DOING BUSINESS IN Hong Kong

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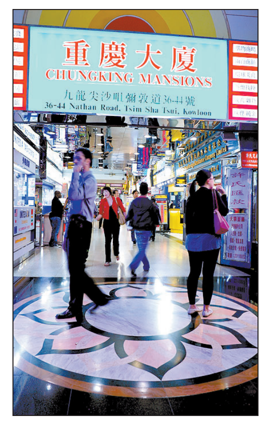

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Entrepot with political attitude

While the mainland promotes Hong Kong's financial sector, pro-democracy protests will not go away, writes **Rahul Jacob**

Last month, Li Keqiang, China's vice premier, arrived in Hong Kong for a three-day visit during which he doled out financial liberalisation measures like confetti.

In Beijing's biggest effort to help Hong Kong's economy since it was laid low by the Sars epidemic in 2003, Mr Li announced policies expanding its pre-eminent role as a centre for trading renminbi and allowing mainland citizens to invest in the Hong Kong stock market through exchange traded funds. In addition, financial firms were given preferential access to the mainland market.

Mr Li is in charge of economic affairs but, even so, it was surprising that politics was not mentioned in the three days of public events. Predictably, pro-democracy legislators did not have a chance to chat with Mr Li, even though he met business leaders and the top people at the stock exchange.

At a dinner to which Hong Kong's 60 legislators were invited, a security guard kept a close eye on the head of the Democratic party, presumably to ensure that he did not try to speak to Mr Li.

In the days after Mr Li's departure, however, the political fallout dominated the newspapers. More than 300 local journalists staged a march to protest at the police's heavy-handed arrangements that had made their coverage of the visit problematic. The Bar Association said the police had compromised the government's responsibility to uphold the right to freedom of expression. The police commissioner was questioned by the legislature about the police's conduct during the visit.

Both Mr Li's interest in boosting Hong Kong's financial sector and the spirited criticism about the excessive security arrangements are good prisms through which to view the one country, two systems" autonomy promised to the territory when it was returned to China in 1997.

In boosting the role of Hong Kong as a laboratory for the slow and steady liberalisation of the renminbi, China continues to acknowledge the city's pre-eminence as a financial centre for the mainland.

The protests about the police arrangements are a reminder that many in Hong Kong are determined to ensure its political freedoms remain similar to those of a liberal democratic society rather than its autocratic sovereign.

"Hong Kong is free only if it insists on being free," says Bao Pu, who worries that the territory's establishment defers excessively to Beijing's will. Still, Mr Bao has made his name as a profitable samizdat publisher of a host of Chinese political memoirs, satires and biographies banned in communist China.

The pressure on Hong Kong's independent-minded judiciary to refer controversial legal issues to Beijing instead of deciding on them itself is a growing area of concern, say critics. On August 26, China's top legislature ruled that sovereign states enjoyed special immunity from being sued in Hong Kong after the city's highest court decided in June to refer a case to Beijing that involved a US distressed debt fund that was trying to recover $100m from the government of the Democratic Republic of Congo.

Beijing's ruling means Hong Kong's laws on this matter are now at variance with other common law jurisdictions, which allow sovereign states to be sued in commercial cases. Simon Young, a professor of public law at the University of Hong Kong, says that accepting sovereign immunity is "bad for business [for the territory] as a free international financial centre".

A legal battle over whether foreign domestic helpers should be granted permanent residency after having lived in the territory for seven years is another test.

While Hong Kong awaits a legislature and a chief executive elected on the conventional basis of universal suffrage – measures expected to be introduced in 2017 – having an efficient, impartial judiciary that acts as a check on the government is seen as a crucial protector of its freedoms.

Anson Chan, the former chief secretary, and pro-democracy legislators, say the road map to full democracy has not been clearly laid out, even as the drumbeat for a popularly elected government is getting louder.

Earlier this year, the government's budget proved to be so out of step with what legislators and the public wanted that John Tsang, the financial secretary, was forced into an embarrassing U-turn within days of announcing it. Mr Tsang was forced to hand out HK$6,000 to all permanent residents to spend as they chose instead of placing it in the accounts of those with mandatory provident funds.

A protest march attended by 8,000 people went ahead, anyway: many middle-class marchers said it was irresponsible to give out money in this way when there was a need for more targeted spending directed

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After the party: the fallout following a visit to Hong Kong by Li Keqiang, China's vice-premier (centre) focused on heavy-handed policin Getty

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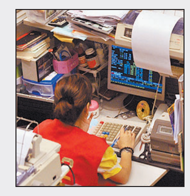

Renminbi has yet to find great favour in loan market

Currencies

Deposits are surging but borrowers still prefer dollars, writes **Robert Cookson**

Anyone walking past HSBC's Norman Foster-designed skyscraper in Hong Kong this year could not escape the billboards advertising the fast-growing suite of services the bank now offers in the Chinese currency.

With an image of an aircraft soaring into the sky, the billboards captured the optimism among Hong Kong bankers about the potentially vast opportunities presented by Beijing's push to "internationalise" the renminbi.

As a result of these marketing campaigns, HSBC and its rivals have, over the past year, accumulated a large pool of renminbi deposits which flowed out of the Chinese mainland through controlled channels such as cross-border trade.

So far, however, the business has not been very profitable because there is almost no international demand for renminbi-denominated loans and Beijing strictly limits flows of the currency offshore.

Mark McCombe, chief executive of HSBC's Hong Kong operations until last week when he quit to lead Black Rock, the asset management company, in Asia, says the freedom to do business in renminbi is "probably one of the single greatest opportunities presented to the Hong Kong financial centre for a generation."

