



SERVICE EXPORTS: THE NEXT ENGINE OF GROWTH FOR HONG KONG?

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Abstract

Increasing economic integration with Mainland China has contributed to the rapid expansion of service exports in Hong Kong. Growing at the current pace of 10-20% per annum, service exports would be a key contributor to GDP in the coming years, thanks to vibrant expansion in offshore trade and strong growth in financial service exports and inbound tourism. Our projections show that, if the size of the Mainland economy doubles over the next decade, service exports could increase from the current 40% of GDP to 50% of GDP by 2016, probably the fastest growing component in GDP.

JEL Classification: F1, F2

Keywords: Trade in services, Offshore trade, Hong Kong, Mainland China

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The views and analysis in this paper are those of the authors, and do not necessarily represent the views of the Hong Kong Monetary Authority.

Executive Summary:

- *Service exports have become an increasingly important source of income growth for the Hong Kong economy. Mainland China is the largest buyer of services produced in Hong Kong, and its rising service demand has played a key role in driving the strong performance of Hong Kong's service exports in recent years.*
- *Trade-related services, which include merchanting and merchandising for offshore trade, have been growing rapidly to become the largest component of service exports. The robust growth of the Mainland's export sector, as well as its moving up the value chain, should continue to underpin trade-related service exports, offsetting some of the loss in market share that Hong Kong may experience in handling offshore trade of Mainland origin. Growing diversification into non-Mainland supplier markets, coupled with Hong Kong service providers' expertise in supply chain management, should also be supportive to trade-related service export growth going forward.*
- *Financial service exports registered remarkable growth in recent years, benefiting from new listing and increased trading of Mainland-related shares in the domestic stock market. The recent rise in asset management and securities transaction service exports reflects a shift from traditional banking business to areas with higher value-added. The outlook for financial service exports remains positive, as further liberalisation of the capital account and growing financial needs on the Mainland are expected to boost the demand for Hong Kong's financial services. While competition from other regional centres such as Shanghai may intensify, the level of sophistication in the financial services provided in Hong Kong, such as in derivatives and private wealth management services, should provide support to the growth of financial service exports.*
- *Travel service exports have seen notable growth in recent years, driven in part by the strong growth in inbound visitors from the Mainland following the introduction of the Individual Visit Scheme. While vacation visitors have been the key driving force of inbound tourism earnings, the contribution from business visitors is expected to grow, reflecting Hong Kong's increasing role as an international business hub and the expansion of convention and exhibition activities in Hong Kong.*
- *Service exports are projected to sustain robust growth in the medium term, underpinned by growing demand for services from Mainland China. While trade-related service exports are expected to remain the largest service group, financial service exports have the highest growth potential. Meanwhile the growth of travel-related service exports is projected to remain solid. Our projections show that, if the size of the Mainland economy doubles over the next decade, service exports could increase from about 40% of GDP in 2006 to 50% of GDP by 2016.*

I. INTRODUCTION

Service exports have become an important source of income growth for the Hong Kong economy. At the current pace of expansion of 10-20% per annum, service exports would be a key contributor to GDP in the coming years. In 2007, income generated from net service exports accounted for 20% of GDP, while consumer and business spending constituted 60% and 20% of GDP respectively. The growing significance of service trade to the domestic economy mainly reflects faster growth in service exports relative to imports, thanks to vibrant expansion in offshore trade, strong growth in financial service exports and rising number of inbound visitors.

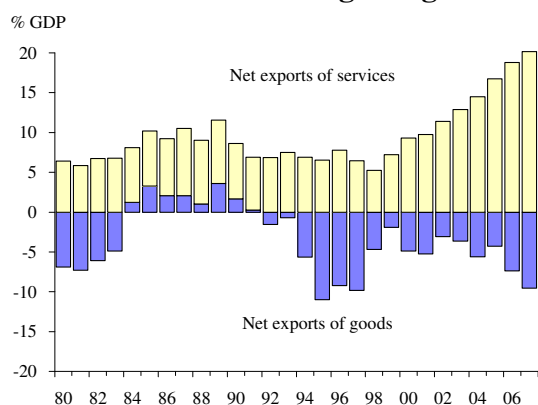
A key impetus to the recent strong performance of service exports is the growing service demand from Mainland China. The implementation of the Closer Economic and Partnership Arrangement (CEPA) since 2003 has created new business opportunities for service providers in Hong Kong. Recently, the Mainland's financial sector reforms and capital account liberalisation have boosted fund-raising and asset management activities in Hong Kong. In fact, Mainland China is the largest buyer of services produced in Hong Kong followed by the US, and its significance is growing. Our projections show that, if the size of the Mainland economy doubles over the next decade, service exports would rise from the current 40% of GDP to 50% of GDP by 2016, of which about half of the increase could be attributable to the Mainland factors.

This paper is organized as follows: Section II analyses the key drivers of service exports in Hong Kong and discusses the growing importance of service exports to output growth. Section III identifies the opportunities and challenges ahead in the face of growing service demand from Mainland China, and discusses the possible constraints faced by service providers in Hong Kong. Section IV measures the benefits brought about by the continued expansion of the Mainland economy to Hong Kong, and projects the medium-term growth path of service exports in Hong Kong. Section V concludes.

II. SERVICE EXPORTS AS A KEY DRIVER OF ECONOMIC GROWTH

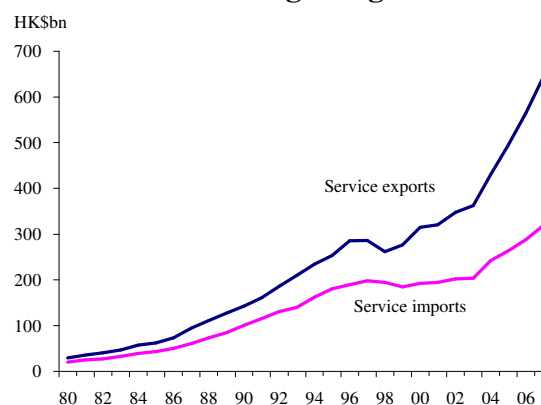
The rapid expansion of Hong Kong's services trade in recent years has been a key driver of economic growth. The surplus in services trade has been growing strongly, accounting for 20% of GDP in 2007, up from 6-7% in the late 1990s. This compares with persistent merchandise trade deficits of 5-10% of GDP (Chart 1). The steady expansion in the service trade surplus has been driven by the strong growth in services exports relative to imports (Chart 2). The rise in services trade is indeed a global trend, as services increasingly take on tradeable characteristics and become more specialized, which can be seen from the rising trend of service off-shoring and growing business flows between the parent company and its affiliates overseas. Hong Kong has positioned itself well to capitalize on this trend, given its proximity to Mainland China, and its competitive advantage in trade and financial services.

Chart 1: Net exports of goods and services in Hong Kong



Source: C&SD.

Chart 2: Service exports and imports in Hong Kong



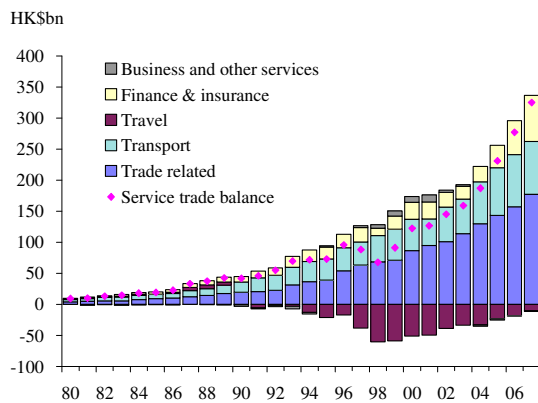
Source: C&SD.

Disaggregate data show that offshore trade is the major source of earnings in service exports, contributing to more than half of the surplus from trade in services, followed by transport and financial services. The balance of trade in travel services turned negative starting from the 1990s, but the deficit has been narrowing recently thanks to the strong growth in Mainland visitors (Chart 3). The rise of Mainland China as the largest exporting country in the world will continue to boost Hong Kong's offshore trade of Mainland origin.¹

¹ According to the IMF Direction of Trade Statistics, Mainland China overtook Germany as the world's largest exporting country in US dollar terms in late 2007.

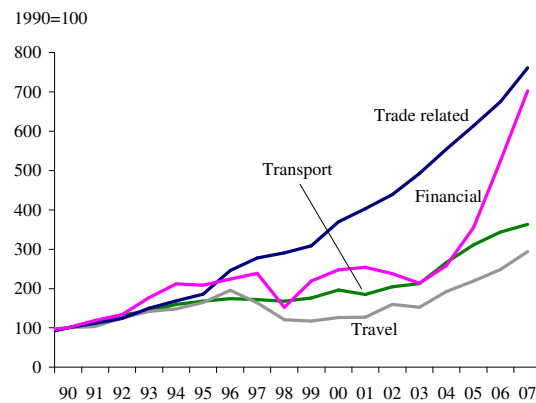
At the same time, a more salient feature has been the fast-growing exports of financial services recently, in part reflecting increasing financial integration between Hong Kong and Mainland China (Chart 4).

Chart 3: Contribution to net service exports by service group



Source: C&SD.

Chart 4: Growth in service exports by key service group



Source: C&SD.

For a small, open and service-oriented economy like Hong Kong, service demand from non-residents has become an important factor driving GDP growth. Over the past two decades, the sizable re-export and offshore trade of merchandise of Mainland origin increased the value-added of the import/export sector from less than one-tenth of GDP in the early 1980s to more than one-fifth of GDP in the 2000s to become the largest service sector in Hong Kong. Recently, financial sector liberalisation on the Mainland has boosted the external demand for financial services in Hong Kong particularly those related to IPO and fund management services, raising the ratio of financial sector output to GDP from 9% in 1996 to 14% in 2006. The implementation of the Individual Visit Scheme by the Chinese authorities was another strong boost to the tourism industry in Hong Kong, raising its contribution to GDP from 2.3% in 2000 to 3.2% in 2006.

Given that trade in services is also the largest contributor to the current account surplus, the factors driving the growth of service exports are not only important for understanding GDP growth but also have important implications for the external payment position of Hong Kong. In the following sections, we take a closer look at the underlying driving forces of offshore trade, financial service exports and inbound tourism in recent years.

