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Hong Kong into the Greater China Economy

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On the Logic of the Economic Integration of Hong Kong into the Greater China Economy

Hoi-cheung Cheung¹

Abstract

Hong Kong has encountered an economic downturn since the outbreak of the Asian Financial Crisis in 1997. It was a result of the lack of long-term preparation for adjustment to changes in the industrial structure. Without a foundation to upgrade its industrial structure from labour-intensive manufacturing to mid and high-tech industry, Hong Kong could only transit its industrial structure directly from the secondary sector to the tertiary sector – financial services, trading and logistics, and related services. Nonetheless, due to the keen competition in terms of cost advantages from the neighbouring economies, mainly those regional economies in the Pearl River Delta and the Yangtze River Delta in Mainland China, Hong Kong has encountered the “Problem of Production Cost” in various industries. Since land rents and labour wages are the two major components of cost structure, the core strategy in economic development for Hong Kong is to maintain its competitiveness, by all policy means, helping to reduce the total cost of production for all sectors in the SAR.

1. An Overview

Since the Asian Financial Crisis, Hong Kong has encountered an economic downturn with the collapse of the property market, falls of

¹ The author is the Research Development Officer of the Centre for Asian Pacific Studies, Lingnan University. This is a revised version of the author’s paper entitled “Substitute, Complement, and Economic Integration: Policy Implications for Hong Kong SAR” presented in the Forum of *A Tale of Two Regions: China’s Pan PRD and ASEAN – Cooperation for Mutual Benefit*, co-organized by the Hong Kong Policy Research Institute, Guangdong Academy of Social Sciences, Centre for Asian Studies of the University of Hong Kong, and the Centre for Asian Pacific Studies of Lingnan University, held in Hong Kong and Guangzhou during 4-6 November 2005.

gross domestic product (GDP) growth, and high unemployment rates. Despite some economic indicators recently showing that the Hong Kong economy has entered into a so-called “fully-fledged upturn” since 2004, when the “Individual Visit Scheme” under “Mainland and Hong Kong Closer Economic Partnership Arrangement” (CEPA) was first introduced, Hong Kong still faces a number of economic issues that may get its economy into trouble in the days to come. The following section reviews a number of indicators of economic situation in the Special Administrative Region (SAR).

While the property market has shown some prosperity as the price of residential property increased in 2004, recapturing a level in the residential market value of about half that before the economic downturn, the value and rents of commercial property – office sector – have increased about 30%.² The GDP growth of the SAR increased up to the level of about 80% of the previous peak of year 2000 at constant price, counted at 8.2% in 2004 compared to 10% in 2000. In the second quarter of 2006, the unemployment rate was at 5%, with 179,000 unemployed out of total work force of 3,426,000; this was still 0.3% higher compared to 4.7% in 1998, the first year of economic downturn.³

After the economic downturn, Hong Kong’s four key industries, namely the Financial Services, Tourism, Trading & Logistics, and Professional Services & Other Producer Services, have been emphasized as the pillar industries for the economic development of the SAR. However, the economic performance of the four pillar industries has not been consistent. Indeed, apart from a sharp increase in tourists particularly in 2004 because of the introduction of “Individual Visit Scheme” under CEPA, the economic performance of the sectors of the Financial Services, Trading and Logistics, and Professional Services and Other Producer Services has been stagnant for the past three years.

² Colliers International Quarterly Research Report – Hong Kong, April 2006, Colliers International.

³ Press Release, *Unemployment and Underemployment Statistics for April - June 2006*, Census & Statistics Department, Hong Kong SAR Government, July 18, 2006.

Table 1 and Table 2 show the economic performance of the four key industries during 1996-2004 in terms of absolute values and growth rates.

Since the “Individual Visit Scheme” under CEPA was introduced in 2004, earnings from Tourism increased from US\$3.5 billion in 2003 to US\$4.7 billion, up to 34% in comparison with that of 2003. Trading & Logistics increased from US\$40.6 billion in 2003 to US\$44.5 billion in 2004, about 9.5% growth in the same period compared with 2.8% in 2002-03. However, earnings from Financial Services just barely increased from US\$19 billion in 2003 to US\$19.6 billion in 2004, representing 1.1% decrease in the growth rate. In fact, by 2004 the economic performance of Financial Services had just returned to the level of 2000, Tourism to the 1996 level, Professional Services & Producer Services to the 1999 level.

