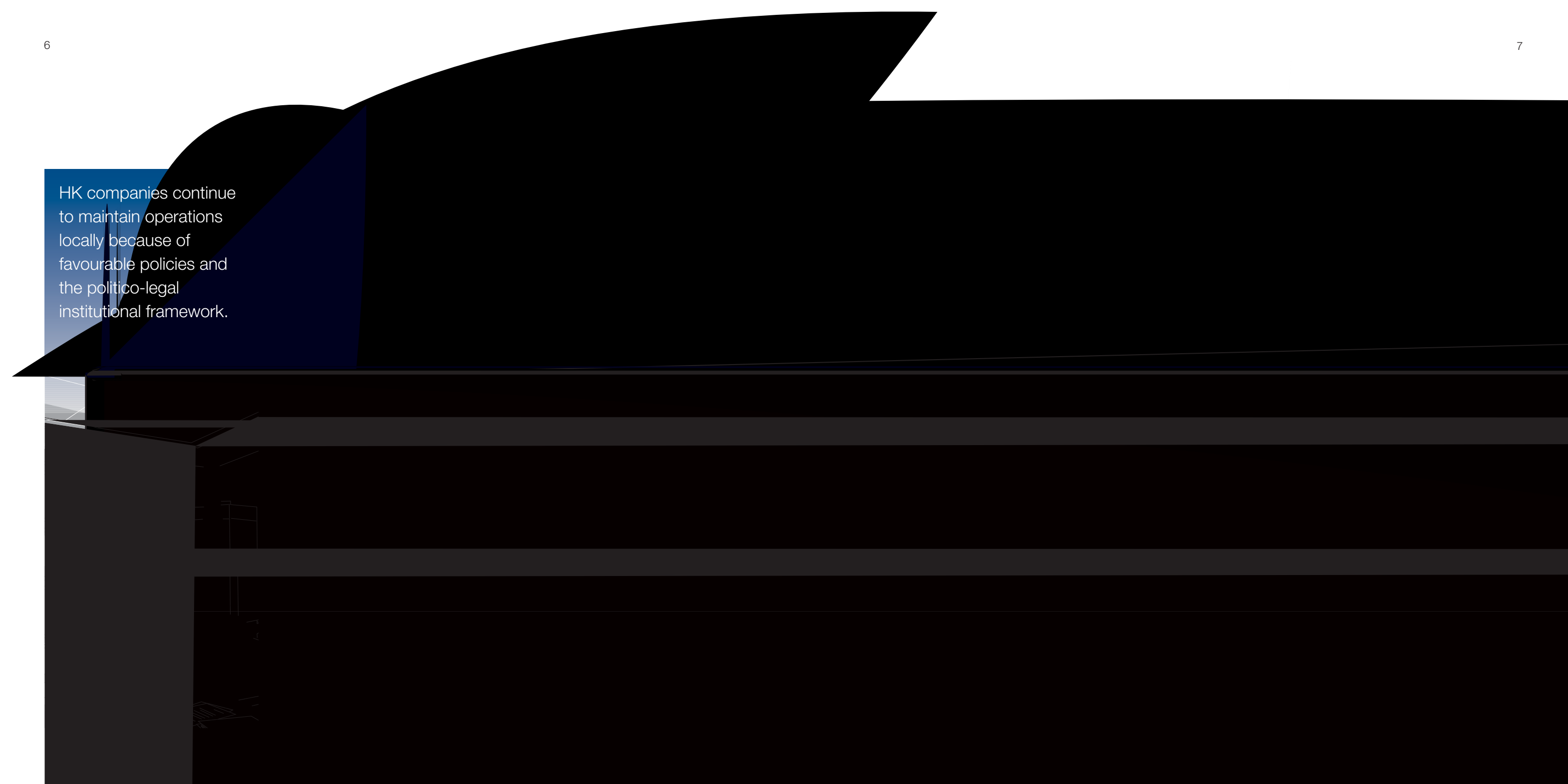
The most important reason chosen by 64 percent of the companies surveyed for moving operations and production to Guangdong is to reduce labour costs. Other significant reasons are to reduce rental/land costs, scale up production, move closer to their customers and business partners, and exploit domestic sales opportunities.

About 80 percent of the companies surveyed indicated that their Hong Kong offices were serving as regional headquarters and were performing financial management functions, 76 percent indicated that their Hong Kong offices were principally performing sales and marketing activities, 51 percent indicated that storage and transportation were principally carried out in Guangdong, and 83 percent indicated that production was principally carried out in Guangdong. Hong Kong today is the management centre of global supply chains with a concentration of manufacturing activities located in the Greater PRD.

