

Hong Kong and Shanghai

A tale of two cities in China¹

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Introduction

There is much talking about Hong Kong's role as an international finance centre being replaced by Shanghai, ever since its sovereignty returned to China. Indeed, for the two cities shared much similarities, it is very natural that people will ask which one will eventually come up as the lead in China as well as in the region. Shanghai's growth has been spectacular, alongside with many other mainland cities ever since China's open-up policy, and perhaps more than any others. The construction boom and dramatic urban transformation led by mega investment projects starting in the 1990s in Shanghai have totally changed the city. It is very ambitious to regain its past glory by building an expansive financial district with its new stock exchange twice as large as Hong Kong's (Huo and Ahmed, 2017).

In 2003, a research team from the Chinese University of Hong Kong and the Shanghai Academy of Social Sciences jointly conducted a survey involving 204 CEOs of 187 multinational companies in the two cities. The collective perception/predictions held by the CEOs in the survey was that although Shanghai was lagging in competitiveness but would catch up with Hong Kong by 2020 (Cheung 2012).

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On the other hand, Hong Kong's economy has also been experiencing a gradual and robust recovery ever since the Asian Financial Crisis (also the year of its hand-over), with its gross domestic product (GDP) growing at 4.1% from 2004 to 2013. It is very likely that some favorable and Chinese mainland-related policies have helped to pull the economy out of recession and given strong impetus and added to the robustness. Among them, the "Free Individual Travel" scheme implemented in July 2003 by the Chinese government and the Close Economic Partnership Agreement (CEPA) between mainland China and Hong Kong signed in 2003 and implemented in 2004 are some important ones (Xu, 2015).

Some will wonder whether the pleasing but somehow policy-driven development trend can be sustainable. The rise of Shanghai as the emerging financial centre has caused concerns about Hong Kong's future. The two economies clearly possess their own comparative advantages and weaknesses, with their own unique economic structures. And as Hong Kong's economy becomes more and more integrated with the mainland, it is argued in this paper that the two cities' development paths will be more decided by governments at different levels with their different hinterlands to serve and niche markets to aim, their relationship will likely evolve into a more complementary instead of rivalry in nature. In the following, the paper will give a comprehensive analysis from their historical evolution, economic structure, the two different and non-overlapping hinterlands, and more importantly governments' approach and positioning.

The rest of the manuscript is organized as the following. The second section discusses the prevailing opinions about Hong Kong's economy's prospect in relation to Shanghai's. The third analyzes the relative rise and fall of the Hong Kong and Shanghai from a historical aspect. The fourth examines the future evolutionary paths of the two economies on the basis of political factors together with their current economic structures. The fifth proposes some policy recommendations and the last concludes.

Review of literature

There are largely two opposing camps existing in the current literature on Hong Kong's long run development (in relation to Shanghai's), those holding positive perspective versus those holding negative views. The negative camp argued that Shanghai will exceed Hong Kong in the near future, while the positive camp argued that Hong Kong will continue to keep its dominating position with a wide gap remaining between the two cities.

The group of CEOs' views about Hong Kong's future mentioned in the introduction session, as shared by a few Hong Kong economists who predicted that Shanghai

would take over Hong Kong as an international finance center in five years, provided that China's messy financial sector can be cleaned up, and Renminbi (RMB) can be fully converted, while marveled the towering skyscrapers mushroomed in its remarkable financial district, with its new stock exchange volume twice as much as Hong Kong's (Cheung, 2012).

However, the positive camp viewed the huge gap between the two cities, not in terms of physical infrastructure, but in terms of institutional infrastructure and economic system. They argued Hong Kong's wealth was built largely upon these strengths. Shanghai on the other hand is inflexible in its political structure and arbitrary in conducting legal affairs, something not attractive to foreign investors. Hong Kong is one of the world's ten largest banking centers, the fifth largest forex market, and the third largest stock market, and there are more foreign banks in Hong Kong than in Singapore and Japan combined. They argued that Hong Kong need not to feel threatened by Shanghai's re-rise and competition. Shanghai is still struggling to handle many tough problems of its own financial infrastructure, such as lagging behind financial research, backward financial education, the insensitivity of firms to interest rate changes, the low credibility of economic agents, severe moral hazard, adverse selection in bank lending and stock listing, and corruption and rent-seeking culture of government officials. Since these problems cannot be solved any time soon, Shanghai cannot constitute a real threat to Hong Kong in the foreseeable future (Horesh, 2013). Moreover, Hong Kong still has a much bigger economic base than Shanghai. In 2014, for example, Shanghai's GDP per capita, foreign direct investment (FDI) and total trade (exports plus imports) were only 38%, 17% and 21% of Hong Kong's, respectively (Ho and Odhiambo, 2015). So, a catching-up in the near future is not very probable.