Table 1. The Economic Performance of the 4 Key Industries in the Hong Kong Economy 1996-2004 (US\$ Billion)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Financial Services	15.50	17.08	15.30	16.92	19.13	18.00	18.14	18.96	19.60
Tourism	4.73	4.30	3.23	3.46	3.74	3.55	4.39	3.52	4.73
Trading & Logistics	34.21	36.21	34.99	34.54	38.37	38.78	39.53	40.63	44.47
Professional Services & Other Producer Services	18.72	21.55	19.15	16.17	16.44	16.54	16.28	15.91	16.97

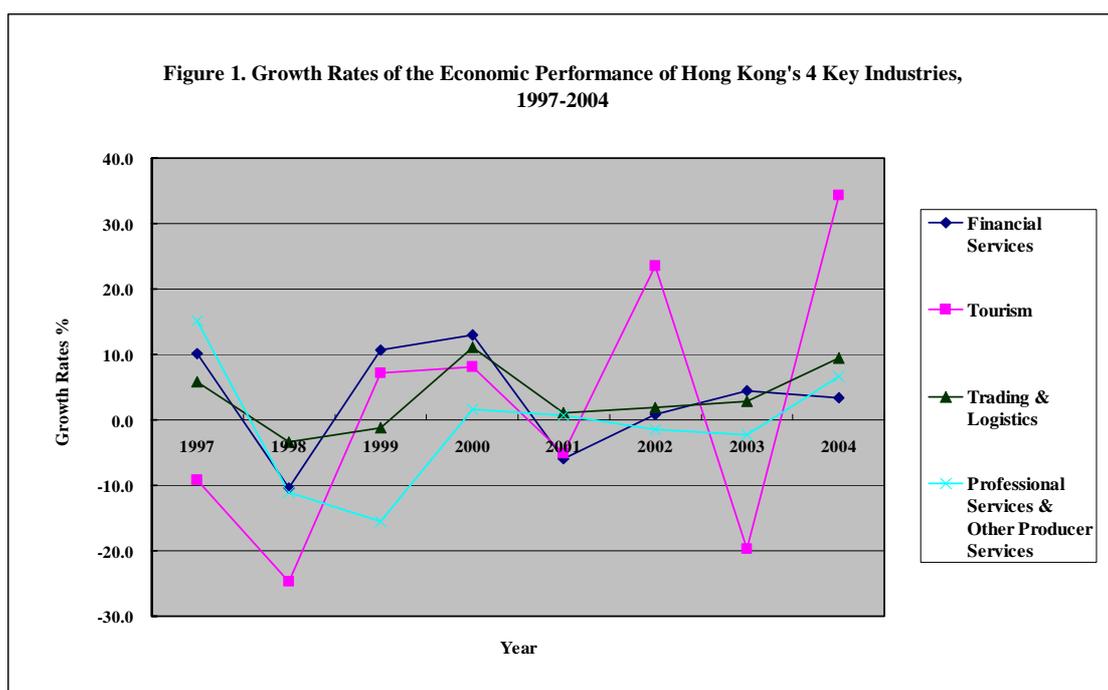
Source: Computed with the data from the Census & Statistics Department, HKSAR.