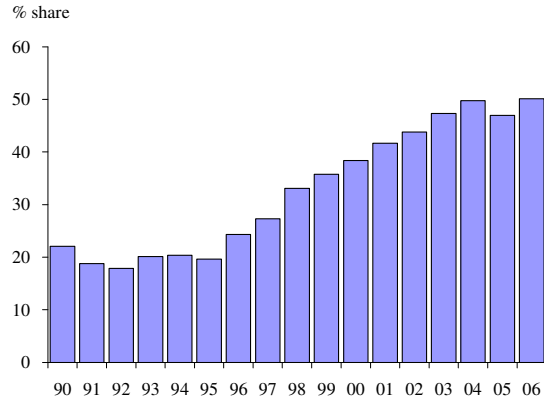
Offshore trade

Trade-related services accounted for nearly one-third of Hong Kong's total service exports in 2007, making it the largest component of service exports. Trade-related service exports refer to the provision of services to non-residents to facilitate merchandise trade that for the most part does not actually pass through the territory. In recent years, Hong Kong's traditional strength in handling re-exports is coupled with the rise in the exports of trade-related services, illustrating the evolving nature of trade in the economy. Our estimates suggest that roughly one-half of the value-added of the import-export industry can be attributed to net exports of trade-related services in 2006, up from just over 20% in the early 1990s, suggesting the rising importance of the earnings from the provision of trade-related services for the sector (Chart 5).

Over 90% of trade-related service earnings is made up of those from merchanting and merchandising for offshore transactions, which together are also known as offshore trade.² Merchanting refers to the trading of goods which are purchased from and sold to parties outside Hong Kong without the goods ever entering and leaving Hong Kong, while the one engaged in merchanting takes ownership of the goods involved. Merchandising for offshore transactions, on the other hand, refers to the case where the agent does not take ownership of the goods involved. Merchanting is the key driver of trade-related service exports in recent years, given that it makes up over 80% of Hong Kong's offshore trade and posts a higher growth rate. Merchandising, on the other hand, makes a smaller contribution to the growth of trade-related service exports (Chart 6).

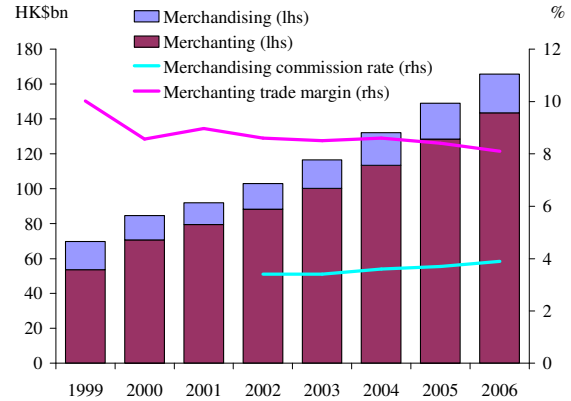
² Other than merchanting and merchandising for offshore transactions, trade-related services also include merchandising for onshore trade as well as other services such as the arrangement of sub-contract processing services, but as these make up a small share of total trade-related services exports, they are not discussed in depth in this paper.

Chart 5: Share of net exports of trade-related services in the value-added of the import/export sector



Sources: C&SD and staff estimates.

Chart 6: Gross offshore trade earnings and commission rate by service group



Source: C&SD.

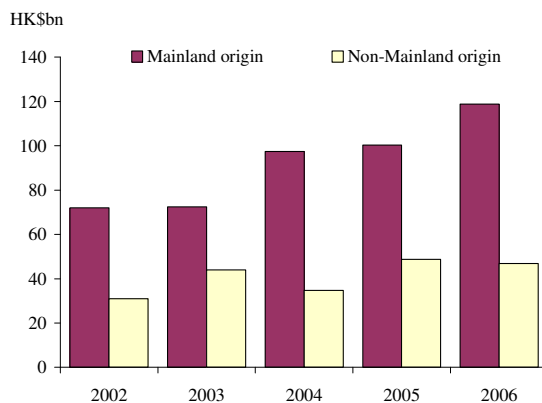
One of the reasons for the rapid growth of merchanting trade is the increasingly complex global supply chain, which led to importers' demand for a broader range of services and more risk-sharing with its suppliers. For the importer, the outsourcing of such operations as sourcing, production, and logistics helps reduce the risks involved in working with different suppliers and coordinating from overseas. Some tasks are also less costly for the merchanting service provider than for the importer to do, such as ensuring compliance with relevant environmental and labour standards, where local knowledge and expertise are needed. Furthermore, given Hong Kong's robust legal system, importers may also feel more confident entering into contractual arrangements with Hong Kong service providers rather than with the manufacturers directly.

For the service provider of merchanting trade, taking ownership of the goods concerned means that they are typically more involved in the production process than are service providers of merchandising trade. For instance, merchanting service providers often help source and provide credit for raw materials and parts, and are sometimes affiliated with the production units to ensure smooth operation. Commensurate with the provision of more value-added services and the higher risk-taking, the trade margin in merchanting services is higher than the commission rate in merchandising (see Chart 6). In any case, both the trade margin and the commission rate have been stable in the past few years, suggesting that service providers have been able to keep their

margin steady in face of keen global competition.³

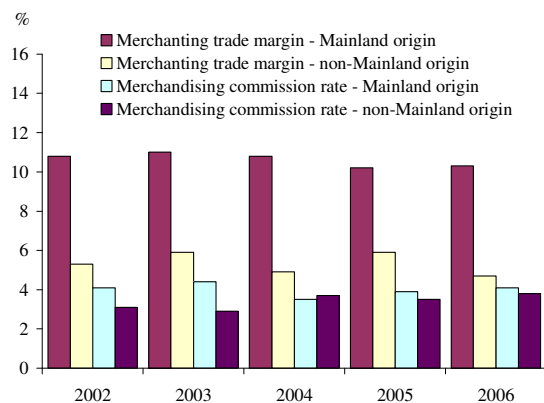
Offshore trade by supplier country shows that the Mainland is a key factor behind the rapid rise of Hong Kong's offshore trade. Earnings from providing offshore trade services to goods of Mainland origin make up 70% of total offshore trade earnings, due to both the larger volume of goods traded as well as the higher trade margin (Chart 7). This is not surprising given the robust trade performance of Mainland China in recent years, the key role it plays in the global supply chain, and Hong Kong's long-standing role as an entrepot for Chinese exports. While the Mainland may have developed the requisite port facilities and the necessary logistics expertise to handle direct shipments, there still exist important gaps in the supply chain that Hong Kong service providers can fill – such as finding overseas buyers and meeting their quality standards, as well as sourcing raw materials and parts and co-ordinating work with other suppliers etc. Knowledge and experience of the Chinese market is likely to have allowed Hong Kong service providers to add more value and thus command a higher margin in China-originated offshore trade than in trade of other origin (Chart 8).

Chart 7: Gross margin/commission by origin of supplier



Source: C&SD.

Chart 8: Gross trade margin and commission rate by service group and origin of supplier



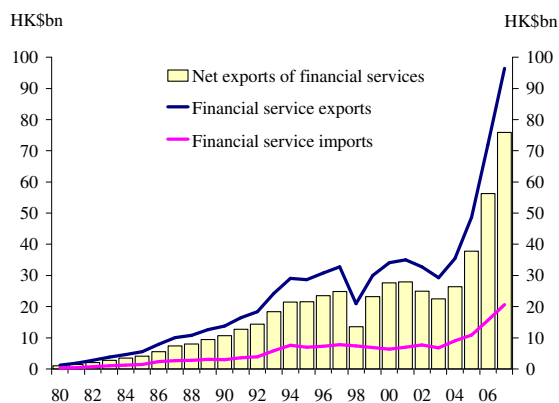
Source: C&SD.

³ Merchancing and merchancing service providers may have broadened the range of products and services they provide, and diversified their sourcing markets and destination countries, and in the process kept their trade margin stable.

Exports of financial services

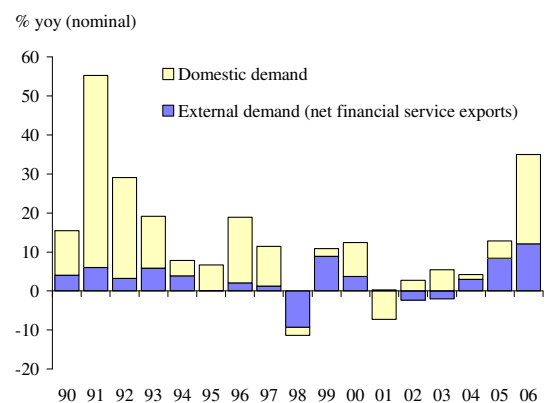
Financial service exports have registered remarkable growth in recent years, more than triple in value between 2003 and 2007. This is equivalent to a compound annual growth rate of 35%, faster than the 32% growth in imports of financial services (Chart 9). As a result, financial service exports, which are the sales of financial services to non-residents, have become an important source of income growth to the financial industry in Hong Kong. During 2003-2006, net financial service exports as a share of financial sector output rose from 17% to 27%, and about 40% of output growth in the financial sector could be attributed to external demand (Chart 10).

Chart 9: Financial service exports and imports



Source: C&SD.

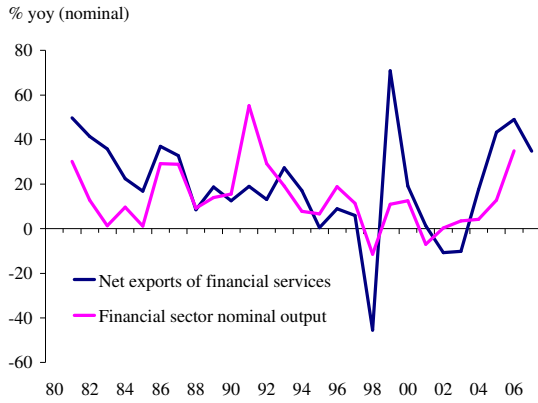
Chart 10: Contribution of financial service exports to financial sector output



Sources: C&SD and staff estimates.

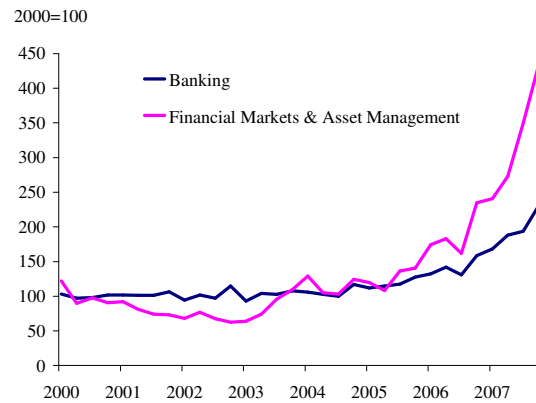
Reflecting Hong Kong's status as an international financial centre, a significant portion of financial services produced in Hong Kong is consumed by non-residents. Over the past two decades, growth in net financial service exports has tracked growth in financial sector output closely (Chart 11). In recent years, growth in net financial service exports has become more volatile, in part reflecting the swing in financial market activities following the Asian financial crisis in 1998 and the burst of the global IT bubble in 2000. Recently, increased IPO and fund-raising activities of Mainland enterprises in Hong Kong have boosted the business receipts of the non-bank financial sector, mainly driven by increased activities in domestic securities markets and the asset management industry (Chart 12).