The division of labour between Hong Kong and Guangdong is changing. At least half of the companies surveyed indicated that functions relating to regional headquarters, financial management, sales and marketing, information technology management, procurement of materials, R&D, storage and transportation, and production in Hong Kong would not change in the next two to three years. But more than half of the companies indicated that, with the exception of headquarter functions and financial management, they would increase their activities in Guangdong. About 30-40 percent of the companies planned to move their procurement of materials, storage and transportation, and production activities to Guangdong.

An estimated 64 percent of the companies indicated that they would start or increase their domestic sales activities in the Mainland because the markets there are growing. Such an orientation would further shift the centre of gravity of the Hong Kong–Guangdong partnership toward Guangdong.

HK companies continue to maintain operations locally because of favourable policies and the politico-legal institutional framework.



completed junior college or above in the period 1990–2000 was the highest in the Mainland, at 13.8 percent. The corresponding figure for Shanghai is 7.7 percent; for Jiangsu, 11.4 percent; and for Zhejiang, 11.9 percent. The growing supply of educated manpower and the R&D talent pool in Guangdong has to be taken very seriously by companies in Hong Kong.

The Greater Yangtze River Delta (YRD) is an attractive location to set up R&D centres because of the concentration of universities there. The large population base in the Greater YRD, which is 1.6 times that of Guangdong, makes it possible to draw on a large talent pool.

Investing in R&D activities is important for the future of manufacturing activities. R&D investments enhance competitiveness, lead to industrial upgrading, and create better product designs that are required for future success. Continued reliance of

labour-intensive low technology manufacturing will not work in the future. Combining Guangdong's talent pool with Hong Kong's cluster of research universities and well-articulated legal framework for protecting intellectual property rights to advance R&D activities may have considerable payoff. However, these investments should be relevant to the critical needs of industrial development in the region rather than to create leading edge technology industries for its own sake.

With relation to the advancement of R&D activities, combining Guangdong's talent pool with HK's cluster of research universities and robust legal framework for protecting intellectual property rights could prove lucrative to the HK economy.



The Greater PRD and the Greater YRD Economic Regions

The Greater YRD and the Greater PRD are often perceived as competitors. For Hong Kong based companies, both regions present business opportunities for manufacturing operations. Hong Kong based companies have invested heavily in Guangdong and will continue to do so. Hong Kong is also the largest overseas investor in the Greater YRD, accounting for 39 percent of cumulative FDI in Shanghai, Jiangsu, and Zhejiang, which totalled US\$42 billion at the end of 2001.

The two region's measured GDPs are about the same, but the Greater YRD is likely to grow faster because of the much slower growth rate of Hong Kong's service economy. In 2001, FDI flows into the Greater YRD stood at US\$13.7 billion—close to the corresponding figure for Guangdong (US\$13.0 billion). Adding Hong Kong's massive FDI inflow of US\$22.8 billion overwhelms the balance in favour of the Greater PRD. The value of the Greater YRD's domestic exports is half of the value of the Greater PRD's domestic exports. At the moment, the Greater

YRD lags behind the Greater PRD, but the former is growing rapidly and is attracting foreign investments quickly, and will probably experience a faster export growth rate than the latter. Both regions are developing into more open and transparent markets. Guangdong is more advanced in this respect than the Greater YRD, but the gap is closing.

Guangdong, Shanghai, Jiangsu, and Zhejiang are primarily industrial economies. Shanghai has experienced rapid service sector growth recently, primarily in the areas of finance, real estate and transportation. Hong Kong is predominantly a producer services economy. The producer services in Hong Kong are primarily oriented toward servicing the manufacturing base in Guangdong. However, Hong Kong's role as a manager of the global supply chains has already reached out to the Greater YRD in the same manner in which it has been servicing the Greater PRD.

Policy Implications and Recommendations

The partnership between Hong Kong and Guangdong reflects a deep and broad engagement of companies and workers across the border that goes beyond the description of “front-end shop and back-end factory.” The partnership has transformed Guangdong into one of the leading industrialized provinces in the Mainland. The partnership has also transformed Hong Kong's industrial and employment structure from one focused on manufacturing to one specializing in producer services. Hong Kong's producer service thrives on the cross-border manufacturing operations and in turn enhances their overall productivity. Therein lies the real partnership between Hong Kong and Guangdong; together the two form a producer services hub and manufacturing base.

