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A New Cross-Straits Relation: The Challenges to Hong Kong

Economic ties between the Mainland and Taiwan look set to strengthen in the years ahead under the new leadership in Taiwan. Hong Kong stands to suffer as a large part of the cross-straits passengers and cargo flows could quickly by-pass the territory if direct links are eventually established in full scale.

The estimated maximum total losses to Hong Kong in the worst case under a so-called “three-links” scenario will probably be 0.3 to 0.5 percentage points off Hong Kong’s 2007 GDP growth, largely as follows:

(1) Trade and logistics sector

- USD24 billion, about 6.9% of Hong Kong’s total exports;
- 388,000 TEUs of port cargoes, about 1.6% of Hong Kong’s total container throughput, or an estimated revenue of HKD766 million for port operators; and
- 468,000 tonnes of air cargoes, about 13.0% of Hong Kong’s total.

(2) Tourism sector

- 1 million Taiwan visitors, about 3.5% of Hong Kong’s total visitor arrivals,
- HKD235 million of tourism spending, or about 0.2% of Hong Kong’s total.

(3) Investment

- HKD34 billion of direct investment from Taiwan companies, or 0.6% of total FDI, in Hong Kong. In addition, the territory may lose a potential of HKD480-720 billion of FDI (or 8.9% to 13.1% of total) routed through tax haven economies.

The immediate impact does not seem to be material, but probably not the key message behind. The new Mainland-Taiwan economic relations serve as a reminder that Hong Kong’s middleman role for the Mainland is under constant threat. The longer term impact would depend on how Hong Kong faces up to the challenge.





Strengthening Mainland-Taiwan Economic Relations

The newly-elected Taiwan president, Ma Ying-Jeou, pledged to improve ties with mainland China. Currently, Taiwan imposed various restrictions on the flows of goods, people and capital across the straits. The economic ties between the Mainland and Taiwan are likely to strengthen in the years ahead under the new leadership.

Exhibit 1

	The Status Quo	The News President's Pledge
Investment	<ul style="list-style-type: none"> - Taiwan companies' investments in mainland China are subject to approval by the Investment Commission of Taiwan's Ministry of Economic Affairs. Investment in a number of industries in the mainland, including hi-tech products, agricultural products, financial services and infrastructure projects, are not allowed. - Taiwan listed companies can invest no more than 40% of their net worth in the mainland. 	<ul style="list-style-type: none"> - Allow Taiwan financial institutions to establish presence in mainland China - Lift the 40% cap on investment in mainland China - Allow mainland investors to invest in Taiwan stock and real estate market
Flights	<ul style="list-style-type: none"> - Foreign flights and vessels may not travel directly between Taiwan and the mainland - Taiwan flights and vessels cannot carry mainlanders to Taiwan - Special chartered flights are permitted to carry Taiwan people across the straits during Lunar New Year and Mid-Autumn festivals - Direct passengers and Cargo shipments between mainland and Taiwan's outlying island of Kinmen, Matsu and Penghu have been allowed since 2001 under the "Partial Three Links" arrangement. 	<ul style="list-style-type: none"> - Open up direct links for both air and sea traffic - Allow weekend charter flights within one month of inauguration and regular direct flights within a year - Increase mainland tourist quota visiting Taiwan
Trade	<ul style="list-style-type: none"> - Taiwan's trade with the mainland must be "indirect" (i.e. via a third place). 	

Source: Taiwan's Ministry of Economic Affairs, Hong Kong Trade Development Council

The Potential Losses to Hong Kong are Relatively Small in the Short Term

Hong Kong has served as an important base to bridge the gap, as direct links between Taiwan and the Mainland are not yet fully in place. This has raised questions on whether Hong Kong will be able to sustain its middleman role in the years to come.

If restrictions on cross-strait flights, vessels and investment are lifted, a large part of the cross-strait flows of physical goods and people will inevitably by-pass Hong Kong or its logistics supports, though investment flows tend to shift more gradually. Let us take a worst case scenario, assuming all the present flows disappear overnight and estimate the maximum impact on Hong Kong – it will probably take 0.3 to 0.5 percentage points off Hong Kong's 2007 GDP growth, largely from diminishing trade and investment, estimated losses from tourism sector are likely to be minimal.





Tourism

Taiwan was the second largest source of visitors to Hong Kong in 2007. Over 2.2 million Taiwan visitors came to Hong Kong in 2007, accounting for about 7.9% of the total. Of the Taiwan visitors, one million were “same day” visitors using Hong Kong as a transit to mainland China.

If these one million Taiwan visitors by-pass Hong Kong after the direct travel link is established, Hong Kong’s total tourist arrivals could fall by about 3.5%. However, the loss in tourism spending would be much less, at only 0.2% of total, as transit passengers tend to spend proportional less than other visitors.