Chart 11: Net financial service exports and financial sector output



Source: C&SD.

Chart 12: Business receipts of banking and non-bank financial services



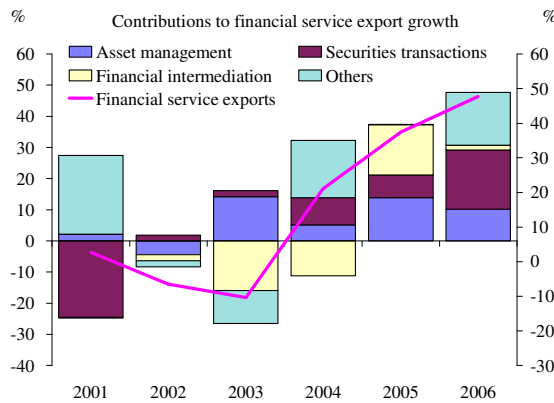
Source: C&SD.

Like other international financial centres such as New York and London, Hong Kong has successfully attracted companies and private capital around the world, particularly within the Asian region, to use the financial services and infrastructure in Hong Kong. External demand has played an important role in boosting financial sector activities recently, especially in areas like asset management and securities transactions. In general, financial services could be broadly grouped into four key categories, namely asset management, securities transactions, financial intermediation and other financial services.⁴ Based on official statistics and market sources, a crude estimate shows that asset management and securities transactions have been the two most important drivers of growth in financial service exports in recent years (Chart 13). Reflecting the strong growth in these two financial service areas, their combined share in financial service exports increased from 30% in 2001 to nearly 60% in 2006 (Chart 14).⁵

⁴ We follow the classification of financial services used by the U.S. Bureau of Economic Analysis (BEA). Asset management includes fund management and investment advisory (e.g., merger and acquisitions) services. Securities transactions include brokerage, underwriting and private placement services. Financial intermediation includes interbank and customer credit services. Other financial services include securities lending, clearing and other financial services.

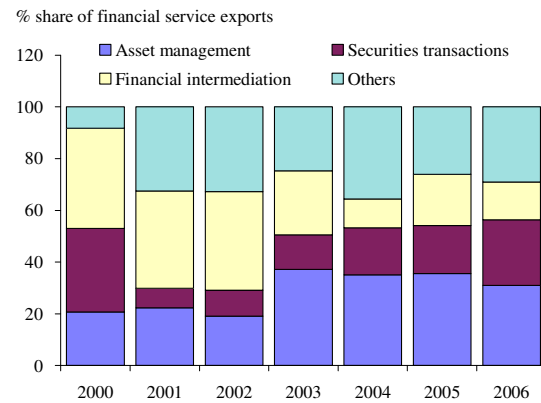
⁵ Please refer to the Annex for the fee structure used to derive the composition of financial service exports by service type.

Chart 13: Contribution to growth in financial service exports



Sources: C&SD and staff estimates.

Chart 14: Share of financial service exports by service group



Sources: C&SD and staff estimates.

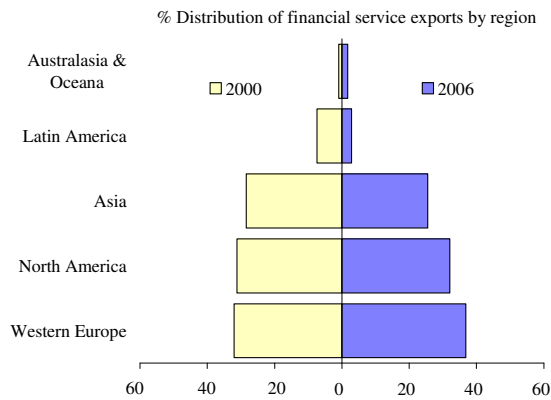
The growing significance of asset management and securities transaction services in Hong Kong’s financial service exports reflects the shift from traditional banking business to areas with higher value-added, which is a natural outcome as the domestic financial industry moves up the value chain. In fact, it is a global phenomenon for financial institutions to strengthen their capacity in customized financial services like IPOs, structural finance and private wealth management, as keener competition has suppressed the interest margin of conventional banking business like trade finance and customer lending.

Despite growing fund-raising activities by Mainland enterprises in Hong Kong, the US remains the largest destination of financial service exports in Hong Kong, followed by the UK and Singapore. Grouping by region, Western Europe and North America contributed more than two-third to export earnings of financial services in 2006, while Asia contributed a quarter to the total (Chart 15). The contribution from China remains tiny, at about 3% of Hong Kong’s exports of financial services.

However, alternative measures point to growing importance of the Mainland factors in the recent expansion of financial service exports. To gauge the benefits derived from growing financial integration with the Mainland, four key areas of financial developments are used to measure the contribution of the Mainland factors to the financial industry in Hong Kong. These include: 1) increased number of Mainland shares listed in Hong Kong; 2) increased turnover

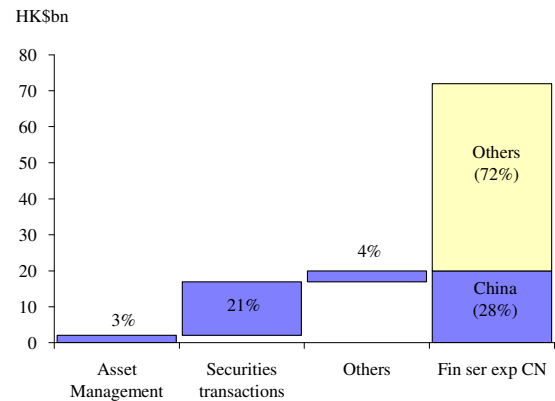
of Mainland-related shares in the Hong Kong stock market; 3) the rise of merger and acquisition (M&A) activities in Hong Kong and Mainland China; and 4) increased inward portfolio investment (PI) from Mainland investors. Based on survey results and information on the fee structure of these financial services, a crude estimate shows that about 30% of financial service exports in 2006 could be attributable to the Mainland factors, mainly reflecting the sizable underwriting fee from IPO services and brokerage fee from trading Mainland-related shares by non-residents (Chart 16).⁶

Chart 15: Financial service exports by major destination



Source: C&SD.

Chart 16: Financial service exports contributed by the Mainland factors in 2006



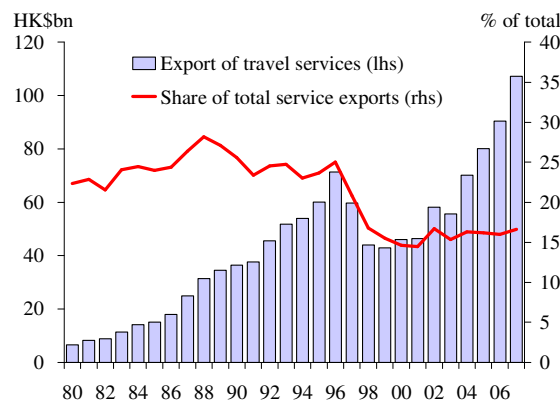
Source: Staff estimates.

⁶ Two possible reasons explain the difference between our estimates of financial service income derived from China and official estimates of financial service exports to China. First, a usual practice for the allocation of IPO underwriting fee between foreign-owned affiliates in Hong Kong and their parent companies overseas (mainly in the US and Europe) is that the former book the fee income to the latter after completing the IPOs for Mainland enterprises. In return, their parent companies will distribute a portion of the underwriting fee to their affiliates in Hong Kong. This redistribution of fee income from the US and Europe will be captured as financial service income received by their affiliates in Hong Kong in official statistics, although the underlying demand for the IPO services comes from Mainland enterprises. Secondly, we classify the brokerage fee due to trading of Mainland-related shares (e.g. H-shares and red-chips) by overseas investors in Hong Kong as service income derived from the Mainland factors, even though most of overseas investors are from places outside China.

Exports of travel services

Exports of travel services measure the expenditure on goods and services consumed by overseas visitors in Hong Kong.⁷ During 1998-2007, service income from inbound tourism rose by 10% per annum, and its share in total service exports remained stable at around 16% in recent years.⁸ During 1980 -1996, exports of travel services increased at an annual growth rate of 16%, with its share of total service exports moving between 22% and 28%. Exports of travel services then declined markedly during the Asian financial crisis in 1997-98, partly reflecting recessions in the regional economies and a reduction in the number of visitors from Asia. Exports of travel services recovered starting from 2002, more than double in value between 2001 and 2007, despite a temporary dip during the SARS outbreak. However, its share of total service exports has not increased in recent years, reflecting the strong growth in offshore trade and exports of financial services (Chart 17).

Chart 17: Exports of travel services



Source: C&SD.

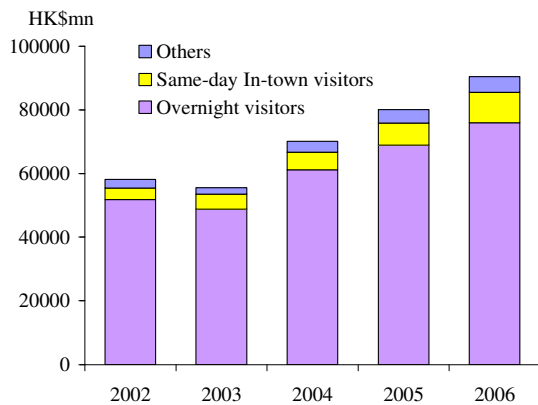
According to a regular survey conducted by the Hong Kong Tourism Board (HKTB), overnight visitors have been the major contributor to tourism spending in Hong Kong, while spending by the same-day in-town visitors is growing (Chart 18). Most of the tourism spending comes from visitors for vacation purpose, followed by business visitors (Chart 19). However, on a

⁷ Visitors refer to civilian visitors, cruise passengers, service visitors, transit passengers and foreign crews. Export of travel services includes the expenditure on all goods and services (e.g. accommodations, shopping and meals) of these visitors in Hong Kong.

⁸ Exports of travel services do not include the expenditure on transportation services by visitors, which is captured in the trade of transport services. If the expenses of passenger transportation were counted in travel services, exports of travel services would account for 22% of total service exports in 2006.

