ECONOMIC NOTE

Montreal Economic Institute
Ideas for a More Prosperous Nation

Hong Kong: The Ongoing Economic Miracle

by **Jean-François Minardi**

Hong Kong today is a doorway to China and the rest of Asia for foreign investors, and one of the wealthiest societies in the world. Its gross domestic product per capita is even higher than Britain's.[1] And yet, after the Second World War, this minuscule territory of the British Empire, devoid of natural resources, was faced with the problems of a developing country, with a rapidly expanding poor population. In 1960, the average income per capita was still just 28% of what residents of the far-off mother country earned at the time.[2] What explains this economic miracle and the continuing dynamism of Hong Kong's economy?

November 2013

From rags to riches

When the Japanese occupation ended in 1945, Hong Kong's economy was completely devastated. Furthermore, with the establishment of an embargo on trade with China in 1951 during the Korean War, Hong Kong was no longer in a position to maintain the entrepot trade upon which a large portion of its traditional economic activity was based.[3]

The territory nonetheless managed to meet this challenge by finding new sources of development that were at the root of its industrial takeoff in the 1950s. It generally benefited from the arrival of hundreds of thousands of refugees fleeing the civil war and searching for employment, and also from entrepreneurs, knowledge and capital from Shanghai, the great capitalist Chinese city of the day.

Hong Kong's entrepreneurs created an impressive number of small and medium-sized businesses during this period, especially in the textile sector. These SMBs, which gradually branched out into garments, electronics and plastics, were essentially producing to meet the growing demand for affordable manufactured goods in North America and Europe. Their success was remarkable and exports grew from 54% of GDP in the 1960s to 64% in the 1970s.[4]

The rapid industrialization of the 1950s is due to conditions in which property rights were protected, the judiciary power was independent and the courts impartial, and there was a minimum of interference on the part of the colonial authorities when it came to international trade.

Moreover, while the United Kingdom was setting up a highly interventionist welfare state at home, the territory enjoyed a fundamentally free-market economic policy personified by Sir John Cowperthwaite, Financial Secretary of Hong Kong from 1961 to 1971. Despite opposition from London, but with the support of the local business community, Cowperthwaite banked on free trade, the non-intervention of the state in the

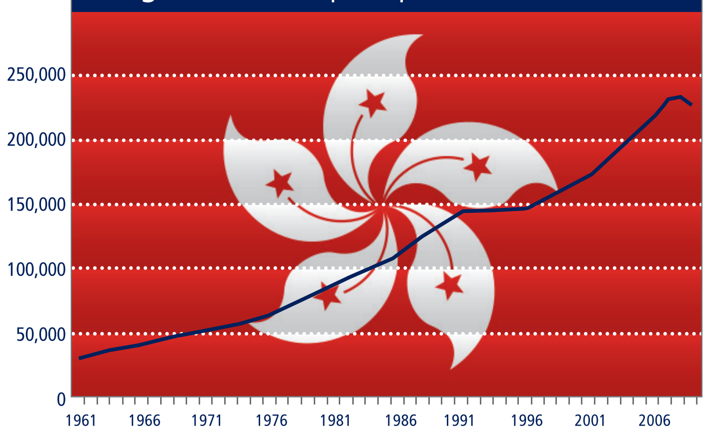
This *Economic Note* was prepared by **Jean-François Minardi**, public policy analyst at the Montreal Economic Institute. The author wishes to acknowledge **Marie-Josée Loiselle** for her assistance in researching and writing this *Economic Note*.

economy, a strict budgetary policy, a flat personal income tax of 15% and a flexible labour market.[5]

This economic policy, which promoted competition and a spirit of enterprise, created the conditions for very rapid economic growth. It is during this time that Hong Kong became one of the four Asian Tigers, along with Singapore, South Korea and Taiwan.

Between 1961 and 2009, Hong Kong's real GDP per capita was multiplied by a factor of nine (see Figure 1). Today, its GDP per capita at purchasing power parity is the 13th highest in the world.[6] Hong Kong therefore succeeded, in just a few decades, in transforming its economy into one of the wealthiest in the world.

Figure 1 — GDP per capita in 2007 HK dollars



Source: Kui-Wai Li, *Economic Freedom: Lessons of Hong Kong*, 2012, p. 47.

From a manufacturing economy to a service economy

The first stage of Hong Kong's development had relied on the manufacturing industry. Mainland China's economic reforms and the policy of openness to foreign investment put in place by Deng Xiaoping starting in 1978 profoundly changed the nature of Hong Kong's economy in the ensuing years.

