Doing Business in HONG KONG

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Justine Lau on a growing interest in the arts. This Qianlong period vase was sold last month at auction by Sotheby's for $32.4m **Page 3**

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Model economy's quest to spread its riches

Tom Mitchell finds there is another side to the world's most open market and its enormous capacity for wealth generation

Tale of two territories: beneath the spectacular Hong Kong skyline lies a huge gulf between rich and poor, which the government is now beginning to tackle with the introduction of a minimum wage Getty

Hong Kong government officials covet the territory's status as "the world's freest economy", an honour bestowed on it for 16 years running by the conservative, Washington-based Heritage Foundation.

That designation tells only half the story. Hong Kong's admirers like the fact the former British colony and free port, which reverted to Chinese sovereignty as a "special administrative region" in 1997, taxes very rich people at very low rates. Tax rates on salaries and company profits are set in the mid-teens, with capital gains and inheritances exempt entirely.

Hong Kong's capital-friendly regime is just the tip of a much larger and more complicated social compact that, from another perspective, belies its reputation as a model free economy. The territory is much poorer than its impressive per capita GDP figure, $42,800 last year, implies. Half of all workers earn less than HK$9,750 per month – an amount equivalent to, in US dollar terms, just $15,000 per annum. In 2009 the average annual wage of Hong Kong's 550,000 cleaners, who account for 15 per cent of the workforce, was a mere $7,960. As Leung Chun-ying, a member of the pro-Beijing establishment and a potential future Hong Kong chief executive, put it in a presentation to the Oxford & Cambridge Society earlier this year: "The trickle-down effect has not happened."

For overseas professionals, this combination of low taxes and cheap labour (for everything from taxi rides to domestic help) make Hong Kong a kind of expat heaven. But the gulf between rich and poor has become an embarrassment and a political liability for the government. To the dismay of free-market purists, last week the territory introduced its first minimum wage, set at HK$28 ($3.55) an hour.

To help people survive on such low wages, the government has for decades provided public housing to half the population, making it by far Hong Kong's biggest landlord. The government-owned MTR Corp also runs what is arguably the world's best underground and light-rail network, subsidised by property development rights the company is granted at the stations along its various lines.

This is just the start of the Hong Kong government's direct involvement in even surprisingly trivial areas of the economy. While the Chinese communist party made a conscious decision to retain control of the commanding heights of China's economy – state-owned companies monopolise heavy industry, telecommunications and other strategic sectors – the territory's supposedly laissez-faire government has a majority stake in Hong Kong Disneyland and, through its Trade Development Council, dominates the market for trade fairs and exhibitions.

Elsewhere in the world's freest economy, de facto cartels operate. One unintended consequence of the Hong Kong government's reliance on tightly controlled and lucrative land sales for revenue – rather than salary, profit and capital gains tax – has been the emergence of a half-dozen property companies that can compete at auctions for the territory's most precious commodity.

"Government land policies and high prices have concentrated power in the hands of a few large developers," says Christopher Dillon, a Hong Kong property investor who has written a book about the market. "They time their land purchases and home sales for maximum profitability, contributing to market volatility."

The vast profits these companies have reaped from their commercial and residential property investments have in turn been the basis for their dominance of other areas of the economy, most notably ports, retailing and telecommunications.

Hong Kong's retail market is such a stitch-up that not even as ruthless and efficient a competitor as Walmart has been able to get a look-in. And even if suspicions of collusion between the territory's largest companies to exclude outside competitors could be proved, such behaviour would not be illegal in the absence of a competition law. But as with the plight of the working poor, this too has become an embarrassment. The government is currently drafting a competition law.

With so many rent-generating sectors effectively cornered by a handful of tycoons in their late 70s and early 80s, the profits their empires rake in are self-perpetuating and will soon be passed to a new generation. "The old man is in good health, but at his age anything can happen," says a heir to one of the region's great fortunes. The pampered sons and daughters of Hong Kong's richest men, however, will struggle to take the family business in innovative directions.

Hong Kong Inc is at its competitive and innovative best away from its cosy home market. An increasing number of the territory's largest fortunes are being made in southern China, especially in Guangdong province's Pearl river delta region. The territory's entrepreneurs have thrived in a hypercompetitive environment characterised by tight margins and punishing product development cycles. The scale of the Pearl river delta's export sector is difficult to capture, although one comparison quoted by Michael Enright, a regional development expert, is particularly telling. Shenzhen, a city of 10m people and a magnet for Hong Kong investment, exports almost as much as India ($162bn in 2009 vs $177bn) and boasts an economy that is one-third bigger than Vietnam's (pop 90m).

Techtronic Industries is an example of a Hong Kong-based manufacturing juggernaut. Headed by German and Hong Kong entrepreneurs, TTI was established in 1985 as a contract manufacturer with factories in the Pearl river delta. Contract manufacturing, however, can lead a company on a downward spiral; manufacturers' margins are under constant pressure and most of a product's value flows to its brand owner. So TTI began acquiring some of the world famous power-tool and floor-care clients it used to supply, such as Milwaukee Tools, Ryobi, Homelite and Hoover.

"We bought [Hoover] for a small price because it was losing money, but we knew it was the best cleaning brand in the world," says Joseph Galli, TTI chief executive. "The true profitability falls to those who supply the brand." The company also opened what Mr Galli describes as the world's "most modern power-tool plant" in Dongguan, a manufacturing centre north of Shenzhen, and reduced its product-development cycles from 10 months to eight, compared with an industry standard of one-two years. "I was at Black & Decker for 19 years and I've never seen that," says Mr Galli. "[Product development] is so fast you can't believe it. It reminds me of the high-tech industry."

The Hoover acquisition saddled TTI with an unproductive operation in Ohio. After negotiations with the factory's "enormous union" and the state's governor, the facility was wound down but a research and development centre opened. "The business was losing $75m a year so the choice was no jobs," Mr Galli says. "Now Hoover is growing so fast we are adding more [engineering R&D] jobs."

As a result, he adds: "We have 24/7 R&D. Right now America is asleep but China is working."