As to any change in relative positions of the two cities caused by China joining the World Trade Organization (WTO), the pessimists argued that Hong Kong's role as a bridge to China for international business would become obsolete. With China's accession to the WTO, foreigners can now deal directly with Shanghai and elsewhere in China. In addition, Shanghai is an obvious new focus for foreign companies to benefit from the huge China's market. Many worry that, if Shanghai will soon become a substitute for Hong Kong as regional or China headquarters of foreign companies, Hong Kong's role as an intermediary for China's trade is seriously undermined. Also, Shanghai making quantum leaps in its institutional reform will eventually rob Hong Kong of competitiveness (T. Lai *et al.*, 2016).

This view is, however, not shared by the opposite camp. It is good for Hong Kong, as they argued, that international business community is focusing on China's market after it joined the WTO. Although it is easier for companies to enter China's

market directly, they still need Hong Kong entrepreneurs, knowing international business as well as Chinese culture, to help them navigate through the maze of regulations and customs on how to do business in China. As Deng Xiaoping put it, China would need many Hong Kongs. In fact, the increased Chinese share in world trade will increase Hong Kong's prosperity, and China's huge and rising external trade produces enough business for several ports. Also, Hong Kong and Shanghai with non-overlapping hinterlands (the Yangtze River Delta – YRD and the Pearl River Delta – PRD) can pursue different regional development strategies (Imbruno, 2016).

Pessimists criticized that Hong Kong's economic structure is too lopsided to be adjustable or that its manufacturing is too weak to grow. As a small open economy, Hong Kong is developed as an "independent" entity. But its growth rests largely on imported resources and outside markets. As its traditional manufacturing firms moved northward to Canton for cost reduction, Hong Kong's industry share in its economy has dropped to less than 5%. Services account for 89% of the city's aggregate output; the economy of such kind is susceptible to speculative bubbles or outside fluctuations (Burdekin and Yang, 2013). Moreover, finding neither accumulated stock of advanced technology nor strong capacity of R&D to modernize Hong Kong's industry, people doubt if it is able to compete with Shanghai with its solid technological foundations and industries of six pillars.

However, optimists were confident that Hong Kong can develop such industries as IT, biology engineering and Chinese medicine products by using its wide commercial network and capital. They cite Singapore as an example which Hong Kong can follow. As a tiny open economy, Singapore succeeded in establishing the world's third largest petroleum refinery industry even if it does not have any oil deposit. They believed that Hong Kong can do as well as Singapore to revive its industry by financing certain joint ventures, and attracting projects into Hong Kong, to optimize its structure, so as to keep its leading position (Li and Whalley, 2017).

The majority of the present literature focused mostly on hard figures and economic factors to do their analysis and predication. With very little consideration of political and historical perspectives, the scenarios, therefore, provided by both of the groups, tend to be simplistic, either Hong Kong overtaken by Shanghai or Shanghai lagging behind. A more realistic possibility may well be something in between, and more complex, different in nature.

History

Prior to 1978

The tale of two cities contains certainly their respective rises and falls in history. It is certainly worthwhile to look at their past interactions, since a review of their evolutionary paths often shed light on their future ones. According to the history, the rise of Hong Kong coincided exactly with the fall of Shanghai, and this relative rise/fall had to do with the wars inflicted on China. Hong Kong has emerged as a modern metropolis from a fishing village in South China, and its fortunes have varied with its changing relations with the Chinese mainland. Its relationship with the mainland in general and with Shanghai in particular is more interesting after WWII than before it.

The small population inflow from the mainland to Hong Kong before WWII suggested that there had been no significant difference in living standards between both areas. Although some Chinese families made fortunes via trading activities in this British colony seized through the Opium Wars, life for the majority of the small Hong Kong population was far less exciting than that in Shanghai, one of the most advanced industrial and commercial center in Asia at that time. Each year 5% to 10% of the population and in some years even 10% to 15% left Hong Kong and returned to the mainland. The colonial government had provided most of the public revenue through its opium monopoly until WWII (Miners, 1983).

A dramatic upturn of Hong Kong's fortunes occurred when refugees from WWII and the 1946-1950 Civil War fled to Hong Kong and numerous firms relocated there from Shanghai and other mainland cities. Northern capital entering Hong Kong, amounting to many billions of Hong Kong dollars (a huge amount at that time), was a big impetus to the territory's development. The refugees coming from Canton were mainly laborers; but there were many industrialists coming from Shanghai. These entrepreneurs carried to Hong Kong not only capital and technology, but also a large number of skilled workers, marketing knowledge and sales network. Their businesses covered various sectors such as manufacturing, retail, banking, movies, shipping and professions; the new arrivals of businesses were much broader than the simple trading activities in Hong Kong, spurred the rapid growth of its economy (Peterson, 2008).

