FEATURE ARTICLE

# Service exports: The next engine of growth for Hong Kong?

*by Frank Leung, Kevin Chow, Jessica Szeto and Dickson Tam of the Research Department*

Increasing economic integration with Mainland China has contributed to the rapid expansion of service exports in Hong Kong. With vibrant expansion in offshore trade and strong growth in financial service exports and inbound tourism, service exports have been growing at 10-20% per annum in recent years. Underpinned by growing demand from the Mainland, service exports are expected to sustain robust growth in the medium term. Trade-related service exports will remain the largest group, while financial services exports have the greatest growth potential, and exports of travel-related services will continue to grow at a solid pace.

## I. Introduction

Service exports have become an important source of income growth for the Hong Kong economy. At the current expansion rate of 10-20% per annum, service exports will 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 the 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 Partnership Arrangement (CEPA) since 2003 has created new business opportunities for service providers in Hong Kong. The Mainland's recent financial sector reforms and capital account liberalisation have also boosted Hong Kong's fund-raising and asset management activities. Indeed, the Mainland is now the largest buyer of services produced in Hong Kong followed by the US, and its significance is growing.

This article reviews recent developments in Hong Kong's trade in services and discusses its future prospects. Section II analyses the main 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 highlights possible constraints faced by service providers in Hong Kong. Section IV concludes.

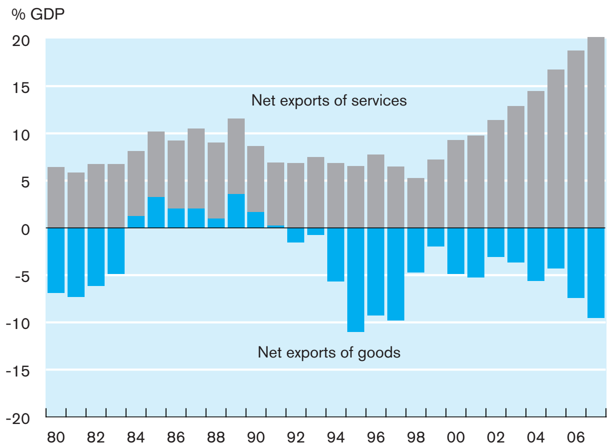
## II. Service exports as a key driver of economic growth

The surplus in services trade has been growing strongly in recent years, and in 2007 accounted for 20% of GDP, 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 strong growth in services exports relative to imports (Chart 2). The global trend of services increasingly taking on tradable characteristics and becoming more specialised can be seen from the rise in off-shore servicing and growing business flows between the parent company and its affiliates overseas. Hong Kong has positioned itself well to capitalise on this trend, given its proximity to Mainland China, and its competitive advantage in trade and financial services.

A breakdown of the figures shows 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 from the 1990s, but the deficit has been narrowing recently due 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] At the same time, a more salient feature has been the fast-growing exports of financial services, in part reflecting increasing financial

CHART 1

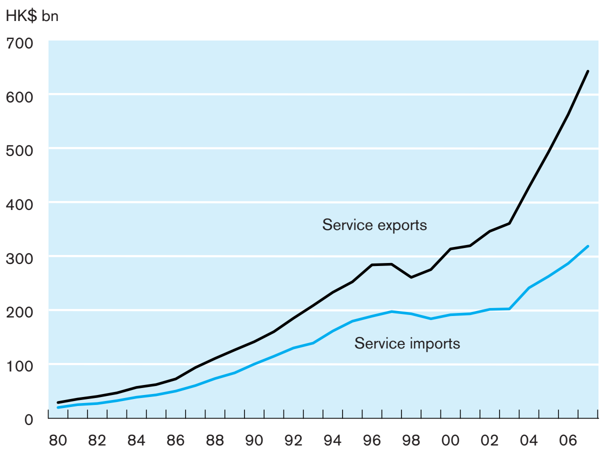
**Net exports of goods and services in Hong Kong**




Source: C&SD.

CHART 2

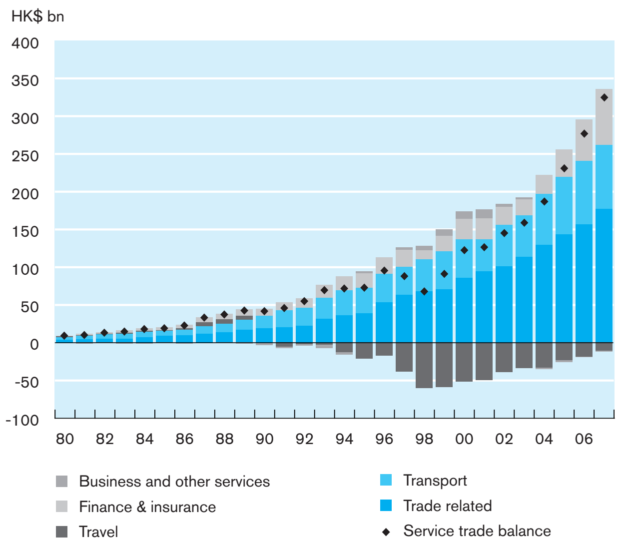
**Service exports and imports in Hong Kong**




Source: C&SD.

CHART 3

**Contribution to net service exports by service group**



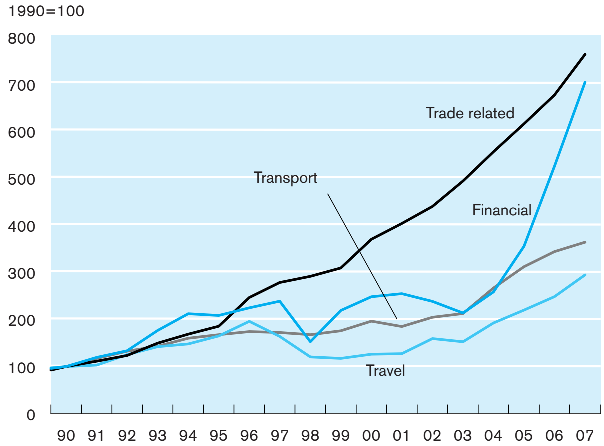

Source: C&SD.

[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.

integration between Hong Kong and the Mainland (Chart 4).

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 Mainland origin merchandise 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 (IVS) by the Chinese authorities was another strong boost to Hong Kong's tourism industry, raising its contribution to GDP from 2.3% in 2000 to 3.2% in 2006.