Hong Kong's manufacturing sector began to decline in the late 1970s due to increases in the price of land and rising salaries. However, Hong Kong's increased economic integration with mainland China allowed it to relocate its production to the special economic zones in the bordering province of Guangdong. These zones, which were set up beginning in 1980, offered Hong Kong investors the opportunity to enhance their competitiveness by relying on plentiful low-cost labour, while still enjoying the same non-interventionist conditions from the Chinese government as they did in Hong Kong. From 1978 to 1997, trade between Hong Kong and the People's Republic of China grew at an average yearly rate of 28%. By the end of 1997, direct investment from Hong Kong accounted for 80% of all foreign direct investment in Guangdong.[7]

The territory enjoyed a fundamentally free-market economic policy personified by Sir John Cowperthwaite, Financial Secretary of Hong Kong.

These new developments altered Hong Kong's economy significantly. Industry's share of the economy declined from 31% in 1980 to 14% in 1997 and 8% in 2008; the service sector, on the other hand, increased its share considerably, from 68% in 1980 to 86% in 1997 and 92% in 2008.[8]

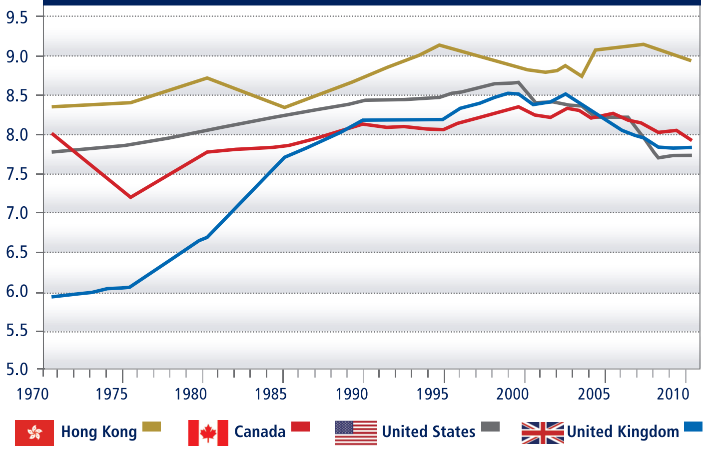
Since 1997, Hong Kong's economy has become a centre for high value-added services (finance, management, logistics, business consulting, trade, etc.), as much for Chinese businesses seeking to break into international markets as for businesses around the world looking for access to the markets of mainland China and the rest of Asia.

The maintenance of free-market institutions

From the early 1980s, the perspective of an impending return of Hong Kong to Chinese sovereignty produced great uncertainty with regard to the maintenance of the institutions that had made the territory wealthy. This concern, however, was quickly appeased.

In the Sino-British Joint Declaration, signed on December 19, 1984, it was established that Hong Kong would cease to be a territory under British control on July 1, 1997. The "one country, two systems" principle was also agreed upon at this time. Excepting foreign affairs and national defence, it grants broad autonomy to the territory and allows it to retain its capitalist system as well as its way of living for a period of 50 years, until the year 2047.

Figure 2 — Economic Freedom Index



Source: *Economic Freedom of the World Report 2013*, Fraser Institute, 2013.

Note: The economic freedom index measures the degree of economic freedom in 151 countries on a scale of 0 to 10, in which 0 indicates the absence of economic freedom and 10 a high level of economic freedom.

Hong Kong is now a Special Administrative Region of the People's Republic of China that has preserved the bulk of the political, judicial, economic and financial system that characterized the colony when it was in the British fold. The judicial power is independent of the political power and continues to operate under the common law system inherited from the British. Property rights are guaranteed by the *Basic Law*, which today serves as the constitution of the Hong Kong Special Administrative Region, and the citizens enjoy fundamental individual liberties.

According to the Fraser Institute's *Economic Freedom of the World* index, Hong Kong's economy has been the freest in the world since 1970 (see Figure 2). This economic freedom rests on three elements:

1. Smaller government

Government spending as a percentage of GDP is just 19.2% in Hong Kong, compared to 42.9% in Canada.[9] Personal income tax is a flat 15% and the corporate tax rate is set at 16.5%.[10] It should be noted also that there is no sales tax, and no tax on dividends or capital gains.

2. Flexible, efficient regulation of economic activity

Hong Kong is the second easiest place in the world to conduct business, according the World Bank's *Doing Business* report, which measures the cost of business regulation for companies each year.[11] Hong Kong has always had a flexible labour market, although in 2011, the legislature adopted, for the first time in its history, a minimum wage law. Finally, the Hong Kong dollar is a stable, fully convertible currency.