Hong Kong's fortunes continued to rise after the Civil War and during the worldwide Cold War, while Shanghai continued its falling and eventually lost its pre-eminent status as an Asian business hub. Following the Korean War, the U. S. imposed a trade embargo against China, so that Hong Kong's advantageous role as entrepot trade centre came to a halt. During this difficult time, Hong Kong's tie with

the mainland was greatly weakened, and a number of businessmen of Shanghai origin pioneered the shift of Hong Kong economy to export-oriented manufacturing. In 1959, domestic exports exceeded re-exports for the first time in Hong Kong history, taking up 70% of its total trade. This labor-intensive, outward-looking manufacturing later became the engine for Hong Kong's lasting growth, which reached 11.7% in the 1960s and 9.2% in 1970s (Clayton, 2007).

For all the years until 1997, the year Hong Kong returned to China, the colonial government with a high discount rate had pursued a light-handed approach to economic policy. They had little incentive to undertake grandiose projects to promote development but cared only about to make sure that Hong Kong not becoming a fiscal burden of London. Governing Hong Kong in this way allowed its businessmen to dodge the U. S. sanctions, and consequently the mainland had remained the second largest source of Hong Kong imports by 1978 (Lam, 2000). Serving as a middleman between China and the world market, Hong Kong reaped numerous gains from re-exports. While most of China's external trade was carried out through Hong Kong, Shanghai was acting only as a producer of goods, much lower in the hierarchy. China's closed-door policy put Shanghai like a big lion in a tight cage of the planned economy and effectively insulated Hong Kong from Shanghai's competition (Horesh, 2013).

Hong Kong's fortunes have expanded explosively since China opened to world trade in 1978. Hong Kong enjoyed huge re-exports benefits, rising at an increased pace, thanks to the fast-growing Chinese economy. For example, trade between Hong Kong and the mainland reached HK\$ 987.1 billion in 1995, 88.64 times than in 1978, and the gross yield on these re-exports amounted to HK\$ 204 billion. Ninety percent of Hong Kong's re-exports involved the mainland as a source or destination, and the trade between both sides accounted for 40% of Hong Kong's total trade value; about a quarter of U.K.'s exports to mainland China goes through Hong Kong. By contrast, from 1978 up to mid 1990, Shanghai, subject to the heavier inertia of planned economy than other parts of the country, experienced drops in its share of external trade in national total (dropping from 1/6 in early 1980s to 7.8% in 1995) (Chan and Zhao, 2012).

Part of Hong Kong's fortunes can be attributed to China's Taiwan problem. Hong Kong played a role of the entrepot for much of trade between Taiwan and the mainland, due to the "cold war" (the extension of the 1946-1950 Civil War) still across the strait, and direct trade or transport with the mainland was banned by Taiwan until 1990s. Hong Kong, along with neighboring Macau, had benefited from this cross-strait situation, political hostility with economic increasingly connecting. For example, Taiwan visitors made 450,000 trips to Guangdong via both

cities in 1996 alone (Sheng, 2012). Once complete direct links are allowed across the strait, it is Shanghai not Hong Kong which will become Taiwan's first port of call.

As is seen from above, the rise of Hong Kong punctuated the fall of Shanghai. The outcomes/fortunes of the two cities in this period were clearly not the result of their internal economic system's working and development, but largely caused by the prevailing political factor, the "hot" and "cold" wars inflicted upon China at that time.

From 1978 to the early 1990s

During this period of time, Shanghai was largely neglected due to the central government's focus on opening up Shenzhen and Guangdong, while Shanghai as a national asset continued being over-exploited by the whole country. Deng Xiaoping realized this with regret in his final days of life, and Shanghai was then liberated. In 20 years after its taking off, Shanghai grew at a fantastic pace and Hong Kong felt unprecedented pressure. Yet, it is better for Hong Kong to respond positively than passively to this new, exciting challenge presented by the re-rise of Shanghai. Historically, the fall of Shanghai implies the rise of Hong Kong; but in the future, the re-rise of Shanghai need not to spell the demise of Hong Kong.

