**A CHANGE IS NEEDED**

Hong Kong has a history of re-inventing itself according to circumstances. It is now confronted by the need to change. The challenge is as great as any faced since the China trade embargo during the Korean war, which forced a complete realignment of the economy.

If Hong Kong fails to respond, its attraction as a location for investment will wither, albeit gradually. But if it does respond, the changes will destroy comfortable old assumptions as well as opening up new opportunities.

**OLD ASSUMPTIONS HAVE TO BE DISCARDED**

Either way, investors must prepare for the urgent need for a paradigm shift. They must throw away old assumptions about property and banking cycles and look for which companies and sectors are going to profit from change. Most of all these will be service businesses able to prosper in a more competitive domestic environment and from selling their expertise to the mainland, the region and the world.

**RANKING LISTS PAY LESS ATTENTION TO DOMESTIC ISSUES**

It has usually been assumed that Hong Kong is among the most open, liberal and competitive economies in the world. It is regularly described as such in the likes of the *World Competitiveness Report* and *Economic Freedom* tables where it regularly ranks in the top three. However, such lists tend to focus on openness to foreign trade and investment, and levels of taxation. They pay less attention to domestic issues, whether local supply cartels as in Hong Kong or forced savings schemes such as Singapore.

**WHAT IS THE ROLE OF CARTELS AND OLIGOPOLIES IN HONG KONG**

The main purpose of this piece is to look at the role of cartels and oligopolies in Hong Kong, what they do to the cost base of the economy, how far they retard business development, and their importance to the earnings of major listed companies.

There is a general perception in government and among business leaders that Hong Kong needs to raise levels of productivity and competitiveness of its service industries. However, there is scant agreement about either the nature of the obstacles or the urgency of addressing the issues.

Many senior people in government and business circles apparently take the view that Hong Kong has already proven its resilience and thus is in good shape to take advantage of the Asian recovery. This argument contends that though Hong Kong's GDP over the two years 1998-99 will show combined contraction around the east Asian average, it has not been accompanied by major corporate or (with the exception of Peregrine which was due to non-HK causes) financial collapses.

This is factually correct. However, it has been possible only via massive intervention by the government in asset markets made possible by huge fiscal and Monetary Authority reserves. These not only provided cash for the HK$120bn or so of stock market intervention but enabled the government to maintain budgeted spending while denying itself a major revenue source - land sales - and tax breaks to homeowners in order to protect property prices. The capital inflow associated with this reserves draw-down had a significant positive impact on bank liquidity and interest rates.

**LONG-TERM NEGATIVE IMPLICATIONS**

However, this has serious long-term negative implications. The deficit cannot be viewed as sustainable for more than two years. But projections in the latest budget show a 2% deficit in 2000-2001 and 1% in 2001-2002. The current deficit level, just under 3% of GDP, may not be noteworthy by international standards, but it is large relative to the size of the government sector in the economy, and by past experience.

Secondly, reliance on reserves is delaying the asset price adjustment which ought to be a major part of making the economy as a whole more competitive by stimulating business not related to property and asset trading.

**Are property values a key to prosperity?**

There is a curious belief in Hong Kong that property values are a key to prosperity rather than a reflection of it (other than in the short term when credit growth is the most important driver). It is curious not just because it suggests that Hong Kong is somehow "different" from other economies and can play by different rules. It is curious too because this is the most purely domestic feature of an economy which prides itself on its external orientation. Nor has it always been the case. Banks of course have always played a major role in Hong Kong because they are intermediaries in all kinds of commerce. But at other times different groups have played lead roles at least in the stock market. Trading companies - the British 'hongs', textile manufacturers (the Shanghainese magnates of the 50s and 60s), shipping companies (Pao and Tung & Co in the 70s) have, at different times, been the leaders.

**Future lies in new areas of dominant activity**

So it is both reasonable and desirable to assume that the future lies in new areas of dominant activity. The OPEC-like phenomenon which has dominated the property sector is gradually going the way of the oil cartel, having in the meantime wreaked the kind of havoc that OPEC wreaked on the industrial world in the mid 70s and early 80s.

It must be assumed that a small coherent, educated, well organised, well positioned city state - for it must be ever thus - is capable, despite huge vested interests, in recognising and acting on the impediments to its further prosperity, creating the circumstances in which the economy can grow again even in the face of adverse circumstance abroad or in China.

At an ideal geographical juncture on the edge of China and between east and west, north and south in east Asia should be able to prosper. But there is nothing certain. HK will not go the way of Aden or Beirut but the fate of Weihaiwei or Tangier or Trieste, of gradual genteel relative decline into international insignificance is possible if there is not a new economic impetus.

**Hong Kong stock market is a poor reflection**

It has always been the case that Hong Kong is primarily a small business economy, a fact that gives it flexibility and dynamism. However it is also true the stock market is a poor reflection of this. A handful of large property, finance and utility companies dominate market capitalisation. Even excluding H shares and Red Chips, market capitalisation to GDP ratio is about the highest in the world. Even allowing for the double and even triple counting caused by cross holdings - eg Hutchison, Cheung Kong and HK Electric.

**A few very large companies have been especially profitable**

Actual profit growth and rising expectation reflected through PE ratios suggests that a few very large companies have been especially profitable. Up until 1997, profit growth of the top 50 stocks was greater than the market as a whole. How it compares with economy-wide profits is more difficult to judge because of lack of data. But in 1997, development profits as measured by the Real Estate Developers Margin were a remarkable 8% of GDP, capping a five year period when they consistently exceeded private sector investment in construction. Bank profits have also been high compared with most other jurisdictions (net interest margin x loans in HK).

