SUPPLY CHAIN IMPLICATIONS FOR HONG KONG
WITHIN THE PEARL RIVER DELTA

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ABSTRACT

Hong Kong has suffered a major setback from a severe economic downturn since the Asian financial crisis in 1998. The situation has deteriorated ever since, with the problem being cyclical as well as structural in nature. It has endured a lengthy period of deflation and record high unemployment. This paper proposes that Hong Kong can ‘stand on its feet’ through effectively managing supply chains involving companies in Chinese cities in its hinterland, i.e., the Pearl River Delta region. By leveraging its existing capabilities, it could re-shape its economy for long term gains and ultimately achieve a win-win situation by contributing to the further growth of both the Mainland and Hong Kong.

KEYWORDS: supply chain management, logistics

INTRODUCTION

The effective management of supply chains has been instrumental in reshaping Hong Kong companies. The relaxation of the travel restrictions on the Mainland Chinese has seen an inflow of cash and possibly hopes for Hong Kong to combat its economic downturn. The signing of the Closer Economic Partnership Arrangement (CEPA) is anticipated to add impetus and momentum to some industries. Hong Kong is an international financial center and a regional trade hub. With its superior infrastructure in air cargo and container port services, it is in close proximity with the world’s largest factory base known as the Pearl River Delta (PRD), an area which is one of the fastest growing and most affluent regions in China. Since the 1980s, Hong Kong has started to relocate most of its manufacturing assembly lines in the PRD region. This turned PRD into the most significant economic region within China, contributing 40 percent of the national’s export and 30 percent of foreign direct investment values. Being at the forefront of PRD, Hong Kong’s fortune also relies greatly on its successful integration with the emergent growth of its hinterland. However, Hong Kong has to face new challenges on creative and flexible supply chain management and logistics strategies to lift its competitiveness.

THE EMERGING PEARL RIVER DELTA

The PRD covers a surface area of 41,698 square kilometers and its population is about 40 million. Since 1980 the region has been transformed from an economy based on agriculture to an economic powerhouse with strong manufacturing capabilities and great potential for growth.

Between 1980 and 2000 the GDP of PRD has grown an average of 17 percent per year, well ahead of the national GDP growth of 9.5 percent per year during the same period. By 2000 the gross domestic product was US$89.2 billion, 7.4 percent of the national total and the GDP per capita was nearly US$3,400, one of the highest in Mainland China.
The PRD contributes between 35 to 40 percent of China’s foreign trade. Exports were worth US$84 billion in 2000, which represents 31 percent of the national total. The region has attracted US$12 billion in foreign direct investment in 2000, which comprises 27 percent of the national total and among the enterprises based in the PRD, there are 38,000 companies with foreign participation.

The PRD’s economic importance in China stems from early economic reforms, starting experimentally in the Shenzhen and Zhuhai special economic zone (SEZs) that quickly spilled over to adjacent cities and towns in the Guangdong Province. It was blessed with foreign direct investment, initially from Hong Kong (which shifted 70 percent of its industrial capacity to PRD in less than a decade) and then from Taiwan all of which has brought about massive economic growth and exports. Foreign direct investments from other countries like Japan and the United States have followed since the mid-1990s.

Most investment from Hong Kong and Taiwan has been in the low value-added manufacturing and this has created employment for huge pools of low cost labor from inland provinces. Among the migrants are those from the poor rural areas (mainly women aged between 17 and 24 looking for manufacturing jobs) as well as educated workers working in technology-related employment.

As other parts of China became more competitive during the 1990s – particularly the Yangtze River delta, the PRD has started to lose its appeal to foreign investors. This can be seen from the fact that though the PRD accounted for more than 40 percent of actual FDI in 1990, its share of the national total has declined to just over 25 percent in 2000. On the other hand, the Yangtze River delta’s share has increased from 10 percent in 1990 to 25 percent in 2000.

HONG KONG’S CURRENT ROLE IN THE PRD SUPPLY CHAIN

Hong Kong is economically closely integrated with the PRD. Hong Kong is the leading investor in the region and about 90 percent of Hong Kong manufacturers have production facilities in the PRD. On the other hand, the PRD is the world’s fastest growing export-oriented manufacturing region. The rapid growth of manufacturers in the PRD has been the major impetus behind Hong Kong’s economic development over the past two decades.

The partnership between the PRD and Hong Kong has always been described as a “front-end shop and back-end factory” relationship. Nonetheless Hong Kong’s relationship with PRD is not limited to the manufacturing exports arena. Hong Kong contributes to the supply chain management of the PRD through its business modelling, product research, design, logistics and marketing. The service center function of Hong Kong is now integrated with the PRD production “powerhouse”.