Exhibit 2

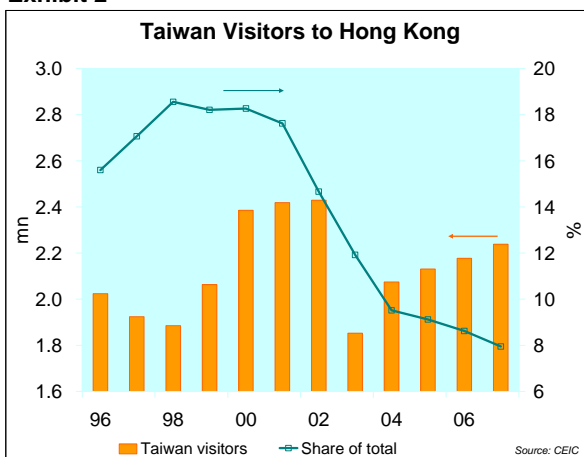


Exhibit 3: Taiwan Visitors to Hong Kong (2007)

Visitors No.	mn	% share
Total visitors	28.2	100.0
Taiwan visitors	2.2	7.9
Overnight	0.7	2.5
Same day	1.5	5.3
(Departure for mainland China)	1.0	3.5
Spending	HKD mn	% share
Total visitors	101,483	100.0
Taiwan visitors	3,838	3.8
Overnight	3,485	3.4
Same day	353	0.3
(Departure for mainland China)	235	0.2

Source: Hong Kong Tourism Board

Investment

Taiwan was the seventh largest source of foreign direct investment (FDI) in Hong Kong, excluding those from the tax havens. Taiwan’s direct investment in Hong Kong rose from HKD9.4 billion in 1998 to HKD33.7 billion in 2006. As a proportion of total FDI in Hong Kong, the share of Taiwan has been steady at less than 1% in the last decade.

The number, however, may understate Taiwan’s actual investment in Hong Kong. A significant proportion of Taiwan’s FDI in Hong Kong is routed through tax havens targeting mainland China as the final destination, as Taiwan companies’ investment in the Mainland is subject to stringent regulations. Tax havens’ investment in Hong Kong amounted to HKD2,402 billion at the end of 2006, accounting for 41.6% of total FDI in Hong Kong. It is estimated that about 20%-30% of which were from Taiwan companies.

If all existing Taiwan companies choose an alternative routing, some HKD514 billion to HKD754 billion of investment could leave Hong Kong, or about 8.9% to 13.1% of foreign direct investment in Hong Kong. According to a study conducted by the OECD, the average inward FDI stocks representing around 15% of the gross domestic capital formation in developing countries. An exit of all the existing Taiwan investment from





Hong Kong, in theory, will led to a one-off drop of 1.3% to 2.0% of Hong Kong's gross domestic capital formation.

Exhibit 4

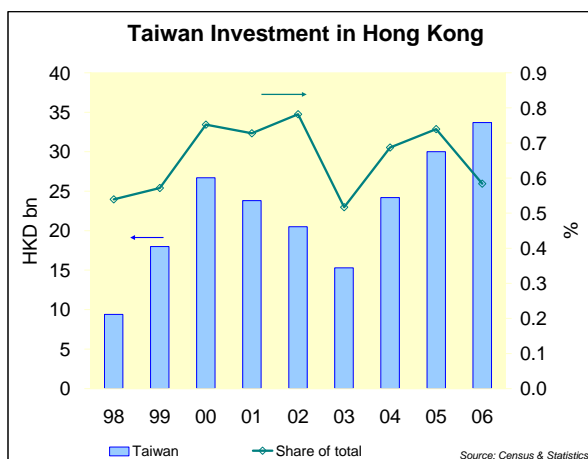


Exhibit 5: Position of Foreign Direct Investment in Hong Kong at end-2006

	HKD bn	% Share
Tax havens	2,402	41.6
Mainland China	1,951	33.8
Taiwan	34	0.6
Others	1,385	24.0
Total	5,772	100.0

Source: Census & Statistics Department

The 40% investment cap in the mainland has also pushed many Taiwan companies to list in overseas market to fund their Mainland business expansion. As of July 2007, there are 56 Taiwan companies listed in Hong Kong, 14 in Thailand, 10 in Singapore, 6 in mainland and 5 in Vietnam.

Even if the investment cap on Taiwan-listed companies is lifted, a significant de-listing of Taiwan companies from Hong Kong is highly unlikely in the short- to medium-term, as the choices also probably gave a considerable weight to the fact that Hong Kong's financial platform is the most liquid for global investors to trade shares of companies with substantial operations in mainland China.

Trade and Logistics Services

In the last decade, cross-straits bilateral trade expanded over six times from USD19 billion in 1996 to USD125 billion in 2007, according to statistics from China's Customs. Hong Kong has been the prime base to facilitate the cross-straits flow of goods, as Taiwan's trade with the Mainland must be "indirect" (i.e. via a third place) according to Taiwan's regulations.

Hong Kong bridged over USD24 billion of goods to cross the straits in 2007, which was equivalent to about 73% of the Hong Kong-Taiwan total trade or about 7.3% of Hong Kong's total exports. But the relative importance of the territory's middleman role has been diminishing. While 64.1% of the Taiwan-Mainland bilateral trade went through Hong Kong in 1995, the share dropped sharply to 19.4% in 2007.