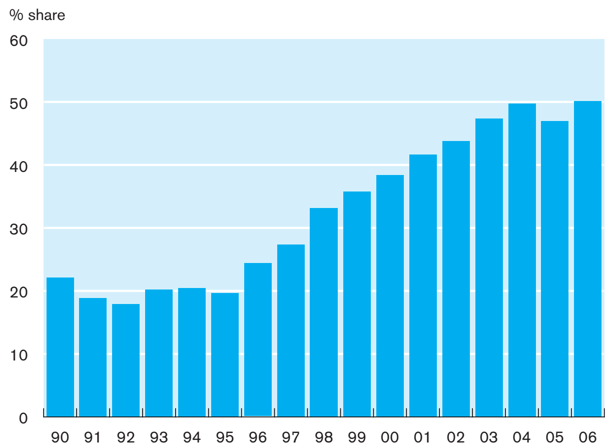
As trade in services is also the largest contributor to the current account surplus, the factors driving the growth of service exports are not only important for understanding GDP growth, but also have important implications for Hong Kong's external payment position. In the following sections, we take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

## *Offshore trade*

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 Hong Kong. In 2007, they accounted for nearly one-third of Hong Kong's total service exports, making it the largest component of service exports. In recent years, Hong Kong's traditional strength in handling re-exports has been coupled with the rise in 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. This indicates the rising importance of earnings from the provision of trade-related services (Chart 5).

CHART 5

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

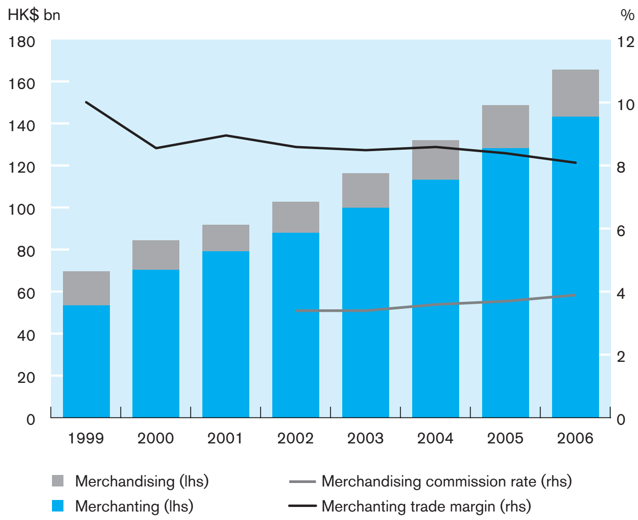



Sources: C&SD and staff estimates.

Over 90% of the trade-related service earnings is derived from merchanting and merchandising for offshore transactions, which together are also known as offshore trade.[2] Merchanting refers to the trading of goods that 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 has been a major contributor to 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, however, makes a smaller contribution to the growth of trade-related service exports (Chart 6).

CHART 6

**Gross offshore trade earnings and commission rate by service group**




Source: C&SD.

One of the reasons for the rapid growth in merchanting trade has been the increasingly complex global supply chain, which led to importers' demands for a broader range of services and more risk-sharing with their suppliers. For the importer, the outsourcing of such operations as sourcing, production and logistics helps to reduce the risks involved in working with different suppliers and co-ordinating from overseas. Some tasks are also less costly for the merchanting service provider than for the importer, such as ensuring compliance with relevant environmental and labour standards, where local knowledge and expertise are needed. In addition, with Hong Kong's robust legal system, importers may 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 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 the face of keen global competition.[3]

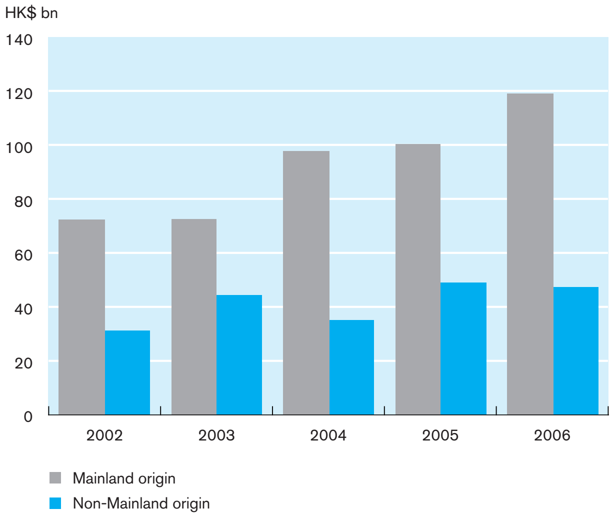
[2] Other than merchanting and merchandising for offshore transactions, trade-related services also include merchandising for onshore trade as well as other services such as the arrangement of sub-contract processing services. But, as these make up a small share of total trade-related services exports,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

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

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 and the higher trade margin (Chart 7). This is not surprising given the robust trade performance of Mainland China in recent years, the role it plays in the global supply chain, and Hong Kong's long-standing role as an entrepôt for Chinese exports. While the Mainland may have developed the requisite port facilities and the necessary logistics expertise to handle direct shipments, important gaps in the supply chain still exist that Hong Kong service providers can fill, including finding overseas buyers and meeting their quality standards, as well as sourcing raw materials and parts and co-ordinating work with other suppliers. 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 origins (Chart 8).

CHART 7

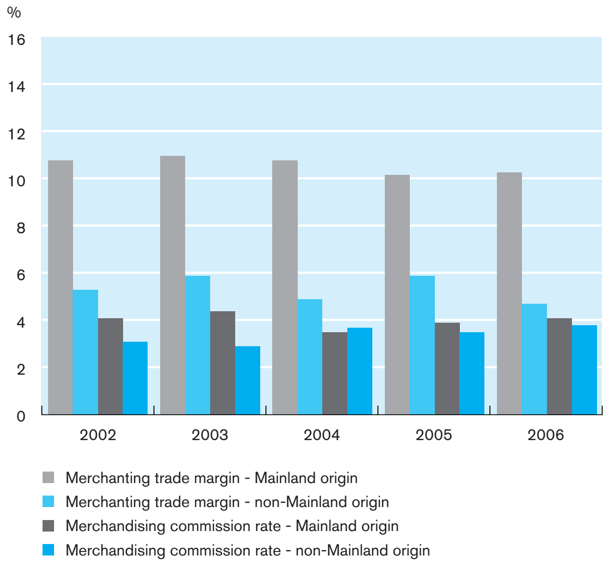
**Gross margin/commission earnings from offshore trade by origin of supplier**




Source: C&SD.