Table 2. Growth Rates of the 4 Key Industries in the Hong Kong Economy, 1997-2004 (Year-on-year %)

	1997	1998	1999	2000	2001	2002	2003	2004
Financial Services	10.17	-10.44	10.64	13.03	-5.90	0.78	4.51	3.39
Tourism	-9.22	-24.77	7.15	8.15	-5.15	23.49	-19.73	34.38
Trading & Logistics	5.85	-3.36	-1.28	11.10	1.07	1.92	2.79	9.46
Professional Services & Other Producer Services	15.14	-11.12	-15.59	1.66	0.62	-1.55	-2.28	6.66

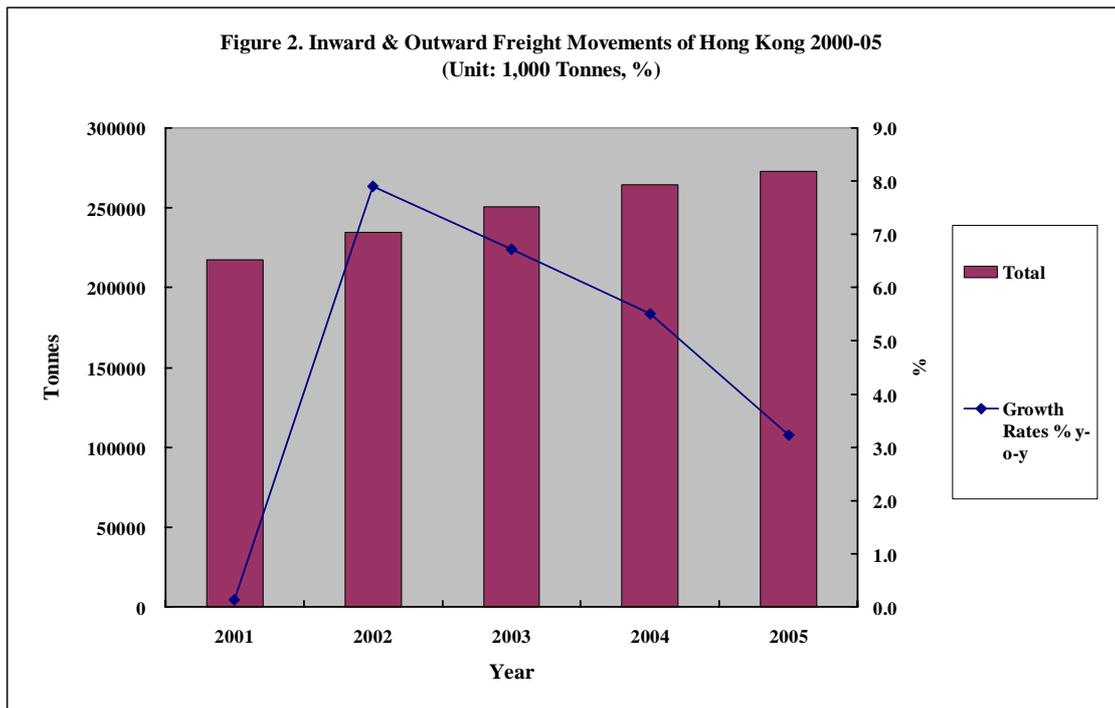
Source: Computed from the data in Table 1.

Figure 1 shows the overall trends of the economic performance of the four key industries of the SAR from 1997-2004 at a glance. Even though inward tourism to the SAR has been flourishing from the introduction of the “Individual Visit Scheme”, the overall trends of the economic performance of the other three key industries in the SAR have been stagnant.



Source: Computed with the data from Table 2.

The volume of freight movements is also a key indicator to reflect the overall trends of development in Financial Services, the Trading & Logistic, and the Professional Services & Other Producer Services of Hong Kong. The stagnant economic performance of the three sectors was also evidenced by the changes in the total volume of inward and outward freight movements of the SAR during 2002-05. Even though the total volume of the inward and outward freight movements of Hong Kong increased from 234,747,000 tonnes to 272,856,000 tonnes, the growth rates of total inward and outward freight movements from Hong Kong decreased, as shown in Figure 2, from 7.9% in 2002 to 3.2% on year-on-year basis in 2005.



Source: Economics Development & Labour Bureau and Census & Statistics Department, HKSAR Government. For the actual figures of the data shown in this Figure refer to Table 3 in the Appendix.