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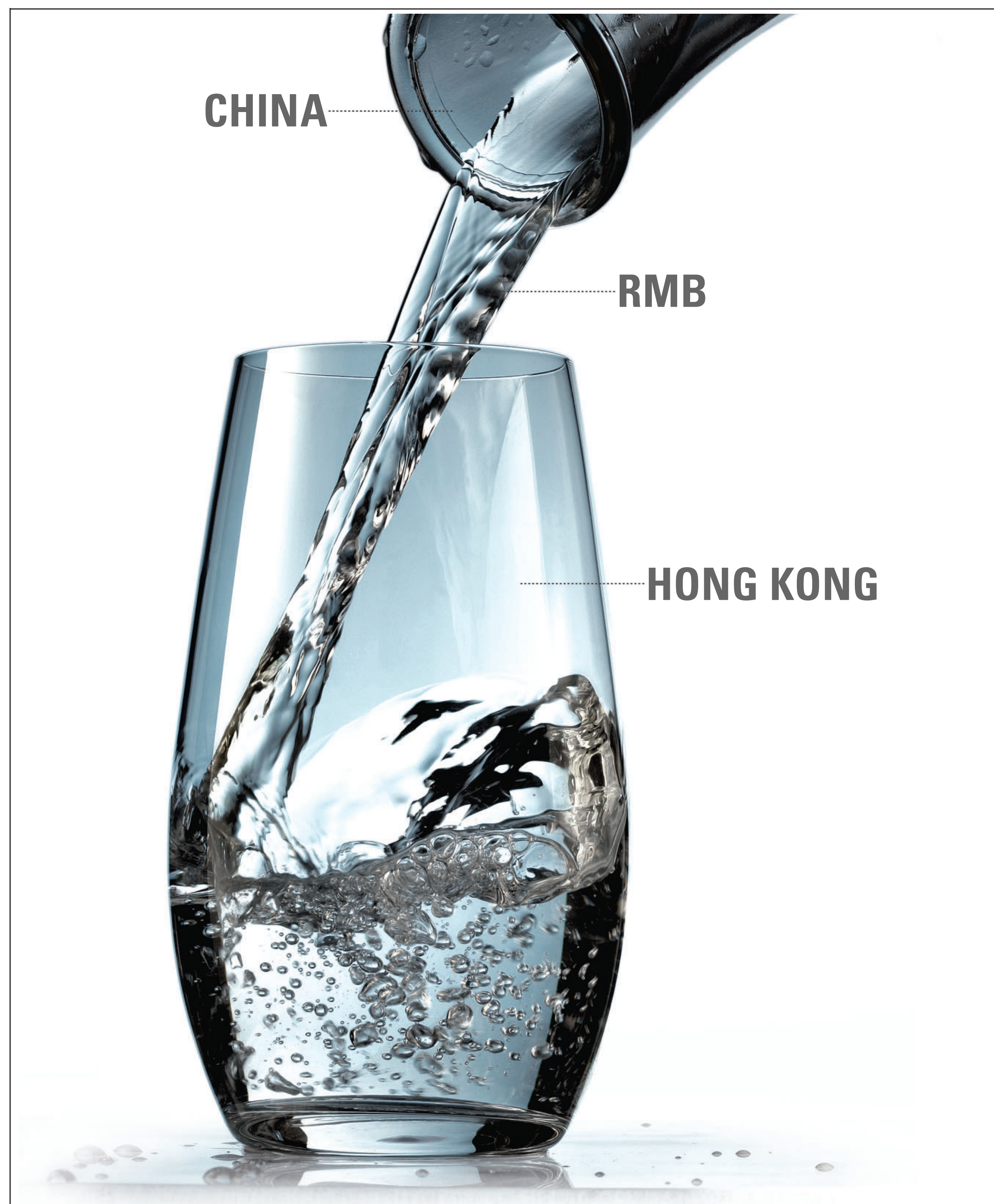

Hong Kong is the only international financial centre in the world with free and open RMB exchange. It holds the largest offshore repository of RMB liquidity and is the only place outside Mainland China where you can freely invest in RMB bonds and other RMB-denominated financial products.

WHERE DEALING WITH RMB DOESN'T MEAN DEALING WITH RESTRICTIONS.

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Currency faces a future of fears and uncertainty

Dollar peg

Ben McLannahan on a relationship with the greenback, and what happens when it ends

Talking point: HK's dollar

In the debate over the future of Hong Kong's currency, two arguments tend to go unchallenged.

First, the link between the Hong Kong dollar and the US dollar will come to an end. Second, that it will happen much sooner than 2047, when "one country, two systems" becomes "one country, one system".

But how much sooner? And what should replace it?

These are questions being asked with increasing regularity. Few would dispute that the peg introduced 27 years ago has served Hong Kong well, helping it to withstand a series of shocks. But there is a growing sense that the misalignment of the Hong Kong and US economies can no longer be reconciled.

Thanks to ultra-low interest rates, and a determination by the US Federal Reserve to hold them there until recovery is cemented, Hongkongers have two problems: skyrocketing asset prices and a currency that is fast losing value against almost all its neighbours.

The Hong Kong Monetary Authority, the city's de facto central bank and guardian of the peg, is in a tricky position. Eddie Yue, deputy chief executive, notes that loose monetary policy in the US "could increase the risk of a property price bubble in Hong Kong".

But the HKMA cannot fully engage in exploring the alternatives, for fear of inviting speculative attacks.

Discussions tend to end with familiar conclusions. "Given the small and externally-oriented nature of the Hong Kong economy and its role as an international trade and financial centre, maintaining exchange-rate stability against the US dollar remains most appropriate," says Mr Yue.

And yet distortions are in evidence in the territory. "Hong Kong cannot directly control the key governing factors of any property market, which are interest rates and liquidity," notes Joseph Tsang, head of capital markets at Jones Lang LaSalle, the real estate services firm.

The HKMA's tightening measures to date, such as higher downpayment requirements and limits on the debt-service ratio, have been only patchily effective.

Further, there is growing interest among Hongkongers in holding and exchanging "the people's currency". Renminbi bank

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Facing a future of fear and doubts

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deposits in the territory have swelled rapidly to almost Rmb150bn, about 2.6 per cent of total system deposits. In its third-quarter monetary policy report, the People's Bank of China revealed that cross-border trade settlement in renminbi shot up from Rmb48bn to Rmb127bn in the second quarter.

Late last month, the HKMA was forced to tap its renminbi swap arrangement with the PBoC, after demand for trade settlement using the currency outstripped supply.

The HKMA faces a choice, says Peter Redward, head of emerging Asia research at Barclays Capital: continue as is, allowing the steady "renminbi-isation of Hong Kong"; or realign monetary settings towards the renminbi.

For John Greenwood, the economist credited with designing the 1983 peg, such talk is nonsense. He insists that Hong Kong's trade-dependent economy cannot be shackled to a currency that cannot be exchanged freely on both the current and capital accounts.

Even at the current rate of development, full convertibility of the renminbi will take several years, if not decades.

"If the Hong Kong dollar were to be pegged in a currency board format to the renminbi, Hong Kong-based banks would need to be able to pay renminbi for the right to issue Hong Kong dollar banknotes. They couldn't do that easily, or in large volumes, as long as the renminbi is not convertible," says Mr Greenwood, now chief economist at London-based Invesco Asset Management.

Another option is to peg the Hong Kong dollar to a Singapore-style basket of currencies, weighted against the city's main trade partners.