In other sectors, real profitability is much harder to assess. Mainland companies in particular like to generate profits in HK rather than at home to avoid tax and/ or foreign exchange regulations. Much of the 15% value-added margin assumed on re-exports of China-origin goods is now the product of re-invoicing rather than traditional entrepot trade.

LARGE PROFITS ON CHINA OPERATIONS MAKE FOR POOR HK PROFITS

For several years poor profits in Hong Kong for many manufacturers and traders - as profits moved to the property and finance sectors - were compensated for by very large profits on China operations as they simultaneously enjoyed the profits gain of shifting to low wage locations across the border with the rapid growth of China's export trade and of the blossoming of consumer and property demand in Guangdong.

However, the slowed growth of China trade, excess capacity in many industries, and the strength of the HK and Chinese currencies have all eroded mainland-origin profits for HK companies. Although this should prove a temporary situation, the cycle is likely to be long because of the sheer volume of over-capacity, and the shift in growth emphasis in China away from the former front runners, the southern coastal provinces.

The closer links with the mainland implied by the 1997 handover confront Hong Kong with three issues which impact its competitiveness and prospects.

ASSET PRICE INFLATION DRIVEN BY MONETARY GROWTH AND CAPITAL INFLOW

1. The huge productivity gains for HK made possible by the transfer of labour and land intensive manufacturing activities to Guangdong are now almost exhausted. Manufacturing is down to 6% of GDP. Indeed, this source of productivity growth has been of declining significance for some while. Serious weaknesses in the HK economy in recent years have been covered up by asset price inflation driven by monetary growth and capital inflow. Although real GDP growth achieved what looked to be a stable rate of around 5%, this was in significant part due to an increase in the labour force caused by increased inflow from China and return of migrants from Canada etc. In contrast to the 1985-92 period, when labour force growth was minimal, productivity growth declined to a modest 2-2.5%.

WHAT HAPPENS TO LOCAL RETAIL BUSINESSES

2. Closer integration with the mainland brings more business opportunities for individual companies. However, it implies that pricing of some factors of production move closer together. It also opens up Hong Kong business to the prospect of greater competition from the mainland. In the past, external competition in many areas of the domestic market was limited by cultural and linguistic factors. Some of the new competition also has - or is assumed to have, which amounts to the same thing - political influence. The gap between HK and Shenzhen is now roughly four to one for wages and mass residential housing. The wage gap may not narrow so long as HK has a reasonable degree of control on the rate of immigration. But the border is increasingly porous in the other direction, giving HK people the possibility of lower price goods, personal services and even housing across the border. These are already hurting local retail business. Recent calls for an exit tax for HK people visiting the mainland suggests that HK is feeling the heat of its own loss of competitiveness. The knee-jerk protectionist response will do further lasting damage to Hong Kong's position by delaying needed changes.

POLICY ON FUTURE MIGRATION

3. The demographic question. It is not at all clear whether HK has any policy on future migration. The current 150 days from the mainland is a legacy of the colonial era and is controlled by China. In view of the low birth rate in HK, there is a long term economic case for allowing in more young people. However, recent negative reaction to the Court of Final Appeal's grant of rights of abode to all offspring of Hong Kong residents suggests that few in government recognise the long term benefits of youthful intake. Even assuming the present entry level from China is unchanged, population growth will slow to 1.2% and the average age will continue to increase. It has risen from 26 years in 1981 to 36 today.

**DEMOGRAPHICS IS VERY IMPORTANT**

Demographics is very important. The percentage of the population over 65 is increasing steadily. This implies that a faster rate of productivity gains is now needed to achieve a given rate of GDP growth. However, an ageing population generally implies a lower savings rate. In other words, capital must be used more efficiently. An ageing population also implies a lower marriage and therefore household formation rate - which has implications for new housing demand.

## CARTELS AND OLIGOPOLIES IN APPROXIMATE DESCENDING ORDER IN THEIR IMPACT ON THE ECONOMY AND CONSEQUENCES OF THEIR EROSION FOR PROFITS OF OLIGOPOLISTS

**THE CULPRITS:**

- Land and property
- Utilities: power, telephones, water
- Banking services
- Stock market
- Media
- Professional services: doctors, lawyers, accountants
- Retail: margins of supermarkets, exclusion of newcomers
- Airline, airport, ports

Secondary and tertiary education: inflexibility, cost, language

Secondary economic impact of special interest groups: diesel/environment, importers/parallel imports/intellectual property.

**GOVERNMENT: NO FORMAL BODY NEEDED**

Whatever the extent of anti-competitive practices in Hong Kong, the government has repeatedly rejected suggestions that there should be a formal body to identify and address them such a Competition Commissioner, Monopolies Commission or anti-trust law. They exist in almost every OECD country, including Korea. The reasons for opposing such measures have ranged from it being “unnecessary” because competition is already unfettered to being hostile to business, anti Hong Kong’s laissez-faire doctrine or a discouragement to investment (presumably by the existing oligopolists rather than aspirant entrants).

However, in general there is scant bureaucratic support for strong action on this front and little political pressure. Though favoured by the Consumer Council, Citizens Party and some other groups, such thinking is not favoured by the commercial interests which predominate on the legislative and executive councils. Competition Policy as enunciated amounts to little more than platitudes. It was in any case a response to a Consumer Council document issued in 1996, *Competition Policy: The Key to Hong Kong’s Future Economic Success*, which called for competition legislation. This was rejected. Legislation is confined to the need to protect consumers from unsafe products rather than from monopoly exploitation. Even the Consumer Council does not address issues such as monopoly pricing of inputs to businesses that do not directly affect consumers.