3. Openness to international trade

Hong Kong charges no customs duties and imposes no quotas. The bulk of trade in goods takes place with mainland China, which accounted for 54.1% of the total value of exports in 2012, as well as 47.1% of imports.[12] There are no restrictions on the entry or repatriation of capital either, nor on the conversion and transfer of profits and dividends from direct investment. This explains why Hong Kong ranked third in the world after the United States and mainland China in terms of inflow of foreign direct investment in 2012, and fourth after the United States, Japan and mainland China in terms of outflow.[13]

The free flow of capital has helped make Hong Kong an international financial centre of the first order. In September 2012, the Hong Kong Stock Exchange was the sixth largest in the world and second largest in Asia in terms of market capitalization.[14] According to the Global Financial Centres Index, Hong Kong is also the most competitive financial centre in Asia and the third most competitive in the world behind only London and New York.[15]

The "one country, two systems" principle grants broad autonomy to the territory and allows it to retain its capitalist system as well as its way of living.

The rules of the game are fair for all investors, whether or not they are residents of Hong Kong. There are no restrictions on foreign ownership; foreigners can invest in local businesses and hold up to 100% of capital.[16] Intellectual property is protected, and Hong Kong is one of the least corrupt societies in the world.[17]

Access for foreign investors is facilitated by the fact that in 2003, Hong Kong signed a Closer Economic Partnership Agreement (CEPA) with mainland China. Now, practically all goods and services produced in Hong Kong can enter mainland China's market without paying customs duties. Importantly, foreign companies can enjoy these same conditions by outsourcing their activities or by setting up a joint venture with a Hong Kong firm.

In 2014, Hong Kong will begin negotiations for a free trade agreement with the Association of Southeast Asian Nations (ASEAN), which includes ten countries in the region. The members of ASEAN want to form a single market by 2015. The group is made up of both emerging markets like Indonesia, Malaysia and Thailand, whose middle classes are in full expansion, and of developing countries with low-cost labour like Vietnam, Laos, Burma and Cambodia.

Practically all goods and services produced in Hong Kong can enter mainland China's market without paying customs duties.

Signing a free trade agreement with ASEAN would also allow Hong Kong to take part in the negotiation of the Regional Comprehensive Economic Partnership. This project aims to create, by 2015, a vast free trade zone for goods, services and investment between the ASEAN member countries and the countries with which the organization has signed free trade agreements (Australia, China, India, Japan, South Korea and New Zealand). Such a treaty would therefore cover all of the major economies of Asia.

Conclusion

Hong Kong is one of the most striking and conclusive examples in the world of a society that succeeded in escaping underdevelopment by relying on economic freedom. With the transition to Chinese sovereignty, Hong Kong preserved the bulk of its liberties and maintained the dynamism of its economy. The future prosperity of the territory will depend largely on the preservation of the free-market institutions and the maintenance of the economic policies that have served it so well to this day.

References

1. Hong Kong's gross domestic product per capita at purchasing power parity is 40% higher than Britain's (US$52,830 compared to US$37,860). The World in figures: Hong Kong and United Kingdom, *The Economist*, November 21, 2012.
2. Milton Friedman, “The Hong Kong Experiment,” *Hoover Digest*, No. 3, 1998.
3. Entrepot trade is trade that rests on the importation and re-exportation of goods sheltered from the collection of tariffs or taxes.
4. Catherine Schenk, “Economic History of Hong Kong,” *EH.Net Encyclopedia*, March 16, 2008.
5. Milton Friedman, *op. cit.*, note 2.
6. Central Intelligence Agency, *The World Factbook. Country Comparison: GDP per capita (PPP)*, 2012.
7. Catherine Schenk, *op. cit.*, note 4.
8. Kui-Wai Li, *Economic Freedom: Lessons of Hong Kong*, 2012, p. 53.
9. Heritage Foundation, *Index of Economic Freedom*, 2013.
10. Kui-Wai Li, *op. cit.*, note 8, p. 507.
11. The World Bank, *Ease of Doing Business in Hong Kong SAR, China*, 2014.
12. Hong Kong Special Administrative Region Government, *Hong Kong: The Facts. Coming to Hong Kong*, 2013.
13. United Nations Conference on Trade and Development, *World Investment Report 2013*, 2013, pp. xiv-xv.
14. Hong Kong Special Administrative Region Government, *Hong Kong: The Facts. Financial Services*, 2013.
15. Z/Yen Group, *The Global Financial Centres Index 14*, September 2013.
16. With the exception of crown corporations as well as broadcasting and cable television, where foreign ownership cannot exceed 49%. Deloitte Touche Tohmatsu Limited, *Taxation and Investment in Hong Kong*, 2013, p. 2.
17. Hong Kong is ranked 14th by Transparency International's *2012 Corruption Perceptions Index*, ahead of countries like Japan, the United Kingdom, the United States and France.

910 Peel Street, Suite 600
Montreal (Quebec) H3C 2H8, Canada
Telephone: 514-273-0969
Fax: 514-273-2581
Website: www.iedm.org

Illustration: Ygreck | Graphic design: Mireille Dufour