More simply, the HKMA could widen the band in which the Hong Kong dollar can trade against the US dollar, thus allowing a steady appreciation. The default option is to create, over time, a dual currency system, similar to Macao's. There, the pataca is still legal tender; it has a 49 per cent share of currency in circulation, versus the Hong Kong dollar at 48 per cent.

But the longer the territory imports loose monetary conditions through the current system, the louder the calls will become for more radical action.

Hong Kong, after all, has a tradition of flexibility: silver dollars were used as legal tender until 1935, after which the local currency was fixed to sterling until 1972, then US dollars for the following two years.

From 1974 until 1983, it allowed its currency to float. A dynamic currency regime that shifts according to wider conditions has been the foundation of Hong Kong's success.

Whatever it says in public, the HKMA should keep an open mind in private.

Emerging from the minibond minefield

Regulation

Ben McLannahan analyses changes in investor protection

Visitors to Hong Kong's financial district don't have to wander far to be made aware of an inglorious episode in its recent history.

Demonstrations outside some bank branches are a legacy of the "minibonds affair", in which tens of thousands of retail investors bought HK$20bn of credit-linked notes that collapsed in value after Lehman Brothers imploded two years ago.

Protests have continued even after last year's government-brokered settlement between holders of the notes and the banks that sold them.

That ensures the spotlight remains on Hong Kong's unusual regulatory structure, where four main regulators govern four sub-regulators (*see panel*).

At its core, the structure is simple: a firm's legal status – bank, broker or insurance company – determines which regulator is responsible for supervising its activities, from both a financial stability and consumer protection perspective.

But as institutions have strayed on to each others' patches, gaps in supervision have opened up. Minibonds, for example, were investment products (approved by the Securities and Futures Commission) sold by banks (overseen by the Hong Kong Monetary Authority).

"The current situation is a mish-mash of overlapping responsibilities," comments David Webb, a governance activist.

"There's a strong case for a more consistent approach to the licensing, distribution and selling of financial products."

Some have recommended that Hong Kong consider adopting a so-called "Twin Peaks" approach, similar to Australia's, which allocates responsibility for prudential regulation and conduct of business regulation to two separate agencies, APRA and ASIC respectively.

Rather than tear up the structure, however, local regulators have simply resolved to do their jobs better.

"The lesson we all learnt from the minibonds affair was that to improve investor protection, we needed to improve the co-ordination between the HKMA and the SFC," says KC Chan, chair of Hong Kong's Financial Services and Treasury Bureau.

"All regulatory models were tested by the crisis, and all failed in some way," adds Martin Wheatley, chief executive of the Securities and Futures Commission. "More important is how we've responded."

Among the SFC's changes

> 'The current situation is a mish-mash of overlapping responsibilities'

are: a requirement for products to be accompanied by a simple "key facts statement," and a new entitlement to a five-day cooling-off period, during which investors can be refunded almost in full if they decide to change their minds.

The difference between Hong Kong and some of the jurisdictions that are revamping their regulatory structures – such as the UK and New Zealand – was that – minibonds apart – there were few debits on Hong Kong's ledger.

The HKMA slashed the rate at which it was prepared to lend emergency funds to banks, while easing collateral requirements. Meanwhile, the Deposit Protection Board extended its guarantee to cover 100 per cent of accounts.

The linked exchange-rate system with the US dollar, meanwhile, helped smooth trade frictions.

Hong Kong came through the crisis without big corporate failures and no failed lenders.

That is not to say that anyone should take for granted Hong Kong's position as Asia's premier international finance centre.

There are some obvious improvements to be made: the listing rules administered by the stock exchange, for example, lack the statutory backing of many other jurisdictions, while the listing regulator sits within the for-profit Hong Kong Exchanges and Clearing – an obvious conflict of interest.

But modifications can be made. "Change for change's sake is painful and costly," says the SFC's Mr Wheatley.

Regulators

Hong Kong Monetary Authority (HKMA) Runs currency board; manages reserves; regulates banks.

Securities and Futures Commission (SFC) Regulates exchanges, brokers and fund managers; authorises prospectuses; oversees disclosure.

Mandatory Provident Fund Schemes Authority (MPFA) Regulates retirement savings scheme.

Office of the Commissioner of Insurance (OCI) Regulates insurers.

Sub-regulators

Stock Exchange of Hong Kong Limited (owned by Hong Kong Exchanges and Clearing Ltd) Regulates listed companies, under the oversight of the SFC.

Hong Kong Federation of Insurers (HKFI) Operates the Insurance Agents' Registration Board.

Hong Kong Confederation of Insurance Brokers Regulates insurance brokers under the approval of the OCI.

Professional Insurance Brokers Association Regulates insurance brokers under the approval of the OCI.

Currency of the moment creates a stir

Renminbi

Robert Cookson observes the progress of a financial juggernaut

Hong Kong may have pegged its currency to the US dollar, but the renminbi is flavour of the year as the territory pushes for stocks, bonds and other financial products denominated in the mainland currency.

Financial groups are rushing to take advantage of key reforms introduced by China in July, which liberalised the flow of renminbi in Hong Kong and paved the way for a burst of financial innovation.

"This is a huge opportunity for Hong Kong," says John Greenwood, Invesco chief economist and architect of the exchange rate mechanism that governs the Hong Kong dollar, the territory's main currency.

The liberalisation of the renminbi in Hong Kong is part of China's plan to transform it from a domestic currency into a global one. Since July, any company in the world has been free to open a renminbi bank account in Hong Kong while groups in the city are now able to transfer funds among themselves and create new renminbi-denominated investment products.

Joseph Yam, former chief executive of the Hong Kong Monetary Authority, says Hong Kong is "the ideal laboratory" within which Beijing can experiment as it internationalises its currency. Foreign companies, the thinking goes, will be more willing to use the renminbi in cross-border trade deals if they are able to invest or hedge the Chinese currency in the sophisticated financial system of the former British colony.

The pace of change has been dramatic. Banks, fund managers, and insurance companies have launched a wide array of products denominated in the renminbi, seeking to capitalise on fervent investor demand for exposure to the Chinese currency. In the foreign exchange markets, renminbi-dollar trading volumes have surged to more than $200m per day. Forwards, swaps and options are also starting to trade but at low volumes. "This market is going to grow in an exponential way," says Jens Scharff-Hansen, co-head of foreign exchange trading for Asia at Deutsche Bank.

But the biggest splash came in the bond market in August when McDonald's, the US burger chain, became the first multinational company to sell renminbi bonds in Hong Kong, raising Rmb200m ($29m).

Financiers hope the city will eventually become an important fundraising centre for groups that have operations in China. However most observers reckon this will happen only if Beijing scales back the strict controls on flows of capital from Hong Kong to the mainland. At present, approvals to move the renminbi in or out of the mainland for investment purposes remain subject to approval of Beijing on a case-by-case basis.

