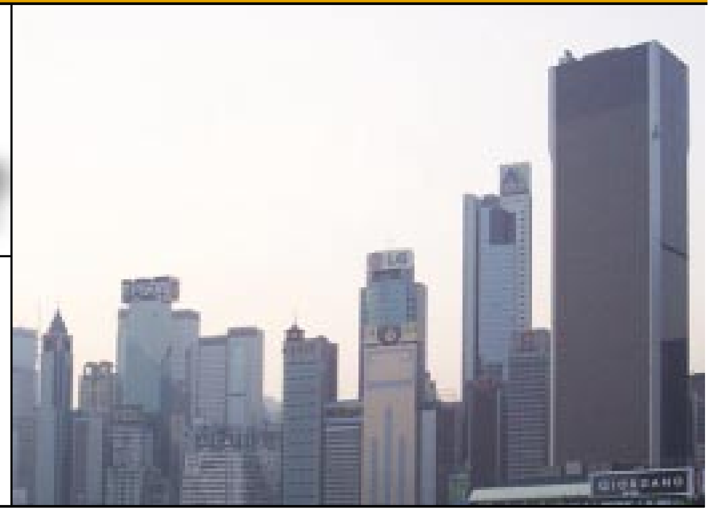
Hong Kong or Shanghai?



Where will you make your next corporate home? It may depend on your size and sector.

William H. Overholt

Shanghai is the flavor of the year. Membership in the American Chamber of Commerce (Amcham) Shanghai is growing explosively, while Amcham Hong Kong membership is declining. Fifty-five multinational companies established regional headquarters in Shanghai since new rules were passed in August 2003. Shanghai is the New Thing, a central symbol of the Chinese economic miracle.

But Hong Kong already has much of what Shanghai is trying to get. The old Hong Kong refrain that the territory has rule of law, minimal bureaucracy, and no corruption is tired but true.

Example: While researching this article, I bought antiques in Hong Kong and stone lions in Shanghai for shipment home to southern California. The small, privately owned shop in Hong Kong offered standard international insurance, and shipment either by sea or, for double the price, by express one-week delivery. The big Shanghai state enterprise, perched prominently on Shanghai's most famous shopping street, Nanjing Road, offered no insurance and only sea shipping for the same price as the Hong Kong FedEx price. The store promised repeatedly that the high price included delivery to

William H. Overholt is chair of Asia policy research at the Center for Asia Pacific Policy at RAND Corp.

Most Fortune 500 companies focused on China's domestic market belong in Shanghai, while most exporters and many sophisticated service industries belong in Hong Kong.

my door and said not to worry about the lack of insurance; in accordance with Chinese custom, the store would replace anything damaged.

The Hong Kong shipment arrived at my door in 10 days. The Shanghai shipment took two months and was delivered not to my door, but to the Port of Long Beach. I had to take one full afternoon to drive over and clear the customs papers and another afternoon to collect the actual goods—and pay large warehouse fees. When I complained, the Shanghai firm denied promising home delivery and blamed the high shipping cost on numerous charges, especially those from PRC Customs. (There are, of course, no customs charges for craft exports.) The store promised to fax receipts documenting these expenses but never did so.

The lesson: It can be better for an individual to deal with a nondescript Hong Kong shop than with a prominent Shanghai state enterprise. This lesson is backed up by seven weeks of interviews in Hong Kong and Shanghai, which indicated that big foreign companies can often use their political and market weight to overcome risks or adverse business conditions, while small and medium-sized companies (or individuals) rarely can. This complements another theme that emerged out of these interviews: Most Fortune 500 companies focused on China's domestic market belong in Shanghai, while most exporters and many sophisticated service industries belong in Hong Kong.

Rule of law, business talent, and other "software"

One prominent American executive in Shanghai asserted that the most important rule of law difference was not between Shanghai and Hong Kong, but rather between Shanghai and elsewhere in mainland China.