The disappearance of the USD24 billion cross-straits trade could be translated partially into a loss of 388,000 or 1.6% of containers going through Hong Kong's container ports



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or a revenue of HKD776 million for port operators, as well as some 468,000 tonnes of cargos or 13.0% of Hong Kong's total air cargos going through Hong Kong's airport.

Exhibit 6



Exhibit 7

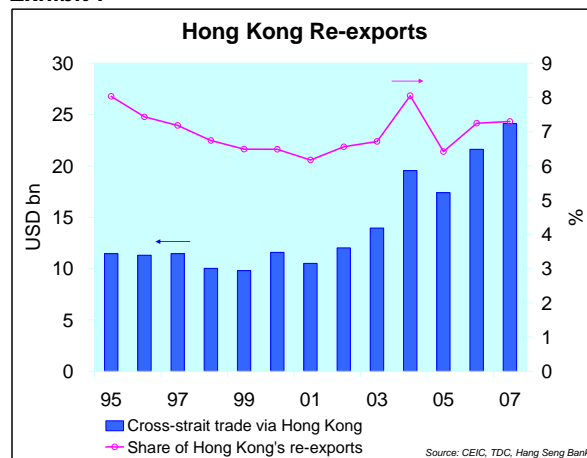


Exhibit 8: Hong Kong Port and Air Cargos

	'000 TEUs	% share
Total container throughput (2007)	23,998	100
Laden containers	19,907	83
Waterborne total	15,135	63
Mainland-related	5,104	21
Cross-straits	388	2
	Tonnage (mn)	% share
Total air cargo tonnage (Apr06/Mar07)	3.6	100
Mainland China	0.4	11
Taiwan	0.5	13
Others	2.7	76

Source: Census & Statistics Department, Hong Kong Airport Authority

The Longer Term Impacts Cannot Be Ignored

The immediate impact of so-called "three-links" scenario does not seem to pose material losses to Hong Kong, but this is probably not the key message. The new Mainland-Taiwan economic relations serve as a reminder that Hong Kong's middleman role for the Mainland is under constant threat. The longer term implication should not be ignored.

Diminishing role as entrepôt for physical goods

It cannot be denied that Hong Kong no longer has comparative advantages in handling physical goods, no matter they are to cross the straits or to other parts of the world. The territory has lost its position as the busiest container port in the world, ranking only third after Singapore and Shanghai and is increasingly reliant on its airport to compete for trade flows.





Hong Kong still has many advantages as a hub for air cargo, but its supremacy is under threat. Hong Kong is facing increasing competition from new airports in the Pearl River Delta and Shanghai, as the Mainland has substantially relaxed landing rights control and foreign airlines have responded positively by adding more direct flights to the Mainland. Moreover, air cargo market is increasingly taken up by freighters like Fedex, UPS, DHL and TNT, who have steadily expanded their base in the Mainland.

Managing the “invisible trade”

Hong Kong’ role as an entrepôt in handling physical goods looks set to diminish over time, but its role in managing offshore trade and facilitating financial and other business transactions will likely to grow.

According to available statistics from the Census and Statistics Department, Hong Kong managed a total of HKD2,346 billion of “invisible” offshore trade¹ for Taiwan and other foreign companies with production in the mainland in 2006. This has already exceeded the size of Hong Kong’s re-exports at HKD2,327 billion for the same year.

The volume of offshore traded goods that can be handled by Hong Kong is constrained not by Hong Kong’s port or airport capacity, but only by the availability of profitable trade opportunities and Hong Kong companies’ ability to provide value-added services.

If the “entrepôt” concept is extended, Hong Kong is the most important “financial entrepôt” in the region, in particular the most liquid financial platform for global investors to trade shares of companies with substantial operations in mainland China.

The “entrepôt” concept can be extended further. Hong Kong is the preferred platform for companies and decision makers to manage their business, people and funds. Hong Kong hosted some 4,000 overseas companies’ headquarters/regional headquarters. These probably demonstrate the dynamics of Hong Kong’s role as a “middleman”.

Conclusion

Hong Kong is unlikely to suffer material losses in the short term from strengthening cross-strait ties. However, the new Mainland-Taiwan economic relations serve as a reminder that Hong Kong’s middleman role for the Mainland is under constant threat. The longer term impact would depend on how Hong Kong faces up to the challenge.

¹ Hong Kong’s importers/exporters conduct trade in the following ways: (1) domestic export; (2) re-export through Hong Kong; (3) transshipment via Hong Kong with through-bill-of-lading; and (4) direct shipment from place of origin. Transshipment and direct shipment are referred to as “offshore trade” under which merchandise trade is handled by an office located in Hong Kong, but the goods themselves do not physically enter or leave Hong Kong. Without any customs clearing, this type of trade is less “visible” as it is not included in Hong Kong’s external trade statistics. It is viewed as “services rendered” and related earnings are treated as income from exports of services.





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