However, the renminbi's path to full internationalisation and convertibility is unlikely to be entirely straightforward.

Almost 150 years after it was established in Hong Kong and Shanghai to finance the growing trade between China and Europe, the territory's biggest bank is moving aggressively to gain a dominant position in the renminbi market.

In July 2009, HSBC was the first foreign bank to settle cross-border trade in renminbi following landmark reforms by Beijing. Since then, the amount of trade settled in the Chinese currency has surged, with more than Rmb800bn of such transactions passing though Hong Kong in the first half of this year.

As a result, the renminbi has accumulated rapidly in the banking system, crowding out Hong Kong dollars and US dollars, the traditional source of bank funding. As of July, renminbi deposits made up 9.5 per cent of the total $947bn of deposits in Hong Kong – up from less than 2 per cent just a year ago. "If the renminbi develops the way we expect it to, in a few years it will be a key source of our funding," says Thomas Poon, HSBC's head of business planning and strategy for the territory.

HSBC has overhauled its Hong Kong operations to ensure that everything the bank can do in Hong Kong or US dollars is also enabled for payments in renminbi, from trade finance to dealing bonds and equities.

Yet, while the growth of renminbi deposits in the territory has been rapid, the development of renminbi-denominated assets in which to place those deposits has been more modest. In April, HSBC helped arrange the first, and so far only, initial public offering outside mainland China to be denominated in renminbi.

The offshore market for renminbi-denominated bonds has proved much more lucrative. A procession of companies, from UK supermarket group Tesco to US engineering group Caterpillar, have raised more than Rmb54bn selling renminbi bonds in the year to date, up from Rmb34bn for the whole of 2010.

> The development of renminbi-denominated assets in which to place deposits has been modest

Competition is fierce. Global banks, including Standard Chartered, Citigroup and Deutsche Bank, are all fighting to gain a bigger share of the market, while the state-owned Chinese banks are also making their presence felt.

Last month, Industrial and Commercial Bank of China flew a helicopter over Hong Kong trailing a red banner that advertised a Rmb20bn sale of Chinese government bonds, the biggest ever issue of offshore renminbi debt.

Mike Werner, Hong Kong-based banks analyst at Sanford Bernstein, says the territory's banks will find it difficult to generate profits from the offshore renminbi business for at least the next three or four years. "While the offshore renminbi business has got off to a fast start, it is still a very imbalanced market," he says

The biggest concern for Hong Kong banks is that there is almost no demand from customers to take out renminbi loans. There were just Rmb11bn of these loans at the end of June, compared with Rmb550bn of renminbi deposits.

"As long as the market expects the renminbi to appreciate against the US dollar, companies will be unwilling to borrow in renminbi," says Mr Werner.

Mainland Chinese companies would love to borrow in renminbi from Hong Kong banks, since offshore interest rates are lower than those onshore. However, Beijing places strict limits on cross-border lending and investment.

Until Hong Kong banks find a way to expand the asset side of their balance sheets using renminbi, their overall profit margins will be under pressure.

Mr Poon of HSBC is optimistic. He reckons companies will become more willing to borrow in renminbi in future, especially if dollar borrowing rates continue to rise.

"One way or another, the market will find its equilibrium," he says. But first the bank's customers may take some persuading. Time to bring out a fresh set of billboards.

In the money: freedom to do business in Rmb is huge Reuters

Luxury of a long view of the mainland

Equity market

Ben McLannahan finds trading is becoming more Beijing-friendly

When surfing for car insurance or a tablet PC, shoppers generally do not care which website they use, as long as the service is quick, inexpensive and reliable. The same applies, increasingly, to the business of equity trading.

In financial centres across the world, a combination of deregulation and technology has transformed the landscape.

In New York, for example, where authorities began to encourage a migration of turnover to alternative platforms more than a decade ago, the New York Stock Exchange and Nasdaq have ceded almost half the market to rivals. A similar process has unfolded in Europe since the mid-1990s; Japan and Australia look to be heading the same way.

In Hong Kong, though, things are different. Hong Kong Exchanges and Clearing (HKEx), the world's largest exchange group by market capitalisation, owns the territory's only stock exchange, its only futures exchange and its only clearing house for stock transactions. In the case of the Stock Exchange of Hong Kong, a "de facto monopoly" is embedded in a series of definitions in Article 19 of the territory's Securities and Futures Ordinance, notes David Webb, a corporate governance activist.

It is one of the main reasons why a host of alternative venues have amassed only about a 3 per cent market share in equity trading between them, over several years of competition; even then, all trades on platforms other than the SEHK are reported to, and cleared through, HKEx. "Our primary role is to ensure that we maintain orderly and informed securities markets in the public interest," says Ronald Arculli, the chairman of HKEx. "We have to work within the mandate we're given."

A new competition bill, due to be enacted next July, could contain some more challenging provisions for HKEx. But it seems unlikely that the group will be exposed to the kind of wholesale reforms that swept across Europe under MiFID, the Markets in Financial Instruments Directive, legislation for the regulation of investment services.

Hong Kong's government owns 6 per cent of HKEx, and appoints half of its non-executive directors. KC Chan, secretary for financial services and the treasury, is known to take a critical view of the fragmentation of liquidity. That suggests that HKEx's operating margins, typically about three times higher than peers in the US or Europe, are likely to remain among the best in the world. The group's average return on equity over the past five years is 61 per cent – comfortably the highest on the Hang Seng benchmark index.

