



## What Are the Solutions of Hong Kong's Trade Predicament?

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### 1. Mired in a predicament of persistent contraction

Hong Kong's trade has been persistently contracting. It has contracted for 15 months in a row from May last year to July this year. The period of contraction not only exceeds the period during the global financial crisis between 2008 and 2009, but also breaks the record during the Asian financial crisis. Judging by the current external and internal environment, the contraction in Hong Kong's trade will undoubtedly become the longest since records began. Although the contraction is less severe than the previous two occasions, the negative impacts on exports of services, cargo logistics, financial services, labor market and economic development would be no less harmful due to the ultra-long period of sluggishness. This is an important feature of Hong Kong's trade recently.

Another feature of Hong Kong's trade predicament is that Hong Kong underperforms the overall global standard. For a long period of time, as the most important trading hub in Asian Pacific, Hong Kong imports and exports trade performed outstandingly. In the 25 years between 1990 and 2014, Hong Kong's trade outperformed the overall global standard by an average annual growth rate around 3%. Nevertheless, the situation has reversed since early last year. According to World Trade Organization (WTO) statistics, the volumes of global trade increased by 2.8% last year, while the volumes of Hong Kong's trade decreased by 2.5%. The volumes of Hong Kong's trade dropped 2.1% for the first seven months of this year. Negative growth will likely be recorded for this year, while WTO estimates the volume of global trade will increase by 2.8% this year.

Compared with global performance, the consistently lower growth of Hong Kong's trade completely diverges from the previous trend. In the past few decades, this situation only happened during the Asian financial crisis in 1998. Hong Kong was seriously impacted by the regional financial crisis at that time, but no similar financial crisis took place recently. What are the underlying reasons of this phenomenon?

### 2. Structural factors are the cause

The anemic performance of Hong Kong's trade is the result of cyclical and structural factors combined. In terms of cyclical factors, in the three decades before 2012, global trade grew two times faster than the global economy, making exports an important economic growth engine for many countries. However, the global economy recovered slowly after 2012. In particular, advanced economies in Europe and the US cannot be stimulated effectively because of their high debt levels. Rising trade protectionism also contributed to lower growth of global trade compared with the global economy. The growth of global trade has been below 3% for four conservative years, which was only half of the normal level in the past and undermined the growth of Hong Kong's trade.

Compared with the global average, the growth rate of Hong Kong's trade has reversed from an outperformance of around 3 percentage points in the past to currently an underperformance of 5 percentage

points. It should be noted that such shift is not only affected by cyclical factors but also by significant structural changes listed below:

Firstly, it is closely related to the shifting of processing trade by multinational companies. For a long period of time, the East Asian region has established a production chain for global processing trade, with China playing a central role. As a “originator” of the Mainland’s processing trade and a partner under “front shop, back factory” model, Hong Kong has benefited tremendously. However, the condition has quietly changed. In light of skyrocketing processing cost in the Mainland, many multinational companies have moved their processing trade activities from the Mainland to other countries in ASEAN and South Asia with lower costs. For example, in August last year, Panasonic, a Japanese company, announced the closure of its lithium-ion battery factory in Beijing. This was the company’s third migration after the closure of its plasma television factory in Shanghai in 2012. Foxconn, the Original Equipment Manufacturer for Apple Inc., is facing challenges of rising wages and labor disputes in China. It plans to build 12 factories and hire 1 million local workers in India in 2020. Korea’s Samsung will invest USD 10 billion for constructing production bases in Vietnam. In the future, the company will transfer 80% of its production capacity in China to Vietnam. Many Taiwanese companies also move their footwear factories to ASEAN. Other companies, such as Japanese casual wear brand UNIQLO and Lever Style, a Hong Kong-based garment processing manufacturer for the US department store Nordstrom, have transferred parts of their production lines to Vietnam and India.