The inflow and outflow of foreign direct investment (FDI) for Hong Kong also reflect the degree of attractiveness of investment in Hong Kong. Table 4 shows the data of inflow and outflow of FDI of Hong Kong from 1998-2004. Even though Hong Kong suffered from an economic downturn after Asian Financial Crisis in 1997, the FDI inflow into Hong Kong actually increased by 80.5% in 1999. Although FDI into Hong Kong was ranked the second largest in Asia in 2004, the actual trends of FDI for the SAR was decreasing.⁴ In 2004, the total amount of FDI inflow for Hong Kong was US\$34 billion, while the outflow was US\$39.7 billion. Hong Kong's outflow of FDI was more than the inflow by 16.7% in 2004.

⁴ World Investment Report 2005, UNCTAD.

Table 4. Hong Kong's Position and Flow of Inward / Outward Direct Investment 1998-2004, (US\$ Billion)

Year	US\$ in		Inflow in year	US\$ in		Outflow in year
	Position at Year end	% Year-on-year		Position at Year end	% Year-on-year	
1998	224		14.8	222		17.0
1999	404	80.5	24.6	320	44.1	19.4
2000	455	12.9	61.9	388	21.2	59.3
2001	419	-7.9	23.8	353	-9.2	11.3
2002	336	-19.8	9.7	309	-12.2	17.5
2003	375	11.5	13.6	336	8.6	5.5
2004	457	21.8	34.0	406	20.7	39.7

Source: Census & Statistics Department, HKSAR Government & World Investment Report, UNCTAD, various issues.

2. The Core Issue of Development – the Problem of Production Cost

There are two prevailing perspectives to account for the economic downturn of Hong Kong since 1997. First, using the cross-section perspective, the economic depression of the SAR was due to the outbreak of Asian Financial Crisis in 1997, which gave rise to the broken bubble economy in which the stocks and property markets had been dominant. Secondly, from a historical perspective, it was attributed to the fact that Hong Kong lacks a long-term preparation for adjustment to changes in the industrial structure. Nonetheless, no matter what the *ex ante* and/or *ex post* expositions for the economic downturn Hong Kong has encountered are, a consensus is that Hong Kong lacks a set of well-framed development strategies to cope with the dynamic developments within and beyond the SAR.

Studies of development strategies traditionally focus on the theories of comparative advantages. There are two main streams of theories on comparative advantage, namely the classical and the neoclassical. Classical theory of comparative advantages comes from the contribution of David Ricardo (1951), while neoclassical

theories have been developed by Heckscher and Ohlin (1991), Porter (1990), and Lin (2003, 2004a, 2004b).

When Ricardo, Heckscher and Ohlin argue that the development of regional economies should be in line with the principles of comparative advantages, Lin further argues that the development strategy of regional economies/countries should follow the principle of “comparative advantage-following strategy (CAF)” instead of “comparative advantage-defying strategy (CAD)” (Lin, 2003, 2004a, 2004b). By employing a CAF strategy, firms and/or regional economies are, by policy measures, encouraged to enter or choose an industry/technology according to the existing comparative advantages in the regions/country that are constrained by their own factor endowment structure of the regional economy/country. Therefore, in short, the development strategies of regional economies should be in line with the principles of comparative advantages, while comparative advantages are constrained by the endowment structure of the economy. Comparative advantage is defined as being that an economy can produce certain goods and services with less cost of production than other economies do because it has a relative abundance of some factor inputs, such as capital or labour. Endowment structure is defined as the composition share of factor inputs of an economy, namely natural resources, labour, and capital. Endowment structure reflects the relative abundance or scarcity of factor inputs in the economy.

The composition share of factor inputs in the endowment structure of an economy determines whether the economy has a comparative advantage in producing certain goods and/or services. An economy is said to enjoy a comparative advantage in producing the related goods and/or services if it can utilize the abundant factor input to produce the related goods and/or services. In other words, an economy has a comparative disadvantage in producing some particular goods and/or services if it has a relative scarcity of the related factor input because a relative scarcity of the factor input implies less supply of it so that its price is higher. The scarcity or

abundance of factor inputs in the endowment structure of an economy does matter in terms of production cost.