Economic position

A sensible opinion is that given the larger economic size and the smaller population of Hong Kong than its Shanghai counterparts, it is certain that Shanghai cannot surpass Hong Kong in terms of real GDP per capita in the near future. Presently, we see no possibility of a successful, quick catching-up by Shanghai unless Hong Kong plunges into a prolonged, deep recession like Japan. It is too early to seriously predict the long run relative prospects of the two economies, since prediction for a long horizon becomes extremely unreliable under great uncertainty. Let us look at future prospects in about 20 years.

In fact, Shanghai's GDP had surpassed that of Hong Kong in 2009 while its per capita GDP made up only 39% of Hong Kong's in 2014. In addition, Shanghai's double-digit growth will be very hard to sustain in 20 more years. The time needed to catch up will be longer if Hong Kong economy grows faster. More importantly, Shanghai is subject to a constantly flowing population that adds to its large population of permanent residents. The faster Shanghai's economy grows (*i. e.*, the greater its GDP), the larger population inflow it will attract and hence the more difficult it may be for Shanghai to close its gap with Hong Kong in per capita GDP. In fact,

both Shanghai growth and Hong Kong growth are positively correlated with China's growth, and the three economies affect each other complementarily (Zhang, 2013).

Financial status

While some people doubt about Hong Kong's lead over Shanghai in finance for a long time, we hold that it will be very hard for Shanghai's finance to outstrip Hong Kong's in scope and level in a short time. Although Shanghai's Global Financial Centres Index (GFCI) increased from around 600 in the year 2007 to around 700 in 2016, its performance did not have great improvement from 2010 until now (Fan and Wang, 2017). Shanghai's finance is in its infancy and cannot be regarded as a serious rival to Hong Kong. Few financial practitioners and bank employees in the mainland know much about financial innovations, modern derivatives or asset securitization. In recent years, some factor costs (e. g., real estate prices) in Shanghai rose substantially and added to its high transaction costs; this reduces the low-cost advantage of doing business in Shanghai. With its impressive finance center housed in the world's tallest building, Shanghai's advantage of "hardware" is nonetheless far from being enough to make up for its weakness of "software". Experts point out that Shanghai cannot be expected to catch up with Hong Kong in at least 10 years. In fact, the central and local governments are planning to complete the rebuilding of Shanghai as an international finance center in 15 to 20 years (Wang *et al.*, 2013).

Hong Kong's finance can continue to grow by benefiting from China's financial liberalization. From 1993 to 2013, Hong Kong helped state-owned enterprises with overseas listings, what raised HK\$ 6 trillion worth of funds, which accounted for over half of its market value. At least 176 mainland companies applied to list in Hong Kong in 2013, and more of them are coming to the city than the other way around (Güçbilmez, 2015). Even if Shanghai were to fulfill its ambition, Hong Kong's role as China's financier would not be eroded nor eliminated. Until the RMB becomes fully convertible, which may take one or two decades, China will need Hong Kong to tap international finance.

Structure and relationship

Complementarity

The economic relationship between Hong Kong and Shanghai is affected by their geographically non-overlapping hinterlands and by the large difference in their economic structures, which are difficult to change. The economic relationship and

structural shifts suggest certain bearings for Hong Kong's long-term development. The relations between Hong Kong and Shanghai are largely complementary rather than substitutable, with more or less competition in their structural adjustments.

Economic structure

Hong Kong has grown more closely tied to the mainland economy since 1997, owing to the city's ability to develop an advanced service economy. This put Hong Kong in an ideal position to benefit from structural shifts going on in the neighboring mainland. China's capital, resulting from external trade and earnings of its huge manufacturing sector, has been growing fast and will be spent on tourist trips, world-class restaurant dinners, brand-name products, stock listings etc. Hong Kong is most suitable for meeting this high consumption demand of newly moneyed mainlanders. The purchase of these visitors to Hong Kong accounted for about 12% of the city's retail sales in 2004, and by 2015 this figure reached as high as 34% (Shen *at al.*, 2017).

Shanghai's economic structure is more balanced than Hong Kong's. Under planned economy, Shanghai put emphasis on the capital-/engineering-intensive heavy/chemical industries. Emphasis has been shifted to technology-intensive or high-tech industries since the reform. Although it promoted its tertiary sector intentionally over the past two decades, Shanghai has not ignored the growth of its secondary sector. The service sector's share in the city's GDP rose from 18.6% in 1978 to 60.7% in 2013. The contribution of the tertiary sector to Shanghai output growth was 61.4% in 2001 while the secondary sector still contributed to 38.0% (Bastida & Huan, 2014). Thus, unlike Hong Kong, Shanghai does not rely on services alone for growth. Such a big difference in economic structure implies that there will be no direct competition between the two cities.