There does exist an enunciated Competition Policy, but it is rather vague statements of principles of motherhood. Within the government there is an advisory body, the Competition Policy Advisory Group (COMPAG) which is examining some of them, partly with a view to ensuring that Hong Kong does not fall foul of WTO and similar international obligations. COMPAG's report for 1998 outlines a number of issues it is looking at ranging from admission of foreign barristers to electricity supply, building standards, rice imports, driving schools and live chicken supplies. Studies are being conducted to see how far practices are anti-competitive, or contrary to WTO and what might be done about them.

**COMPAG: SET UP BY THE GOVERNMENT**

The same body is also looking at areas where the government itself has an anti-competitive position by providing services, ranging from IT to care of the elderly, which are hindering the development of private sector businesses.

All this is better than nothing but there is an evident lack of zeal, particularly to tread on the toes of entrenched interests.

Generally, the government wants to be "business and profits friendly" rather than "competition and efficiency friendly". Though officials frequently talk about laissez faire and Adam Smith, few of them seem to have read Mr Smith or be aware of his concerns about business conspiracies against the public interest and the importance of ensuring that a competitive environment exists if the "invisible hand" is to work its magic.

## LAND AND PROPERTY

**LAND AND PROPERTY PRICES REMAIN SERIOUS THREAT**

It has been said before but must be said again and again that (assuming a fixed exchange rate) land and property prices remain the most serious threat to Hong Kong's economic resurgence. Despite the falls of the past 18 months, asset prices have way outstripped consumer prices over the past 15 years. The spectacular movements of the past three years can be attributed primarily to changes in money supply. But the underlying cause is a price cartel led by the government and maintained for the benefit of a powerful group of developers for whom margins are far more important than production.

**HONG KONG IS DENSELY POPULATED, BUT VAST AREAS REMAIN**

There is scant underlying reason for the cost of land. Hong Kong may be a densely populated territory, but only a little more than Singapore. Vast areas remain capable of development and the cost of land reclamation is still a fraction of current land values. Property and hence rental costs are particularly damaging at a time of declines in activity of the highest value added sectors of the economy and when prices around the region are continuing to fall. Worse, the land price feeds through into high office, retail and hotel prices which push up wages for all other sectors, deter tourism, etc. It is evident to even the most casual observer that even though Hong Kong has a higher GDP per capita than Australia the actual standard of living falls far, far short.

**LAND POLICY FLIP FLOPPING**

For years, the government favoured a scarce land policy because of its importance as a source of revenue, direct and indirect. But the existing tendency was exaggerated by the land sales ceiling imposed under the Sino-British Joint Declaration. Following the handover, the government promised to rectify the situation with a large and sustained land supply increase. However, it quickly backed off this in the face of opposition from the developers' cartel and banks that had been financing land purchases at the absurdly high levels reached in early 1997. It also ended the government's so-called Sandwich Class housing scheme which was seen by developers as competing with them at the lower end of the home ownership market. The same interests were also behind the introduction of mortgage tax relief, another measure to boost asset prices rather than production.

The 12-month moratorium on land sales is likely to ensure a new flat supply squeeze early in the new millennium. It is not merely misguided from an economic and social perspective. It has discriminated massively in favour of existing large players.

### A property cartel?

The cartel is not a formal agreement - though leading developers have been seen to operate as such at auctions. It is a mutual interest club which dominates some 80% of private sector development. Its objective is not to produce more apartments but to maximise profits by maintaining an artificial shortage of supply and influence over the supply of development land through timing of the conversion of agricultural land that they hold. In major developments such as those associated with the MTR and airport railway, developers form consortia to minimise risk rather than compete against each other.

They have been able to continue with land conversions at very low premiums - even though premiums are supposed to be set by reference to auction prices. Those with cash but without land to convert and wishing to enter the market to buy land at auction have been denied the opportunity. This kind of cronyism is familiar in Southeast Asia.

The success of the developers' past strategy can be seen in the growth of profits during the 90s, which has moved in roughly the opposite direction to the supply of private housing. For example profit relative to turnover for Henderson and SHK Properties has been as high as 50%.

From a broader perspective, real estate developer margins exceeded total private sector investment in construction every year between 1990 and 1997. Even in 1998, supposedly a year of profits collapse and buoyant private building, REDM was only marginally less than private construction.

### Artificial scarcity of private housing

This artificial scarcity of private housing has been enhanced by the government's own public sector housing policy. The stock of public rental housing - which accommodates 40% of the population - rose only 5% in the past five years while the population has grown by 13%. The net result has been to inflate developer profits and government land sales revenues, which in 1997 hit a record 5% of GDP. These are in effect indirect taxes, especially on households. The result has been not merely to push up the cost of doing business in Hong Kong relative to other locations. Just as bad, it has reduced incomes capable of being disposed other than to rent or mortgage payments.

### Home mortgage debt is high

The indebtedness of the household sector goes a long way to explain the extent of the collapse of retail demand - far greater than experienced in previous recessions. Home mortgage debt is roughly 50% of GDP and absorbs as much as 60% of some household incomes.

Commercial real estate has been less subject to supply constraints. Though values have followed overall trends and been subject to bouts of speculation, rentals have proved quite flexible. Large residential developers do not have the same hold on the commercial market where there are more players, including investment companies, in the prime office market, and a large number of players in secondary office and commercial locations. The result has been that commercial development, though cyclical, has not suffered the decline seen in housing in the 90s.