Mr Arculli and his executive colleagues thus have the luxury of taking a long view. Increasingly, that is towards mainland China. As the 71-year-old chairman explains, the group has always had a "natural bias" toward the mainland. In July, mainland enterprises accounted for 55 per cent of the market's capitalisation and 69 per cent of its turnover; three years ago, the ratios were broadly similar. But now, as Beijing looks to use its special

Ronald Arculli, chairman of HKEx: 'Our primary role is to ensure we maintain orderly and informed securities markets'

administrative region as a laboratory to observe how the renminbi and renminbi-denominated assets are traded, HKEx sees itself playing a vital role.

The group recently realigned its trading hours to be a better fit with those of Shanghai and Shenzhen – mainland China's dominant equity markets, churning out about $18bn of equity trades between them every day (roughly two and a half times Hong Kong's volumes).

Last month, as Li Keqiang, the Chinese vice-premier, toured Hong Kong, the trio announced that they had embarked on a joint venture to develop cross-border products. "This can be seen as a first step towards working together commercially, starting to engage," says Sam Hilton, a Hong Kong-based analyst at Keefe, Bruyette & Woods, the research company.

In the short term, deepening ties with the mainland is not the sole objective. As Mr Arculli notes, HKex has made a "big push to attract international listings" – the likes of Prada of Italy and AIA, the Asian arm of the New York-headquartered AIG.

But over the long term, those efforts should be set in the context of the gradual opening of China's capital account. Hong Kong, ultimately, wants to achieve a transformation: from being a place where Chinese issuers meet international investors, to one where Chinese investors meet international issuers.

In a recent research note, HSBC, the banking group, said it expected renminbi-denominated stocks to account for 15 per cent of Hong Kong's total market capitalisation and 20 per cent of turnover by the end of 2015 – a much faster pace of liberalisation than anyone had been expecting two or three years ago. "If the development of Hong Kong as an offshore centre for renminbi is anything like the development in London of the eurodollar market in the latter half of the last century, we'll have an awful lot of opportunities on our plate," says Mr Arculli, now in his sixth year as chairman of HKEx. The group recently disclosed that 81 of its members had signed up to use a new platform to trade renminbi-denominated stocks.

Of course, there are potential dangers in drawing closer to mainland China. Hong Kong is already heavily exposed to its fundraising cycles. So far this year, companies offering shares for the first time in the territory account for one in every 10 dollars raised globally; in 2009, when China was powering through the global downturn, that ratio was one in four.

Deeper ties with unlisted mainland groups also imply that the HKEx will be a bystander as listed peers do deals. Notably, shares in HKEx dropped 5 per cent on the day in February that NYSE Euronext said it was tying up with Deutsche Boerse, suggesting investors suspect the company will play no meaningful part in the current wave of industry consolidation.

But when Mr Arculli argues there is no sense in the group "doing a combination for the sake of doing one", it is hard to disagree. Freed from serious competition for cash-equities trading, and almost guaranteed regular flows of primary business from north of the border, HKEx remains an anachronism. And for investors in it, a pretty glorious one.

Entrepot with political attitude

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at care centres for the elderly, for instance, as the city faces an accelerating ageing crisis.

There is also a widespread dissatisfaction that the government, like the British colonial governors before it, is not doing enough to rein in property cartels and build subsidised housing.

This is leaving middle class first-time buyers increasingly unable to get on the property ladder. Average property prices are a staggering 11.4 times annual household median incomes, the most lopsided multiple in the world.

Hong Kong is seeing rising disaffection with government and big business, says Joseph Cheng, a professor of political science at City University of Hong Kong, because "the children of the middle class find it difficult to earn enough to maintain the lifestyle their parents provided them with".

Hong Kong's peg to the US dollar, which served as an anchor of stability in the panic-prone local economy in the jittery years leading up to the handover in 1997, has played a part in inflating the property price spiral as well.

The peg means that, even in times of robust economic growth such as the past couple of years, the territory must ape US monetary policy and cannot use interest rates as a tool to tackle inflation.

Thus far, the territory's central bank has used tactics such as raising the down-payment-to-mortgage ratio to rein in property prices.

Almost 15 years after Hong Kong's return to China, though, many of these problems are also problems of success. Even as external demand for products made in southern China slows in the US and EU and small and medium-sized enterprises struggle as wage costs rise in the manufacturing powerhouse of Guangdong across the border, wealthy Chinese travellers to Hong Kong are providing a cushion. They have pushed up retail sales in the city and filled hotels, creating a wealth effect for the rest of the economy.

With all the world's eyes on China, the city's role as a hub of headquarters for multinationals looms larger every year. Senior executives from General Electric to Caterpillar make their homes in Hong Kong as does the regional head of just about every global investment bank.

Executives at an international fund management company recently grumbled about rental increases for their apartments of an eye-watering 90 per cent one moment, then segued to expanding their equities team in Hong Kong (rather than in Singapore) the next.

It is this clustering effect of financial firms in the city that also make Hong Kong central to Beijing's plans for internationalising the renminbi, as Mr Li's visit affirmed yet again, and capital-raising for its companies. For a financial centre, this amounts to as nice work as you can get in good times.

Mansions a melting pot of low-end globalisation

Migrant hopes

Kanupriya Kapoor finds economic ambition has an unlikely home

A look of nervous curiosity clouds the faces of those who walk haltingly past the crumbling facade of Chungking Mansions in Kowloon district. The building, though flanked by some of Hong Kong's most glamorous malls, has a shifty aura; seedy loiterers and over-eager restaurant touts do little to dispel the feeling. But the dimly lit, unimpressive entrance hides a sprawling – and largely harmless – bazaar, where people from a dozen or so Asian and African nations do not just shop, but conduct full-on trade transactions in cheap electronics and textiles.