CHART 8

**Gross trade margin and commission rate by service group and origin of supplier**



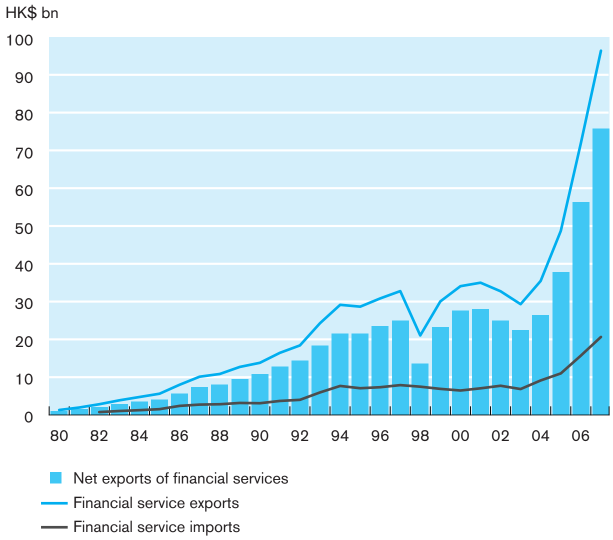

Source: C&SD.

## *Exports of financial services*

Financial service exports have registered remarkable growth in recent years, more than tripling their 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

CHART 9

**Financial service exports and imports**

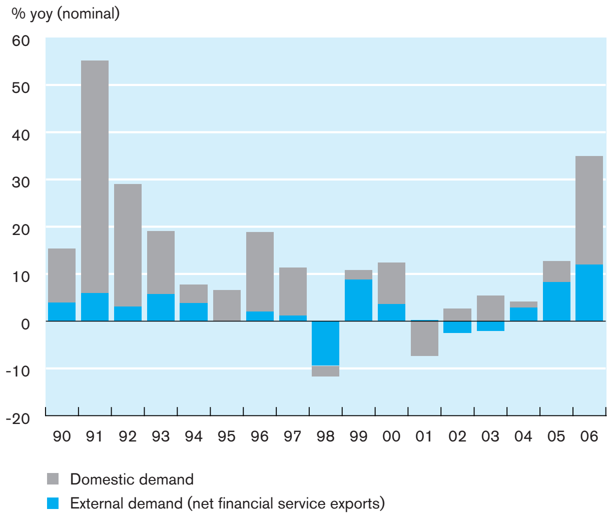



Source: C&SD.

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%. About 40% of output growth in the financial sector could be attributed to external demand (Chart 10).

CHART 10

Contribution of financial service exports to financial sector output

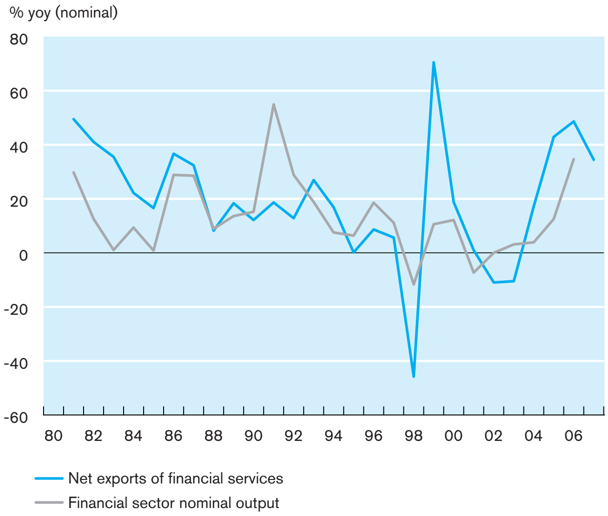



Sources: C&SD and staff estimates.

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 closely tracked growth in financial sector output (Chart 11). However, 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 1997-1998 and the bursting 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

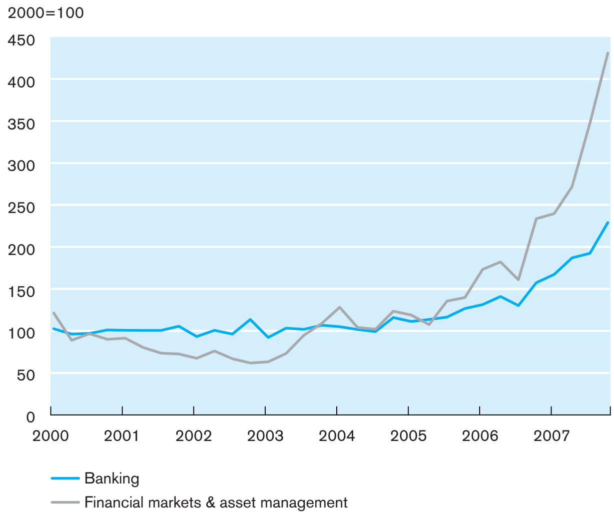
Net financial service exports and financial sector output




Source: C&SD.

CHART 12

Business receipts of banking and non-bank financial services

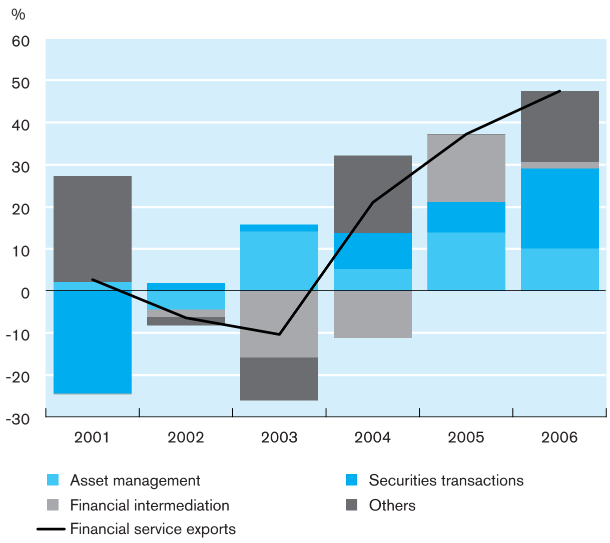



Source: C&SD.