Hong Kong companies gain the reputation as reliable partners in licenses production and distribution for overseas companies targeting China’s domestic market. As a service center, Hong Kong offers an ideal location for regional offices, in marketing and distribution. Hong Kong provides the higher end value services in the supply chain of the PRD and in some ways, Hong Kong is exempted from direct competition in the provision of these service exports because a substantial proportion is provided by the parent company in Hong Kong to its subsidiary or affiliates across the border. In fact, most of the production capacities in light industries in the PRD are controlled by Hong Kong’s small and medium enterprises. Thus, when China exports show
strong growth, Hong Kong will benefit as the level of production-related services increase accordingly.

Table 1

Top Three Industries in Major Guangdong Cities by Gross Industrial Output Value, 2001

<table>
<thead>
<tr>
<th>City</th>
<th>First Share</th>
<th>Second Share</th>
<th>Third Share</th>
<th>Gross Industrial Output Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shenzhen</td>
<td>Electronic and Telecommunications 51%</td>
<td>Electric Equipment and Machinery 6%</td>
<td>Plastic Products 3%</td>
<td>307.96</td>
</tr>
<tr>
<td>Guangzhou</td>
<td>Transport Equipment Manufacturing 12%</td>
<td>Raw Chemical Materials and Chemical Products 11%</td>
<td>Food Processing and Manufacturing 8%</td>
<td>282.92</td>
</tr>
<tr>
<td>Foshan</td>
<td>Electric Equipment and Machinery 27%</td>
<td>Non-metal Mineral Products 10%</td>
<td>Electronic and Telecommunications 8%</td>
<td>178.24</td>
</tr>
<tr>
<td>Dongguan</td>
<td>Electronic and Telecommunications 34%</td>
<td>Textiles 8%</td>
<td>Electric Equipment and Machinery 7%</td>
<td>103.97</td>
</tr>
<tr>
<td>Jiangmen</td>
<td>Metal Products 12%</td>
<td>Electric Equipment and Machinery 12%</td>
<td>Textiles 8%</td>
<td>94.44</td>
</tr>
<tr>
<td>Huizhou</td>
<td>Electronic and Telecommunications 58%</td>
<td>Electric Equipment and Machinery 8%</td>
<td>Plastic Products 5%</td>
<td>70.81</td>
</tr>
<tr>
<td>Zhongshan</td>
<td>Electronic and Telecommunications 17%</td>
<td>Electric Equipment and Machinery 12%</td>
<td>Metal Products 9%</td>
<td>68.44</td>
</tr>
<tr>
<td>Zhuhai</td>
<td>Electric Equipment and Machinery 20%</td>
<td>Electronic and Telecommunications 19%</td>
<td>Garments and Other Fibre Products 5%</td>
<td>66.23</td>
</tr>
<tr>
<td>Zhaoqing</td>
<td>Electronic and Telecommunications 13%</td>
<td>Textiles 7%</td>
<td>Metal Products 7%</td>
<td>43.04</td>
</tr>
</tbody>
</table>

# Figures only cover industrial enterprises with annual sales above RMB 5 million
Source: Guangdong Statistical Yearbook 2002

To illustrate, contribution from the services industries to Hong Kong’s GDP rose to 85.6 percent in 2000 from 74.5 percent in 1990. In year 2000, services exports had doubled that of goods exports and the value of Hong Kong’s services exports was US$41.4 billion whilst the value for goods exports was US$19.6 billion.

Figure 1
Among the major service groups, trade-related services contributed most significantly to the overall invisible trade surplus at US$11 billion in 2000. This was followed by transportation at US$6.5 billion, financial services at US$2 billion and other services at US$1.2 billion. These service groups are either directly or indirectly involved in the supply chain management for the PRD region. The services sector is now the principle source of employment in Hong Kong. In 2001, 83.5 percent or 2.72 million of the working population of 3.25 million worked in services.

To a large extent, the relocation of Hong Kong’s factories to the PRD has generated considerable demand for various support services with the key ones being transportation and logistics, insurance and professional services. These come by as a result of Hong Kong’s enterprises in the supply chain management of the PRD region, and Hong Kong’s fortune will rely more than ever on its successful integration with the emergent growth of its hinterland.