Even so, banks such as Standard Chartered – which arranged the McDonald's bond – are beefing up their teams in expectation that the market will continue to grow apace.

Hong Kong Exchanges and Clearing, operator of the city's stock exchange, is also moving to get in on the action, and hopes to offer shares denominated in renminbi by next year.

Yet the growth of the renminbi capital markets in Hong Kong will depend on the speed and extent to which the Chinese currency flows out of the mainland and into the pockets of foreign investors. On this count, the city's dealmakers have grounds for optimism.

The pool of renminbi deposits in Hong Kong's banking system has been expanding exponentially in recent months, reaching Rmb149bn in September, more than twice the level at the start of the year.

And while the renminbi still constitutes less than 3 per cent of total deposits in Hong Kong, bankers expect that proportion to rise rapidly in the coming years as China allows more of its currency to flow out of the mainland.

"It doesn't take much deposit migration from the mainland to Hong Kong to

Joseph Yam, former chief executive of Hong Kong Monetary Authority

have a phenomenal effect," says Robert Minikin, a foreign exchange strategist at Standard Chartered.

As well as through trade, the renminbi flows into Hong Kong from residents who are allowed to buy as much as Rmb20,000 per day with foreign currencies. These flows are expected to continue apace given the widespread expectations that the renminbi will appreciate sharply against the US dollar. A new source of renminbi to the Hong Kong market is the HKMA, the city's *de facto* central bank, which last month drew down Rmb10bn of its Rmb200bn currency swap facility with the People's Bank of China.

But the reason the HKMA exercised the swap in the first place was that Bank of China (Hong Kong), the city's designated clearing bank for renminbi trade settlement, had reached the limit of its 2010 quota for renminbi conversion. The news took the market by surprise, since Beijing had never announced that the supply of renminbi for trade settlement was subject to a quota.

Whatever the hopes of Hong Kong's financial community, there are likely to be even more hidden bottlenecks when it comes to the growth of offshore renminbi financial markets. Beijing will not allow things to go too far too fast.

Powerful dynamics at the hub of change

Interview Margaret Leung

A leading banker talks to **Enid Tsui**

Margaret Leung says wistfully: "You used to be able to see the harbour from here," standing by the window of her office in the Hang Seng Bank headquarters on busy Des Voeux Road.

Unfortunately for her, the 18-year-old building had become enveloped by even newer high-rises in the heart of Central district by the time she joined the bank as vice-chairman and chief executive last year.

Visitors to Hong Kong and residents alike comment on the relentless building and rebuilding of the city, either as an exciting sign of a dynamic economy or unnerving symbol of impermanence. For Mrs Leung, ceaseless change is inherent in the place, and the best plan is to go with the flow.

She was born here in the 1950s, a time when hundreds of thousands of mainland Chinese refugees settled in the then-British colony as they fled from the new communist regime in Beijing. Hundreds of thousands were on the move again in the years following the 1984 Sino-British joint declaration, which set the stage for Hong Kong's return to Chinese rule on July 1 1997.

"People in Hong Kong are very [adaptable], she says. "They do the right thing at the right time, or what's perceived to be the right thing at the right time. In the 1980s, lots of people sought a second passport in the lead-up to 1997. I did the same, so I went to Australia."

The self-imposed exile lasted three years, but her career did not suffer. Having joined HSBC in 1978, she continued to work for the bank in Sydney.

Upon her return to Hong Kong, a steady climb up the ladder ensued, culminating with her appointment as group general manager and global co-head of commercial banking before she moved to Hang Seng Bank, a local lender majority-owned by HSBC.

Today, she heads a retail and corporate bank with an extensive China network.

As with many others in the corporate world, any uncertainty she might have once had about Hong Kong's future had long turned into unequivocal support for Beijing's economic policies.

The city's growing role as an offshore renminbi

Different viewpoint: Margaret Leung in her office at the Hang Seng Bank Colin Beere

centre – where Beijing allows the Chinese currency to be traded more liberally than in the tightly controlled mainland market – is a boon for the financial sector, she says.

"The central government doesn't want to [open up trading of the renminbi] in a mainland city at the

> 'People here are adaptable . . . they do the right thing at the right time'

moment. Onshore, they don't want any disturbance. The reason why mainland China escaped in 1998 and 2008 is because it's a closed economy and the currency is not freely convertible. I think they will still proceed cautiously, using Hong Kong as a platform."

This, she says, is reminiscent of the city's role as a conduit for foreign direct investment to the mainland in the 1980s and 1990s. "And 20, 30 years ago, people were sceptical about the mainland. So [foreign companies] would put their money in Hong Kong, set up a separate company in here and use Hong Kong people to go into mainland China." Hong Kong is again playing the role of a "firewall", she says, but, this time, it is protecting the mainland against the unfamiliar risks of opening up to global capital.

She is also an enthusiastic advocate of greater integration between Hong Kong and the Pearl River delta region in southern China.

Yet, the city's attraction as a place to do business is unlikely to diminish relative to the mainland, as long as it maintains a sound legal system, a free flow of human capital and a simple and low tax system, she adds.

She refuses to discuss politics, but advises the city's youths – many of whom have become disillusioned with the widening wealth gap in the city and the slow process of political reform – to "work hard", saying Hong Kong remains a land of opportunity.

"There are many small-to-medium size businesses in Hong Kong that are very nimble. Their ability to adapt is something Hong Kong is very proud of. People here do accept change and grab opportunities out of it," she says.

As if to prove her point, she stands by the window and asks the photographer to use the building opposite – the one blocking her sea view – as background. "It is a nice looking building," she says.

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Store colossus sets a firm course for domination

China resources

Zach Coleman finds a retail growth story with no end in sight

For almost half a century, the business of China Resources was selling Chinese goods and commodities in Hong Kong. These days, the company makes most of its money using international retailing strategies that it imported via Hong Kong back to the mainland.

The turnround has been a great success. China Resources is now one of the mainland's largest food retailers, with more than 3,000 stores and a much wider network in the world's most populous country than close western rivals Carrefour and Walmart.

"Our strategy is to target the entire country," Wang Weiyong, senior vice-president of China Resources' retail group, says."We want to be the leading player in the domestic market. We have more understanding of the market."

The group's goal, Mr Wang says, is to more than treble annual revenues from $4.6bn to $15bn within five years and become one of China's three largest retail companies, projecting the opening of 60-80 hypermarkets among 500-600 total new stores each year.

China Resources' voracious appetite for growth contrasts with its relative stasis until the mid-1980s. At that point, it operated five downmarket department stores and a similar number of Chinese Arts & Crafts stores, all in Hong Kong.

Both store groups were the legacy of patriotic efforts to promote Chinese products in colonial Hong Kong and earn hard currency for the mainland.