The partnership also defines Hong Kong's basic business model. It involves an elaborate division of labour that forms the core elements of the global supply chains managed out of Hong Kong. The business model succeeds by shortening cycle time

through responding rapidly to market demand, managing just in time production and delivery schedules, fostering cluster effects among related products and services, and supporting product innovations.

Although core services associated with managing the global supply chains still remain in Hong Kong; however, the centre of gravity of this partnership is shifting towards Guangdong as more producer services are transferred across the border. The shifting division of labour is sometimes seen at the company and worker level as a zero-sum game benefiting Guangdong at the expense of Hong Kong.

The key challenge is not to arrest the process of integration but to scale it up further, to enhance Hong Kong's value-added portion in the global supply chains, and deploy the Greater PRD platform to leverage the entire Mainland, including the Greater YRD. The objective is to enhance the competitiveness of both and to attract

more investments to the region to start new and higher value-added activities.

Policy in Hong Kong should not be narrowly focused on fostering high value-added technology based industries or keeping a manufacturing base in Hong Kong. It should be focused more broadly on enhancing the overall competitiveness and vitality of all manufacturing activities and manufacturing related producer services in the Greater PRD. This has to be achieved through better coordination and cooperation among authorities in the region to the benefit of all.

The companies we surveyed and interviewed believed that the efforts of the relevant authorities in the region should focus on:

1. Maintaining a Good Business Environment in Hong Kong

Most Hong Kong based companies surveyed were satisfied with Hong Kong's business environment - a simple tax system with low tax rates, absence of foreign exchange controls, free flow of information, free trade, rule of law, and independence of the judiciary. They felt strongly that this is the single most important aspect of Hong Kong's advantage.

2. Cooperation in Infrastructure Development and Setting Rules and Regulations

Reduction of customs delays and traffic congestion in the movement of goods by land across the border is the most important feature that has to be addressed. The benefits could amount to tens of billions each year over time.

The development of basic infrastructure, like roads, bridges, and border check points, to shorten the time for the flow of goods and the clearance of customs is an urgent concern.

A bridge link to the West would open up new opportunities in the Western part of the PRD where foreign investments are much less than in the Eastern part and also provide relief for congestion on existing land access.

Relaxation of rules and regulations in the Mainland that require factories to clear customs in their local cities, to submit applications for moving goods across the border three days in advance, and to insist on a rigid system of requiring the same container driver, container truck, container box, and container chassis to cross border as a single unit all contribute to higher costs and delays.

3. Establishing a Special Public Agency for Aggregating Common Concerns and Mediating with Mainland Authorities

A Special Public Agency should be established to collect, aggregate, and convey common concerns to Mainland authorities. Such an agency would allow all companies, especially small and medium sized enterprises, to have an efficient and convenient way to reflect their views and help improve the business environment in Guangdong. It would help Guangdong maintain its competitive position after China's accession to the World Trade Organization (WTO).

4. Strengthening R&D Capabilities in Hong Kong

The government should enhance the overall infrastructure to facilitate R&D activities among companies in Hong Kong. Policy aimed at boosting R&D activities in the region should recognize that its main purpose is to allow companies to become the best in the

class of products they manufacture rather than to be at the leading edge of modern technology.

Better coordination with Guangdong would make it possible to build on each other's respective strengths: Hong Kong's intellectual property rights protection framework, Guangdong's availability of affordable R&D staff, and instituting proper incentives to facilitate cooperation between industry and universities in the region.

5. Training, Education, and Admission of Talent and Professionals from the Mainland

The government should make suitable provision to train and educate local staff and students with a view to equipping them with the requisite skill set to operate throughout the region and to allow more talent and professionals

from the Mainland to work in Hong Kong. A more relaxed policy on admitting talent and professionals from the Mainland and allowing them to come to Hong Kong through both one-way permits and long term two-way permits is critical if Hong Kong is to develop a substantial R&D capability in the future.

6. Business Environment in Guangdong

Further improve the business environment in Guangdong through greater transparency of government policies and regulations and a more uniform set of regulations and fees and charges throughout Guangdong would benefit both Guangdong and foreign investors. This should be an important goal for enhancing the competitiveness of Greater PRD especially after China's accession to the WTO and will be vital as competitive pressure mounts.

7. Attracting Multinational Enterprises to Hong Kong

The companies we interviewed believe that Greater PRD has much to offer to foreign investors, especially small to medium-sized companies. Hong Kong provides a favourable business environment and a reservoir of knowledge and expertise to manage operations in the Mainland. The Mainland has an abundance of skilled and unskilled manpower and also a growing market for investors. The region should be promoted and branded as a whole to attract overseas investors.