ADVANTAGE OF THE PRD REGION

The PRD region benefits from its links with Hong Kong, its international orientation, its flexibility and decentralized development, its ability to attract skills and resources, and its clusters of internationally performing industries. The competitive edge of Hong Kong lies in its rule of law, high quality supervision and regulation, corruption-free civil services, sophisticated financial infrastructure and free flow of information. These advantages have put Hong Kong at the top as the world’s freest economy. Through its link with Hong Kong, the PRD region-oriented industries for the PRD region.

CHALLENGES FOR HONG KONG IN THE PRD

Lack of Unifying Vision and Collaboration between Local Authorities

Even when there are calls for economic integration between Hong Kong and PRD, there seems to be no shared visions and goals among the local governments of the region. Instead of collaboration, competitive perspectives existed between Guangdong and Hong Kong. Numerous jurisdictions within the PRD have been trying to outdo each other especially in building infrastructure. The
excessive airport capacity, over-building ports, science parks, exhibition spaces, and so on are
typical examples of this rivalry. This creates potential internal threats to the PRD region.

The ability to achieve a true integration among local authorities, and to develop coordinated vision
and goals, so that strategies and policies can be formulated on a partnership basis for the benefit
among the stakeholders, are the major challenges for both Hong Kong and PRD.
Physical Borders Between the Two Areas

There are four physical borders – Lo Wu, Lok Ma Chau, Man Kam To and Sha Tau Kok separating Hong Kong from its hinterland. Each border checkpoint is a bottleneck for transportation between Hong Kong and Shenzhen. Delivery trucks being delayed for three to eight hours at the border is not uncommon. This not only increases the logistics time and cost, it also creates barriers to free flow of people, goods, information can capital, thus interrupting the supply chain between the two areas.

Even though these physical barriers cannot be removed in the short run, an immediate challenge for Hong Kong is to simplify border legislations and ease the bottlenecks to facilitate a better flow, so as to strengthen its position in the supply chain management of PRD.

Underdeveloped Transportation Infrastructure

Currently, the only major land transportation linkages between Hong Kong and China are the electrified railway crossing LoWu and the Hong Kong-Guangdong expressway built in the early 1990s. Comparing this with other major international cities, this transportation system is relatively inadequate for connecting Hong Kong’s 6.8 million population with the 27 million people of its hinterland and the 70 million people of Guangdong province. To support a truly integrated economy within PRD, Hong Kong needs to develop better transportation systems to improve the linkage.

OPPORTUNITIES

As a Business Platform

The US is one of the most significant foreign investors in China. It accounts for 8.9 percent (US$39.9 billion) of China’s foreign investment projects with actual utilized foreign direct investment in 2002. On the other hand, China is the second largest trading partner of the US and a top source of US imports outside the NAFTA. A large proportion of US-China bilateral trade is managed by Hong Kong. To maximize the benefit of PRD’s cheap manufacturing environment and its growing consumer market, many US companies make use of Hong Kong’s business infrastructure in arranging mainland-Chinese sourcing and providing just-in-time delivery. Large companies like Li & Fung in Hong Kong also act as risk managers by ensuring quality and by providing just-in-time delivery. China’s private enterprises also consider Hong Kong as a strategic geographical location to manage regional business activities and an ideal platform for seeking foreign capital and human resources.

WTO Entry – Distribution and Logistics

As part of the WTO terms, China agreed to open its distribution and logistics sector. This urges the modernization and consolidation of the sector in the coming three to five years. The selling cost proportion in China is much higher relative to the West. One of the major reasons is that 90 percent of a Chinese manufacturer’s time is spent on logistics and only 10 percent on manufacturing. For some commodities, logistics costs can be 40 to 50 percent higher than they would be in the US. However, the industry recorded a very high growth rate in the last five years – from 31 percent in 1999 to 55 percent for 2001 and this is forecast to grow 50 percent annually for the next three years. The
outsourcing of logistics and transportation is expected to expand approximately 25 percent annually through to 2005.

China’s current distribution system is very fragmented and with a strong attitude of local protectionism. Presently, no one company can offer nationwide distribution services and no single logistics provider has more than two percent of the market share. The opening of this sector offers large business opportunities for both local and international operations. Hong Kong, with its better management systems and technologies, knowledge of local operating environment, organization culture and customer service, will definitely have a competitive edge over the local Chinese and foreign competitors in providing these services.

The Closer Economic Partnership Arrangement (CEPA) between Hong Kong and China is regarded as a regional Free Trade Agreement, a “gift” from the central government to Hong Kong. It brings active cooperation between Hong Kong and the key PRD provincial and municipal authorities, thus creating a community of common interest.