Like other international financial centres such as New York and London, Hong Kong has successfully attracted companies and private capital from around the world, particularly within the Asian region, to use its financial services and infrastructure. External demand has played an important role in boosting financial sector activities, especially in areas like asset management and securities transactions. In general, financial services could be broadly grouped into four categories – 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). Their combined share in financial service exports increased from 30% in 2001 to nearly 60% in 2006 (Chart 14).

CHART 13

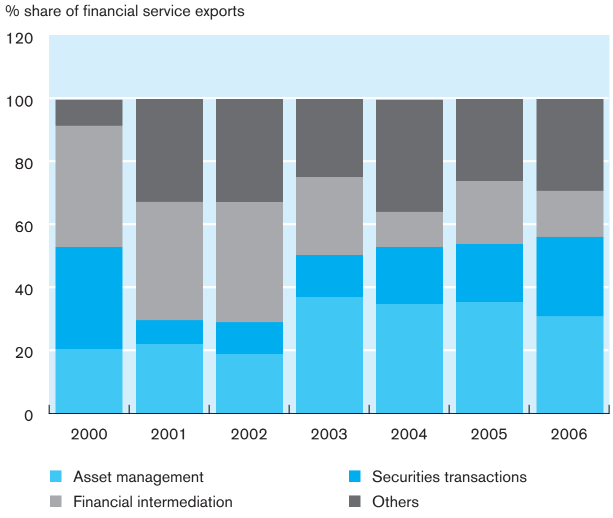
**Contribution to growth in financial service exports**




Sources: C&SD and staff estimates.

CHART 14

**Share of financial service exports by service group**




Sources: C&SD and staff estimates.

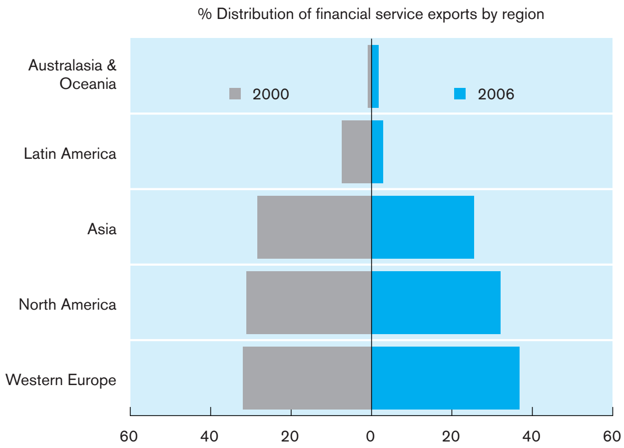
The growing significance of asset management and securities transaction services in Hong Kong's financial service exports reflects the shift from traditional banking business to areas with higher value-added, which is a natural outcome as the domestic financial industry moves up the value chain. Indeed,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

Despite growing fund-raising activities by Mainland enterprises in Hong Kong, the US remains the largest destination of Hong Kong's financial service exports, followed by the UK and Singapore. Grouping by region, Western Europe and North America contributed more than two-thirds to total export earnings of financial services in 2006, while Asia

[4] We follow the classification of financial services used by the US Bureau of Economic Analysis. 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 and clearing services.

contributed a quarter (Chart 15). The contribution from China remains tiny, at about 3% of Hong Kong's exports of financial services.

CHART 15
Financial service exports by major destination

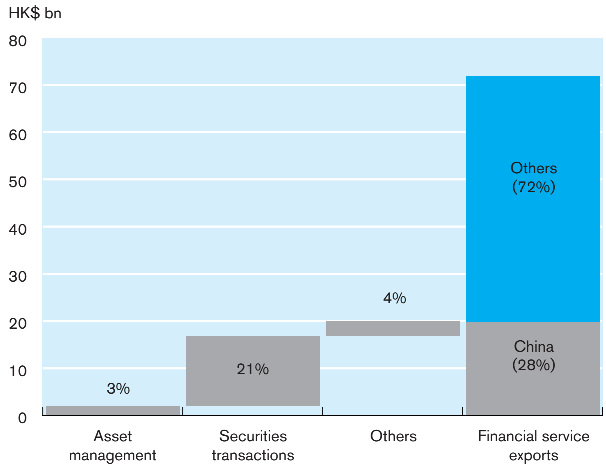



Source: C&SD.

However, alternative measures point to the growing importance of Mainland factors in the recent expansion of financial service exports. To gauge the benefits derived from increasing financial integration with the Mainland, four major areas of financial developments are used to measure the contribution of Mainland factors to Hong Kong's financial industry. These include: 1) the increased number of Mainland shares listed in Hong Kong; 2) the increased turnover of Mainland-related shares in the Hong Kong stock market; 3) the rise of merger and acquisition activities in Hong Kong and Mainland China; and 4) increased inward portfolio investment from Mainland investors.

A crude estimate, based on survey results and information on the fee structure of these financial services, shows that about 30% of financial service exports in 2006 could be attributed to Mainland factors. This mainly reflected the sizable underwriting fee from IPO services and brokerage fees from trading Mainland-related shares by non-residents (Chart 16).[5]

CHART 16
Financial service exports contributed by Mainland factors in 2006




Source: Staff estimates.

## Exports of travel services

Exports of travel services measure the expenditure on goods and services consumed by overseas visitors in Hong Kong.[6] During 1998-2007, service income from inbound tourism rose by 10% a year, and its share in total service exports remained stable at around 16% in recent years.[7] During 1980-1996,

[5] 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 Mainland factors, even though most of overseas investors are from places outside China.

[6] Visitors refer to civilian visitors, cruise passengers, service visitors, transit passengers and foreign crews. Exports of travel services include the expenditure on all goods and services (e.g. accommodation, shopping and meals) of these visitors in Hong Kong.

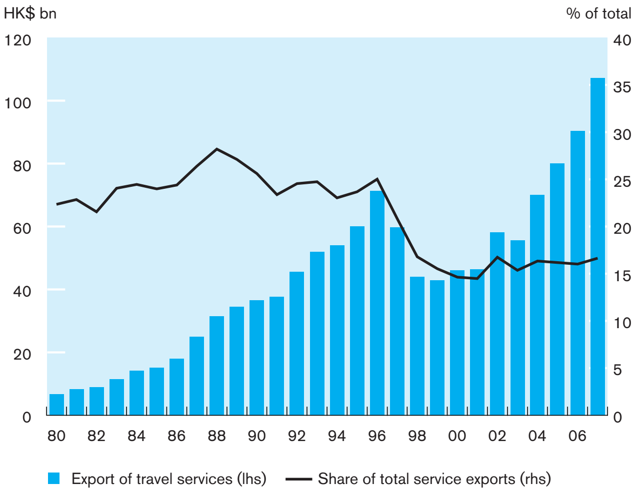
[7] Exports of travel services do not include the expenditure on transportation services by visitors, which is captured in the trade of transport services. If the expenses of passenger transportation were counted in travel services, exports of travel services would account for 22% of total service exports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

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, partly reflecting recessions in the regional economies and a reduction in the number of visitors from Asia. Exports of travel services recovered from 2002, more than doubling 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).