As an arm of what is now China's commerce ministry, China Resources had a monopoly over most trade between the mainland and Hong Kong, including pork and most produce. As China embraced market reforms, China Resources in 1984 capitalised on its role as food supplier to open its first supermarket in the British colony and soon became a solid but distant number three behind entrenched chains owned by Hutchison Whampoa and Jardine Matheson.

"Business in Hong Kong was good, but the market was too small," says Mr Wang.

In the early 1990s, China Resources opened its first supermarkets and department stores in the mainland.

Soaring consumer sales and Beijing's desire to cultivate domestic chains that could stand up to the likes of Walmart when entry to the World Trade Organisation removed investment barriers to foreign operators led China Resources Enterprise, the group's Hong Kong-listed arm, to set its focus on the mainland officially in 2002.

Growth has come from a combination of new stores and M&A, with China Resources Enterprise gradually taking over a series of store groups with support from its parent, China Resources (Holdings). This has expanded the company's store base from southern China up the coast toward Shanghai and Beijing and, with an acquisition this year, into several interior provinces. Sales have climbed, as the company has upgraded stores and opened niche outlets.

Although Hong Kong now accounts for only 6-7 per cent of China Resources Enterprise's store count and retail revenue, the city's outlets generated an outsize 41 per cent of the group's retail earnings before interest, tax, depreciation and amortisation.

The company's profit margin is 10 times higher in Hong Kong than on the mainland owing to a combination of expansion costs and oligopolistic gains in the former colony's mature market,

China Resources owns Vanguard

according to Matthew Crabbe, managing director at Access Asia, a market research company in Shanghai.

Hong Kong remains a key centre for China Resources' retail technology development, planning, store management and design efforts. "Hong Kong is a very good place to test new concepts," Mr Wang says.

The company launched a convenience store format from Hong Kong and the neighbouring mainland city of Shenzhen three years ago. This year, it opened its first two standalone wine shops in Hong Kong and last month debuted a new health and beauty chain with two city stores. This year it also launched a new supermarket concept positioned between its mainline and upscale chains with two outlets in Hong Kong before taking the brand to Shanghai.

"Because Hong Kong is an international city and the retail market is very prosperous, it can serve as a platform for innovation," Mr Wang says.

This year, China Resources also bought Pacific Coffee, a Hong Kong-grown rival to Starbucks, for HK$330m. The company plans to put outlets into its upscale hyper- and supermarkets in China to reinforce their affluent appeal.

Additional reporting by Tracy Tu

Art of the possible aims to transform a cultural desert

Arts

Justine Lau reports on a growing creative energy that is crafting a new landscape on Asia's blank canvas

In a packed salesroom in Hong Kong last month, local collector Alice Cheng beat the crowd to a yellow-ground famille-rose double-gourd vase from the Qianlong period in the 18th century with her bid of $32.4m.

The deal not only set a world record for any Chinese work of art or porcelain at auction at that time, it helped Sotheby's fetch $400m from its seven-day sale – the best auction series ever held in Hong Kong.

When Christie's hold its autumn sale this month, selling more than 2,800 lots of wine, modern and contemporary art, traditional Chinese paintings, watches, jewellery and antiques for an expected $220m, similar signs of ebullience are expected. Thanks to growing wealth in Asia, a friendly tax regime and the logistical ease it offers, Hong Kong has become the world's third largest auction market, after New York and London.

Meanwhile, leading galleries such as Gagosian, Edouard Malingue and Ben Brown have set up shops or are doing so, bringing works by artists such as Picasso or rising stars such as Caio Fonseca to the city.

In 2008, Hong Kong also saw the birth of its first truly international modern and contemporary art fair. Although ART HK is still a far cry from the more established Art Basel or Frieze, it is considered the best in Asia, according to Eric Chang, Christie's head of Asian contemporary art.

Leaving art trading aside, whether Hong Kong has what it takes to become an arts hub is a bigger question.

A former fishing village, Hong Kong has long prided itself on the trading port and financial centre it has become over the past century. The city has one of the world's largest container ports and its stock exchange is the biggest in Asia. When it comes to "cultural", however, "desert" is the word that usually follows it.

"Arts and culture are not built into everyday life here. It takes an effort for people to go to a gallery," says Lorraine Kiang, manager at Edouard Malingue.

Douglas Young, founder of lifestyle brand Goods of Desire, says while Hong Kong has the potential and intention to become a cultural centre, it lacks the right economic set-up.

> 'Arts and culture are not built into everyday life here. It takes an effort for people to go to a gallery'

"The most lucrative businesses here are not creative at all . . . Artists are having to subsidise their passion with day jobs. In effect they are confined to being amateurs," he says.

But Magnus Renfrew, director of ART HK, says things are changing. "When we got here a few years ago, everybody was talking about Hong Kong being a cultural desert.

"You don't hear people talking about it like that any more," he says. In his view, on top of the record-breaking auction sales, new galleries and ART HK, a bigger change to come will be the HK$21.6bn multi-arts complex the government has been planning since the last decade.

In West Kowloon, the centre – the first phase of which is scheduled for completion in 2016 – will have museums, performance venues, theatres and concert halls.

The project has enlisted services of prominent figures, including Graham Sheffield, former director of London's Barbican Centre, and Lars Nittve, former head of London's Tate Modern.

Nick Simunovic, Gagosian's managing director in Hong Kong, says the city is "on its way" to becoming an arts hub, although a lot will depend on the relevance and richness of West Kowloon's offerings. "Hong Kong is close to a tipping point [towards] being an arts hub. Be patient," he says.

Artistic merit: Alice Cheng and the Qianlong period vase she bought at auction for $32.4m

Property High Times

After plunging two-thirds in the wake of the 1997 Asian financial crisis, Hong Kong's property market is booming, writes **Christopher Dillon.**

Fuelled by low interest rates, an open door to foreign investors and a buoyant Chinese economy, the University of Hong Kong All Residential Price Index rose 28.4 per cent during the 12 months to August 31, 2010.

Hong Kong continues to benefit from China's rapid economic expansion. And while the infrastructure in mainland cities is improving steadily, Hong Kong's transport links, business services and rule of law make it a popular beachhead for multinationals operating in China. That role has sparked increases in the price of commercial and residential real estate.

"The rent for a flat suitable for an expatriate family of four can easily top HK$80,000 ($10,300; £6,400) per month," notes Diana Lilauwala, an estate agent specialising in expat rentals.

But it is not only expats who are driving Hong Kong's residential property market. In the first half of 2010, mainland residents reportedly bought one-third of the new homes sold in the territory.

These properties are purchased as investments, as alternatives to a hotel room during shopping or business trips and (until the rules governing Hong Kong's Capital Investment Entrant Scheme were changed last month) as a way to obtain residency.

