



The Trend of Industrial Transformation in Mainland China and Role for Hong Kong

Wong Sze Wah, Economist

Since the China-US trade disputes began in 2018, the bilateral commercial relations between the two nations remained tense. In May 2019, the US further escalated the trade measures, in which around US\$250 billion of Chinese products are subject to additional tariff at 25% (presenting nearly half of the US imports from China). The 25% tariff would substantially increase the trading costs for corporates in both nations. In general, exporters maintain around 5-10% of profit margin. In this connection, even the US importers are willing to share half of the newly imposed tariff, the Chinese producers could still face losses when exporting to the US market. With the China-US trade disputes getting longer and more complicated, corporates are likely to respond by adjusting their global production network and supply chain, in order to minimize the impacts from trade uncertainties. Indeed, Chinese corporates have long been relocating their factories to other low-cost economies based on their own development needs. The China-US trade disputes would only accelerate this process. As the top investment platform and international business hub for Mainland corporates, Hong Kong can play an important role in assisting these corporates to explore overseas markets and upgrade amid the trend of industrial transformation in Mainland China.

1. Structural shift in China's manufacturing investment

In recent years, both labor costs and land prices rose swiftly in China along the rapid economic growth, causing some companies to reduce investment in several low-profit manufacturing sectors, and shift their production capacity to other areas with lower overall costs. It indeed indicated that Chinese manufacturing sector has been in transition from high-speed growth to high-quality development. According to the statistics of fixed assets investment, growth in manufacturing investment started to slow down below 10% in 2015, a sharp slowing down compared to the 20% growth in 2011 and 2012. The downward trend continued until 2016 with growth stabilizing at around 4% from 2016 to 2017. Though a rebound to 9.5% was seen in 2018, it fell back to 3% in 2019. In the meantime, China's industrial value added broadly maintained a real growth at 5-6% per year with export values staying at a relatively high level. These figures suggested that the upgrade of China's overall industrial productivity had helped offset part of the impacts from slowing manufacturing investment.

Based on the FDI figures, multinational companies were also found to have adjusted their investment before the on-going China-US trade disputes. In the five years from 2014 to 2018, FDI into China attained US\$ 637.8 billion, up by 18% from the previous five-year period. Among these investments, FDI into manufacturing activities decreased by 22%, as most of the growth in FDI was driven by the services sector. Through analyzing the same data set, various manufacturing industries were found to have lower investment inflows in the period from 2014 to 2018. For

instance, FDI into textiles, chemical materials, and general equipment were down by 56%, 28% and 17% respectively compared with the previous five-year period. That said, strong growth of FDI was seen in some high value-added industries like the pharmaceutical manufacturing, which was up by 54%. In the first half of 2019, China's FDI grew by 7.2% yearly to RMB478.3 billion. Among these FDI projects, RMB 50.3 billion flowed into the high-tech manufacturing sector, an increase of 13.4% compared to the same period a year ago.

2. Uncertainties from trade disputes will expedite the re-deployment process of global supply chain of Chinese and foreign corporates

At present, the first round of tariffs under the current China-US disputes has been effective for more than a year. Despite a number of negotiations, both sides still could not reach consensus on certain structural issues including complete removal of the tariffs imposed, the size of additional purchase from China, and the wording of the deal. Furthermore, the US decided to increase the additional tariff rates against US\$ 200 billion worth of Chinese products from 10% to 25% in May 2019, and announced a new tariff list targeting the remaining US\$300 billion worth of Chinese products at an additional rate of 10%. The escalation of trade disputes had brought persistent uncertainties to the private sector, which would lead to a faster re-deployment of regional production activities.

When it comes to adjusting global supply chain activities, many corporates consider ASEAN countries as an ideal destination for their new investment. In 2018, manufacturing FDI into Indonesia, Malaysia, Thailand and Vietnam soared by 36%, 24%, 239% and 32% respectively. It is believed that Chinese investment was a major growth driver of FDI in these countries, as 11% of China's outbound manufacturing investment went into the ASEAN region. In addition, South Asia countries such as Bangladesh, India and Sri Lanka are becoming another target market for Chinese corporates to expand their overseas network. In general, the primary consideration for setting up production capacities in emerging market is largely due to their low labor costs and land prices, particularly in the labor-intensive industries like machinery, electrical equipment, transportation equipment and electronic products.

As for the medium and high-end manufacturing industries, most of them are expected to stay in China. First of all, a vast network of manufacturers and suppliers has formed a comprehensive industrial supply chain in China, providing every supporting activity to producers from raw material procurement, sourcing of spare parts, processing and assembly, warehousing, to export logistics. Taking these factors into consideration, the costs saved of moving production lines outside China may not be greater than the additional tariffs imposed by the US. Second, China's consumer market has tremendous potential for growth. Currently, China is home to the world's largest middle-income group with more than 400 million people out of a population of 1.4 billion. The number of middle-income group and their income level are both on an upward trend. Hence, many multinational companies still regard China as an important growth market. Third, capital-intensive machinery and skilled workers are particularly crucial for high-value added manufacturing industries. China has 170 million people with higher education degree or professional training, which many other regions are difficult to match up. Besides, new and core technologies will be a major focus for future China's industrial development. It is widely expected that both the Government and private sector will

greatly increase the resources allocated for R&D activities to further upgrade the high-tech industry chain. These policies will encourage more investment into high-end manufacturing sectors.