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 same-day in-town visitors is growing (Chart 18). Most of the tourism spending comes from visitors on vacation, followed by business visitors (Chart 19). However, on a per-capita basis, business spending is higher. A breakdown by sources of visitors shows that those from the Mainland have been a major driver of growth to Hong Kong's tourism industry, through the

CHART 17

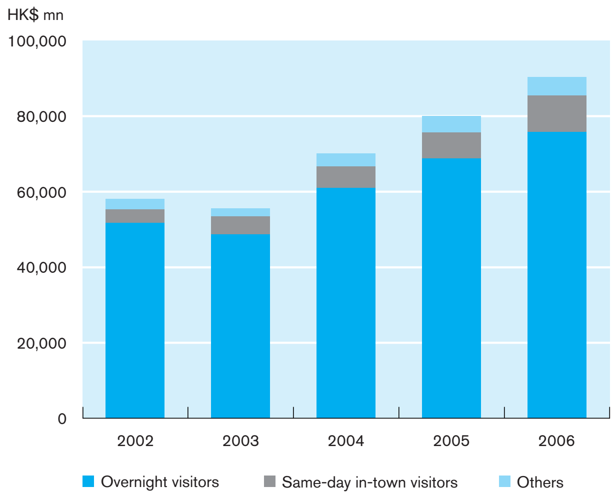
**Exports of travel services**




Source: C&SD.

CHART 18

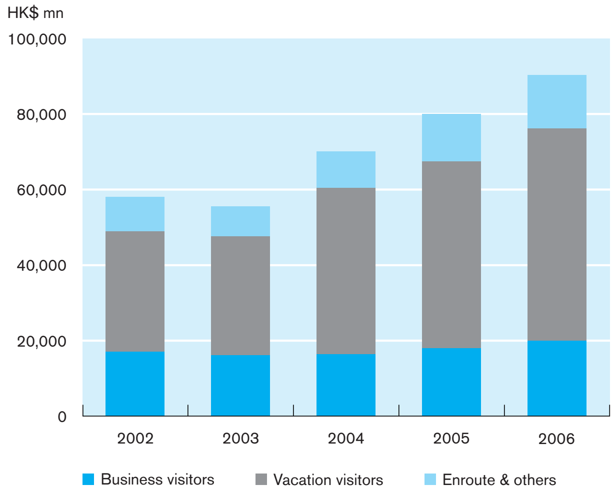
**Total expenditure by type of visitors**




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/relatives.

Sources: C&SD, HKTB and staff estimates.

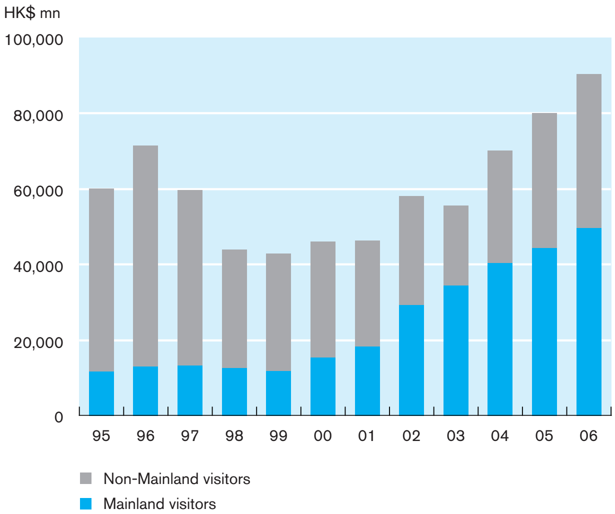
implementation of the IVS in July 2003 (Charts 20 and 21). In 2007, visitor arrivals from Mainland China rose by 14% to reach a record 15 million, of which more than half were under the IVS.

The number of Mainland visitors coming to Hong Kong will be boosted by the extension of the 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% a year while that from non-Mainland increased only 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).

While vacation visitors have been the main driving force for income growth in the tourism sector, the contribution from business visitors is expected to rise

CHART 20

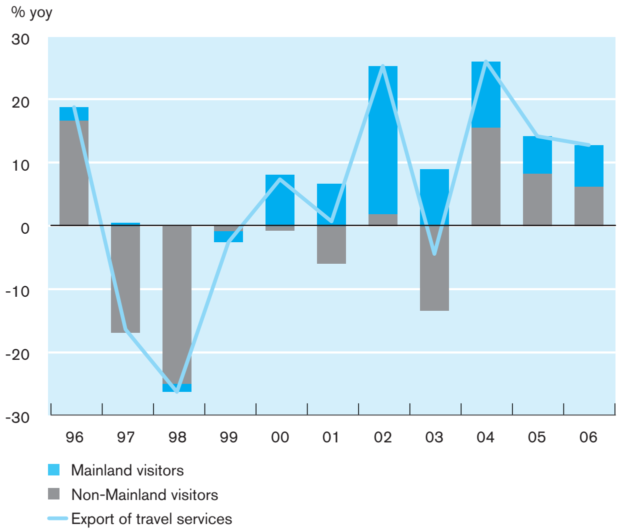
Total travel expenditure by Mainland visitors




Sources: C&SD, HKTB and staff estimates.