### Office and retail rents declining

Commercial properties also mostly have one owner so re-development to higher densities has been easier than for multiple-owned domestic premises. Looking forward, the decline in office rents should work through to further business cost deflation over the next 18 months as supply has been running well ahead even of average take-up. The same applies to retail rents.

LAND SUPPLY IS THE KEY

However, those who want to make a long term investment in Hong Kong as a service or production centre would want to know whether another steep upswing is likely as a result of government policies tailored to the needs of a few influential developers rather than to the economy as a whole. Land supply remains the key.

Land cost is an inhibitor of competition in other areas of the economy because it makes the entry cost for competitors in such activities as supermarkets and petrol stations so high compared with the average land costs of the existing operators.

RESIDENTIAL SECTOR HAS ITS OWN CASH FLOW PROBLEMS

As for the residential sector, there is clearly a need for the government, which has its own cash flow problems, to reduce its involvement in housing and see the private sector do much more. But this will only be possible if real housing costs fall further. Even after a 40% decline, mass housing prices are still 40% above what can reasonably be serviced by a median income household. Median income is around HK$22,000 a month, which can support a mortgage of $10,000, which supports a purchase of about HK$1.3 million. At present, a 700 square foot flat in unlovely Tseung Kwan O costs around $2.1 million.

ARE HOUSING TARGETS NECESSARY?

Hong Kong's population and household growth rates probably make it unnecessary to reach the 80,000 a year housing target promised by the government in 1997. But there is massive scope - if government and the cartel would get out of the way - for sustained private sector development at say, 50,000, a year which would enable the government to get out of the sector altogether. It would also promote the construction industry and demand for consumer durables. However, it is only possible in a free market situation with plenty of land being offered on a stable basis and preferably in smaller lots. (Current policy of selling a few huge sites plays into the hands of the big groups with access to large-scale finance.) It also requires the government to enforce covenants so that land bought is actually developed. For years the relevant departments have shown themselves easily persuaded to help developers by giving waivers from covenants and allowing delays in development.

Going forward there should be plenty of opportunities for residential developers to increase their output. But profit margins of 15-20% would seem more likely if volumes increase and prices rise roughly in line with inflation from whatever new price base is established once land sales have returned to previously promised levels.

DEALS DONE BEHIND CLOSED DOORS

However, there is clearly a tendency on the part of government to do deals behind closed doors with favoured groups. Thus the budget announced two such developments which are supposed to promote new service industries in HK but at the same time deny opportunities to alternative users of scarce land. Thus Disney has been offered what appears to be free land - plus infrastructure - as a carrot for a theme park in an area close to the airport road and railway which would be very valuable for residential and other uses. The 'Cyberport' proposed by a son of Li Ka-shing as a high-tech leap into the millennium seems more a high class residential and office development on a prime site which should have been opened to competitive tender. If its cyber credentials are real, it will also be in competition with a science park being developed by the government near the Chinese University. More than ever it is who you know more than what you can contribute which influences official decision making.

The proposed Disney and Cyberport deals make a nonsense of claims that transparency is a major ingredient of official Competition Policy.

## UTILITIES

**MONOPOLIES STILL EXISTED IN UTILITIES BUSINESS**

So-called natural monopolies have long existed in the utilities business in Hong Kong as elsewhere. However, with the exception of telecoms, there has not been the change that has taken place in many markets over the past decade where privatisation has usually been accompanied by the introduction of competition or changes in the structure of an industry. For example, Malaysia and Thailand now have independent power producers and a partial split between generation and distribution.

**DEREGULATIONS OF TELECOMS ALMOST COMPLETE**

In HK the changes in telecoms have now been almost completed with the opening up this year of international call traffic and the introduction of number portability into the mobile networks. Change in HK telecoms started with the mobile networks and was assisted by technical advances and de-regulation and price cutting elsewhere which make call-back a viable alternative for many HK users. However, equally important was international (mainly US) pressure for deregulation and competition and the Office of the Telecommunications Authority. For a HK government entity, the latter has been an unusually active promoter of change and competition.

Originally established to advise the government on policy towards a rapidly changing industry, particularly under former boss Alex Arena, it saw its role in promoting telecom service development with competition being both an end in itself and a means to helping the Hong Kong economy by lowering costs and providing new services. Although HK Telecom still has an overwhelmingly dominant role in local fixed line services, the OTA has now mainly achieved its objectives - albeit a cost to the public purse in compensation for the early end of the overseas monopoly.

**EMPHASIS IS NOW SHIFTING TO FIXED LINE AND CABLE NETWORKS**

Emphasis is now shifting to the future role of fixed line and cable networks in delivering video on demand, internet and related services. This brings telecoms into the media arena subject to different controls - a cable TV monopoly enjoyed by Wharf Cable but due to end in 2003.

Cable and satellite have for some years now provided competition for the terrestrial TV duopoly; one which has always been a losing proposition for the second ranked player. Hong Kong’s programming choice is superior to that in some Asian countries but falls far behind Taiwan. One problem for the media industry has not been the growth of channels but of satellite uploading capability. This is said to have been one reason why stations such as CNBC and ESPN have chosen Singapore as their regional headquarters despite the fierce restrictions on foreign media circulation which exist there. Singapore is also understood to have offered specific financial carrots to foreign media, including tax breaks, as well as having lower office and housing costs.