The competitiveness of the Mainland’s low value-added industry has been gradually declining. In addition, the focus of processing trade is shifting abroad. Therefore, the performance of Hong Kong’s trade will inevitably worsen due to its status of a re-export trading hub for the Mainland. In the first seven months of this year, total processing trade value in terms of USD plummeted 14.3%. Total processing trade value for Guangdong, a major trading province, also slumped 13.7% in terms of RMB, hindering the normal trade development between Hong Kong and the Mainland. According to government statistics, trade value between Hong Kong and the Mainland contracted by 5.3% for the first seven months, lowering Hong Kong’s total trade by 2.7 percentage points, or 57% of the overall contraction in trade. This shows that more than half of overall contraction in trade can be attributed to slowing Hong Kong—Mainland trade, which was caused by shifting processing trade activities. It should be noted that shifting low value added processing trade activities has nothing to do with economic cycles. As a result, the consequences will be prolonged and structural, making it difficult for Hong Kong to improve its trade performance.

Another reason for the Hong Kong’s lackluster trade performance is that China is transforming from an export-led to a domestic demand-led economy. Moreover, the driving force for China’s economy is shifting from manufacturing to services. These two major structural changes would have huge impacts on imports and exports. Strong imports and exports growth that far exceeded the growth of GDP and global trade average are difficult to replicate nowadays. Strong growth for Hong Kong-Mainland trade is unlikely to repeat either. General trade best reflects changes in economic structure and their impacts. In terms of USD, general trade for the Mainland only grew 1.2% last year and even decreased by 5.1% for the first seven months of this year, far below the average annual growth of 30% between 2002 and 2007 as well as the average annual growth of 17.8% for the five-year period after the global financial crisis. Hong Kong’s trade is not only closely related to processing trade in the Mainland but also hinges on the developments of general trade in the Mainland. The significant changes in China’s endogenous and exogenous economic structure forced Hong Kong’s trade into an adjustment period.

Yet another reason for the persistent contraction in Hong Kong’s trade is the substantial slowdown in visitor arrivals and changes of tourists’ shopping pattern. Visitor arrivals grew 10.8% annually between 2005

and 2014; while visitors' expenditure in Hong Kong, mainly for shopping purposes, increased by 16.2% every year. Visitors from the Mainland grew 14.5% annually during the period, and they became a major shopping force. Nevertheless, the trend of visitor arrivals has reversed since last year, with declining numbers of both total visitors and Mainland visitors. For the first seven months of this year, the number of total visitors and Mainland visitors dropped 6.0% and 8.8%, respectively. Furthermore, Mainland visitors tend to shop in Japan and Europe instead, buffeting Hong Kong's retail sales. The value of sales of jewellery, watches and valuable gifts, items that rely on tourist shopping, has decreased 34% cumulatively since last year. The sales of those items registered the most severe drop among all retail items. As tourist shopping items are mainly retained imports of goods, slowdown in visitor arrivals and changes of their shopping pattern will eventually affect Hong Kong's trade. The impacts are undoubtedly structural.

In general, Hong Kong's trade has entered an adjustment period under the new normal conditions. Trade is expected to remain anemic for the second half of this year. On one hand, insufficient demand due to sluggish global economy will continue to pressure global trade. The WTO estimates that the growth of global trade for this year will be the same as last year, indicating the growth rate will be below 3% for 5 years in a row. It would be the worst period since the 80s of last century. At the same time, rising trade protectionism puts pressure on global trade. WTO report shows that G20 countries have imposed an additional 1,500 trade restrictive measures since 2008. In particular, the US has imposed more than 600 trade protective measures. Furthermore, as Doha Round negotiations failed, many regional trade arrangements have been rolled out, most of which adopted exclusivity trade strategies. It would not be beneficial to global trade in the long run. On the other hand, the restructuring of China's processing trade will continue in the next few years. Therefore, downward pressure on Hong Kong's trade is difficult to eliminate. In the near-to-medium term, Hong Kong will face contraction in trade, as well as the consequences of low economic growth and declining payroll.

### **3. "One Belt One Road" is the solution**

What is the solution to Hong Kong's trade woes? As a leading international trading center in Asian Pacific, Hong Kong still has advantages in trade and logistics. In addition, by exporting its production capacity through "One Belt One Road", China co-establishes industrial parks with participating countries, promotes production and technique co-operations with international peers, providing new opportunities for Hong Kong's trade. Therefore, Hong Kong needs to search for solutions by participating in "One Belt One Road" construction projects in the future.