CHART 21

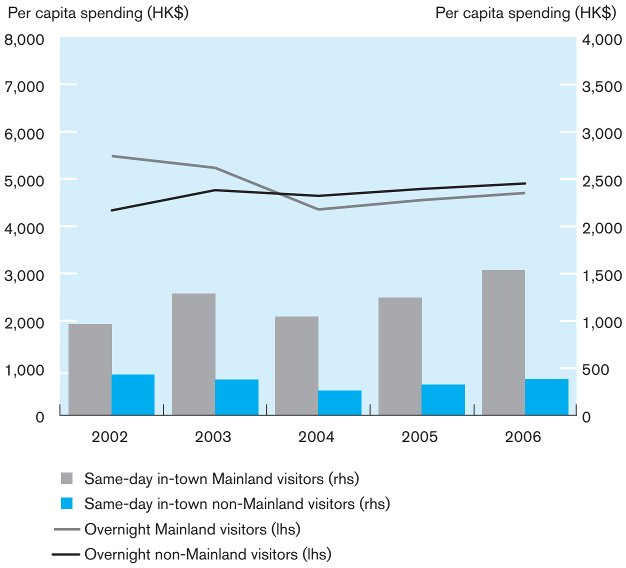
Contributions to growth in total travel expenditure




Sources: C&SD, HKTB and staff estimates.

CHART 22

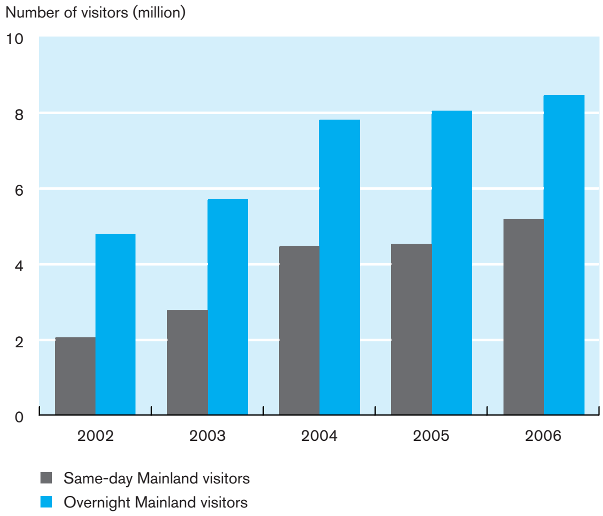
Per capita spending of Mainland & non-Mainland visitors




Sources: HKTB and staff estimates.

CHART 23

Number of Mainland visitors

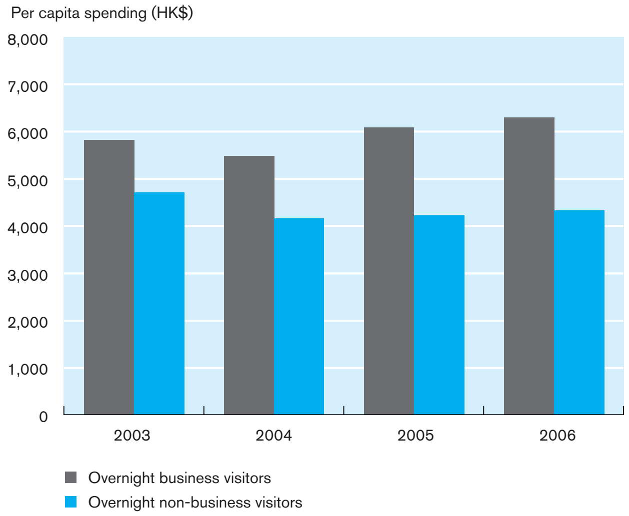



Sources: HKTB and staff estimates.

due to expanding 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 generally 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 the business visitor spending goes to hotel and catering services (Chart 25).

CHART 24

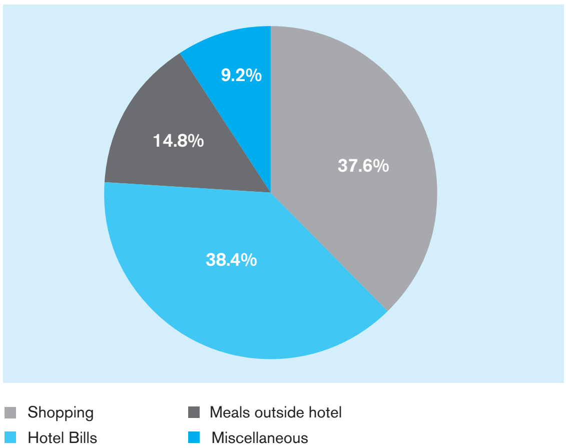
**Per-capita spending of business and non-business visitors**




Sources: HKTB and staff estimates.

CHART 25

**Spending pattern of business visitors in 2006**

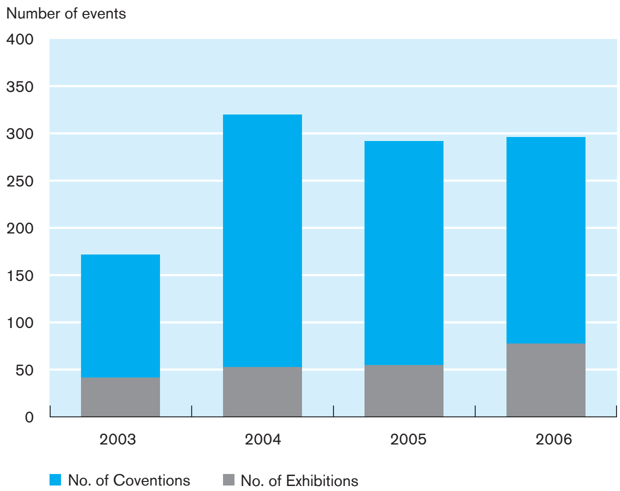



Sources: HKTB and staff estimates.

Reflecting Hong Kong's buoyant convention and exhibition industry, the number of overseas visitors in these areas increased by 33% per annum between 2003 and 2006 (Charts 26 and 27).[8] Spending by exhibitors and exhibition visitors is generally higher than that of other business visitors.

CHART 26

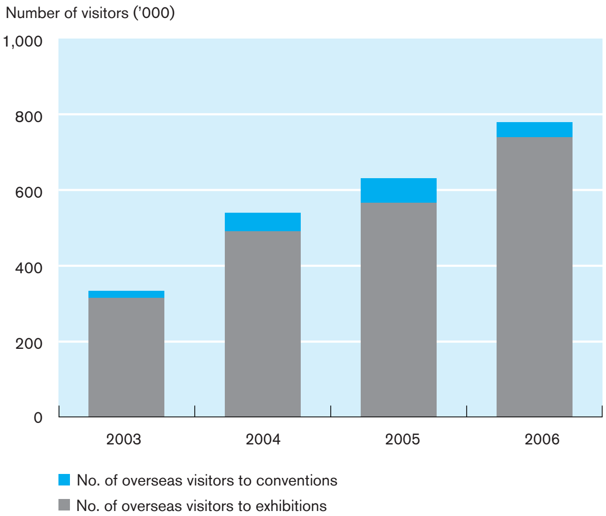
**Number of events for conventions and exhibitions**




Source: HKTB.