Concerns not to offend Beijing have played some role in the attitude of the Hong Kong government to satellite upload, and in the run up to the handover had seemed to be a potential negative for foreign media.

Given the vitality of domestic media and the lack of constraints on foreign journalists, Hong Kong’s loss of media business has been disappointing. It has had implications for the advertising and printing industries as well. However, it is difficult to ascribe the problem to specific anti-competitive forces.

**STRONG COMPETITION AMONG ISPS**

Likewise the internet. Hong Kong had early strong competition among ISP firms, which offered low costs as well as riding on the back of lack of time charging for local phone calls. HK now has a fairly high internet user rate but still lags behind Singapore and Australia among managers and professionals, according to a recent AC Nielsen study, and even further behind in student use.

There has been some amalgamation of providers but there is still plenty of competition. Nonetheless, Hong Kong firms do not appear to have established themselves as regional players and e-commerce has been slow to develop. This may change with the big push that HK Telecom is now making in conjunction with Microsoft and in line with the strategy of parent Cable and Wireless. It has needed the pressure of losing one monopoly to force HK Telecom into new fields.

Meanwhile regulation of oligopolies is splintered and does not take account of the coming together of phone, internet, cable TV and other services. Thus, for instance, OFTA's brief does not extend to ensuring continued ISP competition. This may not matter much given the rate of change in the industry and the difficulty of forecasting. But a piecemeal, reactive policy may be worse than no policy at all.

## Power

**Lack of competition in utilities is significant**

This is now the most significant area of lack of competition in utilities. A Compag study is promised by the end of the year. The overall economic damage of monopoly is unlikely to be great because power is not a major factor of production in a service economy. Nonetheless, the structure and profitability of the industry says much about the influence of entrenched interests and their ability to generate good returns with very little risk. The existence of two separate but not competing companies accepts the notion of the natural monopoly but fails to take it to its logical conclusion by having one supplier for the whole territory. Two, based on geography not economics, reduces potential operating efficiency and has added to the capacity excess which has tended to result from the Schemes of Control applied to the power companies.

**Allowable return is based on return on fixed assets**

Allowable return is based on return on fixed assets so there is an incentive to increase assets rather than use them more effectively. It explains why reserve capacity is now 42 % of peak demand. It also explains why power charges in Hong Kong, though not high by international standards, are not as low as they should be given that distribution costs are low because of building density and transmission losses also low. Nor is there any tax on fuel - now mainly coal and gas.

**SOC only encourages companies to build more power stations**

The schemes of control also encourage the two companies to build more power stations in Hong Kong despite land availability and pollution problems, rather than buy supply from the mainland. Hong Kong sells some power to China, but much less than in the past now that mainland capacity has more than kept up with demand.

Over the past four years, power prices have risen at the same rate as CPI despite the fall in fuel prices over that period.

**Possibility of introduction of natural gas**

Indeed, the only direct competition in the energy field is from another near-monopolist, the HK & China Gas Co which competes with electricity for some domestic and catering purposes. Bottled LPG, which has one third of the gas market, is limited competition for domestic mains gas, of which HK & China Gas is the sole supplier. As most housing developments install mains gas, the gas company has almost assured growth and little competition. There is the possibility of natural gas being introduced and the government has studied the possibility of a common carrier to enable competition between HKCG town gas (made from naptha) and natural gas. But choice is still a long way off.

Although LPG is a low growth business, it has been at the centre of claims of an oligopoly of oil companies keeping prices of all hydrocarbon fuels artificially high. Even the government recently felt compelled to lean on them to reduce LPG prices to reflect international price declines. However, a Consumer Council investigation of petrol and diesel prices has not come up with significant evidence of increased margins. Price competition, however, is confined to bulk customers and generally the industry is believed to be highly profitable despite the high cost of new outlets and the extent to which diesel sales are undercut by smuggled imports of low grade fuel from the mainland.

**The government is the monopoly supplier for many utilities**

The government itself is the monopoly supplier of three items: water, sewage and mail. But it has made scant use of its monopoly power to generate revenue, or even a reasonable return on capital employed, regarding them as public amenities. There has for some time been talk of corporatisation perhaps leading to privatisation. However, nothing has happened so far. The poor commercial record of the water department is as much a result of a high leakage rate as of underpricing. Water, however, is also a quasi-political issue as most is bought from the mainland. The government recently made a large, interest free loan to the mainland to help improve water quality. This kind of non-commercial action makes corporatisation more difficult.

In sewage the "user pays" principle is only slowly gaining acceptance. The inadequacy of treatment facilities and its consequences for seawater and beach quality is self-evident. Past government reluctance to invest has been matched by user reluctance to pay. Consequent environmental damage has not helped Hong Kong's competitiveness.

Corporatisation of the postal service is closer at hand. However this is not exactly a growth industry. Local mail volumes are still growing but international ones have been falling. Hong Kong is still a net exporter of mail, but is not as favoured for bulk mailing as some other locations. Automation is not advanced. Hong Kong as yet still lacks postal codes to mechanise sorting. However, with the spur of corporatisation the post office may in future provide more competition for private sector courier services and capture some of the growing market for delivery of goods ordered by e-mail, such as books. Meanwhile the government is promising that the post office's statutory mail monopoly will be lifted - though in practice it has not hindered courier services.