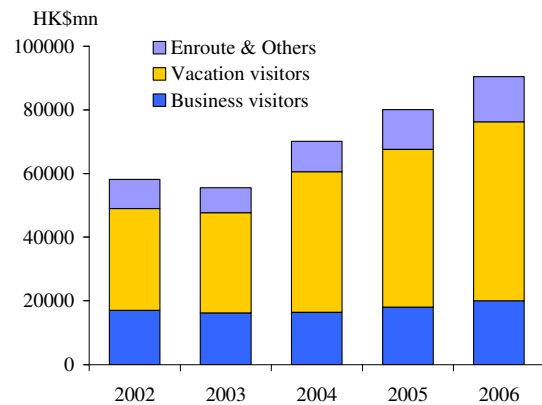
per-capita basis, spending of the latter is higher than the former. Breakdown by sources of visitors shows that Mainland visitors have been a key source of growth to the tourism industry in Hong Kong, thanks to the implementation of the Individual Visit Scheme (IVS) in July 2003 (Charts 20 and 21). In 2007, visitor arrivals from Mainland China rose by 14% to reach a record high of 15 million, of which more than half were under the IVS.

Chart 18: Total expenditure by type of visitors



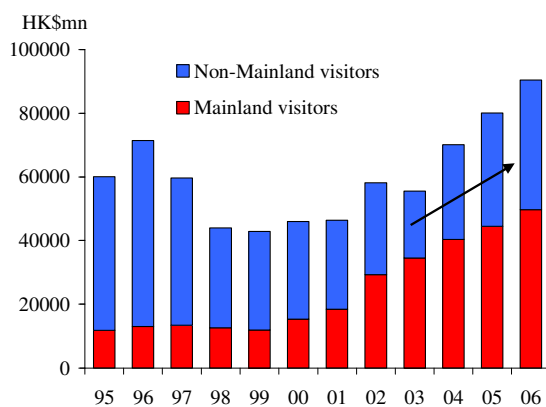
Sources: C&SD and HKTB.

Chart 19: Total expenditure by purpose of visitors



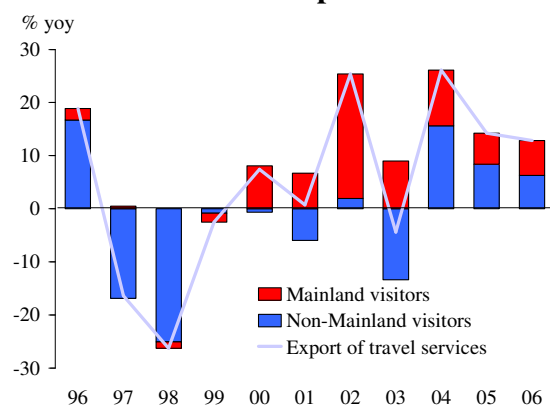
Notes: Vacation visitors refer to visitors going to Hong Kong for vacation and visiting friends/relative.
Sources: C&SD, HKTB and staff estimates.

Chart 20: Total travel expenditure by Mainland visitors



Sources: C&SD, HKTB and staff estimates.

Chart 21: Contributions to growth in total travel expenditure

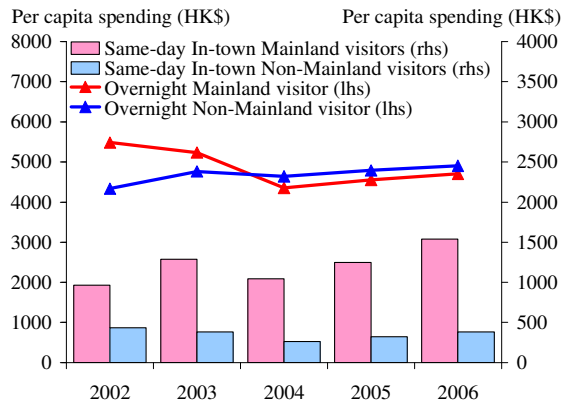


Sources: C&SD, HKTB and staff estimates.

The number of Mainland visitors coming to Hong Kong will be boosted by the extension of IVS and their spending is expected to increase along with the income growth of Mainland residents. During 2002-2006, the number of same-day in-town visitor arrivals from the Mainland grew strongly by 26% per annum while that from non-Mainland only increased slightly by 3% per annum.

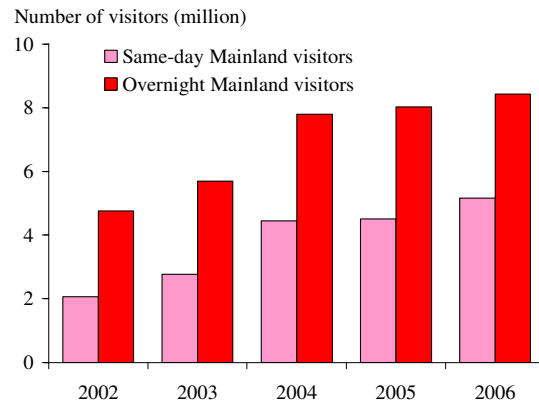
As per-capita spending of the former is almost four times that of the latter, Mainland visitors under the IVS have become an important source of income to the catering and retail sectors in Hong Kong (Charts 22 and 23).

Chart 22: Per capita spending of Mainland & non-Mainland visitors



Sources: HKTB and staff estimates.

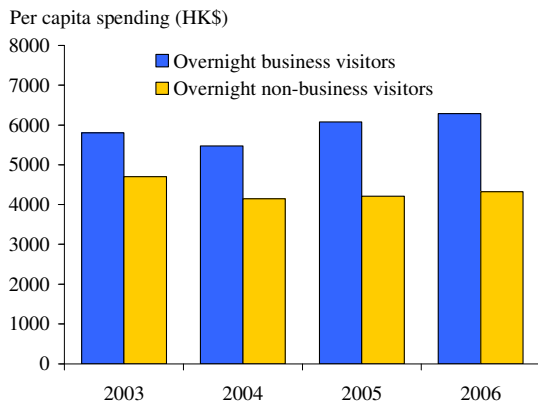
Chart 23: Number of Mainland visitors



Sources: HKTB and staff estimates.

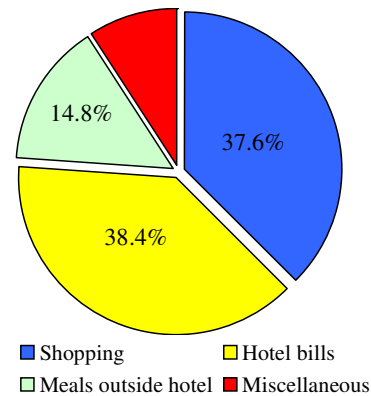
While vacation visitors have been the key driving force of the income growth in the tourism sector, contribution from business visitors is expected to rise due to the expansion of convention and exhibition activities in Hong Kong and growing business activities with Mainland enterprises following the implementation of CEPA. In terms of per-capita spending, business visitors in general create higher value-added to the domestic economy. In 2006, business visitors spent more than HK\$6,200 per trip per capita while vacation visitors spent one-third less (Chart 24). More than half of business visitor spending goes to hotel and catering services (Chart 25).

Chart 24: Spending pattern by purpose of visit



Sources: HKTB and staff estimates.

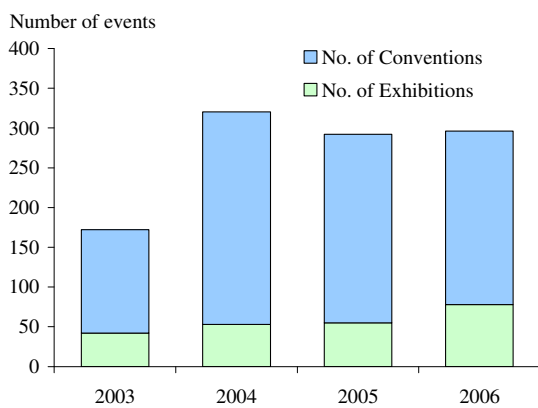
Chart 25: Spending pattern of business visitors in 2006



Sources: HKTB and staff estimates.

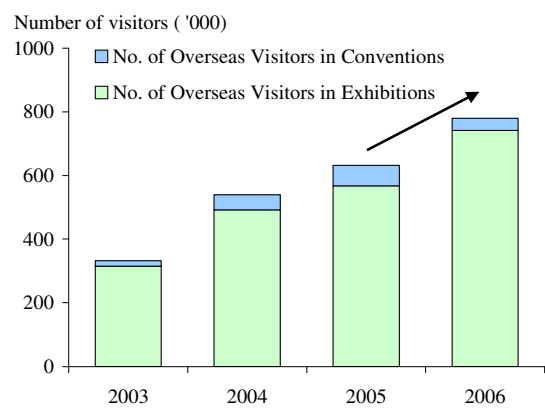
Reflecting the buoyant convention and exhibition industry in Hong Kong, the number of overseas visitors in these areas increased by 33% per annum between 2003 and 2006, thanks to the renowned and mega-size international exhibitions organized in Hong Kong (Charts 26 and 27).⁹ Spending by exhibitors and exhibition visitors is generally higher than that of other business visitors.

Chart 26: Number of events for conventions and exhibitions



Source: HKTB.

Chart 27: Number of overseas visitors in conventions and exhibitions



Source: HKTB.

⁹ For instance, Hong Kong Trade Development Council (HKTDC) organized nearly 30 world-class international trade fairs in Hong Kong each year - some of which are the largest in Asia.

III. CHALLENGES AND OPPORTUNITIES AHEAD

The near-term prospects for service exports will depend on the developments in the external environment, which has become more uncertain given the economic slowdown in the US and tighter macroeconomic measures on the Mainland. While deterioration in cyclical conditions may weigh on the external demand for services produced in Hong Kong, the potential service demand unleashed from liberalisation of the Mainland's service sector would be a strong structural factor supporting service exports in Hong Kong over the medium term.

However, keener competition within and outside Asia and growing pool of talent on the Mainland may erode the role of service intermediary performed by Hong Kong. Service providers have to strengthen their expertise in trade and financial areas by diversifying and expanding the range of services to maintain their competitiveness. The challenges and opportunities faced by service providers in Hong Kong are discussed in the following paragraphs.

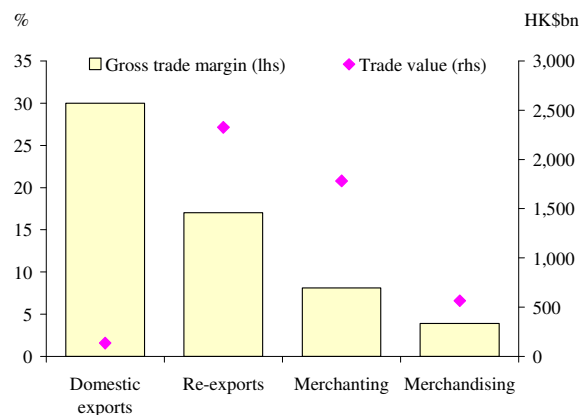
Offshore trade

As Mainland China is such a large driver of Hong Kong's offshore trade, one natural question that arises from its further development and liberalisation is whether Hong Kong will continue to have a role to play in intermediating China's exports. We note that while there would be less of a role for a middle-man given an increasingly open Chinese economy, there is still an important role for the supply chain specialist to perform sourcing, quality assurance, logistics management, and compliance work, especially as product cycles get increasingly tight.