Nevertheless, in the context of the size and resources of Mainland China, a pure development strategy in line with the principle of comparative advantage and endowment structure for Hong Kong may not be feasible because when Hong Kong develops an industry which has a comparative advantage with one neighbouring economy, say Guanxi Province, the comparative advantage Hong Kong enjoys may become a comparative disadvantage with another neighbouring economy, say Fujian Province. Although the principle is that when an economy is said to enjoy a comparative advantage in producing a certain good or service it means it enjoys the advantage of lower production costs in that good or service, it may not be feasible for the Hong Kong economy to struggle for survival if it intends to develop a position in the regional division of labour for a particular good or service. There are a large number of studies on the future economic development of SAR. Most of them focus their arguments on the role of complement and/or substitute that Hong Kong has to play in response to the development of its her peripheral economies, those along the southern borders of China in particular. Indeed, the development issues of the Hong Kong economy originate from the dynamic development of its peripheral economies that have developed and grown due to the open door policy adopted by China since the end of the 1970s. Following the development of the regional economies along the southern borders of China, Hong Kong's secondary sector, mainly the labour-intensive manufacturing sector, has moved to these regions since early the 1980s because of their cheaper labour and land inputs.

Entering into the 21st Century, the movement of industries from Hong Kong to the inner parts of Mainland China has still continued, but this most recent phase of industrial movement not only focuses on the secondary sector but also tertiary services such as IT industries and professional services due to the same reason - cheaper

factor inputs. No matter what sectors and when these sectors moved away from Hong Kong to its neighbouring economies, the major rationale for this industrial movement is “the Problem of Production Cost” in Hong Kong.

The root cause of high production costs in Hong Kong largely originates from the high-land-price policy the Hong Kong Government has adopted. The high-land-price policy has led to the rise in general prices of all kinds, including the wages of labour, since the time of British colonial rule but also in the SAR after 1997. If the production cost does matter for competitiveness in the market, no matter what industrial structure Hong Kong intends to develop, it has to take the minimization of production costs into serious account. There is a measuring yard stick for Hong Kong to develop any kind of industry by reducing production costs to a competitive level if it compares with the costs of similar industries developed in its neighbouring economies.

On the issue of high production costs in Hong Kong, there are some statistical data to illustrate the related scenario. Table 5 shows a comparison of annual average wages between Hong Kong, the 9 provincial capitals of Pan Pearl River Delta and the National level. By the end of December 2005, the annual average wages for general cleaners in Hong Kong – the occupation category of the lowest wage in Hong Kong – was US\$7,670.71, but the average wages of general workers at the national level was US\$1,954.98, while that of the 9 provincial capitals in Pan Pearl River Delta ranged from US\$1,771.76 in Guiyang to US\$3,970.17 in Guangzhou in 2004.

Hong Kong’s lowest annual average wage was 4 times greater than the annual average wage at the national level, and as high as 1.9 to 4.3 times compared with those of the Pan Pearl River Delta.

Table 5. Average Annual Wages of Pan PRD 9 Provincial Capitals and Hong Kong (Unit: US\$, %)

	Average Wages	% of Hong Kong
Chengdu	2206.19	29
Changsha	2380.62	31
Fuzhou	2084.29	27
Guangzhou	3970.17	52
Guiyang	1771.76	23
Haikou	2213.35	29
Nanchang	1959.76	26
Nanning	1924.70	25
Kunming	1845.53	24
Hong Kong SAR*	7670.71	100
National-scale**	1954.98	25

Source: 《Survey on Major Social & Economic Indicators of 9 Provincial Capitals/Cities 2004》, Mayors Committee of Pan Pearl River Delta Cities, 26 May 2005, www.pprd.org.cn/shuju/fz/200505270658.htm, Conversion rate US\$ = 7.95759 RMB as at 13 September 2006.

* Computed with the figures $\times 12 / 7.77972$ (as at 13 September 2006) of the *Average Monthly Wage Rates of Selected Occupations (General Cleaner)* as at December 2005, Census & Statistics Department of HKSAR Government, 27 June 2006.