## Public transport

**Competition has increased in transportation**

Competition has increased in recent years. The former bus monopolies on either side of the harbour have been partially opened up but pricing is still mainly determined by government regulations. The result has been an improvement in the quality of services but fares have risen rapidly as operators have sought and mostly been granted increases to offset investment in new buses etc. The opening of the new airport and railway have seen increased competition between MTRC and bus companies, and even between the bus companies. Both have been helped by tighter controls on mini-buses. Ferry services, however, are still subject to regulated but not very profitable monopolies mostly using old and highly polluting craft.

**Public transport is not a very profitable monopoly**

In general, the pricing of franchised public transport is aimed at ensuring a reasonable return on investment but fares are mostly allowed to move up in line with the CPI rather than with costs. Industry lobby groups are influential. They are even more in evidence in the taxi industry, which long and successfully resisted replacing diesel (much of which is smuggled, low quality fuel) with less polluting petrol engines. Only recently did the government decide eventually to replace diesel with LPG. The taxi lobby has also been successful in obtaining faster-than-inflation fare increases despite falling fuel prices. The exaggerated influence of taxi operators over transport and environmental policy is partly due to their political connections with legislators, and government memories of a destabilising taxi strike in the early 1980s.

Taxi and private motorist lobbies have also successfully resisted road pricing schemes which would substitute user pays principles for other forms of revenue collections from vehicles. An electronic road pricing scheme was abandoned in the 80s due to this opposition. Nor has there been any attempt to follow Singapore by heavily pricing private vehicle entry into the central business district.

RAILWAYS TO BE PROTECTED?

Railways remain government owned monopolies but face competition from buses in particular. Privatisation remains a goal but the timing has yet to be appropriate. Though the latest budget promises partial MTRC privatisation, timing may depend partly on the performance the loss-making airport railway in which MTRC has invested heavily. The Kowloon Canton Railway Co (KCRC) is about to embark on the very costly west rail development. Remember that railway development has traditionally been financed by profits of above station development with the railway garnering a large proportion of the value added brought by it.

## FINANCIAL SERVICES

DE-REGULATION OF INTEREST RATES HAS BEEN A SLOW PROCESS

The de-regulation of interest rates has been a slow process, constantly impeded by the banks' argument that the cartel was needed to maintain the stability of the system by limiting competition. That had, they have argued, been one cause of the banking crisis of the mid-1980s, when little regulated deposit-taking companies caused banks, as well as themselves, to take rash actions.

The past few years have seen significant erosion of the cartel. Deposit rates are now free for all but savings and demand deposits. On the lending side, prime rate has become less important than other factors. Large corporations borrow at spreads over Hibor and for individuals rates over prime are variable and competitive, at least for residential mortgages. Nonetheless, the argument about the potentially de-stabilising impact of full de-regulation continues to be heard - accompanied by the threat that were rates fully de-regulated and interest on current accounts permitted, banks would have to introduce many new charges, which would leave small depositors worse off. Be that as it may, two facts stand out about banking in HK that suggest that the cartel system has served the banks rather better than the public:

BANKS HAVE A MUCH LONGER SHARE OF FINANCIAL INTERMEDIATION

1. The banks have a much larger share of financial intermediation than in almost any jurisdiction. Finance companies, building societies, post office savings systems are small or non-existent. Life insurance is growing fast but from a low base, unit trust/mutual funds are not very popular, and there are no government securities aimed at the retail market. With bank lending (for use in Hong Kong) to GDP ratio at 163%, banking is huge business.

SMALLER BANKS ONLY SURVIVE DUE TO A LACK OF COMPETITION

2. The territory is massively over-banked. Many smaller institutions only survive because of a lack of competition. Even the difficulties of the past year have not (yet) generated many mergers or acquisitions. Indeed, it seems that HKMA support for the weaker ones during last year's crisis enabled them to survive when merger would have been more appropriate. The interest rate cartel keeps these banks in business while ensuring that the larger ones are sufficiently profitable not to press for a change in the system which might increase their market share but do nothing for their margins. Another prop for the locals is that foreign banks established since 1978 are restricted to one branch, which effectively keeps them out of retail business.

   The argument that the cartel creates stability is flawed. It did nothing in the 80s, when half a dozen banks collapsed due to overly aggressive lending. Nor did it do much to curtail the madcap lending spree of 1996-97, when loans for use in HK rose by 30% over 18 months and average loan spreads on mortgage loans fell to a mere 25 points over prime. Indeed, though Hong Kong's banking system has certainly been better supervised than most in the region, amelioration of the Asian crisis was more the result of massive cash injections by the government through its own deficit and via the stockmarket rather than wisdom on the part of local bankers.

Domestic banking profitability has necessarily been at the expense of households and other businesses. This was especially so during the period of low to negative real interest rates that prevailed during most of the decade to mid-1997. That, however, has come to an end for the time being.

## Stockmarket

It is one of the myths of Hong Kong that everyone invests in the market. Certainly, during bull periods such as the Red Chip fever in 1997 there has been mass participation by taxi drivers, secretaries etc. However the norm in quieter periods has been for only 10% of individuals to own stock directly. Though many own indirectly through pension funds and life insurance, unit trust ownership is also low.

**Investment in home ownership is emphasized**

The emphasis on investment in (very expensive) home ownership is probably one reason. But another surely is the relatively high cost of trading on the stockmarket. This is particularly noteworthy when comparing HK with Taiwan, with its very low commission rates and highly automated trading system.

**High commission rates in stock broking**

In turn, Hong Kong's high commission rates (and an imposed minimum of 0.25%) are due to the monopoly granted to the SEHK when it was created in 1986 to supplant the four rival exchanges which existed before.