Offshore trade earnings can grow either through volume or margin expansion. Hong Kong's trade structure has shifted from domestic exports to re-exports, and from re-exports to offshore trade, with gross trade margins declining during the process (Chart 28). However, the higher volume that can be handled in re-exports over domestic exports, and subsequently in offshore trade over re-exports, more than offset the decline in margins to enhance overall earnings. For instance, in merchandising, where the commission rate is lower than it is in merchanting, the large merchandiser Li & Fung have expanded their

handling volume and bought out the sourcing units of branded goods in ways to boost their earnings. On the other hand, trade margins can be maintained or enhanced if service providers move to provide higher value-added services, such as design and marketing, or develop new or niche markets and product knowledge. Given that Mainland's exporters are moving up the value chain, this would give service providers in Hong Kong opportunities to provide higher value-added trade-related services. Whether and how Hong Kong service providers adapt to accommodate new, higher value-added product types such as capital goods, and expand their supplier markets to increase volume, would determine how Hong Kong's offshore trade would evolve.

Chart 28: Gross margin by types of trade in 2006



Source: C&SD.

Some observations suggest that Hong Kong service providers have adapted with flexibility to protect their volume and margins in the face of increasing competitive pressures. Meanwhile, Hong Kong merchancing service providers are reportedly under mounting challenges in the face of a rising cost structure and the lack of pricing power, with margins being increasingly compressed. In response to this threat, service providers have been broadening their sourcing markets beyond the Mainland to other cost-efficient regional economies. Indeed, in offshore trade of non-Mainland origin, there is a trend towards increasing affiliation between Hong Kong service providers and the suppliers, suggesting strengthening business relationships and a more diversified supplier base. At the same time the range of destination markets has also been broadened beyond traditional markets like the US and Western Europe to such markets as Latin America and Eastern Europe.

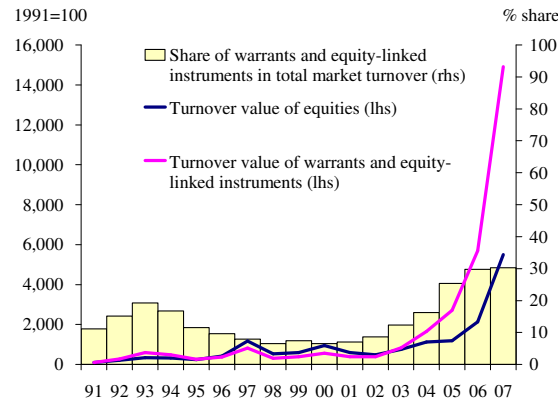
The provision of offshore trade services is an extension of Hong Kong's traditional strength in re-exports. Looking further ahead, one might see the potential for Hong Kong service providers to set up affiliates on the Mainland and in other supplier markets to provide more local and immediate trade-related services. CEPA already allows Hong Kong service suppliers to provide logistics, freight forwarding, shipping, and warehousing services in the form of wholly-owned operations on the Mainland, opportunities which Hong Kong service providers can seek to exploit. This may be a significant growth area in the future.

Financial service exports

Given the strong economic performance and the rapid accumulation of wealth and financial assets, the pace of financial development in Mainland China will be faster and more liberalisation measures will be implemented to meet the growing financing needs of households and firms. A more developed and liberalised financial system on the Mainland will pose challenges to Hong Kong in two aspects. First, the role of Hong Kong as the financial intermediary for Mainland entities could become less prominent. Secondly, growing foreign participation in Mainland's financial service sector may reduce the Mainland's demand for financial services provided by Hong Kong.

Over the medium term, a more developed and open stock exchange in Shanghai or Shenzhen may reduce the number of new listing and turnover of Mainland-related shares in Hong Kong. This could undermine the growth of service income from securities transactions in the form of underwriting and brokerage fee, which has been the key driver of financial service exports in Hong Kong. While the listing and trading of Mainland-related shares in Hong Kong have boosted financial service income from non-residents, disaggregate data show that exchange-traded equity-linked derivatives have gained importance in the stock market turnover value recently (Chart 29). In fact, it is a global trend for increasing share of derivatives trading in world's leading stock markets like New York and London, as the customised and innovative features of derivatives generate higher service income for financial institutions.

Chart 29: Turnover value of equities vs warrants and equity-link instruments

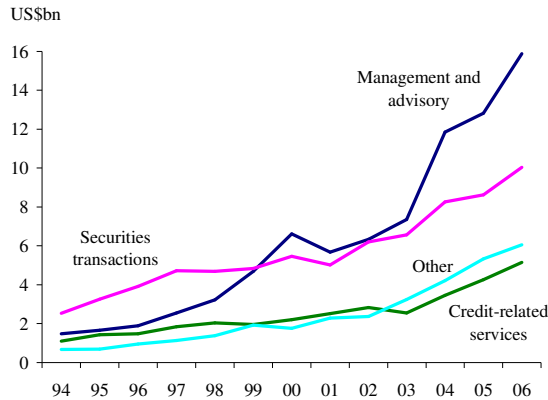


Sources: CEIC and Hong Kong Stock Exchange.

Given the growing global interest in trading and investing in Mainland-related securities, the demand for new derivative instruments for risk management and investment purposes is expected to rise over time. Hong Kong has an edge in creating and promoting new derivative products linked to equities of Mainland enterprises, and there is ample room to further develop the derivatives market following the financial liberalisation on the Mainland.

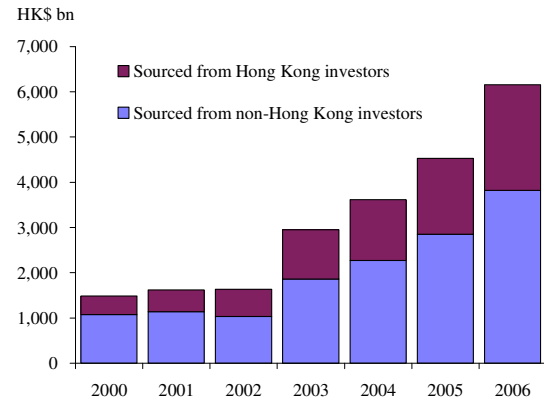
Although the recent stock market rally in Mainland-related shares has boosted the service income from securities transactions in Hong Kong, this source of income is more volatile in nature and its growth prospects depend much on the pace of financial liberalisation on the Mainland. It is desirable to diversify the sources of financial service income to other areas such as asset management and investment advisory services. In the US, income from providing fund management and investment advisory services to non-residents has registered the fastest pace of expansion among various types of financial services (Chart 30). This reflects steady growth in global demand for US dollar assets and the highly developed asset management and investment advisory industry in the US.

Chart 30: US financial service exports by service group



Source: US Bureau of Economic Analysis.

Chart 31: Hong Kong's fund management business by source of investor



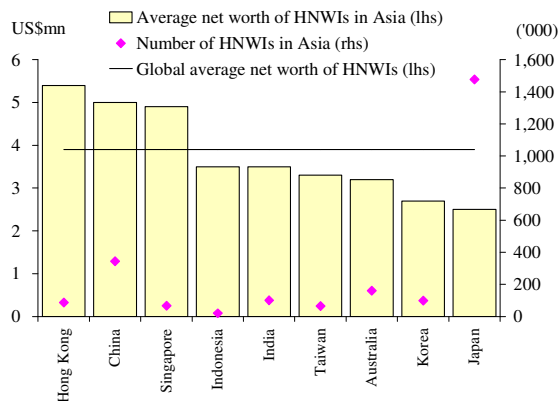
Source: Securities and Futures Commission (SFC).

Growing interests of Mainland entities to invest overseas provide great opportunities for Hong Kong to develop its fund management industry catering for the demand of private and institutional investors in Mainland China. Depending on the pace and scale of liberalisation of capital account transactions on the Mainland, private assets under management in Hong Kong could increase significantly. This will increase the service income from asset management, investment advisory and securities custody. It is expected that Mainland investors would become one of the major client groups for the asset management industry in Hong Kong (Chart 31).

Within the asset management industry, private wealth management (or private banking) could be an area with the highest growth potential in the coming years. The rapid pace of wealth accumulation and rising number of high net worth individuals (HNWIs) on the Mainland could boost the private banking business in Hong Kong (Chart 32).¹⁰ In comparison to other major players, offshore private assets under management in Hong Kong only accounted for 4% of the world total in 2005, much smaller than the 28% in Switzerland and 8% in London (Chart 33). If fund managers in Hong Kong can successfully promote their wealth management and investment advisory services to the HNWIs on the Mainland, this could be another important source of financial service income given the higher value-added nature of private wealth management services.

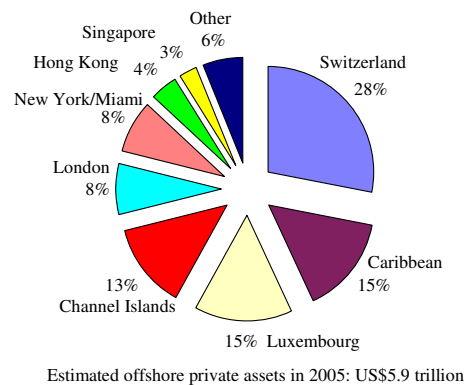
¹⁰ According to the Asia-Pacific Wealth Report prepared by Capgemini and Merrill Lynch, the number of HNWIs on the Mainland rose from 287,000 in 2003 to 345,000 in 2006.

Chart 32: Average net worth of HNWI in Asia in 2006



Source: Capgemini and Merrill Lynch.

Chart 33: Estimated destination of offshore private banking wealth, 2005



Source: Swiss Bankers' Association.

Travel service exports

Hong Kong's unique role as an international business hub and global platform for China business will continue to underpin export of travel services. In particular, with China's increasing economic and financial integration with the rest of the world after the accession to the World Trade Organisation, Hong Kong is playing an increasingly important role in helping local and foreign exporters and investors to tap into the Mainland market. Thus, the contribution from business visitors to Hong Kong's travel service exports is expected to increase. In addition, infrastructure projects announced in the 2007 Policy Address will foster cross-boundary transportation between Hong Kong and the Mainland.