CHART 27

**Number of overseas visitors to conventions and exhibitions**




Source: HKTB.

[8] For example, the Hong Kong Trade Development Council organises 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 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 the deterioration in cyclical conditions may weigh on the external demand for services produced in Hong Kong, the potential service demand unleashed from the liberalisation of the Mainland's service sector will be a strong structural factor supporting service exports in Hong Kong over the medium term.

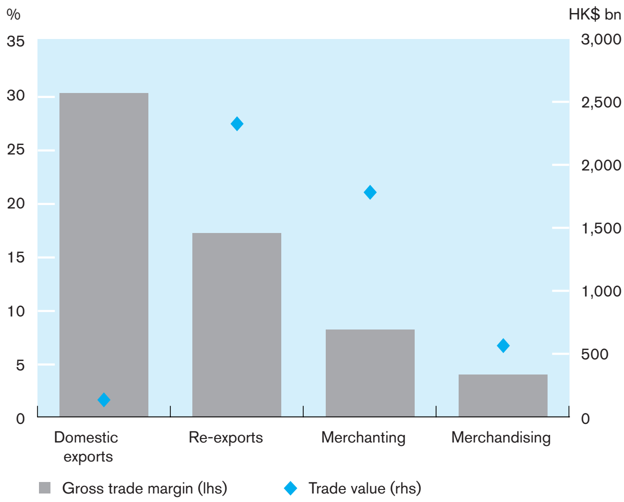
However, keener competition within and outside Asia and the growing pool of talent on the Mainland may erode Hong Kong's role as a service intermediary. Service providers have to strengthen their expertise in trade and financial areas by diversifying and expanding the range of services to maintain their 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 contributor to Hong Kong's offshore trade, one natural question arising from its further development and liberalisation is whether Hong Kong will continue to have a role in intermediating China's exports. We note that while there would be less of a role for a middle-man in 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 become tighter.

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 improve overall earnings. For instance, in merchandising, where the commission rate is lower than it is in merchanting, the large merchandiser Li & Fung has expanded its handling volume and bought out the sourcing units of branded goods in ways to boost its earnings. On the other hand, trade margins can be maintained or increased if service providers introduce higher value-added services, such as design and marketing, or develop new or niche markets and product knowledge. As the Mainland exporters are moving up the value chain, this would give service providers in Hong Kong opportunities to create higher value-added trade-related services. The way 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, will determine how Hong Kong's offshore trade evolves.

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 volumes and margins in the face of increasing competitive pressures. However, Hong Kong merchanting service providers are reportedly under mounting pressure because of rising cost pressure 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 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 include 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.

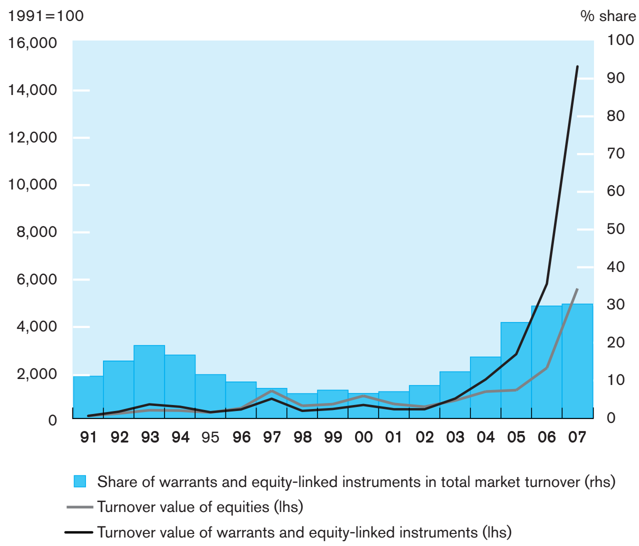
## *Exports of financial services*

The pace of financial development in Mainland China will quicken as a result of its strong economic performance and rapid accumulation of wealth and financial assets. A more liberalised financial system will be implemented to meet the growing financing needs of households and firms and this 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 the Mainland's financial service sector may reduce Mainland China'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 listings 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 fees, which has been the principal 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 recently gained importance in the stock market turnover value (Chart 29). The increasing share of derivatives trading has become a global trend on the world's leading stock markets, like New York and London, because the customised and innovative features of derivatives generate higher service income for financial institutions.

CHART 29

**Turnover value of equities vs warrants and equity-linked instruments**



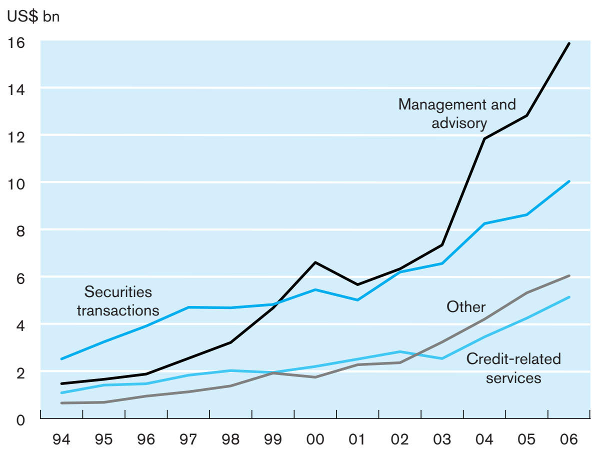

Sources: CEIC and Hong Kong Stock Exchange.

With 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 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, therefore, 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 growth 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**

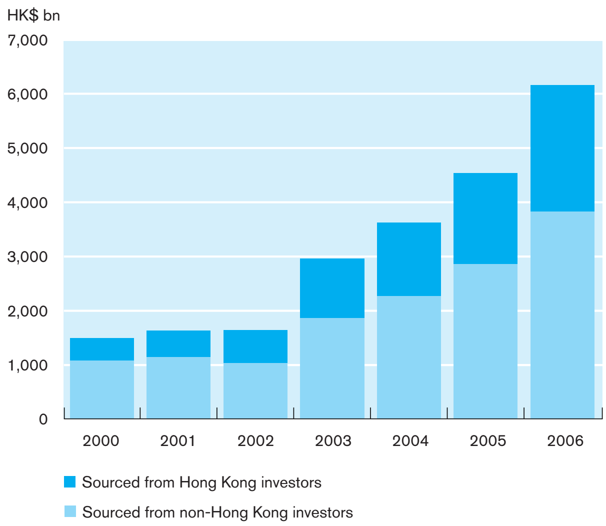



Source: US Bureau of Economic Analysis.