High commissions have protected the smaller local brokers who control the SEHK. But they have had negative consequences beyond simply discouraging broader participation. They include the loss of foreign institutional business to London, the advantage of trading derivatives through the futures exchange rather than dealing in the cash market. Even so, foreign institutions account for about 40% of local stock trading. The Stock Exchange monopoly may also account for the relatively slow growth of internet based trading - which elsewhere makes low cost as well as ease of access its main selling point.

**No tax breaks to financial service industries**

Hong Kong does not offer tax breaks such as Singapore has done to attract financial service industries. It is thus especially important if it is to retain its position as a regional and global centre that it facilitates competitive access to trading of all kinds.

Regulatory demands within the SAR are not especially burdensome, despite measures introduced last year allegedly to deter speculation against the currency via the futures market. But restrictive practices to protect local broker interests are evidently a serious deterrent to financial sector development. In particular, Hong Kong must learn that for its future prosperity it cannot simply rely on being China's leading international financial centre and listing place for leading mainland companies. Unless it retains a wholly open and internationalist outlook, it will continue to lose international business to Singapore and Tokyo, and eventually the China business to Shanghai.

Hopefully the decision announced in the budget to amalgamate the stock and futures exchange, separate ownership and trading rights and revamp the governance of the stock exchange will lead to rapid, if belated, improvement in Hong Kong's competitiveness.

The restrictive practices found in the broking business are also evident in many professions. These have negative implications for the development of service export industries.

Hong Kong is noted for the high quality of many of its medical experts. However, this does not translate into provision of medical services to visitors - again, unlike Singapore. Indeed, due to the high cost of local private treatment, many go overseas for non-urgent treatment. A local shortage of medical personnel is partly attributable to restrictions on practice other than those who have qualified locally or at a few British Commonwealth institutions, and partly to deliberate restrictions on the number of entrants to local medical schools. Add in very high land costs, high hospital profit expectations and an implicit subsidy from private to public sector medicine through the scales of fees, and Hong Kong private medicine ends up being among the most expensive in the world. Yet Hong Kong ought to be in an ideal position to offer quality medical services to the region, and especially China.

**COURTS ARE VERY SLOW AND EXPENSIVE**

The situation for lawyers is not so bad. Though lawyers from non-British jurisdictions cannot practice locally, their ability to provide offshore services for corporate and banking purposes has made HK into an important international legal centre. Meanwhile, access to the HK courts themselves is attractive for much regional business. However, the quality of the legal system is not just a benefit for Hong Kong but a burden on the economy. The courts are very slow and very expensive due to archaic procedures and restrictive practices by the profession. Hong Kong lags far behind even Britain's reforms of the system, the lawyers using the 1997 handover as an excuse to argue that "no change" was the order of the day if confidence was to be preserved. Fee levels are such they discourage some international business, and conveyancing fees are absurdly high given the minimal amount of work involved in most apartment transactions. Although conveyancing fees are no longer fixed and negotiation is allowed, scale fees still apply in most instances.

Perhaps because practices are more uniform, accountancy has been much less afflicted by local interests. This has enabled consultancy as well as auditing services to flourish. Likewise quasi-professional service activities such as advertising, head-hunting, computer software, where industry bodies do not control entry, have flourished without impediment.

**LOCAL PROFESSIONAL BODIES REFUSE TO RECOGNISE MAINLAND QUALIFICATIONS**

Local professional bodies are naturally nervous of making overseas entry easier, especially if it opens them up to having to recognise many mainland qualifications. There are plenty of ways in which offshore services such as engineering and architecture can be provided by firms employing professionals who are not licensed locally. Nonetheless, it is going to be easier for Hong Kong to grow services which are not subject to the entry controls administered by local professional bodies.

**EDUCATION BEING IMPORTED**

The business of education is also one which ought to export but is now importing on a large scale. Thanks in large part to the government, the educational system is monolithic, uncompetitive and unattractive to outsiders. It is noteworthy that over the past four years educational and medical service costs have grown much faster than any CPI component other than housing.

**ENTRY OF NON-LOCALS IS POSITIVELY DISCOURAGED**

The secondary system has a rigid curriculum in a mix of Cantonese (which is unappealing to mainlanders and Taiwanese) and English (of modest linguistic standard unappealing to students or teachers from other parts of Asia). Entry of non-locals is positively discouraged and boarding facilities almost non-existent.

**INTERNATIONAL SCHOOLS ARE EXPENSIVE**

The international schools cater for non-locals and locals rich enough to afford the fees and who want their children to have an international education. They are defined by the interests of their sponsoring nation - German, Japanese, French, Korean etc - and are very expensive.

The net result of the secondary system is that almost no one comes to HK for education, and many leave. The same applies at the tertiary level where excellence is mostly found in subjects where language is of minor importance. Links with mainland universities are limited both by mainland rules and preference for links with North American institutions. Unlike Taiwan, links with industry are modest.

**Education system is lacking vs global standards**

The state of the educational system can be attributed to lack of competition, lack of parental choice, reliance on huge government grants, lack of commercial incentive, rigidly hierarchical structures at the universities and at the secondary level subservience to the government's educational bureaucracy. University teachers in Hong Kong are among the highest paid in the world - but few have global standing.

Whether new internet-based teaching systems undermine the existing high cost structure of tertiary education remains to be seen. Some HK institutions are developing internet based programmes for sale to the mainland. However, institutional obstacles which deter choice and competition, as well as HK's usual cost disadvantages, lie in the way of the SAR's developing itself as a centre of academic excellence and attraction for foreign students, professors and commercially funded research institutes.