Hong Kong should continue to attract more high-yield visitors who spend more and stay longer in general, by hosting more mega international events and exhibitions and promoting the M.I.C.E. (Meetings, Incentives travel, Conventions and Exhibitions) industry, which is one of the fastest growing segments within the tourism industry. Secondly, the Hong Kong Tourism Board should continue to promote Hong Kong as an Asian vacation city to long-haul visitors, introduce new scene spots and promote Hong Kong's traditional festivals.

Over the medium-term, building new exhibition venues is the key to attract business visitors. The second expansion of Hong Kong Convention and Exhibition Centre, which is scheduled for completion in early 2009, will increase the gross exhibition area by 42% to cater for the medium-term demand in the convention and exhibition industry. Hong Kong will strengthen its role as a

gateway to the Mainland market and a springboard for Mainland enterprises to venture into the global marketplace, which will attract more convention and exhibition business.

Possible constraints faced by the service providers

Similar to other highly developed trade and financial service centres, how to maintain and attract talent to work and stay in Hong Kong has been the key priority on the policy agenda of the authorities. Fostering growth and accumulation of human capital is the key to success for a knowledge-based economy like Hong Kong, as information discovery and product innovations have become increasingly important to value creation in a service-oriented economy. Over the past few years, the government has implemented a number of measures to enhance the quality of the labour force and attract more talent from overseas.

On the financial front, a well established legal system and robust financial infrastructure in Hong Kong have built a solid foundation for the future development of the financial industry. While financial liberalisation on the Mainland is a golden opportunity to expand the size and product range in the domestic financial markets, there is room to develop and expand the asset management industry in Hong Kong, particularly in the areas of private wealth management and alternative investment funds. The role of government in providing a favourable legislative environment is important to the growth and success of these specialised segments.

IV. POTENTIAL GAINS FROM GROWING INTEGRATION WITH CHINA

Following the implementation of the open-door policy in the late 1970s, the Mainland economy has been growing by nearly 10% per annum from 1980 to 2007, raising per-capita GDP by 40 times to renminbi \$19,000. The robust economic expansion and growing personal income have increased the demand for services, boosting the tertiary industry (excluding construction) to GDP ratio from 26% in the 1980s to 39% in 2007. With the Mainland economy moving up the value chain, the tertiary industry is expected to grow faster and ultimately become the largest component in GDP. This shift in the Mainland's economic structure implies spending on services will take up a larger portion in consumption and business investment, which will create enormous business

opportunities for service providers in Hong Kong.

To measure the potential gains from the continued expansion of the Mainland economy to the domestic economy, a number of scenarios are used to project the future growth path of service exports in Hong Kong. Our key question is: if the size of the Mainland economy doubles in the next decade (i.e., real GDP grows by 7% a year), how large will be the potential gains to service providers in Hong Kong? Based on some crude assumptions derived from past developments in service trade, we project different future growth paths for offshore trade, financial service exports and inbound tourism over a 10-year horizon.¹¹

Offshore trade

Trade-related service exports are expected to continue to grow at a solid pace in the medium term. Two developments in particular are likely to benefit Hong Kong's trade-related service exports. First, globalisation is likely to continue to drive the trend towards specialised supply chain management. Trade intermediation services are expected to become increasingly customised so that there continues to be a role for trade service specialists. Secondly, exports of the Mainland are moving up the value chain, which should open up the potential for the provision of higher value-added trade-related services. On the other hand, as Mainland exporters acquire experience in handling marketing and logistics arrangements, there could be a decline in the share of total Chinese exports that Hong Kong service providers help service.

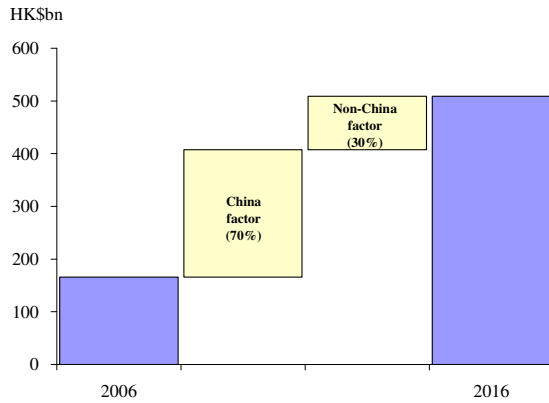
Our projections suggest that, when the size of the Mainland economy doubles from its 2006 level, which we project to take place in 2016, earnings from offshore trade of Mainland origin could reach over 11% of Hong Kong's GDP, up from 8% in 2006. This reflects both the continued importance of exports sourced from the Mainland economy, as well as the upgrading of Chinese exports in the value chain. Our assumptions are for Chinese exports to increase by 12% year on year to 2016, a rate that is slightly faster than the projected 11% growth rate of Chinese nominal GDP, but represents a slowdown from the 18% average annual growth in exports observed in 1996-2006. We also assume that the value of Hong Kong's offshore trade of Mainland origin to

¹¹ The assumptions used and the rationale behind our projections of service exports of key service groups are set out in the Annex.

gradually decline to represent 12% of the value of the Mainland's total exports by 2016, down from 17% in 2006, as bilateral trade links between the Mainland and its trading partners improve and as Hong Kong service providers who support the lower rungs of the value chain may be displaced. We continue to see a role, however, for Hong Kong service providers in facilitating Chinese exports especially in higher-value-added services and thus expect the decline in the share to taper off at some point. In terms of the trade margin, the assumption is for the weighted merchanting/merchandising margin to remain steady at 8% during our projection period, roughly in line with the 9% observed for 2006, as the upgrading of Chinese exports helps maintain the margin in the face of global and local competitive pressures. Chart 34 shows the results of our projections, which suggests that the Mainland factor would account for 70% of the growth in offshore trade earnings between 2006 and 2016.

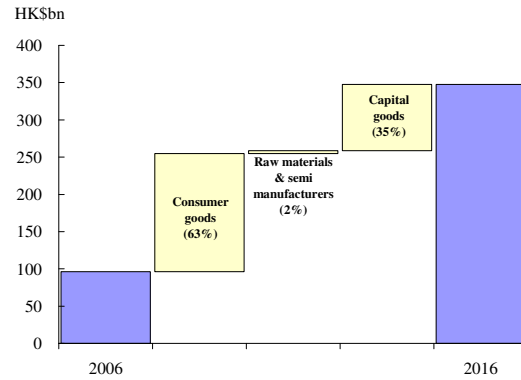
If we focus on merchanting trade of Mainland origin, our projections suggest a shifting pattern in the underlying product types, reflecting Mainland China's changing export structure and Hong Kong service providers' move to accommodate the change. Indeed recent trends suggest that, within Hong Kong's merchanting trade of Mainland origin, exports of capital goods increased at a faster rate than those of consumer goods, which in turn also grew more quickly than the exports of raw materials and semi-manufactures. In our projections, the assumptions are for consumer goods to increase by 12% per year, raw materials and semi-manufactures by 7%, and capital goods by 20% during our projection period, in line with per annum growth rates of 14%, 8%, and 27% observed in 2003-2006 respectively. In terms of trade margins, we assume them to be 11% for consumer goods, 4% for raw materials and semi-manufactures, and 7% for capital goods, in line with trends observed in re-export trade. Chart 35 shows the projection results. While consumer goods are expected to remain the largest goods category, capital goods are likely to grow to account for over one-third of the expected increase in merchanting trade earnings between 2006 and 2016.

Chart 34: Contribution from Mainland China to the projected increase of offshore trade earnings in Hong Kong



Sources: C&SD and staff estimates.

Chart 35: Merchanting trade of Mainland origin by service group



Sources: C&SD and staff estimates.

Meanwhile offshore trade of origin other than the Mainland is also projected to see solid growth, although not at rates as high as those expected of Mainland-originated offshore trade, helped by such trends as the diversification of sourcing markets amid increasing product specialisation, as well as China’s rising import demand. We assume that Hong Kong’s offshore trade of non-Mainland origin to increase by 12% a year to 2016, slightly faster than the 11% average annual growth rate observed between 2002 and 2006. The weighted merchanting/merchandising trade margin is assumed to remain steady at 4.5%, in line with the 4.4% observed in 2006. Our projections suggest that earnings from Hong Kong’s offshore trade of non-Mainland origin would grow to make up almost 5% of Hong Kong GDP by 2016, and to account for 30% of the increase in offshore trade earnings (see Chart 34). Together, Hong Kong’s total offshore trade could reach 16% of GDP in 2016, up from 12% in 2006, suggesting the continued importance of trade for the Hong Kong economy.

Financial service exports

Among the key service groups, financial service exports are expected to have the highest growth potential. The growth impetus mainly comes from two sources: growing financial integration between Hong Kong and the Mainland; and financial sector liberalisation on the Mainland. Over the past few years, a number of initiatives have been introduced to strengthen financial intermediation between Hong Kong and Mainland China, including the conduct of renminbi business in Hong Kong, the listing of H-shares on the Hong Kong Stock

Exchange and the implementation of the QDII scheme. These activities have boosted the underwriting fee, brokerage fee and management fee received by financial institutions in Hong Kong. Under the framework of CEPA, an increasing number of financial institutions in Hong Kong have set up their subsidiaries or branches on the Mainland. This also raises the sales of financial services between the parent companies in Hong Kong and their affiliates on the Mainland.

To gauge Mainland's contribution to financial service exports in Hong Kong over the next decade, we project the potential gains in service income from securities transactions, asset management and other financial services. Fee income from securities transactions mainly include underwriting fee for IPO and private placement services, and brokerage fee for trading Mainland-related shares listed in Hong Kong. With the increasing use of equity financing by Mainland enterprises, the ratio of equity funds raised to M2 increased to 1.6% in 2006 on the Mainland. If M2 grows at the same rate as nominal GDP and the ratio of equity funds raised to M2 remains stable, total equity funds raised by Mainland enterprises could increase by nearly two-fold to RMB \$1.7 trillion or 2.6% of GDP in 10 years. If about one-third of these funds are raised through the stock market in Hong Kong, total equity funds raised by Mainland enterprises in Hong Kong will double after 10 years.¹² Increased listing of Mainland shares will also boost stock market turnover in Hong Kong. If the turnover of domestic stock market in 2007 doubles in value by 2016, total service income from securities transactions (including underwriting and brokerage fee) attributable to the Mainland factors will increase to 1.5% of GDP in Hong Kong.