Regional competition

Given high factor costs in Hong Kong, it may lose its competitiveness to Shanghai unless it speeds up integration with the thriving PRD. This is necessary, not only because the PRD provides for Hong Kong a hinterland with cheaper/skilled labor and less expensive land comparable to Shanghai's, but also because the PRD's advantages of primary and secondary industries can complement Hong Kong's advantages of capital and services and low transaction costs (Loughlin and Pannell, 2010). This economic fusion will make the Greater Hong Kong's economic structure more balanced and generate a strong synergy effect on its long run growth.

Many believe that competition between the two cities is actually between the PRD area centered on Hong Kong and the YRD area centered on Shanghai. Although Hong Kong still benefits from the cross-strait “cold war”, it cannot lean on this political crutch indefinitely. Shanghai and its hinterland have now become a hot new favorite for Taiwan investors, and about 700,000 Taiwanese live and work in the Greater Shanghai. This change not only hurts Hong Kong but also the whole PRD, where a large portion of Taiwan’s US\$ 100 billion investment in the mainland is based (G. Li *et al.*, 2013). Once direct cross-strait links are permitted, regional competition will be rising as Taiwan investors continue to shift northwards.

Dominant relationship

The PRD and the YRD are non-overlapping geographical regions, so that the role played by each city for its own hinterland is not substitutable. But competition may arise and get stronger if both regions’ economic structures become more similar. Taiwan’s investment in the mainland high-tech industry is making the YRD the hub of China’s IT economy, leaving smaller room for Hong Kong’s ambitious plan to become a regional cyberport. Free competition without government intervention would end up with this disappointing outcome (Sheng, 2017).

Currently, competition between the two deltas is not strong due to their differing economic structures. In 2013, the ratios of services and trade to GDP are 71% and 221% for the Greater Hong Kong, and 51% and 121% for the Greater Shanghai, respectively (L. Lai *et al.*, 2014). Also, each hinterland’s economic structure has assimilated with that of its own central city. Such cross-region difference and within-region similarity would mitigate competition between the two areas and leave more room for complementarity. Probably, complementarity would dominate competition.

Both cities can cooperate to extract complementary benefits since what is weak in Hong Kong is what is strong in Shanghai and vice versa; this is the source of complementary efficiency. Hong Kong may assist Shanghai in the development of its financial sector while Shanghai can help Hong Kong in its effort to modernize manufacturing. The result from doing so will be a substantial rise in the combined competitiveness of both cities. To accomplish this requires strong inter-government coordination.

Modern industry

Governmental approaches

The development of large-scale modern industry in Hong Kong rests on right approaches taken by its government with great vision and strong determination. In this

regard, the mainland and Hong Kong have quite different traditions. The mainland governments (local and central) are good at resorting to administrative measures to undertake large projects; the results, whether good or bad, are quick and significant. China's becoming the world's largest manufacturing country has to do with active and effective government intervention. On the contrary, Hong Kong's government (previous and current) gets used to light-handed policies for "managing" its economy, so that it is up to entrepreneurs to self-select whatever projects they like. The consequent outcome is that Hong Kong has seen a swelling tertiary sector and a set of light industries with numerous small factories.

Unlike Hong Kong, all the other Asian Tigers (South Korea, Singapore, and Taiwan) are not of hands-off *laissez-faire* type. Their governments aggressively carried out industrial policies in their successful development of heavy/chemical and high-tech industries. The Korean policymakers intensively and even forcefully employed various incentives and disincentives to affect industrial activity. Singapore's government also adopted numerous policies to attract foreign investment into its targeted manufacturing with the support of forced savings of as high as 40% of earnings. In 1983, manufacturing accounted for around 23% of GDP both in Singapore and Hong Kong; by 2013, this proportion had risen to 26.1% in Singapore but fallen to 3.4% in Hong Kong (Cressy and Farag, 2014).

Industrial prospects

Given the tradition of Hong Kong's government and the experience of other economies, we are not optimistic about Hong Kong's development of IT or any other modern industry. Five years ago, Hong Kong and a few neighboring local governments declared to upgrade their industrial structures. Five years passed; Hong Kong has made little progress, while Shenzhen has established on a large scale its IT, new materials, biotech and medicine industries, and Dongguan's IT products have been sold out all over the world (G. Li *et al.*, 2013). To revive manufacturing appears to be a "mission impossible" for Hong Kong. Too much empty talk in too many debates within the city council may render it too late to make Hong Kong's IT dreams come true.