This mass exchange of goods – paid for in cash and carted across oceans in suitcases or flimsy old cardboard boxes – makes Chungking Mansions one of the most unlikely, but arguably one of the most prolific, centres for low-end globalisation.

While it is the underbelly of a hyperconnected material world, for a range of people – from south Asian and mainland Chinese store owners to entrepreneurial traders from sub-Saharan Africa – Chungking Mansions represents what thousands of others look for in the shimmering skyline of Hong Kong: economic ambition.

> Many store owners swear by the trust they have built within this community

Gordon Mathews, a professor of anthropology at Chinese University of Hong Kong, reveals the inner workings of this building, which remains a mystery to most Hong Kong residents, in his recent book, *Ghetto at the Center of the World*.

He calls it an "island of the developing world in the heart of Hong Kong". Through anecdotal evidence from people he has come to know as friends over the years, Prof Mathews celebrates the seething activities of its wholesale cellphone and clothing stores, its guest houses packed with globetrotting travellers and its diverse offering of authentic Asian and African food, describing it as "probably the most globalised building in the world".

A chapter dedicated to Chungking Mansions' economy makes clear its significance as a transit point for cheap, and often fake, goods that take circuitous routes around the world

In one such example, Australian opals are shipped to southern China to be polished and set, before being sent back to Australia to be sold as souvenirs to Chinese tourists, all via Chungking Mansions, of course.

Prof Mathews says up to 20 per cent of cellphones in use in sub-Saharan Africa have passed through the dingy corridors of Chungking Mansions, many of them discarded from Europe, or knock-offs from southern China.

Prof Mathews does not dwell on figures in a place that operates largely off the books anyway, but he attributes this unusually high passage of goods to Hong Kong's open borders and its proximity to southern China, the manufacturing powerhouse of the world.

The building also offers the cheapest rents in the city, which, by Hong Kong's ever-rising standards, gives it a definite allure for store-owners and travelling tradesmen alike.

Despite prevailing perceptions that the building is a place where drug addicts and prostitutes congregate, most men who operate in Chungking Mansions do so while sticking to their religions, and at times, according to Prof Mathews, they personally police upper-floor guest houses that attract sex workers and their clients, or keep junkies at arm's length outside the premises.

Though a little cut-throat business is run-of-the-mill practice, many traders and store owners, African buyers and South Asian or Chinese sellers, swear by the trust they have built within this community.

A Pakistani store owner would invite his Nigerian buyer to inspect 8,000 handset units before helping pack them into his suitcases. If necessary, he would even be willing to extend credit to his client, comfortably expecting to be paid on the buyer's next trip in a few months' time.

The ways in which some store owners minimise costs include hiring illegal workers, though there is a vague knowledge and acceptance of this practice among Hong Kong police and immigration officials. People who have either overstayed their visas or asylum seekers waiting for a decision on their applications are eager to contribute to the society that took them in without too many questions being asked. According to Prof Mathews, these illegal workers carry the economy of Chungking Mansions as they are willing to work for a pittance.

As he bustles around the ground floor, signing and handing out copies of his newly minted book like a self-styled "quasi-celebrity", Prof Mathews' emphasis on the people in and around Chungking Mansions is evident. Those who manage to set up and keep shops in this competitive environment reflect an aspiring class of entrepreneurs and business owners, not only in their home countries but also here in Hong Kong.

While it is true a divide exists between the rich who sail past this building and those who eke out their living within it, Hong Kong has ever sought to fulfil its economic promise to those who have come to its shores, and the division is only one of relative earning power.

Going up: the annual average demand for new flats is 20,000 but by the time they are built the market is likely to have changed AFP/Getty

A question of not when but how fast prices will fall

Property

Rises in supply and interest rates beckon, writes **Enid Tsui**

When the Hong Kong property market collapsed at the end of 1997, prices fell for nearly six years before bottoming out at one-third of the pre-crash level.

The Asia financial crisis and the Sars epidemic were devastating blows to the territory in 1998 and 2002 respectively, but public policy controlling the supply of land and the provision of public housing was widely blamed for exacerbating and prolonging the property market decline. It fanned widespread anger towards the first postcolonial administration and contributed to the eventual ousting of Tung Chee-hwa, then chief executive.

Today, Hong Kong is the world's most expensive place to buy a home, according to global property agency Savills, following years of abundant liquidity in mainland China, ultra-low local interest rates and a supply shortage. Local indices show the average price in the secondary market is about HK$6,000 per square foot – about the same as in 1997, before the market crashed.

The question most people are asking is not whether there is going to be a correction, but how big it will be.

Transaction volumes and land sale prices have fallen recently, an indication that buyers and developers see risks increasing. Anecdotally, the wealthy mainland Chinese buyers who have been propping up the high end of the market are holding back as a result of Beijing's tightening policies.

The government's monetary hands are tied as Hong Kong is pegged to US interest rates. However, local banks have been raising mortgage rates since March as Hong Kong dollar loan growth outstrips deposit growth. Local savers are increasingly converting their Hong Kong dollars to the renminbi, while corporate borrowers are happy to pay higher interest rates in Hong Kong as it gets harder to borrow money on the mainland.

Another damper on prices, analysts say, is a change in government policy. Apart from introducing short-term measures to cool the markets – anti-speculation stamp duties and lowering the loan-to-value ratio for high-end residential properties, for example – the government seems determined to increase land supply and stabilise property prices.