The companies surveyed and interviewed in this study believed that the changing face of manufacturing requires a redefinition of the aims of government in supporting manufacturing in Greater PRD as a whole for Hong Kong and the region's future:

1. The good business environment in Hong Kong should be maintained.
2. There should be greater cooperation in infrastructure development and the setting of rules and regulations.
3. A special public agency for aggregating common concerns and mediating with Mainland authorities should be established.
4. Hong Kong's R&D capabilities should be strengthened.
5. More training and education should be offered to local people, and more talented professionals from the Mainland should be granted visas to work in Hong Kong.
6. The Guangdong business environment should be further improved.
7. Greater efforts should be made to attract more multi-national enterprises to Hong Kong.

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Steering Committee:

Mr Victor Lo
Chairman & Chief Executive, Gold Peak Industries (Holdings) Limited

Mr Donald Chia
Managing Director, Medipharma Limited

Mr Kenneth Ting
Chairman, Kader Industrial Company Limited

Mr Andrew Leung
Managing Director, Sun Hing Knitting Factory Limited

Mr Jeffrey Lam
Managing Director, Forward Winsome Industries Limited

Mrs V C Davies
Director-General, Federation of Hong Kong Industries

Dr Andrew Chuang
Director, Gold Peak Industries (Holdings) Limited

Mr Roy Chung
Managing Director, Techtronic Industries Company Limited

Dr W K Lo
Managing Director, Artesyn Tech Asia-Pacific Limited

Dr K B Chan
Chairman & Managing Director, Surface Mount Technology (Holdings) Limited

Mrs Anna Lai
Deputy Executive Director, Hong Kong Trade Development Council

Mr Edmund Sung
Branch Director, Services and Business, Hong Kong Productivity Council

Research Team:

The Hong Kong Centre for Economic Research

Prof Y C Richard Wong
Professor of Economics and Dean of the Faculty of Business & Economics, The University of Hong Kong

Dr Alan K F Siu
Executive Director
Hong Kong Centre for Economic Research

Dr Dennis M Y Wong
Associate Professor, School of Business, The University of Hong Kong

Ms Ginie Choi
Research Associate, Hong Kong Centre for Economic Research

Federation of Hong Kong Industries Co-ordinating Team:

Mrs V C Davies
Director-General

Ms Alexandra Poon
Director, Industry & Research Division

Mr Roger Tam
Senior Research Officer, Industry & Research Division

Mr Edmond Fung
Research Officer, Industry & Research Division

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Federation of Hong Kong Industries

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Glossary

Compensatory Trade

Compensatory trade (補償貿易) is an arrangement whereby a foreign company provides a loan (either in the form of money, equipment or technology) to a Mainland enterprise to either set up a factory (or factories) or to explore resources. When the project is completed, the domestic enterprise uses its products or other products to pay back the loan by instalments within an agreed period of time.

Economically Active in the Mainland

Since our study only focuses on manufacturing operations of Hong Kong based companies in the Mainland, a company is said to be economically active in the Mainland if it is engaged in any of the following three activities there: (1) investing in factory facilities in the Mainland; (2) having management and operation control of factory facilities in the Mainland; and (3) making sub-contracting processing arrangements with foreign invested or local enterprises in the Mainland. For the purpose of our study, a company is deemed to be not

economically active in the Mainland if it does not pursue any of these three activities, even though it may have other non-manufacturing related business activities in the Mainland.

FFEs (Foreign Funded Enterprises)

FFEs refer to those joint ventures or co-operatives established in the Mainland with foreign investment, as well as establishments wholly funded by foreign capital.

OCFs (Other Contractual Forms)

OCFs refer to three forms of processing and assembly operations, compensatory trade and any other processing arrangements or relationships into which a foreign company enters with a Mainland factory. OCFs include OFIs and OTHs.

OFIs (Other Foreign Investments)

OFIs refer to “three forms of processing and assembly operations and compensatory trade” (三來一補), in which the foreign partner does not have legal ownership of the companies.

In China, they are classified as domestic enterprises even though the management of these companies is controlled by their foreign partners.

OTHs (Other Arrangements)

OTHs refer to other arrangements by means of which Hong Kong based companies have share in, control of, or manage domestic enterprises.

Three Forms of Processing and Assembly Operations

Three forms of processing and assembly operations refer to processing with supplied materials (來料加工), assembly with supplied parts (來件裝配) and processing in accordance with supplied samples (來樣加工).