Expensive "trophy" homes are popular with mainland buyers, and concerns that foreigners are pricing Hong Kong people out of the market are prompting demands for government intervention.

In spite its reputation as one of the world's most open economies, the Hong Kong government plays a large role in the real estate market.

About half the population lives in government-owned or subsidised housing and — with the exception of the ground under St John's Cathedral — all land in Hong Kong is owned by the government and made available to users through long-term leases.

This ownership structure lets the government expand or restrict the availability of land to meet changing conditions. However, this is a blunt policy tool: it takes years for homes to be built on newly released land, by which time an overheated market can become depressed.

In addition, Hong Kong cannot calm or stimulate the property market by raising or lowering interest rates.

As a result of the currency board system through which the Hong Kong dollar is pegged to the US dollar, interest rates are in effect set in Washington. The Hong Kong government can, however, provide guidance on lending policy.

In August, the Hong Kong Monetary Authority reduced the maximum loan-to-value ratio for mortgages on residential properties valued at more than HK$12m from 70 per cent to 60 per cent. To date, the authority's decision has not damped buyers' enthusiasm.

The government also faces conflicting demands from first-time buyers, who want affordable flats, and existing homeowners, who want steadily rising prices. Until 2003, the government built and sold subsidised flats for low-income families through the Home Ownership Scheme (HOS).

The recent increase in property prices has sparked calls for the construction of HOS flats, which the government has resisted.

In his October 13 policy address, Hong Kong's chief executive, Donald Tsang, announced plans to build 5,000 small- and medium-sized flats under a new programme, called My Home Purchase Plan.

Under the plan, tenants will receive a subsidy equal to half the rent that they have paid, which they can use as a downpayment on a flat.

A senior government official, who asks not to be named, says the new scheme was launched because: "We knew we needed to do something — today — to help people." The first 1,000 flats to be built under the programme will be completed by 2014.

Some observers worry that Hong Kong is in the midst of a property bubble that will collapse when interest rates begin rising. But this view is not universal. "Despite property prices in Hong Kong rising significantly from the trough in 1998, we expect mass residential prices to increase by 11 per cent in 2011," says Buggle Lau, chief analyst at Midland Realty.

Christopher Dillon is the author of 'Landed: The expatriate's guide to buying and renovating property in Hong Kong' (www.landedbook.com)

One of Hong Kong's skyscraper blocks

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Peter Forsythe, Jing Lee - sailing enthusiasts

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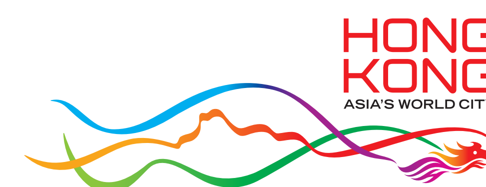


Resource groups tap a rich vein of capital

Mining IPOs

The raw materials sector has found a new centre of attraction, writes **Leslie Hook**

China's appetite for commodities is having a little-noticed side effect: global resources companies are increasingly choosing to raise capital next to their biggest customer by listing in Hong Kong.

Miners around the world, from small coking coal companies to leading iron-ore giants, have sought out the Hong Kong exchange this year for IPOs or share offerings, attracted by its deep pools of capital and proximity to China.

"Hong Kong is really making a strong push to become one of the world's leading capital markets for the resources sector," says Mike Elliott, mining and metals leaders for Ernst & Young. "They've been quite successful this year in attracting new floats."

In February the listing of Rusal, the Russian aluminium company controlled by oligarch Oleg Deripaska, raised $2.2bn, making it one of the largest mining IPOs in the world this year. The listing was highly controversial because regulators imposed unprecedented restrictions that prevented retail investors from buying stock. David Webb, a shareholder activist, says that decision created "a very bad precedent and they shouldn't ever do it again".

Yet the deal still set the stage for subsequent IPOs and put Hong Kong on the map for other Russian resources listings. The Rusal listing catalysed a trend that was already in place: Hong Kong saw resources and mining IPOs triple from 2008 to 2009, according to PwC. This year's mining and resources IPOs have already raised HK$36bn, according to the company.

This trend could accelerate thanks to new listing rules that the exchange introduced in June, partly in an effort to encourage early-stage resources companies to list there.

The exchange eliminated its requirement that companies going public had to be profitable (many resources start-ups are not) and updated its rules about proving mining reserves.

The first listing that took advantage of the new rules struggled, however, prompting some to wonder whether the exchange had lowered its standards. Russian iron ore miner IRC went public in October after it was forced to slash the size and price of its listing, and its share price still fell on listing.

Others have fared better: Last month a private Mongolian mining company with rich deposits of coking coal close to the Chinese border raised $650m in an IPO, and has seen its share price rise since.

> 'We enforce rules and regulations without fear or favour, that's why we attract so much foreign capital'

The Hong Kong exchange also sees resources firms as a way to diversify from the China-based companies that have fuelled the exchange into the global powerhouse it is today.

"As time goes by we hope we can go beyond the China story and become an Asia story," says Lawrence Fok, chief marketing officer for the Hong Kong Exchange.

"We enforce our rules and regulations without fear or favour, and that's why we attract so much foreign capital," he adds. The market capitalisation of the exchange is now around $2,500bn, Mr Fok says.

Even chief executive Donald Tsang has joined the bandwagon, declaring in a recent policy address that the city would "tap into business opportunities in Russia, Central Asia, India, South America and other emerging markets to attract more large enterprises to list in Hong Kong".

Those ambitions are being realised too, but more slowly. In September Brazilian iron ore group Vale announced it would list depositary shares in Hong Kong, in a sign of confidence in the liquidity of the Hong Kong market.

Another Brazilian company, Agrifirma Brazil, is planning to list on the Hong Kong exchange next year, in a sign of how the exchange's remit is widening. Agrifirma's business is to purchase scrubland and transform it into farmland. Brazil is one of the world's largest exporters of agricultural commodities, such as soya beans, to China.

Mr Webb says that this new strategy makes sense. "I think the exchange should be repositioning itself away from the almost obsessional focus on mainland listings towards a more balanced position as an Asian emerging markets hub," he says.

"It's not surprising then if we are trying to attract companies from emerging markets that a lot of those companies might come from resources."

Neighbours explore route to friendship

Taiwan relations

Opportunities for integration are high on the agenda, says **Robin Kwong**

When John Tsang, Hong Kong's financial secretary, blogged about his visit to Taiwan at the end of August, he began his post with the exclamation: "I've finally arrived in Taipei!"

Mr Tsang's sentiment could well be applied more broadly to official relations between Hong Kong and Taiwan, which has taken a dramatic turn for the better recently after years of neglect on both sides. In spite of being just an hour and half away by air, there had been no official visits between Hong Kong and Taiwan for 12 years after the former British colony returned to Chinese rule in 1997.