It announced this year it would resume regular land sales and provide land sufficient for the annual construction of 20,000 private housing units for the next 10 years. It also said it would provide 15,000 public rental housing units a year to help those who cannot afford to buy a home.

Donald Tsang, the chief executive, is widely expected to restart the Home Ownership Scheme – subsidised housing that low-to-mid income families can buy. This was suspended in 2002 when property prices were falling. If the government really commits itself to the 20,000 unit target – that is the annual average demand for new flats – it could go a long way to reducing price volatility caused by a big gap between demand and supply, analysts say.

The government has a monopoly over the availability of new land for property development in the region and its traditional, supply-side approach is to halt land sales when prices are low and then sell a lot of land when prices are considered too high.

There are two problems, says Albert Wong, deputy chairman of Midland Holdings, a local estate agency. First, the government tends to make these decisions too late. "We were telling officials four, five years ago that they should start selling land again, but it's taken them this long to do it, which is why prices have been rising since 2003," he says.

> The wealthy mainland buyers who have been propping up the high end of the market are holding back

Another problem is that, by the time the new flats are built – it usually takes three or four years to build a Hong Kong skyscraper – the market is likely to have changed. "Over 30,000 new private flats were completed in 1999, compared with average annual demand of 20,000. They were legacies of aggressive land sales in previous years designed to cool prices, when prices were still high. Instead of the desired effect, their arrival on the market put additional pressure on already falling prices," he says.

So how much will prices fall? Given that they have risen about 70 per cent since 2009, most forecasts are not pointing to a big crash.

Andrew Lawrence, Barclays Capital's head of regional property research, is among the most bearish of analysts. By his estimate, Hong Kong property prices will fall by 25 to 30 per cent next year, sparked off by higher borrowing rates.

Yu Kam-hung, executive director of valuation and advisory services at CB Richard Ellis in Hong Kong, is expecting a 10 to 20 per cent fall in the next 18 months. "All the major positive drivers of prices are over and done with. There can only be less money coming in from mainland buyers, and interest rates have bottomed," he says. "But the depreciation of the Hong Kong dollar – which makes local assets relatively cheaper for overseas buyers – and the continued shortage of first-hand property should give some support to the market."

There will be fresh demand from mainland buyers if the Hong Kong currency falls by as much as 10 per cent in the coming year, he says. If the devaluation happens at a slower pace – say 3 to 4 per cent – the attraction for overseas buyers will not change much, he adds.

An adjustment is overdue, says Chak Wong, a finance professor at the Chinese University of Hong Kong. "You shouldn't have a market where people end up paying 12 times their household income for a flat," he says.

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Foxconn effect sparks change in direction

Pearl River delta

John Gapper reports on a new lease of life for Hong Kong's middlemen

A road less travelled: cities such as Guangzhou are having to adapt fast as costs rise and production moves inland Dreamstime

The Pearl River delta, the area of Guangdong province adjoining Hong Kong that has over the past 20 years become the world's manufacturing workshop, is in the middle of wrenching change.

Guangdong is trying to wean itself from low-cost manufacturing of textiles and electronics such as iPhones into a zone of high-end manufacturing and services. It is the biggest transformation of the region since Deng Xiaoping's "southern tour" in 1992 boosted the growth of China's special economic zones.

The spark was the string of suicides in 2010 at the factory-town operated by Foxconn, the Taiwan electronics manufacturer, in the Longhua district of Shenzhen, employing 300,000 people – most of them young migrants from China's interior. The ensuing criticism of working conditions led to double-digit wage rises across the region.

But the "Foxconn effect" was not just a private sector response to discontent and despair among workers. The wage rises, which have caused a wave of closures among low-margin factories, were tacitly approved by Beijing as part of its intention to restructure the export-led economy.

Not only does official policy favour wage rises in an effort to boost domestic consumption, but the government would like industry to transfer from the coastal zones to provinces such as Sichuan and Hunan to spread the benefits of industrialisation to the interior.

That has unleashed creative destruction in Guandong's sprawling industrial cities – Shenzhen, Guangzhou and Dongguan. Some companies are investing in new facilities for higher-margin products, others are diversifying into other provinces and lower-wage countries such as Bangladesh and Vietnam. Others are simply closing down.

"As costs go up, a lot of traditional manufacturing is being squeezed out," says David Chu, the clothes designer and founder of the Nautica brand whose family makes clothes for western brands, including Burberry, in Dongguan. "Unless you produce highly value-added goods, it is impossible."

"Foxconn produced a sea change in how workers are treated and the whole distribution of income. Post the Foxconn effect, we are seeing a dramatic rise in labour costs," says Victor Fung, chairman of the Li & Fung, group of companies and of the Greater Pearl River Delta Business Council.

Spencer Leung, an analyst at UBS, says that in the first few months after the Foxconn affair, local manufacturers expected wage rates to rise by 10 to 12 per cent a year, but in practice they rose by 18 to 20 per cent. As operating margins were already very thin, this has put them under intense cost pressure.

"We have seen a lot of factories going out of business. Usually factory owners would wait until the New Year [the January holiday when many migrant workers return to their provinces] to walk away and not come back," he says. "This year, they are not even waiting, which tells you how difficult it is."

Many companies are trying to shift inland – Foxconn has opened a large plant in Chengdu in Sichuan province. Mark McCombe, who resigned last week as head of HSBC's bank in Hong Kong to lead Black Rock, the asset management group, in Asia, argues that restructuring is already well advanced. "It is not a world in crisis. This has been an evolutionary process over years. Some industries, such as textiles, have already diversified."