** National Bureau of Statistics of China, *Statistics on Township-city Annual Average Wages*, 2005.

Table 6 shows a comparison of rents of Grade A offices and luxury residential apartments between Hong Kong, Beijing, Shanghai, Chengdu, Guangzhou, and Shenzhen in May 2006. In the Grade A office sector, the rent of Hong Kong was US\$87.7, while those of Beijing, Shanghai, Chengdu, Guangzhou, and Shenzhen were US\$28.4, US\$33, US\$12.9, US\$14.6, and US\$13.9 respectively.

When comparing with the rentals of Hong Kong and these mainland cities, the average rental of Grade A office sector of Hong Kong was from 6.25 times to 2.6 times greater than those in these mainland cities. In the luxury residential sector, the rental of Hong Kong was from 5.5 times to 1.7 times greater than those in the said cities in Mainland China.

Table 6. Comparison of Average Monthly Rentals in Hong Kong and Some Specific Mainland Cities, May 2006 (Unit: US\$ / sq. m., %)

	Office Sector (Grade A) (average rentals)	Office Sector - % of Hong Kong	Residential Sector (Luxury) (average rentals)	Residential Sector - % of Hong Kong
Beijing	28.4	32	19.3	43
Shanghai	33.0	38	25.3	57
Chengdu	12.9	15	8.0	18
Guangzhou	14.6	17	20.3	46
Shenzhen	13.9	16	13.2	30
Hong Kong SAR	87.7	100	44.6	100

Source: Colliers International Quarterly Research Report - Greater China, July 2006.

From the data presented in Table 5 and Table 6, it is apparent that the production cost of Hong Kong is inevitably higher than those of its neighbouring economies because the rents of land⁵ and the wages of labour in Hong Kong have been much higher than those of its neighbouring counterparts. As these neighbouring economies have developed from secondary to tertiary in terms of industrial structure, and from labour-intensive to capital-intensive in terms of sectors, these neighbouring economies in fact have become keen competitors for Hong Kong. Therefore, when Hong Kong is said to be integrated into its peripheral economies, the costs of certain factor inputs of Hong Kong should at least be equal to those of its peripheral economies, including the rents of land and the wages of labour force.

Since rents of land and wages of labour form the major components in the structure of production cost, if the price of either land or labour increases, the aggregate production cost for a particular industry will inevitably increase. In order to maintain the competitiveness of Hong Kong, firms in Hong Kong have, by all means, to minimize the cost of production through technological advancement and entrepreneurship on the one hand, while the government should also simultaneously take certain policy measures

⁵ Rents of land usually indicates the return of using a piece of land, including the price of land and the payment of leasing a piece of land.

at the macro level to prevent any possible increasing costs of production for the SAR as a whole. To achieve this strategic objective, the effective policy measures the SAR Government should take undoubtedly start with adopting a low-land-price policy in the first instance. By doing so, the general price of all kinds including the return on labour – wages – can be kept at lowest level and the aggregate production in the SAR will be kept at a competitive level accordingly.

3. The Logic of Economic Integration for Hong Kong

Given the empirical data presented above, there are some implications for the economic development of the Hong Kong SAR.

Development of the peripheral economies of Hong Kong has shown a substitute or a close-substitute to that of Hong Kong in both the secondary and tertiary sectors as these peripheral economies have adopted the development strategies according to their own endowment structure. Ironically, when Hong Kong develops one industry that is deemed to have a comparative advantage over one of its peripheral economies, that industry may also be at a comparative disadvantage for Hong Kong when comparing to another neighbouring economy. The geographical position of Hong Kong gives rise to such a position that it has not only been facing keen competition in terms of various industries but also in terms of various neighbouring regions.

Following this logic of thinking, when Hong Kong thinks about some strategies of development in various sectors or industries so that a cross-industry or multi-sector economy can eventually be developed, no matter whether it is labour-intensive or capital-intensive, so that it can be integrated into the economy of Pan Pearl River Delta as a whole, it has to deal with the fundamental issue of whether its costs of production can be maintained at a competitive level. In order to secure the competitiveness of Hong Kong in relation to its peripheral economies where there is a dynamic development for various industries in the coming decades,

Hong Kong has to make itself homogeneous in terms of production cost. That is, the cost of factor inputs for Hong Kong should not be higher than that of its peripheral economies in the same industry. This is the only “*logic of economic integration for Hong Kong*” when facing the development in various industries and in various regions in the Greater China economy.