Overall, the China-US trade disputes are expected to mainly affect the low-end manufacturing industries in Asia-Pacific, as some firms may speed up relocating their factories to other low-cost regions. However, the impacts on the medium and high-end manufacturing industries are expected to be contained. While a small portion of them may return to the developed market or other regions due to cost considerations, most of them are expected to stay in China.

On industry level, some low-margin manufacturing industries such as textile, plastic products and furniture are expected to experience a faster pace of adjustment. Indeed, textile, leather products and shoe-making industries have started moving to other low-cost regions a few years before. This adjustment process is likely to continue, and even accelerate. In fact, export of China's textile and footwear products reached a peak level in 2014 and kept falling steadily thereafter, reflecting the structural changes within the two industries. Meanwhile, even though major textile and garment products are not yet affected by the tariff measures, the US's plan to impose additional tariffs against the remaining US\$300 billion Chinese import means that these products will also be soon involved in the China-US trade disputes. The number of textile, garment, leather and footwear manufacturing enterprises in China has declined for four consecutive years since 2016. It is expected that some labor-intensive OEM firms in these industries will speed up their relocation into other new markets such as ASEAN, India, Bangladesh or Africa.

In recent years, rubber, plastic and furniture manufacturing industries and their upstream chemical industries have also suffered from overcapacity, dragging the growth of these industries to underperform the overall manufacturing sector. As a result of the US tariff measures, demand for these products and their profits will possibly be pressured further. Therefore, some of the export-oriented producers in these industries may consider moving to other regions, in order to avoid the additional tariffs and lower their operating costs.

3. Hong Kong can play an active role in promoting the high-quality development of Mainland China

Experiences of many advanced economies showed that industrial transformation is often a necessary transition process of industrialization, in which these economies built their sustainable comparative advantages by concentrating on developing core technologies and high-end industries and phasing out the traditional low value-added industries. It is also worth mentioning that only the production part within the whole value chain will be outsourced. In reality, a majority of value-added by multinational companies came from other segments of the value chain. These activities include product development, design, procurement, international logistics, distribution, marketing and sales, etc. As the process of industrial transformation progresses, the Mainland economy will be further upgraded. As the main gateway for Mainland corporates to "go global", Hong Kong can play an active and unique role to leverage its strengths to facilitate the international deployment of Mainland corporates.

First, corporates have a number of options in deciding to expand their production capacity

overseas, most commonly through purchasing land and building a new factory or acquisition of existing production lines in the target market. For example, a Hong Kong listed furniture maker announced the purchase of production facilities in Vietnam in June 2018 for the purpose of avoiding the tariffs imposed by the US. In May 2019, the company revealed that its production capacity in Vietnam was able to meet 40% of the US orders and intended to increase more investment with a target of shifting all US orders from China to the factories in Vietnam by August 2020. Previously, the Hong Kong Trade Development Council conducted a survey on Mainland enterprises in regions with significant outbound investment (including the Pearl River Delta, the Yangtze River Delta, and the Bohai Rim region) between 2013 and 2015. The survey found that most companies would hire external providers for a variety of professional services such as product development, design, branding, marketing and promotion, finance, business consulting, legal, accounting, and so on. Among the respondents, more than half indicated that they preferred Hong Kong as the top choice to look for the professional services they needed. As an international business hub, Hong Kong can take advantage of its professional services sector to support Chinese corporates in their global expansion and help them to manage the investment risks.

Second, Hong Kong is a rich source of international talents with expertise in cross-border investment and cross-cultural management. With its strategic location, Hong Kong's aviation network covers most major Asian cities within a 4-hour flight. These advantages have attracted many US, Japanese and European companies to establish regional headquarters in Hong Kong for managing their Asian businesses and operations. KPMG International publishes a survey of more than 1,000 CEOs of the world's largest economies every year. The reports from 2017 to 2019 showed that operational risk was regarded by global CEOs as one of the top five risks for three consecutive years. It reflected that strengthening operational management was a top concern for global CEOs. Looking ahead, the number and amount of overseas investment by Chinese corporates will continue to grow, which will create rising needs for Chinese corporates to enhance their capacities in international business management. Given their professional knowledge and experiences, international talents in Hong Kong can give full play to their potentials by facilitating the internationalization of Chinese corporates and building up their regional management capabilities.

Last but not least, innovation and R&D will become imperative drivers of high-quality growth and enhancing competitiveness. A key cooperation area under the Guangdong-Hong Kong-Macao Greater Bay Area (GBA) Development is to foster innovation and technology (I&T). The Governments of GBA will continue to promote an efficient flow of resources and factors of production in I&T sector through the establishment of cooperation platforms such as the Hong Kong-Shenzhen Innovation and Science and Technology Park, training and exchange programs for scientific researchers, in order to elevate the overall innovation and R&D capabilities in GBA. Furthermore, Hong Kong has a number of unique strengths including world-class universities, talents in basic research, a sound legal system and competitive business environment with global recognition. In this regard, Hong Kong can facilitate the process of industrial transformation in Mainland China by realizing its function as a connector between Mainland China and the rest of world.