But Guangdong has a sophisticated network of suppliers and logistics as well as a vast and mobile labour force, while inland provinces are developing. "Dongguan is like New York or London. It attracts talent from across the entire country," says Mr Leung. "Inland, you can buy a piece of land at a very attractive price, but the talent is not there."

A further obstacle is the cost and complexity of exporting finished products – the delta provides quicker access to ports than cities such as Chongqing. China's road network suffers from frictions such as the requirement to unload and reload trucks when crossing provincial borders.

Mr Fung senses opportunity for the Hong Kong "intermediaries" of which Li & Fung is the largest. "I think we have a new lease of life. People thought: 'These guys will stick to what they've done for the past 30 years and be bypassed' but this new paradigm requires knowhow."

This means organising the supply chain and logistics for inland production and helping multinationals to start selling to the Chinese consumer. Hong Kong companies also see a demand for their expertise from domestic companies turning into exporters. "We are entering a new era for the Pearl River," says Mr Fung. Until now, the world has concentrated on sourcing from the east and selling to the west. Everyone traded on that because 85 per cent of world's consumption was in the OECD. But it is becoming a global web."

Mr McCombe also argues the evolution will benefit the region and Hong Kong rather than simply drawing jobs inland. "Clients who spent 20 years thinking about the quickest route out are now thinking about the supply chain inside China and, as Chinese companies become more confident, they are coming here to find export markets."

The question is whether change in the delta can bring high-value industries and jobs fast enough to replace old ones. The mood in Hong Kong is optimistic, helped by the visible impact of China's growth, but the proof is still to come.

Restlessness of a new generation

Migrant workers

John Gapper finds younger Chinese have higher job expectations

Li Junjun is one of a fading breed among China's 145m migrant workers who come from rural areas to the Pearl River delta to find well-paid work. Mrs Li, who has worked as a cleaner in Shenzhen for 16 years and is now 45, is not only older than many of them, but more pragmatic.

"I have no education or special skills and if I don't do a good job and work hard, I cannot improve my life," she says. "When I am unable to work, I will go back to my home, but there are few opportunities there."

Mrs Li is speaking from the flat she shares with six young women, all of whom work in local restaurants. Most of those in her block are teenagers or in their 20s, and some have more ambition than to work in the city for a few years, save money to support their families and then return home.

Liu Kaiming, labour consultant: 'They go to the city for their future'

"My hope is that my children can live a better life than me. I think it will happen," says Mrs Li, who is the family's main breadwinner, earning Rmb1,900 ($297) a month. Her husband is in their village in Gansu province and tends their land. The couple has two children – a married daughter and a 23-year-old son in the army.

She represents the classic migrant worker of the first wave that came to the coastal cities in the 1980s. But the "new generation" – those born after 1985 – have bigger ambitions and are less dedicated to saving their wages for the family.

In some ways, the new generation of migrants is luckier and better off than the earlier one. They not only earn more, but they can spend more of it on themselves and their advancement since their parents are less likely to live in poverty – the original generation of migrants helped to ameliorate that.

"The first generation left the village to make money and then come back to build a house," says Liu Kaiming, head of the Institute for Contemporary Observation, which monitors workers' conditions in Shenzhen. "Now, the family's house is built and there are no jobs there. They go to the city for their future."

As a result, they are less docile and harder to manage. Factories in the region commonly experience labour turnover of 10 to 15 per cent a month – or well in excess of 100 per cent a year. This generation does not find it so easy to settle.

"Our parents are too traditional. They think in a straight line. They would like to arrange a life for their children, but young people should enjoy the process of trying out many possibilities," says one 23-year-old factory worker in Shenzhen.

Jane Cheng, a human resources executive for TTI, a power tools and electronics company based in Dongguan which owns US brands including Dirt Devil and Hoover, says the new migrants require careful handling.

"Fifteen years ago, if it was the third day after the new year holiday and you went over to the dormitories and said: 'We have a heavy order, come to work,' they would all do it. The company was the most important thing. These days if you told them the same thing, they would say 'no'."

Ms Cheng says the younger workers are, as the Chinese saying has it, "riding a donkey and looking for a horse" – they work in factories for money but are looking for opportunities. TTI has implemented a programme of community events and sports to make its workers feel happier and more stable.

Yet last year an outbreak of suicides at Foxconn, the electronics manufacturer, revealed the unhappiness among some of the new generation. Their greater ambition to do well for themselves causes its own difficulties – especially when the reality does not match the hope.

Wage rates have been rising sharply across the delta following the deaths, but some of the underlying problems remain. Migrants are still bound by the *hukou* system of household registration, which excludes rural dwellers from education and social benefits in their adopted cities. It has also become very expensive to live outside factories that provide them with free dormitory accommodation and meals. Although they can see wealth and expensive property in the city, their opportunities are limited.

The government's attempt to shift low-cost manufacturing into inland provinces is partly aimed at easing the problems of migrants. The idea is that they will be able to find work closer to home and not face the same isolation as in the coastal cities.

Yet young people will carry on coming to the Pearl River delta to seek not only money, but a better life. Unless factories or the government can fulfil those hopes, they will remain restless.

Additional reporting by Zhou Ping

Democratic Alliance bides time to universal suffrage

Interview
Tam Yiu Chung

Enid Tsui talks to the leader of the territory's biggest political party

Tam Yiu Chung would seem a man ideally placed to take charge of Hong Kong. He is chairman of its largest political party by number of seats in the legislature – the Democratic Alliance for the Betterment and Progress of Hong Kong (DAB) – and has excellent ties with the central government in Beijing. But he sees no reason to throw his hat into the ring as a candidate for next year's chief executive election.