Technological progress is becoming an increasingly important determinant of economic growth. Economic growth attributable to technology already reached 53% in Shanghai 10 years ago while this index was only 40% for Hong Kong. Consequently, Hong Kong's recent growth was left behind other economies; in 1997-2013, Taiwan, South Korea and Singapore grew annually at 4.1%, 4.3% and 4.7%, respectively, whereas Hong Kong's growth was only 3.2% (Yung *et al.*,

2014). To ensure long run growth with fewer bubbles, Hong Kong may have to be determined to develop certain modern industries, even with a shortage of talent, a limited accumulation of technology, and a weak industrial foundation. Shanghai and other local governments will stand ready for help. The complementary benefit may be huge if Hong Kong's capital and trade are combined with the mainland's manufacturing and technological capacities, but to achieve this requires economic vision and political courage on the part of Hong Kong's government.

Pragmatic thoughts

Not everyone is enthusiastic about reviving Hong Kong's manufacturing. They wonder why to force it to pursue modern industries beyond its ability, why not to make good use of the existing service advantage for growth, and whether a service economy is necessarily easy to hollow out or inferior to more diversified economies. We conjecture that these questions also reflect the realistic (though short-sighted) production mentality of Hong Kong political leaders. It is worth elaborating on this mentality. In fact, many economies are dominated by services rather than by manufacturing. It may be a bold idea to base prosperity solely on services since conventional wisdom places emphasis on vibrant manufacturing and economic diversity. Yet, one must admit that the tertiary sector captures most of the value of physical products since the cost of manufacturing them is merely a small fraction of their eventual selling price. Indeed, services exploit manufacturing to the maximum; e. g., for a pair of jeans selling for US\$ 100, what the manufacturers take is as little as US\$ 12 (Sheng, 2014). Where the greatest value added is extracted is in services, and this is why the world's great cities such as Frankfurt, London, Milan, New York and Tokyo have thrived and grown rich.

Hong Kong's concentrated service economy may be fundamental for taking on these cities. Structural changes in China are acting to transform Hong Kong's future into a fully-fledged world-city. Normally, an economy growing richer spends more on services, and this is what has been happening in China. It is projected that if including the underground economy at its minimum level of 50% of GDP, China's high spending population may grow to 350 millions and this figure actually will be larger after taking into account the new, dynamic private sector driven market (Chen and Qin, 2014). The wide range of services Hong Kong can offer to this population will bring unparalleled income and employment opportunities to the territory. Hong Kong's established advantage enables it to become China's unique service centre, if it opens wider as China's biggest window to the world and if it becomes easier for the mainlanders to visit and work. In today's world, service sectors are increasingly

delivering faster economic growth and greater labor productivity. With this in mind, and given the massive changes afoot in China, it is predicted that Hong Kong is on the verge of becoming the world's next boomtown (Sheng and Wan 2017). Considering its weak government policy and low-quality labor force for high-tech industries, Hong Kong will have to stick to services for prosperity.

Policy recommendations

The renowned entrepreneurial spirit of Hong Kong people may be due to the minimalist policy of the colonial government, for it did not care about what local people would do to make a living or a fortune. Under new competitive conditions, Hong Kong government will have to provide its businessmen with enough services in order to achieve steady growth. For this purpose, we supply the following policy recommendations for Hong Kong long-term development.

First, Hong Kong should make full use of CEPA and provide high value-added services to the mainland. The mainland is making great efforts to reform its government regulation, legal infrastructure, financial system, corporate governance, external trade promotion, and professional practices and standards. Many in the mainland believe they have much to learn from the outside world, and this creates a continuous demand for high-end services. The U. S. have already captured the largest share of this potentially immense market; so, it is the U. S., not Shanghai, which compete with Hong Kong. Actually, Shanghai needs to receive rather than provide high-end services; so, treating Shanghai as a rival is a misleading way to plan out Hong Kong's growth. Hong Kong has to be innovative in service skills and attractions to cope with the U. S. challenges. It can add high-value to its services to satisfy the needs of the mainland market and the international business community that is also looking for a foothold there.

To promote Hong Kong's service business, Beijing signed up the CEPA in 2003. With confidence soaring, Hong Kong saw growth reaching 7.3% in 2004. The CEPA lowers Hong Kong's entry barrier to the mainland market. For example, capital requirements for Hong Kong banks to branch in the mainland are reduced from US\$ 20 billion to US\$ 6 billion (Ching *et al.*, 2012). This gives Hong Kong the first-mover advantage before China opens up its financial market as stipulated by the WTO agreement. The waiting foreign institutions are upset, since they feel unfairly treated under the CEPA. The question for Hong Kong is how to take advantage of fast-growing mainland demand for services by quickly making full use of the CEPA.