## *Ports*

**Government attempts to increase competition only partially successful**

A duopoly of HIT and MTL dominates the container port. Attempts by the government to increase competition in the bidding process for CT9 were only partly successful and CT9 has been subject to many delays and long negotiations between the various parties. Port operators have exhibited a high degree of efficiency to maximise throughput. However, HIT and MTL do not appear to have been keen on rapid port expansion in Hong Kong which might bring more local price competition. On the other hand, competition from some mainland facilities, in which HIT itself has invested, are increasing. There are plans for additional terminals in HK after CT9, but it is uncertain what level of land prices would be needed to make their development viable. There has been scant public discussion over whether further port development is desirable given rates of return and other demands on land.

## *Airport and landing rights*

**Airport Authority unwilling to reduce landing fees**

Two monopolies have a huge impact on the attractions of Hong Kong for other businesses. The airport is a natural monopoly, though one which faces some regional competition. Airline operators, particularly the largest, Cathay Pacific, have attacked the landing fees and other charges. Some other airlines are said to have reduced their flights to HK or transferred elsewhere for overnight parking, maintenance etc. The Airport Authority insists that it must achieve a certain level of return to meet commitments to lenders. If this is the case, it is arguable that the AA, a government entity, has been undercapitalised and excessive debt is resulting in landing fees which are damaging the wider economy. Curiously, the AA has been unwilling to reduce landing fees, through it has unilaterally reduced retail rents even though these were leases subject to competitive bidding. (The beneficiaries are mostly companies controlled by the property giants.)

Cathay Pacific is the other quasi-monopolist, being the "national carrier" beneficiary of HK landing rights. Landing rights are technically a matter for Beijing as previously for London, and mainland carriers get some advantages that used to accrue to British ones. But Cathay is the main beneficiary of reciprocal rights under various bilateral treaties. US airlines in particular have been pressing for HK to adopt an open skies policy. This would undoubtedly help Hong Kong business as well as themselves but would undercut Cathay's position. When the airport was at Kai Tak, the shortage of landing slots ruled out an open skies policy. However, with 24-landing and take-off and a second runway due to open in 2000, Hong Kong's aviation parameters have changed.

Another possibility, followed in some countries, would be to auction landing slots. Capital revenue could be used to reduce debt and cut landing fees. However, again it would be to the disadvantage of the local airline, which now occupies many of the favoured time slots.

Since the opening of CLK airport, aircraft servicing and ground handling have become more competitive. But generally policy has not been adjusted to take account of the new circumstances arising from the new airport, or the opening of other new airports such as KL or, soon to come, Seoul and Shanghai and the competitive pricing of well regarded, user-friendly airports such as Singapore.

The airport is public property and traffic rights should also be viewed as publicly owned assets. In which case, a broader view would be taken of Hong Kong's interests in regulating the behaviour of the air-related monopolies.

## Parallel imports/retailing

**Parallel import restrictions encourage counterfeit products and cross-border shopping**

Hong Kong has been moving in the opposite direction to many jurisdictions with laws which prevent parallel imports and underpin resale price maintenance. This keeps distributor and some retail margins high - but also encourages counterfeit products and cross-border shopping.

Under the 1997 law on Patents and Registered designs, the owners of intellectual property rights have the right to determine disposition of those rights in the SAR as well as generally. Thus they can prevent exploitation of those rights in the SAR by those other than their authorised agents. Thus genuine products cannot be bought in other jurisdictions and sold in HK.

The same restrictions do not exist with trademarks, but legislation has been proposed which would have a similar effect.

Less obvious restraints on trade are said to exist in other retail areas, with importers and wholesalers declining to sell to retailers offering large discounts and upsetting established suppliers. Anecdotal evidence on relative prices of toiletries, canned foods etc compared with the US and elsewhere is said to suggest that anti-competitive practices are rampant. In some jurisdictions, some of the practices designed to block out competition and keep margins high would be illegal. However in HK the law either says nothing or supports wide claims to what is "intellectual property". At the same time it has provided scant protection to those such as software and music producers who are subject to blatant pirating.

Ironically, while pirating in HK is rampant, to protect local importers and retailers there has been a proposal to criminalise purchasers of pirated goods when they bring them into the territory. This is as much to discourage shopping in Shenzhen as to stamp out piracy.

## The gambling monopoly

**The gambling monopoly contributes 7% of government revenue**

The Jockey Club's monopoly of gambling on horses and the ban on other forms of gambling have created a powerful nexus of money and power. Taxes on the gambling monopoly generate some 7% of government revenue; and the club itself provides a physical and spiritual meeting place for Hong Kong elites of all races where money talks and voting membership and horse ownership are symbols of prestige. The public is provided with a regular fare of racing spectacles with probably no more dubious practices than found elsewhere. And favoured charities get many millions from the monopoly surplus.

## EVERYONE SEEMS TO BE A WINNER EXCEPT THE PUNTER

However the monopoly has its drawbacks. It encourages illegal betting, a flourishing adjunct to crime. The ban on other gambling also benefits casinos from Macao to Las Vegas, Genting to Sydney, and the cruise ships that ply nearby international waters.

The monopoly is also being eroded at the edges by the ease of betting on Macau racing, and on international telephone and internet betting on horses, football etc.

Racing attracts few tourists, so the lack of other gaming facilities is a disincentive to visitors. Allowing the establishment of casinos would be viewed as an "unfriendly act" by Macao. However, the monopoly is more likely maintained because of the benefits it brings to Jockey Club members and to revenues than out of neighbourly concern.