The head of the special administrative region's government is, technically, an elected post. But only 1,200 individuals – handpicked from groups with significant political or business ties with mainland China – will get to vote in the March election, and most of them are expected to back whomever emerges as Beijing's preferred candidate.

A number of individuals with pro-Beijing credentials have been jostling for position, and the pro-democracy parties – which are at loggerheads with Beijing regarding Hong Kong's and mainland China's lack of political freedom – are expected to field at least one candidate, if only to force the official candidates to discuss contentious issues in public.

But Mr Tam does not plan to join the fray or encourage anyone from his party to do so. "Local political parties are still very small … and generally see very low support," he says. He points out that the DAB only has 10 out of the 60 seats in the legislative council. "We do not have the foundation to [be a ruling party] even though we are the largest party."

Hong Kong's two chief executives since the 1997 handover have been a business tycoon (Tung Chee Hwa) and a career civil servant (the incumbent Donald Tsang, who is barred by law from seeking a third term). Neither had previous political experience, a factor often cited as the main reason the government is unpopular and frequently has to backtrack on policies.

"The administration is not elected by the people and so it lacks legitimacy, which is why it behaves nervously. It knows it lacks legitimacy," says Albert Ho, head of the Democratic party – the largest so-called pro-democracy party.

All that will change when Hong Kong's chief executive is elected by universal suffrage – and that could happen as early as 2017, according to an agreed framework for the region's political development.

Mr Tam thinks that will be a good time to have a ruling party: "When the chief executive is voted in by universal suffrage, all candidates will have to be backed by a political party in order to wage a proper campaign." The DAB will need to broaden its support base and recruit better candidates in order to play that role, he says.

Commentators say the party, which is controlled by politicians who call themselves patriots, needs to increase its appeal to the middle class ahead of next year's legislative council election. These voters tend to sympathise more with the pro-democracy camp, which largely bases its campaign on the fight for universal suffrage, and defending "core Hong Kong values" such as freedom of expression and judicial independence.

'If government policy is not favourable, we will reflect the people's point of view'

Mr Tam – Hong Kong-born but a self-avowed "lover of the motherland" – is among a group of long-term leftist politicians who control the DAB.

While portraits of the Queen were still hanging in government offices and police stations, Mr Tam decided early on that his allegiance was with China. His interest in workers' rights led him to the department store workers' union in the 1970s. He became a full-time member of staff at the Federation of Trade Unions in the early 1980s.

The FTU grew in stature after China and the UK began discussions in 1979 about the future of the territory when the reality of its return to Chinese rule started to sink in. In 1992, he was among the founding members of the DAB – a party created to serve as a larger, more organised platform for "patriotic" politicians who had suffered a sharp loss in popularity following the 1989 Tiananmen Square massacre.

But the territory is still full of people who are more or less agnostic about nationality – many emigrated to Canada and Australia before the 1997 handover and then returned to make their living when the coast appeared to be clear. Others are from families that, not many generations ago, had fled to Hong Kong to escape the Chinese communist regime. A party that highlights its closeness to "the motherland" still does not resonate in many quarters.

The DAB's voters come mainly from other pro-Beijing organisations and from the grassroots level, where more people have benefited directly from the party's focus on local community work.

To increase its appeal, Mr Tam says the party cannot just be a rubber stamp for the government: "If the government's policy is not favourable, we will reflect the people's point of view and urge the government to amend the bill. That is our attitude."

He cites a number of occasions when the DAB decided not to support the government – a new cigarette tax, a plan to put HK$6,000 in each citizen's retirement fund (a sum that has been changed to a cash handout) and a plan to host the Asian Games in 2023.

The party is also trying to lure more middle-class voters by weighing into topics that have been the focus of the democrats – air pollution, and animal rights. But it is expected to take a more traditional line on more controversial issues such as the government's recent proposal to scrap by-elections and the foreign domestic helpers' campaign for permanent residency.

There will soon be a warm-up exercise to next year's elections. In November, district council elections take place and all main parties are going to go all out to prove they are the most representative of the people. All eyes will be on how Mr Tam's party fares.

Vigil for the dead takes on an extra edge

Tiananmen anniversary

Rahul Jacob finds a different spirit at an annual commemoration

Candle campaign: this year's vigil for victims of the Tiananmen Square massacre was influenced by Beijing's tough line on dissidents after Arab uprisings AFP/Getty

Causeway Bay is usually a neon-lit stage for what the US author Joan Didion once described as Hong Kong's "visual poem of buying and selling".

Yet the crowd that poured out of the mass rapid transit exits on the evening of June 4 was neither seeking retail therapy nor queueing for the newest iPad.

Instead, they headed in their thousands to nearby Victoria Park, the site since 1990 of an annual vigil for the victims of the 1989 Tiananmen Square massacre. It is the only place under Chinese sovereignty where the victims are remembered year after year.

Under the "one country, two systems" principles by which China has ruled Hong Kong since 1997, the territory continues to have a separate executive and judiciary and much more liberal laws on freedom of expression.

The Tiananmen massacre occurred fewer than 10 years before Hong Kong was returned to China but, in a sense, it changed the territory's political temperament more than the previous decades of colonial rule had done. The demand for wider representation dates back to that time and was given a new lease of life with the arrival of Chris Patten as governor in 1992.

This year's vigil was much the same as in previous years – and very different. Different because it occurred at a time of heightened concern about Beijing's tough line against dissidents since the Arab uprising that started with the Jasmine revolution in Tunisia. The vigil was just a couple of months after the April 3 detention of the Chinese artist Ai Weiwei, a critic of Beijing, who was released later that month. Posters with his face on it were hoisted by activists all along the way into the park.