Second, Hong Kong should promote closer cooperation with outside business people and governments to develop its modern industries. To make a breakthrough

for high-tech industries, Hong Kong needs to organize local entrepreneurs and financiers to cooperate with Shanghai for assistance in manufacturing, with Beijing for help in R&D, Taiwan for imports of technical know-how, the PRD region for low-cost and skilled labor, and the central government for coordination support. In the recent years, Hong Kong has succeeded in its telecommunications industry through technological innovations. Another successful story is the Hong Kong Disneyland project, which delivered the “magic” in 2005 earlier than expected thanks to the tremendous support by the government. That implies that Hong Kong can do whatever it really wants to do if the government gives a strong hand; so, its problem of industrial modernization is a matter of determination (Sheng *et al.*, 2017).

Third, Hong Kong needs to give efforts to transform itself to be an RMB offshore centre, which is crucial for reinforcing its status as a world class finance center. Singapore used to be considered as a financial competitor of Hong Kong, but real challenges were later found to come from Shanghai whose financial market had engaged in fast expanding RMB business. Shanghai finance, once well developed, will become a real rival to Hong Kong whose banks had no privilege to enter RMB markets. Beijing has now allowed Hong Kong financial institutions under the CEPA framework to conduct some kinds RMB businesses, laying the foundation for the possible establishment of Hong Kong as an offshore trading centre for the RMB whose inconvertibility will remain in years to come. But, Shanghai wants to do this too. Therefore, the Hong Kong government and businessmen should strengthen its lobbying activity in Beijing to expand the scope of offshore RMB business for Hong Kong financial institutions.

To become an offshore RMB trading hub may be very important for Hong Kong finance future and economic growth. Similar to Hong Kong, London has a service sector making up 84% of its economy. In early 1960s, American banks set up an Eurodollar market in London to escape their domestic banking regulation, and by mid-1990s, London has become the world’s largest finance center due to its Eurodollar market, in which about US\$ 462 billion was sloshing around each day, greater than US\$ 236 billion in the U. S. domestic market (Schenk, 1998). If Beijing can be persuaded to choose Hong Kong as an offshore RMB center, then today’s London finance status may mirror Hong Kong’s position in the tomorrow’s world of finance. This is because the RMB is expected to grow in its usage and influence in Asia and beyond, and China’s economy will be approaching America’s in the future.

Hong Kong and Shanghai play different roles on different level and have different functions for the regional and China’s economy. Hong Kong has been a well-established international financial centre, while Shanghai’s financial customers will be Chinese or the foreigners who have business in China for a long term.

Surely, if Hong Kong become an RMB trading hub, it will play a more important role for China's economy. So, based on different levels of scale, financial products, internationalization, and staff's professionalization, Hong Kong and Shanghai will be complementary rather than competitive in a long term, and Hong Kong's status as an international financial centre will not change in the short run.

Lastly, the Hong Kong government system needs to be reformed in order to play a large role in promoting long-term economic development. As shown earlier, Hong Kong's relations with the mainland are fundamental in determining its socio-economic destiny, and the complementarity of this relationship have generated enormous benefits. The easiest cooperation with the mainland has been exploited by Hong Kong private sector, and further integration requires the Hong Kong government to take critical actions. This would create immense opportunities for Hong Kong, but the government may need to rethink whether its *laissez-faire* system continues to be economically sensible.

As high factor costs weaken competitiveness, local businessmen have lobbied for a more liberal issuance of work permit to the mainland talent. This inviting government intervention shakes up the *laissez-faire* system. People come to realize that the government is supposed to play a central role in promoting long-term growth, but that the current governance system is not suitable for this task. In the colonial era, key decisions were directed by London to Hong Kong officials, and now by the Basic Law, Beijing cannot send in instructions. Thus, the government has to make decisions on its own, but this is surely a hard job for the young, inexperienced government.

However, it is the government's responsibility to take care of the city's long-term strategic planning, which can send the markets a clear signal about the direction of development. Private sectors usually seek short-run market returns and will shift their investment to any other places with higher returns. Only the government can act in the city's long-term interests via careful planning. For example, with infrastructure in many parts of Hong Kong dilapidated and backward, urban transformation requires the government to plan and spend. In 2016, the Beijing central government incorporated the Hong Kong and Macau economies in its "13th Five-Year Plan" (Luo and Xiao, 2017). This is a new opportunity for Hong Kong and also a big challenge to its governance system. Much talk was heard in the territory about whether Hong Kong could be marginalized out of national development if the government sticks to its light-handed tradition and remains weak in strategic planning or administrative coordination.