Service income from asset management mainly includes fund management fee and advisory fee from M&A activities. Given the bulk of private savings and limited investment opportunities on the Mainland, the Chinese authorities are expected to further open up its capital account to allow orderly outflow of private capital. Hong Kong will play a pivotal role in channelling these funds to domestic and overseas markets. Our previous studies suggest that if the Mainland economy is mature enough with its capital account as liberalised as in a typical OECD economy, its outward portfolio investment position could

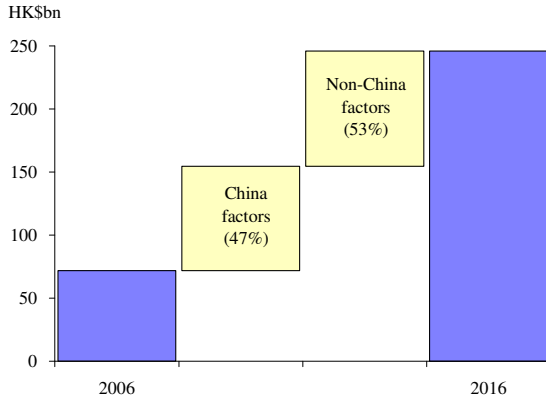
¹² In 2007, Mainland enterprises raised more than half of their equity funds through the Stock Exchange in Hong Kong. It is expected that a more liberalised stock market on the Mainland will attract more enterprises to raise equity funds in the domestic market in the future. As a result, the projected portion of equity funds raised by Mainland enterprises in Hong Kong may decline over the next decade.

increase from the current 9% of GDP to 23% of GDP.¹³ Reflecting the rise of Hong Kong's share in world stock market capitalisation as a result of increased listing of Mainland shares, the estimated share of Mainland's outward portfolio investment captured by Hong Kong could increase to around 15%. Based on these estimates and the standard fund management fee of 0.5%, the projected fee income could rise to 0.5% of GDP by 2016. Growing foreign participation in the Mainland's service industry will increase cross-border M&A activities on the Mainland. Suppose its size doubles in 10 years and about half of these M&A activities are arranged by financial institutions in Hong Kong, the combined fee income from fund management and M&A advisory services due to the Mainland factors could reach HK\$20 billion or 0.6% of GDP.

Combining the projected earnings from the provision of credit facilities, clearing services and other financial services to Mainland entities, the Mainland factors could possibly contribute to 47% of the gain in Hong Kong's financial service exports in 10 years, with the rest of service income generating from places outside China (Chart 36). Growing financial integration between Hong Kong and the Mainland suggests that contribution from the Mainland factors to financial service exports in Hong Kong could increase from 28% in 2006 to 42% in 2016. Disaggregate data show that about 38% of Mainland's contribution to the rise in financial service exports is due to securities transactions including underwriting and brokerage fee. The rest is shared by service income from asset management (22%) and other financial services (40%) (Chart 37).

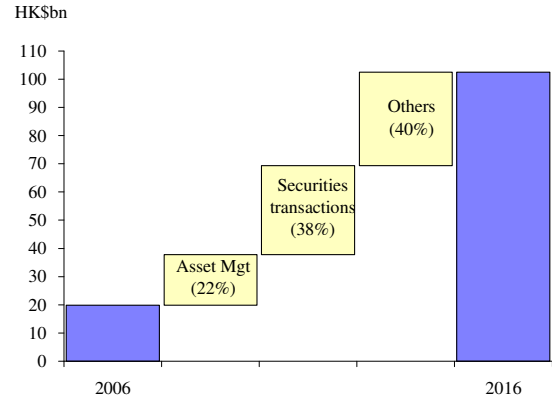
¹³ See "Outward Portfolio Investment from Mainland China: How Much do We Expect and How Large a Share can Hong Kong Expect to Capture?" by Lillian Cheung et. al., Research Memorandum 13/2006, Hong Kong Monetary Authority, September 2006.

Chart 36: Contribution from Mainland China to the projected increase of financial service exports in Hong Kong



Source: Staff estimates.

Chart 37: Mainland's contribution to financial service exports by service group



Source: Staff estimates.

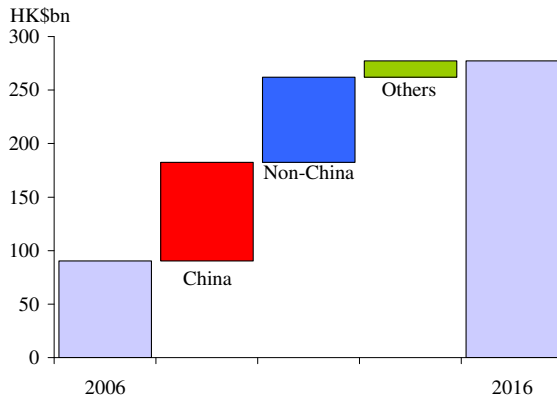
If the projected growth path for financial service exports realises over the next 10 years, its share of GDP would double from 5% in 2006 to 8% in 2016. This will probably raise the share of financial sector output in GDP from the current 14% to 20% in 10 years, comparable to that in London and New York.

Travel service exports

Based on our assumptions of GDP growth for the Mainland and Hong Kong economies, exports of travel services are expected to increase at 12% per annum to reach 9% of GDP in 2016. Breakdown by source of visitors suggests that more than half of the increase in inbound tourism earnings is due to Mainland visitors, thanks to the stronger renminbi and the expected extension of the IVS (Chart 38). We adjust downward the spending growth of overnight vacation visitors from the Mainland, but expect stronger spending growth of overnight business visitors over the next 10 years (Chart 39).¹⁴

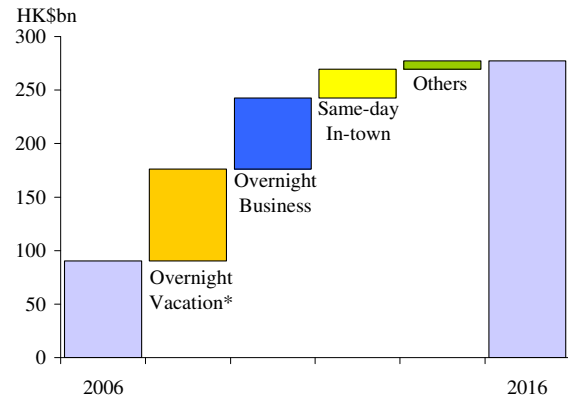
¹⁴ The expenditures of visitors are simply calculated by number of arrivals and per-capita spending. The growth of vacation visitor arrivals is assumed to moderate, reflecting the lack of sightseeing scene in Hong Kong and the more developed tourism industry on the Mainland, which will divert Mainland visitors from Hong Kong. Business visitor arrivals, however, are expected to grow more notably, because of growing business activities and better prospect of the convention and exhibition industry. Per-capita spending on all visitors is also assumed to grow steadily, in line with the expected inflation in Hong Kong and increasing foreign household income. In particular, spending by Mainland visitors would continue to rise on the back of robust economic growth on the Mainland.

Chart 38: Projected increase in travel service exports by source of visitors



Source: Staff estimates.

Chart 39: Projected increase in travel service exports by type of visitors



* Include tourists for visiting friends and relatives.
Source: Staff estimates.

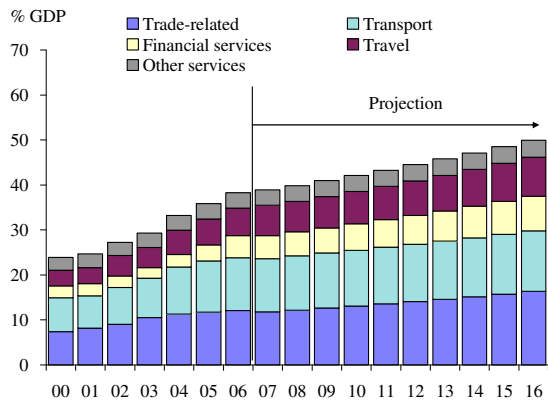
Projected contribution from service exports to GDP

Given the projected growth paths of offshore trade, financial and travel service exports, separate projections on exports of transport services and other business services are made to come up with the estimated growth path for total service exports over a 10-year horizon. Since trade in transport services tracks closely re-export trade and the flow of passengers, the weighted average of the growth rates of passenger and freight/cargo transport is used to project growth in transport services, which is about 9% per annum. Hong Kong’s exports of other business services, including insurance, professional and personal services, have been largely offset by imports during the past two decades, thus the growth paths for exports and imports of other business services are projected to be roughly the same, and similar to the growth rate of nominal GDP.

Based on the projections on exports of the five key service groups (offshore trade, financial, travel, transport and other business services), service exports are projected to grow by 11% per annum in nominal terms over the next 10 years, raising its ratio to GDP from 38% in 2006 to 50% in 2016. Offshore trade is likely to remain the largest component in service exports, while financial service exports would be the fastest growth area thanks to financial sector liberalisation on the Mainland. This will raise the share of financial service exports in total service exports from 13% in 2006 to 15% by 2016 (Chart 40).

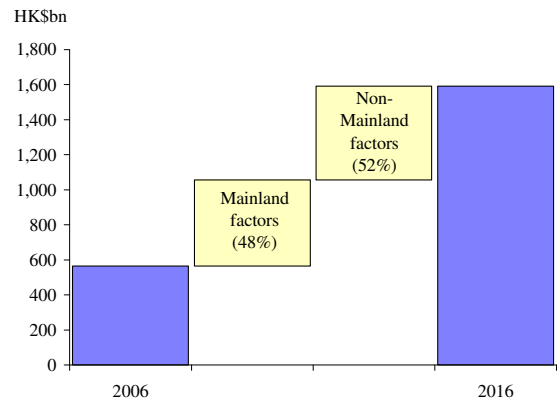
What does our projection mean to the Hong Kong economy? First, Mainland China is expected to be the major driver of service exports in Hong Kong, as nearly half of the gain projected over 2006-16 could be attributable to the Mainland factors (Chart 41). Secondly, the robust expansion in trade in financial services will strengthen the status of Hong Kong as an international financial centre, serving the growing financial needs from Mainland entities. Finally, growing importance of trade in services to the Hong Kong economy could be a catalyst for service providers to move up the value chain in the face of keener global competition.

Chart 40: Projected service exports to GDP ratio by service group



Sources: C&SD and staff estimates.

Chart 41: Projected contribution from the Mainland factors to service exports



Source: Staff estimates.

V. CONCLUSIONS

This paper provides an overview of the recent developments in service exports in Hong Kong. It shows how service exports have become an increasingly important contributor to economic growth, and looks at the drivers behind the growth of three key service groups, namely trade-related, financial and travel services.

The paper also offers a baseline scenario on the growth of service exports in the medium term. The projection results suggest that service exports would take on an increasingly important role in the Hong Kong economy, accounting for 50% of GDP in 2016, up from about 40% in 2006. While trade-related service exports are expected to remain the largest service group,

financial service exports have the highest growth potential. Meanwhile, travel service exports are expected to grow faster than imports to result in a surplus in this service group.