According to TDC’s tentative analysis of CEPA’s impact on Hong Kong (www.tdctrade.com), a number of different opportunities can be seen to position Hong Kong as a major player in the supply chain management of PRD. These include:

Distribution Services Industries: Before CEPA, few Hong Kong companies could participate directly (i.e., without paying as license holders) in foreign trade, wholesale and distribution services on the Mainland. With CEPA, Hong Kong wholesalers with annual sales of more than US$30 million for three years can set up wholly owned enterprises on the Mainland. Hong Kong’s major economic players like the Swire Group and Cheung Kong will get immediate access to expand their branded Hong Kong retail chain outlets such as 7-Eleven and Fortress in China. With CEPA, Hong Kong wholesalers can participate in foreign trade, wholesale and distribution services on the Mainland. With CEPA, Hong Kong wholesalers can participate in foreign trade, wholesale and distribution services on the Mainland.

Manufacturing/Trading: Before CEPA, Hong Kong retail or wholesales companies were in a position where, even though they had factories in China and sales offices for domestic distribution, they were not allowed to trade products nor produce in their own China factories. With CEPA, Hong Kong companies are able to have their own retail and wholesale business licenses, and Hong Kong traders and manufacturers will have better control in the distribution of their products. A product qualified as “Made in Hong Kong” can enjoy zero tariffs for exporting to China. This encourages development of Hong Kong brands for the Mainland market. Subject to the definition of “Made in Hong Kong”, the zero tariffs might also attract foreign goods to be processed in Hong Kong for exporting to the Mainland.

Logistics: China’s WTO commitments agreed to open up the logistics market to foreign companies on an individual industry basis and also allowed them to set up joint-venture “integrated” logistics services in the eight provinces and cities. Under CEPA, Hong Kong companies are granted a “head start” of one or two years over the other foreign companies. They are also permitted to provide direct non-stop road freight transport services between Hong Kong and across the whole of China.

RECOMMENDATIONS FOR HONG KONG’S SUPPLY CHAIN MANAGEMENT OF PRD

To Ease the Border Bottleneck

The most pressing obstacle in the way of closer integration with the PRD is the bottleneck at the existing borders. At the present time, only the Man Kam To border opens 24 hours a day. Opening up the other three borders 24 hours, 7 days a week can substantially improve the situation, but
understandably with increased costs and other administrative charges. As the four existing border crossings to the Mainland are all to the eastern part of the PRD, it could be suggested that at least one crossing should be added to the West. This should be supported especially as the labor rates in the west of the Delta are much lower than the developed east.

To Improve the Transportation Linkage

Apart from the recent agreement on constructing the bridge linking Hong Kong and Macau and Zhuhai on the western side of the Pearl River, other bridges or expressway that can help to ease the flow should be considered.

To Develop the Distribution and Logistics Network in China

With the opportunities provided by CEPA, Hong Kong should use its competitive advantage to develop a stronger presence in China’s distribution and logistics industry before the entry of foreign investors, as it is becoming more recognized that improvements in supply chain management is crucial for business success.

To Strengthen Hong Kong’s Role as the “Bridge Between East and West”

China’s entry of WTO can be both a threat and opportunity for Hong Kong depending on its corresponding actions. To cut down the threats and maximize the opportunities, Hong Kong should invest in innovation, and further strengthen its business infrastructures, supportive services and management skills to meet the growing challenges and demands of both foreign investors and Mainland partners.

CONCLUSIONS

The advantage of Hong Kong relative to other Asian cities is that it is politically, culturally, geographically and economically attached to the largest and fastest growing market in the world – Mainland China. It remains a highly efficient centre for services and fundraising activities, something that China is in desperate need of. To an increasing number of multinationals, Hong Kong is also an ideal base for their regional headquarters and offices. Hong Kong is attractive because of its location and also the value it adds.

To successfully capture these opportunities, Hong Kong has to be able to maintain a strong, transparent and well-regulated financial system; low and predictable taxes; the rule of law; a well-developed transportation and telecommunications infrastructure, the free flow of trade, information and capital facilities, and a level playing field for all corporations. More importantly, it should continue its ability to adjust to changing conditions, from a manufacturing based economy to a service economy. Hong Kong must find new ways of strengthening economic synergy with the Mainland and, in particular, the PRD. Enhancing transportation and other links to ensure the smooth flow of goods and services is recognized to add value to companies in Mainland China.
8. Enright, M. and Scott, E., “Why you shouldn’t bet against the Pearl River Delta region”, South China Morning Post