The change in official relations began two years ago, when Taiwan elected Ma Ying-jeou president and embarked on a path to mend relations with China. Taiwan's political detente with its bigger neighbour, which still claims sovereignty over the democratically-ruled island, has yielded liberalisation and increased interaction across the Taiwan Strait.

It has also opened the door for greater Hong Kong-Taiwan co-operation. Mr Tsang was the second Hong Kong official to visit Taiwan in the past year, and was there as the honorary chairman of the newly-established Hong Kong-Taiwan Economic and Cultural Co-operation and Promotion Council (ECCPC), a quasi-government body set up to negotiate Hong Kong-Taiwan issues.

"The important thing is the visit itself. So what we are looking forward to is a good beginning [to greater co-operation between the two sides]," he told reporters at the time.

Despite the lack of official ties, Hong Kong and Taiwan have long had deep economic links. Hong Kong is Taiwan's fourth-biggest trading partner, and vice versa.

Both places are also popular travel destinations for each other's residents. Taiwanese made 2m trips to Hong Kong last year, and Hong Kong residents took 600,000 tours to Taiwan.

Wang Yuqing, a research fellow at the China Business Centre of the Polytechnic University in Hong Kong, says the improving cross-strait relationship was an overall positive for Hong Kong. "It promotes more exchanges and ties."

Significant benefits from these official links, however, would probably take time to materialise. "The two sides are focused on increasing the flow of people between Hong Kong and Taiwan," in the short term, but there is opportunity for deeper integration between the two economies, Ms Wang says.

"The objective criteria exist for Hong Kong and Taiwan to have closer financial co-operation, to be a common market. But in fact Hong Kong has not made these preparations," she says.

Hong Kong's position as Asia's leading financial centre means the city will benefit indirectly from greater cross-strait investments, according to a report by the Hong Kong-based Bauhinia Foundation Research Centre, a think tank close to the government.

Direct travel links between Taiwan and China alone will boost Hong Kong's GDP by HK$17.9bn, and longer-term benefits could reach HK$64.3bn by 2038, according to the report.

Yet the improvement in cross-strait relations was initially eyed warily by Hong Kong.

Before direct cross-strait flights were established, Taiwanese businessmen travelling to their factories in China had to first stop in Hong Kong. The creation of direct, regularly-scheduled flights, which came in the midst of the financial crisis in late 2008, was seen as a blow to Hong Kong.

"There was a lot of worry in Hong Kong society," says Ms Wang, about the loss of passengers and revenues associated with cross-strait travel.

One airline industry executive had said that Cathay Pacific, the city's main carrier, had cut flights between Hong Kong and Taiwan by between 10 to 20 per cent after direct flights between China and Taiwan were established, but added that it was hard to gauge whether the impact came

> 'The objective criteria exist for Hong Kong and Taiwan to . . . be a common market'

from direct flights or from worsening economic conditions at the time. The report by the Bauhinia Foundation estimated two-thirds of existing passenger flights between Hong Kong and Taiwan would be affected. Hong Kong also stood to lose 60 per cent of its original air shipment business and 40 per cent of the cargo import trade between the city and Taiwan.

Improving cross-strait ties could also place Hong Kong and Taiwan into competition in other areas.

Both governments, for example, are pushing medical tourism as a new industry and source of economic growth. Yet, given lower costs in Taiwan and the island's bigger capacity to accommodate foreign patients, it is unlikely Hong Kong would be able to compete with Taiwan for Chinese patients should China allow visits to Taiwan as the next step of liberalisation, Ms Wang said.

Anthony Wu, chairman of the Bauhinia Foundation Research Centre, says: "Hong Kong's transit role will be inevitably weakened. But, from a long-term perspective, [its] economy will stand to benefit from the cross-Straits developments, given Hong Kong's prime location, sound legal system [and] international business reputation."

Pearl river delta builds up a future for growth

Manufacturing in the Pearl river delta continues to grow — Bloomberg

Regional focus

Michael Enright offers an insight into a region at the forefront of global manufacturing

Hong Kong's economic future is tied to the Pearl river delta in neighbouring Guangdong province.

The delta was an early beneficiary of China's reform programme. In 1979, two special economic zones were established there, in Shenzhen and Zhuhai, and Guangdong was given permission to open up to business before other parts of China. Its gross domestic product (GDP) grew from $8bn in 1980 to $89bn in 2000 – and to more than $450bn in 2009. The region's real GDP growth in the period exceeded 16 per cent per year, well above China's 10 per cent.

The delta has become a manufacturing platform of global importance, and a world leader in electronic goods, electrical products, electrical and electronic components, watches and clocks, toys, garments, plastic products, and numerous other goods. It accounts for only 0.6 per cent of China's land area and 3.5 per cent of its population, but one-tenth of GDP, a quarter of trade and a fifth of inward foreign direct investment.

It was affected by the global downturn in 2009, but growth was still impressive and the subsequent rebound even more so. Guangdong's GDP – 80 per cent of which is generated on the delta – grew 11.6 per cent year-on-year to Rmb3,150bn ($473bn) in the first three-quarters of 2010 after growing 8.6 per cent last year. Guangdong's exports, 95 per cent of which are made in the delta, were up 27.8 per cent to $321bn in the first three-quarters of 2010. Exports of mechanical and electronics products, accounting for almost three-quarters of provincial exports, were up 28.9 per cent. Exports of clothes, footwear, furniture, and toys were up 21.6 per cent, 22.8 per cent, 39.3 per cent, and 29.8 per cent respectively.

The area has had to contend with rising wages, land costs, and utility rates; an appreciating renminbi; a new employment law; instances of labour unrest; and more restrictive export processing regulations. But, while many individual firms have fallen on hard times, the loss of competitiveness that some predicted has failed to materialise.

The renminbi is still undervalued, utility rates are well below world averages, and real manufacturing wages have not caught up to productivity gains over the past two decades. While reported manufacturing margins in the delta are low, cost increases have not resulted in a loss of competitive position because low margins stem more from competition among factories than from competition between the delta and other locations.

Most exports are made by foreign-invested companies, many of which book their profits outside China. Re-export margins for goods shipped through Hong Kong, a low-tax centre, have averaged around 25 per cent.

However, the delta's economy is changing. It has moved beyond simple assembly to include production of components, inputs, and capital goods; beyond light industry into heavier industries such as the auto, chemical, and machinery industries; and beyond low-tech products and simple services into higher-tech products and more advanced services.