"One Belt One Road" promotes trade in three ways. First, it will promote exports of transportation equipment (e.g. high speed rail), construction machinery, steel, cement, etc. through infrastructure and industrial investments. Second, China can negotiate with countries along the Silk Road on implementing trade liberalization measures, which will help expand China's exports of consumption goods. Third, the initiative will help promote imports of energy, resources and featured products from countries along the Silk Road to China. Regional will be strengthened by further promotion of "One Belt One Road" and international production co-operation. In the next decade, trade between China and 64 countries along the Silk Road is expected to grow more than 10% annually. The value of bilateral trade between China and these countries will surge to USD 2.6 trillion from USD 1 trillion currently, and its share of China's total international trade will jump from 24% to 34%.

"One Belt One Road" will bring more business opportunities to Hong Kong, such as cargo re-exports or transshipment, offshore trading, exports of services, etc. Moreover, opportunities for trade supporting

services, including trade negotiation, exhibition, brand promotion, etc. will substantially increase as well. In the next decade, the value of Hong Kong's trade is expected increase by hundreds of billions USD accordingly. More importantly, Hong Kong will be able to strengthen trade restructuring and supply chain management businesses. By seizing the opportunities of "One Belt One Road", Hong Kong can become a primary platform for global trade and supply chain management.

In fact, "One Belt One Road" has already begun to create new changes to Hong Kong's trade structure. Although total exports dropped 1.8% last year, exports to India and Vietnam surged 8.1% and 14.7%, respectively. For the first seven months of this year, total exports of Hong Kong declined 4.1%, while exports to India and United Arab Emirates (UAB) considerably increased by 11.7% and 16.4%, respectively. India has become the fourth largest exports market to Hong Kong. It may surpass Japan to the third position in the second half of this year. Vietnam has already become the fifth largest exports market for Hong Kong, surpassing traditional markets like Germany, Taiwan, Singapore, etc. UAB has also surpassed South Korea to become the ninth largest exports market for Hong Kong. Furthermore, for the first seven months of this year, exports to Commonwealth of Independent States & other East European countries, the Middle East and Pakistan surged 14.8%, 9.0% and 22.3%, respectively. These figures show that the positive impacts of constructions along Silk Road on Hong Kong's trade are emerging. Following the closer economic ties between China and countries along "One Belt One Road", those countries and regions will become a major driving force for Hong Kong's exports with increasing shares in total exports.

However, Hong Kong needs to speed up the negotiation of regional free-trade agreements (FTAs). In particular, the negotiation of FTA between Hong Kong and ASEAN should be completed as soon as possible. Also, Hong Kong should seize the opportunities to negotiate FTAs with countries in South Asia and the Middle East, so as to better capture regional trade growth. So far, Hong Kong has entered four FTAs with the Mainland, New Zealand, European Free Trade Association (including Iceland, Liechtenstein, Norway, Switzerland) and Chile. For the time being, Hong Kong is actively negotiating with ASEAN, Maldives and Georgia. In the meantime, Hong Kong is also negotiating with Macau on developing Closer Economic Partnership Arrangement (CEPA), pushing the negotiation of FTA with Australia, participating in service trade FTA negotiations with 23 WTO members, following up the progress of ultra-large regional trade negotiations such as Regional Comprehensive Economic Partnership (RCEP), Free Trade Area of the Asia Pacific (FTAAP), etc. These endeavors will give Hong Kong more space for trade collaboration. In particular, Hong Kong and ASEAN, the core region of the Maritime Silk Road, have negotiated for eight rounds already. Generally, the negotiation has made good progress, and both parties expect to reach an agreement within this year. After completing the negotiation, merchandises and services from Hong Kong will be able to enter the ASEAN market with better terms. Hong Kong will more effectively participate in supply chain management in countries along the Maritime Silk Road or even globally.

Last but not least, the growth of Hong Kong's exports to the aforementioned emerging markets cannot offset the drop of exports to traditional markets. However, Hong Kong's participation in "One Belt One Road" not only co-ordinates with national development strategy but also offers a way out of the current trade predicament. At the same time, following the restructuring towards producing high-tech and high value-added items in the Mainland, the structure of Hong Kong-Mainland trade will change considerably in the future. The proportion of high-tech and high value-added exports will climb further, facilitating Hong Kong's restructuring of its trading pattern and boosting the value of trade. By maintaining our comprehensive advantages of "facing internationally with the Mainland at our back", Hong Kong's trade will reposition and regain momentum in the medium-to-long term.