The growing interest of Mainland entities to invest overseas provides great opportunities for Hong Kong to develop its fund management industry to cater 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, raising the service income from asset management, investment advisory and securities custody. Over time, it is expected that Mainland investors will become one of the major client groups for the asset management industry in Hong Kong (Chart 31).

**CHART 31**

**Hong Kong's fund management business by source of investor**

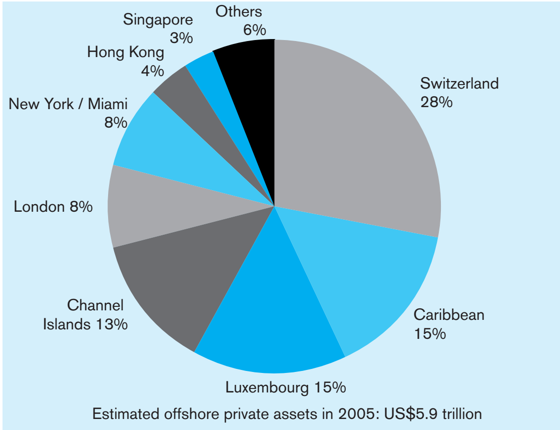



Source: Securities and Futures Commission.

Within the asset management industry, private wealth management (or private banking) could be an area with the highest growth potential in Hong Kong in the years ahead, due to the rapid wealth accumulation and rising number of high net worth individuals (HNWIs) on the Mainland (Chart 32).[9] In comparison with other major players, offshore private assets under management in Hong Kong accounted for only 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 Mainland's HNWIs, this could be another important source of financial service income given the higher value-added nature of private wealth management services.

CHART 33

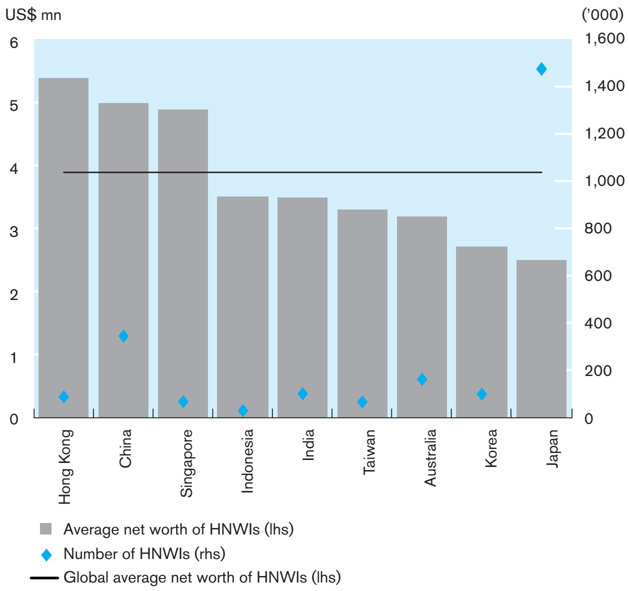
Estimated destination of offshore private banking wealth, 2005




Source: Swiss Bankers' Association.

CHART 32

Average net worth of HNWIs in Asia in 2006




Sources: Capgemini and Merrill Lynch.

## *Exports of travel services*

Hong Kong's unique role as an international business hub and global platform for China business will continue to underpin the export of travel services. In particular, with China's increasing economic and financial integration with the rest of the world following accession to the World Trade Organisation, Hong Kong is playing a progressively 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 rise. In addition, infrastructure projects announced in the 2007 Policy Address will foster cross-boundary transportation between Hong Kong and the Mainland.

9 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.

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 tourism. Secondly, the HKTB should continue to promote Hong Kong as an Asian vacation city to long-haul visitors, introduce new scenic spots and promote Hong Kong's traditional festivals.

In the medium term, building new exhibition venues is the key to attracting business visitors. The current expansion of the 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. This will help strengthen Hong Kong's 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, maintaining and attracting talent to work and stay in Hong Kong has been a priority on local policy agendas. Fostering growth and accumulation of human capital is a necessity for a knowledge-based economy like Hong Kong, as information discovery and product innovations have become increasingly important to value creation. In recent years, the Government has implemented a number of measures to improve the quality of the labour force and to 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. 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 – trade-related, financial, and travel services. While trade-related service exports are expected to remain the largest service group, financial service exports have the highest growth potential. Travel service exports are expected to grow faster than imports resulting in a surplus in this service group.

Service demand from Mainland China plays a prominent role in propelling service exports in Hong Kong. With the Mainland economy moving up the value chain, spending on services will take up a larger portion of consumption and business investment, which will create enormous business opportunities for service providers in Hong Kong. But, while the medium-term outlook for service trade remains positive, 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 main drivers of Hong Kong's service exports growth. At the policy level, the need to develop and retain human capital becomes even more important for a service-oriented economy like Hong Kong.

## REFERENCES

*Asia-Pacific Wealth Report 2007*, Capgemini and Merrill Lynch, 2007.

Banga, Rashmi (2005), "*Trade in Services: A Review*", Global Economy Journal, Volume 5 (2), pp.1-22.

Cheung, Lillian, Kevin Chow, Jian Chang and Unias Li (2006), "*Outward Portfolio Investment From Mainland China: How Much Do We Expect and How Large A Share Can Hong Kong Expect to Capture?*", Research Memorandum 13/2006, Hong Kong Monetary Authority.

Cocca, D. Teodoro (2005), "*The International Private Banking Study*", Swiss Banking Institute, University of Zurich.

Kwong, Kai Sun (1997), "*Tourism and the Hong Kong Economy*", City University of Hong Kong Press.

Su Zhixin (2006), "*On Hong Kong's Trade Transformation and its Intermediary Role*", Hong Kong Trade Development Council.

Wong, Yue-Chim Richard (2002), "The Role of Hong Kong in China's Economic Development", *The University of Hong Kong Working Paper Series*, vol. 2002-26.