Much of the pressure on low value-added industries has come from higher value-added industries competing for land, labour, and resources. The Guangdong government has also embarked on a big programme to upgrade the province's economy, pushing some industries out of the region to make way for others. Wang Yang, provincial party secretary, says it is time to "empty the cage so new birds can come in". This approach is reflected in the National Development and Reform Commission's "Outline of the Plan for the Reform and Development of the Pearl River Delta (2008-2020)". The commission intends the delta to continue to lead China's development by moving up the value-added ladder, fostering advanced manufacturing and technology industries, developing globally advanced

> 'The loss of competitiveness that some predicted has failed to materialise'

innovation capabilities and building strong modern service sectors. Specific targets include a per capita GDP up from Rmb62,644 ($9,400) in 2008 to Rmb80,000 ($12,000) in 2012 and Rmb135,000 ($20,260) by 2020. These are ambitious targets, but the delta has consistently exceeded its targets over the past 30 years.

What does this mean for Hong Kong? Many of the companies coming under cost pressure in the delta are from Hong Kong and also face increased competition from Chinese competitors. Industries and activities continue to shift from Hong Kong into the delta. However, Hong Kong remains the nexus between the most dynamic economic region in China and the rest of the world. The territory also remains a high-end service provider, management centre and financier for much of the economic activity in the PRD. Activities displaced from Hong Kong are replaced by higher value managerial, marketing, and financial activities.

China's leadership recognises the critical role Hong Kong plays in the delta's development. The NDRC's plan calls for greater economic integration with Hong Kong through improved infrastructure (the Hong Kong-Zhuhai-Macao Bridge, the Guan-gzhou-Shenzhen-Hong Kong Express Rail Link and others); streamlined cross-boundary travel and trade; and co-operation in science, technology, education, training, logistics, finance, and the environment. These intentions have been enshrined in the Hong Kong-Guangdong Co-operation Framework Agreement signed in April.

Hong Kong and the delta are likely to benefit from being parts of the one of the world's most exciting regional economies.

Michael Enright is Sun Hung Kai Professor at the University of Hong Kong. He is co-author of The Greater Pearl River Delta (Invest Hong Kong, 2010).

Leading the world

Hong Kong continues to be an extremely important management centre for foreign multinational companies that are operating in the Asia-Pacific region.

According to a survey of 1,000 western and Japanese multinationals in 1998 and repeated 10 years later, Hong Kong substantially extended its lead over Singapore as a regional (Asia or Asia-Pacific) or sub-regional (North Asia-Pacific or South Asia-Pacific) headquarters location.

And, while Shanghai is increasing in importance as a regional centre, it remains way behind Hong Kong.

The results from managers in Hong Kong also demonstrated that the territory's importance to multinationals increased in all but one activity (import/export) – and in that area it remained the same.

In part this was because of the increased importance of the Asia-Pacific region as a whole to the companies – particularly the western companies in the sample – and in part to the expansion of Hong Kong's roles.

Michael Enright

Territory's middlemen forced to diversify to survive

Trading companies

Justine Lau says *hongs* are having to acquire fresh skills

Flipping through a 1988 Hong Kong business directory as thick as a bible, Helmuth Hennig realises many old local trading companies – or *hongs* – that acted as middlemen between China and the west no longer exist.

Mr Hennig, managing director of Jebsen & Co, a 115-year-old *hong* founded by two Danish businessmen, says that while big trading houses such as Jardine Matheson, Swire and Li & Fung still loom large in corporate Hong Kong, some of their smaller rivals simply could not survive.

He says: "Over time, the [Chinese and Hong Kong] market has become more open and mature. The barrier to entry is falling as well. If you are a buyer or producer, you need to have a very good reason to use an intermediary."

Long an entrepot where vast amounts of goods move in and out daily, Hong Kong gave birth to a host of import-export companies that helped Chinese goods to find overseas markets and western brands to tackle the mainland.

But these trading companies have lost a large part of their value since China opened its doors in 1979 and made it easier for foreign companies to do business.

The emergence of e-commerce companies such as Alibaba presents another challenge to the small middlemen, which largely act as buyers and sellers without providing other value-added services.

In recent years, China has also become too big a market for multinational companies to ignore. As a result, some manufacturers that used to outsource their distribution and marketing functions have taken them back in-house.

This has happened to Jebsen, which focuses on helping foreign manufacturers find customers in China.

Two years ago, Porsche, the German carmaker and a long-time customer, stopped asking the Hong Kong company to handle its imports to the mainland. Jebsen was left with the dealership side of the business only.

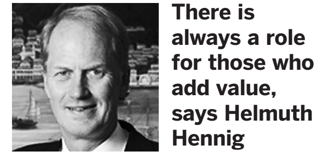
Mr Hennig says it was "no doubt" a loss of business. "That is the biggest threat to a trading company – you build markets, and then you lose them," he says.

Therefore, for Jebsen, whose other clients include Japanese camera makers Casio and Pentax, change was the only way out, Mr Hennig says: "The value chain is long and we are sort of the last mile. We are just before the customer. We have to make sure that, no matter what we do, it's perceived as creating value for the supplier and customer," he says.

"Otherwise, they won't pay us. It has to be something that allows them to say we have to continue to use Jebsen."

To do that, the company built strong market knowledge and close relationships with local governments and customers so that it would not be left out of the supply chain.

Additionally, the company has branched out into manufacturing to diversify its revenue streams.



There is always a role for those who add value, says Helmuth Hennig

In 1995, it set up its first joint venture with an Italian company in the southern Chinese city of Shenzhen to make plastics for spectacles frames. Most recently, it set up a facility in Dalian in northern China with a German auto technology company to make car balancer systems.

Jebsen has chosen to build its manufacturing business by forming joint ventures with foreign manufacturers as it realises it does not have the skills to go solo.

"We are not a technology company. We need to do joint ventures with people, who are either not in a position to go into China because they are too small and lack the experience, or they feel that by working with us, they get a much faster access to the manufacturing capability of China," Mr Hennig says.

It also intends to do it slowly. Mr Hennig expects the manufacturing business, which accounts for a 10th of the company's revenues at present, will grow to 30 to 40 per cent in a decade.

"The business model of manufacturing is very different. You need to invest upfront – machinery, equipment, plant – and your payback comes after many years," he adds.

Dah Chong Hong, another Hong Kong trading company that acts as carmaker Bentley's agent on the mainland, has a similar story to tell.

The company began life as a middleman between western brands and Chinese consumers. More recently, it started offering other services including food safety testing, product repackaging, inventory management and food processing to its clients, such as the maker of Pocari Sweat, a Japanese health drink, in order to move up the value chain.

"We cannot just be a middleman. We need to build partnerships," says Clement Hui, DCH's chairman.

Mr Hui and Mr Hennig are hopeful that trading companies will continue to have a role to play.

"Ten years ago in the dot-com bubble, everyone talked about disintermediation. They were saying companies would be taken out of the supply chain because customers would be able to talk directly to the suppliers but that hasn't really happened," says Mr Hennig.

"There is always a role for people who can add value to the selling cycle."