One snag with the governance reform is the psychological state of some local elite along with the influence of vested interests. Although Hong Kong is now weakened by its physical separation from the mainland, some in the territory still insist that

separation should be maintained. They are pursuing two conflicting matters – social independence and economic interdependence without considering their trade-off. It is inconceivable that a free society deliberately restrains free flows of people and information via the cursed border separation. People do not fear that Hong Kong's pro-democracy movement would spook businesses from setting up here, but that the city will fail to attract the mainland talent. Also, certain arrangements under the current system make it difficult to sacrifice short-run interests of some people for the long-run development of the whole society. If the government cannot stand up to the mental barrier and vested interests, Hong Kong would fail to improve its competitiveness, and Shanghai's quick catching-up would be possible.

Conclusion

This paper has examined a few popular worries about Hong Kong's future from a historic perspective and discussed Hong Kong's long-term development in a forward-looking manner. The rise of Hong Kong coincided exactly with the fall of Shanghai, but the re-rise of Shanghai need not to spell the demise of Hong Kong whose growth rests on China's development. Shanghai cannot surpass Hong Kong in terms of per capita income in the near future nor will it replace Hong Kong as an only Chinese international finance hub. It is likely, however, that Hong Kong will be overtaken by Shanghai if it continues to ignore the education of its population or to be reluctant to cooperate with the mainland. Due to non-overlapping hinterlands and economic structure differences, the two cities are not a substitute for each other in regional development; their relationship is largely complementary, having no direct competition since, unlike Hong Kong, Shanghai does not rely on services alone for growth. Through further integration with the low-cost PRD economy, Hong Kong can stay competitive by shielding itself from low-cost competition posed by Shanghai and the YRD. To extract complementarity requires the two cities to cooperate with strong inter-government coordination. Given its governance system, we are not optimistic about Hong Kong's industrial modernization. We have reasons to conjecture that it will stick more closely to services without major breakthrough in its industrialization, unless its government has firm determination and great vision. The paper also has provided certain policy recommendations, the most important of which is Hong Kong government system reform with a change to its minimalist policy approach. We believe that, if all goes well, Shanghai could become a city like New York in the U. S., while Hong Kong would evolve into a city like London in Europe.

For certain, no government is omnipotent. They cannot make their economies immune from recessions or crises, no matter how much they want. Yet on the other

hand, as now two cities both under the same central government and parts of the same China's economy, Hong Kong and Shanghai are now more closely related than ever, in good times as well as bad times. Their relative positions/relationship, though dynamically evolved, will remain more or less the same under the same government directions, in a win-win situation, complementary to each other.

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Abstract

Hong Kong and Shanghai: a tale of two cities in China

This research discusses Hong Kong's long-run role as a preeminent international finance centre in the greater China with a view of Shanghai's rapid growth. Using a synthesis approach of politics and economics, rather than pure economic analysis and forecasting, it is argued Shanghai is not likely to overtake/replace Hong Kong as an international finance hub in the region. Hong Kong will still keep its position in many years to come even if Shanghai has made enormous efforts to rebuild its financial industry. Due to their diverging industry structure, sheer size of the country, and most importantly different positioning by the central and local governments, the two cities are not necessarily rivals, but can actually be complementary partners, serving two non-overlapping hinterlands. This research also asserts that Hong Kong's integration with the mainland economy is essential for its increasing competitiveness, while putting emphasis on policy reform for Hong Kong to maintain a strategic advantage over Shanghai.

Keywords: Competition; Cooperation; Integration; Competitiveness; Strategic lead.

Resumo

Hong Kong e Xangai: a história de duas cidades na China

Com esta investigação, foi abordado o papel que Hong Kong tem desempenhado a longo prazo como centro financeiro internacional proeminente na Grande China e o impacto do rápido crescimento de Xangai em Hong Kong. A partir de uma abordagem abrangente da ciência política e econômica, ao invés de análises e projeções, é pouco provável que Xangai transcenda ou substitua Hong Kong como um centro financeiro internacional na região, de acordo com esta investigação. Apesar de Xangai ter feito grandes esforços para a revitalização do setor financeiro, Hong Kong manterá nos próximos anos seu *status* atual. Tendo em conta as diferenças das suas estruturas industriais e do posicionamento dos governos central e regional, essas duas cidades não vão necessariamente tornar-se rivais, podendo ser parceiras para se complementarem e servir as duas regiões distantes. De acordo com a investigação, a integração entre a economia de Hong Kong e a do interior da China é essencial para aumentar sua competitividade, ao passo que as reformas de políticas de Hong Kong também são propícias para manter sua vantagem estratégica em relação a Xangai.

Palavras-chaves: Concorrência; Cooperação; Integração; Competitividade; Liderança estratégica.

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