To achieve this objective, it is the responsibility of the government to take certain policy measures to keep the costs of factor inputs of Hong Kong at least equal to those of its neighbouring economies. Since the rents of land and the wages of labour are the two major components of the structure of cost of production, if rents of land can be kept at a low level, then the wages of labour will also be maintained at a competitive level. Thereby, the overall competitiveness of Hong Kong in relation to its neighbouring economies will be maintained. There is the so-called price equalization of factor inputs. Price equalization of factor inputs between different economies can be achieved if the physical and policy barriers on the mobility of the factor inputs between these economies are removed. In order to make the rents of land and wages of labour of Hong Kong equalizing with those of its neighbouring economies, Hong Kong has to formulate certain policy means to facilitate the free movement of factor inputs between Hong Kong and its neighbouring economies. While the movement of labour input can be enhanced by immigration measures, the mobility of land obviously cannot not be realized physically. Different levels of rents of land between Hong Kong and its neighbouring economies can only tend to be equalized by means of facilitating the free mobility of people between the SAR and its neighbouring cities.

4. Concluding Remarks

There is a rather unique situation of economic development for Hong Kong. This unique situation for Hong Kong’s economic development is that it has to face keen competition from its peripheral economies – developing cities not just in the Pearl River

Delta but also in the Yangtze River Delta – which have enjoyed “cost advantages” that are mainly due to relatively low land rents and wages. Therefore, development strategies concentrated on a single industry would not be feasible for Hong Kong because the competition it has been facing from its neighbouring counterparts comes from various geographical locations and various industries. Rather, a multi-sectoral model apparently is an outlet for Hong Kong to further develop in relation to the further development of its neighbouring economies in the coming decade.

There is a principle of development strategy that no matter what industries / sectors Hong Kong has intended to develop it should bear in mind that the production costs should, by all means, be kept lower than those of its neighbouring competitors. It is the logic of economic integration for Hong Kong, as a small city compared to the Greater China economy in which there a large number of big cities on the development path of rapid economic growth, if Hong Kong wishes to successfully integrate into the Greater China economy in the coming decades. Although the wages of labour are equated by the forces of demand and supply, the rents of land in the SAR are solely controlled by the SAR Government as it is the only land supplier. Therefore, the suppression of rents for land is the sole responsibility of the SAR Government.

Constrained by length and scope, this paper does not deal with a number of key policy issues, such as the issues of demographic structure and public expenditure.

I suggest further studies be conducted on these issues because if the future development of Hong Kong is toward the direction of a knowledge-based economy, this will imply intensive human capital investment, a high GDP per capita, and a small size of population. If these attributes for a knowledge-based economy are recognized, some policy means should be formulated to deal with the current demographical structure. The existing demographical structure has given rise to at least two critical issues for the SAR. Firstly, there are a large number of people who, because of age and educational

attainments, cannot meet the demand of the local labour market. Secondly, these people, including those of new immigrants and the existing citizens of certain age groups, have relied on the welfare benefits that induce a heavy burden of public expenditure. Instead of “positive non-interventionism”, these issues are deemed unable to be solved without the “pro-active interventions” by the SAR Government through policy means.

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Appendix

Table 3. Inward & Outward Freight Movements of Hong Kong, 2000-05 (1000 Tonnes)

Year	Discharged	Discharged % y-o-y	Loaded	Loaded % y-o-y	Total	Growth Rates % y-o-y
2000	130349		86919		217268	
2001	132048	1.3	85524	-1.6	217572	0.1
2002	142100	7.6	92647	8.3	234747	7.9
2003	150593	6.0	99933	7.9	250526	6.7
2004	157409	4.5	106927	7.0	264336	5.5
2005	162263	3.1	110593	3.4	272856	3.2

Source: Economics Development & Labour Bureau and Census & Statistics Department, HKSAR Government.