Example: In Beijing, big landlords can disregard leases and their tenants have no effective recourse. The aforementioned executive's company had a lease in a Shanghai building purchased by a Beijing tycoon. Following Beijing practice, the tycoon tried to ignore the lease and expel the Americans, but could not do so in Shanghai. The American executive warned that nowhere on the mainland outside Shanghai is a contract reliably enforceable. Yet business leaders with long experience also warn that, compared with Hong Kong's, Shanghai's legal system is far less developed. Long-term supply contracts, letters of credit for exports and imports, and intellectual property rights can only be enforced effectively in Hong Kong. Again, big foreign companies can often assert their rights in Shanghai, but most small and medium-sized companies need Hong Kong's stronger legal foundation.

The legal differences are part of a larger distinction often summarized as "Shanghai has the hardware, Hong Kong the software." The truth is far more complicated. Though Shanghai is undertaking infrastructure projects of breathtaking scope and breadth, Hong Kong and the Pearl River Delta have already deployed extraordinary hardware in the form of international-grade seaports, airports, road networks, and communications (see the *CBR*, May–June 2003, p.6). Even after Shanghai's deepwater port is finished and the new Beijing-Shanghai high-speed rail begins operations, Hong Kong logistics systems will remain superior for some time.

Likewise, Hong Kong has excellent software—modern institutions such as law, accounting, business consulting, police, intellectual property protection, and deeply rooted ethical standards, together with a small army of well-trained civil servants. But development of soft skills in Shanghai is accelerating and even surpassing Hong Kong in some areas. For example, most Hong Kong people speak English—a Hong Kong taxi driver or clerk

Goodnatured Rivalry

One widely held canard on the competition between Shanghai and Hong Kong that this recent research puts to rest is that China's central government deliberately suppresses Hong Kong to build up Shanghai. If this canard were true, it would be fatal for Hong Kong.

It is certainly true that, particularly under President Jiang Zemin and Premier Zhu Rongji, both former Shanghai mayors, building Shanghai became a top priority and senior Shanghai officials boasted of their determination to surpass Hong Kong. But Shanghai would gain nothing from suppressing Hong Kong, and city officials are outspokenly conscious of this.

The two cities feed on each other. Hong Kong executives have trained Shanghai counterparts in everything from managing a market economy to dealing with the media. Before 1997, China's top leaders spent inordinate amounts of time consulting with Hong Kong business and political leaders to ensure Hong Kong's future success. I participated in many such consultations and the goodwill was conspicuous. Beijing has supported Hong Kong neighbor Shenzhen in its effort to become the national leader in electronics and telecom hardware and has recently designated it as national leader in biotech hardware. The year 2003 saw an enormous outpouring of (largely successful) mainland support, including support from Shanghai, to get Hong Kong's economy moving again. The dominant business and government personalities in Hong Kong are Shanghainese, and everywhere in Shanghai one sees Hong Kong businesses profiting from Shanghai's success. In Hong Kong itself, there is a clear consensus that Hong Kong's economic problems are of its own making, not the consequence of any mainland economic suppression.

—William Overholt

will usually speak English but his Shanghai counterpart will not. If you need to staff a large organization with English speakers who know how to function in a modern business, Hong Kong performs better at all levels below the top. But Shanghai's schools are more exacting and provide higher education to more of the population, so US businesses operating in both cities say they can find highly qualified English-speaking top executives more easily in Shanghai than in Hong Kong. Shanghai's Fudan University graduates typically speak clear, unaccented English and write well, whereas Hong Kong University graduates often write Chinglish and speak with thick Cantonese accents. At the top levels of management, Hong Kong can only hope to import talent. In 2003, Hong Kong lifted immigration restrictions on highly educated Chinese, so it can now better compete with Shanghai to import qualified personnel from across China.

Neighboring Shenzhen, with more PhDs per capita than any other PRC city, will certainly help supply Hong Kong with top-level talent. But for now, the Fortune 500 company building a national presence in China needs international-caliber executives and will prosper best in Shanghai, while the medium-sized exporter that needs a large English-speaking staff with modern business experience will prefer Hong Kong.