Mainland factors feature prominently in the projected growth path of Hong Kong's service exports. Because of the rapid economic growth and rising service demand in Mainland China, as well as the deepening economic and financial integration between Hong Kong and the Mainland, Mainland factors are expected to contribute to 48% of the growth of service exports between 2006 and 2016.

While our baseline scenario suggests a positive outlook, there are challenges and risks. A central challenge common to all service groups is the need to move up the value chain. This is especially important in the face of increasing domestic and foreign competition on the Mainland and in other regional economies, markets which are likely to be the key drivers of Hong Kong's service exports growth. At the policy level, the need to develop and retain human capital becomes increasingly important for a service-oriented economy like Hong Kong.

Annex

Key Assumptions Used in the Projection of Service Exports

I. General assumptions for the Mainland economy

Assumptions	Remarks
<ul style="list-style-type: none"> • Real GDP to double from 2006 to 2016 	<p>This is equivalent to 7% per-annum growth. Real GDP last doubled in the eight years from 1998 to 2006.</p>
<ul style="list-style-type: none"> • GDP deflator to grow by 4% per annum 	<p>GDP deflator grew by 2.1% a year during 1998-2006. The faster growth rate reflects higher inflation pressures driven by domestic demand in the coming years.</p>
<ul style="list-style-type: none"> • The renminbi appreciates to 5.0 per US dollar by 2016 	<p>This is equivalent to a 5% appreciation of the RMB against the USD per year over the projection period.</p>

II. General assumptions for the Hong Kong economy

Assumptions	Remarks
<ul style="list-style-type: none"> • Real GDP to grow by 5% a year in 2006-16 	<p>Official medium-term forecast.</p>
<ul style="list-style-type: none"> • GDP deflator to grow by 3% per annum 	<p>This is higher than the official medium-term forecast, in part reflecting a faster growth in Mainland's GDP deflator.</p>
<ul style="list-style-type: none"> • The Hong Kong dollar weakens to 1.6 per renminbi by 2016 	<p>This reflects the linked exchange rate between HKD and USD, and the gradual appreciation of renminbi against the USD.</p>

III. Assumptions used in the projection of trade-related service exports

Assumptions	Remarks
<p><i>Mainland related assumptions</i></p> <ul style="list-style-type: none"> ● Mainland's exports to grow by 12% a year to 2016 ● Value of Hong Kong's offshore trade of Mainland origin to equal to 12% of China's exports in 2016 ● The weighted trade margin of Hong Kong's merchanting and merchandising trade of Mainland origin to average 8% over the projection period <p><i>Value of Hong Kong's merchanting trade of Mainland origin by product category</i></p> <ul style="list-style-type: none"> ● Consumer goods to grow by 12% per year ● Raw materials and semi-manufactures to grow by 7% per year ● Capital goods to grow by 20% per year <p><i>Trade margin of Hong Kong's merchanting trade of Mainland origin</i></p> <ul style="list-style-type: none"> ● Consumer goods to be 11% ● Raw materials and semi-manufactures to be 4% ● Capital goods to be 7% <p><i>Other assumptions</i></p> <ul style="list-style-type: none"> ● Value of Hong Kong's offshore trade of non-Mainland origin to grow by 12% per year ● The weighted merchanting / merchandising margin of Hong Kong's offshore trade of non-Mainland origin to be 4.5% 	<p>Mainland's exports grew by an annual average of 24.7% in 2001-2006. A slowdown is assumed as the Chinese economy becomes more domestic demand oriented.</p> <p>The share observed in 2006 was 17%. The assumption is for a gradual decline in the share as bilateral trade links between the Mainland and its trade partners improve.</p> <p>The equivalent was 9% in 2006.</p> <p>The annual average growth rate was 14% in 2003-06.</p> <p>The annual average growth rate was 8% in 2003-06.</p> <p>The annual average growth rate was 27% in 2003-06.</p> <p>The overall rate averaged 10.6% in 2002 to 2006. Our assumed trade margins for different product categories are made based on trends observed in re-export trade.</p> <p>The annual average growth rate was 11% in 2003-06.</p> <p>The rate was 4.4% in 2006.</p>

IV. Assumptions used in the projection of financial service exports

Assumptions	Remarks
<ul style="list-style-type: none"> ● Equity funds raised by Mainland enterprises in Hong Kong to double by 2016, equivalent to 7% growth per annum ● Stock market turnover value to double by 2016 from its level in 2007 ● Cross-border M&A in Hong Kong to double in 10 years ● Assume Hong Kong captures 15% of outward PI from the Mainland by 2016, equivalent to HK\$3.4 trillion ● Interest income from providing credit services through the banking sector to double in 10 years ● Mainland demand would account for about 40% of exports of other financial services 	<p>Assume the total equity funds raised by Mainland enterprises (A-shares and H-shares) remain stable at 1.6% of Mainland's M2, and about one-third is raised in Hong Kong.</p> <p>This reflects the rapid expansion in trading of Mainland-related shares and equity-linked derivatives listed on the Hong Kong Stock Exchange. The participation rate of overseas investor is projected to rise to 50% in 2016 from 40% in 2006.</p> <p>Assume about half of cross-border M&A arranged in Hong Kong is related to Mainland enterprises.</p> <p>Total outward PI from the Mainland is projected to be 23% of its nominal GDP.</p> <p>Mainland entities are projected to generate one-third of credit service business for the Hong Kong banking sector, compared to around 20% in 2006.</p> <p>This reflects increases in custody fee and securities lending fee from managing the sizable PI assets held by Mainland entities, and growing contribution from Mainland business to financial service providers in Hong Kong.</p>
<i>Fee structure of financial services</i>	
<ul style="list-style-type: none"> ● Underwriting fee for IPO and private placement services is assumed to be 2.5% ● The standard brokerage fee for securities transactions is 0.25% of the trading size ● Financial advisory fee for M&A services is about 2.0%. ● The standard management fee for fund management is about 0.5% of the asset size 	<p>Average underwriting fee for arranging IPO and private placement services for Asian and Mainland companies is around 2.5-3.0%.</p> <p>Advisory fee for legal and accounting services for M&A is about 2.0%.</p> <p>Asset management fee varies for different types of funds, ranging from as little as 0.15% for passive funds to 2.0% or more for actively managed equity funds.</p>

V. Assumptions used in the projection of travel service exports

Assumptions	Remarks
<i>Number of visitors</i>	
<p><i>Mainland visitors</i></p> <ul style="list-style-type: none"> • Overnight visitors: Arrivals to grow by 5% per annum in 2006-16. • Same-day in-town visitors: Growth of arrivals is assumed to decline starting in 2009, averaging 5% per annum in ten years. <p><i>Non-Mainland visitors</i></p> <ul style="list-style-type: none"> • Overnight visitors: Growth of arrival is expected to ease gradually, averaging 5% per annum in 2006-16. • Same-day in-town visitors: Growth is assumed to decline starting in 2009, averaging 5% per annum in ten years. <p><i>Vacation visitors</i></p> <ul style="list-style-type: none"> • Growth of vacation visitor arrivals is expected to decline, from 10% per annum in 2004-06 to an average rate of 6% per annum in ten years. <p><i>Business visitors</i></p> <ul style="list-style-type: none"> • Growth of business visitor arrivals is assumed to increase, from 6% per annum in 2004-06 to an average rate of 7% per annum in ten years. 	<p>The growth rate reflects the effect of extension of the IVS and tourism developments on the Mainland.</p> <p>Improvement in the tourism industry on the Mainland will divert Mainland tourists from Hong Kong.</p> <p>Due to improvement in the tourism industry and better transportation system on the Mainland.</p> <p>Same as the above.</p> <p>Reflecting the lack of sightseeing scene in Hong Kong and improvement in the tourism industry on the Mainland.</p> <p>Growing business activities and boom in the convention and exhibition sector in Hong Kong.</p>

V. Assumptions used in the projection of travel service exports (Continued)

Assumptions	Remarks
<i>Per-capita spending</i>	
<p><i>Mainland visitors</i></p> <ul style="list-style-type: none"> • Overnight visitors: per capita spending is expected to grow at 5% a year. • Same-day in-town visitors: Growth rate is assumed to decline gradually, averaging 9% per annum in ten years. <p><i>Non-Mainland visitors</i></p> <ul style="list-style-type: none"> • Overnight visitors: Growth is expected to increase by 6% per annum in 2006-16. • Same-day in-town visitors: Growth rate is assumed to decline until reaching 3%. <p><i>Vacation visitors</i></p> <ul style="list-style-type: none"> • Per-capita spending by vacation visitor is projected to grow by 5% per annum in ten years. <p><i>Business visitors</i></p> <ul style="list-style-type: none"> • Per-capita spending by business visitor is projected to grow in line with past growth in 2004-06, at an average annual growth rate of 7%. 	<p>Average annual growth rate of 4% in 2004-06. The expected higher growth rate reflects renminbi appreciation and per-capita income growth.</p> <p>Average annual growth rate of 21% in 2004-06. The lower growth rate is due to development of tourism industry on the Mainland, which will divert Mainland visitors from Hong Kong.</p> <p>More high-yield visitors are expected because of more business and long-haul vacation visitors with higher spending power.</p> <p>Due to foreign income growth and expected domestic inflation.</p> <p>More high-yield business visitors amid a booming convention and exhibition industry are expected.</p>

VI. Assumptions used in the projection of transportation service exports

Assumptions	Remarks
<i>Passenger</i>	
<ul style="list-style-type: none"> Total number of visitor arrivals to grow as projected in the travel service section Value of passenger transportation service exports per visitor to grow at 6% a year to 2016 	The annual average growth rate was 8% in 2005-2006.
<i>Freight</i>	
<ul style="list-style-type: none"> Hong Kong's exports to grow by 8% per year to 2016 The ratio of freight service exports to Hong Kong's exports is assumed to stay at 4%. 	<p>The annual average growth rate was 9% in 2000-2006.</p> <p>The ratio was 4% in 2006.</p>
<i>Others (including airport/port operations and ship chartering)</i>	
<ul style="list-style-type: none"> Airport/port operations and other transportation service exports to grow at 11% per year to 2016 	The annual average growth rate was 10% in 2002-2006.

VII. Assumptions used in the projection of other business service exports

Assumptions	Remarks
<ul style="list-style-type: none"> Exports of other business services grow by 9% per annum. 	Past experience shows that exports of other business services generally grow faster than nominal GDP. We expect this to continue given the growing service demand from the Mainland. Contribution of demand from Mainland entities is projected to increase to one-third of the total by 2016, up from 24% in 2006.

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