Different also because the vigil was the first June 4 assembly to commemorate the life of Szeto Wah, the longtime Hong Kong democracy activist, who died in January of lung cancer. After a short film flashed on the screen at the front of the park about "Uncle Wah", the crowd cheered loudly.

As it does every year, the 100,000-strong crowd observed its ritual of standing up to lift candles in a silent salute to the men and women who faced down soldiers in Tiananmen Square.

A number of young mainland Chinese, both tourists and residents, attended the vigil. They have been among the most curious observers at demonstrations in Hong Kong in support of Ai Weiwei. "Most people who live in China don't know who Ai Weiwei is," observes Beifeng, the *nom de plume* of a dissident Chinese blogger who lives in Hong Kong.

If proof were needed that the spirit of the June 4 vigil lives on in the territory, it was demonstrated on the first day of Chinese vice premier Li Keqiang's visit last month. A protester wearing a T-shirt calling for a reassessment of the Tiananmen massacre was hauled away by plainclothes policemen when the vice premier was visiting a housing estate.

When the demonstrator's young daughter asked the policemen why they were detaining her father, they reportedly shouted at her that to wear such a shirt was "a great insult", to which the girl replied: "It's just a shirt."

A widening divide exists between increasingly angry young protesters in Hong Kong and an ever more hardline police, galvanised by Andy Tsang, the police commissioner who took over in January.

At a march of protesters after the June 4 vigil had ended, protesters clashed with police late that night, a sign that the territory's legacy of peaceful demonstrations hangs in the balance with a radicalisation both on the part of protesters – members of one political party in the city have taken to throwing dog food at public officials – and the police.

Still, most of the attendees at the June 4 event are likely to have remembered the tribute to Uncle Wah and the candles in memory of the victims airbrushed from official history in mainland China. Most memorable, however, was the recorded message from Ding Zilin, a retired philosophy professor who founded Tiananmen Mothers in memory of her teenage son who was shot.

The traffic seemed to stop outside the park. Prof Ding's voice echoed down the urban canyons. She and the other mothers were still waiting for an explanation about the massacre of their children more than 20 years later, she said. They would keep asking the government for answers.

Territory's glittering attractions clouded by health hazard

Opinion
CHRISTINE LOH

Imagine you are hosting a party. You have space to accommodate 100 people. Fire and safety regulations won't allow any more, but you have invited a lot of people. Thus, some must leave before you can allow more in.

This is the situation with Hong Kong's desire to build a third airport runway. There are interesting parallels with the plans to add a third runway at Heathrow. In both cases proponents have emphasised economic benefits, while non-governmental organisations have called for a more holistic assessment that includes social and environmental impacts.

For an eye-watering HK$136.2bn, the region could handle more passenger and cargo capacity, and hold on to its pre-eminent position as a hub. Its economy is expected to benefit by HK$900bn.

An inconvenient problem standing in its way is the number one public health threat – air quality. Two public opinion surveys by my think-tank, Civic Exchange, in 2008 and 2010 show concern over air pollution growing among all walks of life. Most worrying for this knowledge-based economy is that the educated and affluent increasingly plan to emigrate to find cleaner air.

Increasing air traffic and vehicles bringing passengers and cargo to an expanded airport will generate more pollution in a space already highly polluted. An added complication is that the government is due to set new air quality objectives, meaning total emissions would have to come down before projects churning out more pollution could be approved.

Another infrastructure project already in trouble over air quality is the HK$70bn bridge linking Hong Kong, Macao and Zhuhai on the mainland. In April, a judicial review overturned the government's approval of an environmental impact assessment (EIA). The judge found the report failed to identify the scale of the project's impact on air quality and so the evaluation of the acceptability of the project's environmental impacts was flawed. The EIA report also showed air quality near the airport was already close to and, for some pollutants, in excess of the legal limit established by Hong Kong's Air Quality Objectives.

The third runway will face the same issue when the EIA is carried out. A consultant's report shows more airport-related activity will lead to higher pollution in an already highly polluted space, but this study does not include emissions from road vehicles. The airport authority will, of course, propose measures to reduce the impact, but these will have to go far beyond what the authority can manage on its own. Since it is a public project, the government has a duty to look at the overall situation.

Concern over air pollution is growing in all walks of life

Indeed, if Hong Kong wants to expand its airport and build the bridge, its government will have to go on a drive to reduce pollution. It could offer an aggressive programme of improving roadside air quality, something entirely within its own control. This would have a positive impact on public health since a large number of people live and work close to roads.

Such a programme would force the government to push for long-neglected action to improve public health protection: ban old, highly polluting diesel vehicles, which are mostly commercial trucks; upgrade the aged bus fleet; put in place a tough vehicle inspection and maintenance system; expand the rail network; improve urban planning to enable better dispersion of vehicular emissions and pedestrianise where possible; and implement electronic road pricing.

The government has tried. An incentive scheme to help truck owners replace old vehicles failed because no timetable was put in place. Bus companies have not replaced fleets faster because the government allows old buses to remain in use to keep fares low, while local councils resist attempts to streamline over-provisioned routes.

Hong Kong's rail system is good but skeletal in comparison to New York or Tokyo. The government could keep fares down if it subsidised construction cost. Likewise, it could subsidise the differential cost of new buses to achieve earlier replacement.

There are many tried and tested measures Hong Kong could take.

Christine Loh heads the Civic Exchange, a Hong Kong-based think-tank