Hong Kong's civil service is honest, efficient, and, for better or worse, rule-bound. At the Hong Kong-Shenzhen border crossing of Lok Ma Chau, 250,000 trucks a day clear a Customs check geared to pass tough US technology control standards in a world-beating 15 seconds each. Shanghai's civil service is entrepreneurial, enthusiastic, and likes to make money on the side. At all levels of pure administration, Hong Kong's systems are superior. But at the top levels of city government, Shanghai leaders have a range of vision and planning superior to most first-world national leaders. Because London traditionally provided long-range vision and strategic decisions for Hong Kong, the post-colonial Hong Kong civil service simply lacks these skills. Big foreign companies that can connect directly with the top leaders will do better in Shanghai. Small and medium-sized companies that cannot count on top-level intervention will be better off in the Hong Kong-Pearl River Delta region.

The upshot of the "software" issue is that Hong Kong is more of a market economy. Shanghai retains a residue of socialist overregulation, bribe-seeking bureaucrats, and byzantine rules. Access to officials is still a major determinant of business success in Shanghai. Nevertheless, Shanghai is actively restructuring its business atmosphere. Setting up a new business in Shanghai is even easier than in Hong Kong, and both Chinese and Western executives emphasized in interviews that Shanghai's leaders are much more business-friendly, decisive, and willing to listen than Hong Kong's. Shanghai's property, education, and medical sectors encourage competition whereas oligopolies persist in Hong Kong, and the mainland authorities are breaking up monopolies and cartels, while Hong Kong still protects them. Unquestionably, Hong Kong is more market-oriented today, but the situation five years hence is less clear. For a large petrochemical company, the broad balance of considerations probably tips in Shanghai's favor. For the fleet-footed exporter, five years is a long time and Hong Kong is the clear choice.

Different cities for different businesses

Hong Kong has clear advantages in many service industries. Accountants, investment banks, and lawyers in Hong Kong have critical masses of fellow practitioners, clear laws, a supportive culture, and great depth of highly trained secretaries, clerks, and mid-level practitioners. This spills over into the Pearl River Delta, which has built up a base of support for these industries over the last two decades. The Pearl River Delta has a significant edge in logistics and supply chain management and in rapidly changing product areas like toys, gifts, fashion, and some housewares. Hong Kong also remains Asia's media center.

Much basic domestic banking has shifted to Shanghai, but higher-level banking functions need sophisticated legal systems and a convertible currency. These largely remain in Hong Kong, with back offices in the Cantonese-speaking Pearl River Delta. Hong Kong financiers manage complex transactions, both wholesale and retail, mixing equity, debt, and derivatives in real time in US dollars, Hong Kong dollars, euros, and soon renminbi, and simultaneously manage settlement risks. The new Asian Bank Fund in 11 currencies can only be handled in Hong Kong. Shanghai will require many years to create competent, not to say competitive, institutions for such functions (see the *CBR*, March–April 2004, p.38). Moreover, even on the mainland, business executives believe that Hong Kong banks are eating into the locals' business. In short, sophisticated finance still belongs in Hong Kong.

Shanghai has clear advantages in engineering, R&D, and design—sectors in which it has attracted the best talent from all over China. Heavy industries like petrochemicals, steel, information technology, machine tools, white goods, and extruding equipment have a critical mass in Shanghai. Domestic-oriented marketers like the Coca-Cola Co. prosper in Shanghai. Companies that need close ties to the domestic market and high-level political clout belong in Shanghai or Beijing.

Manufacturers of toys and fashions; exporters who need Hong Kong's superior logistics and global market connections; medium-sized companies that need legally enforceable contracts; companies that require large numbers of English-speaking mid-level employees; manufacturers in certain clustered industries like biotech; the most sophisticated service companies and clients who need them; and Western firms with large numbers of expats who will be more comfortable with Hong Kong culture mostly belong in Hong Kong.

The culture choice

Culture is another important dimension of investment location decisions. For example, Taiwan's business culture is very similar to the mainland's but Hong

Kong's culture amalgamates Chinese and Western. When a direct investment company I advised wanted to form management teams for transfer to mainland China, it had to form these teams in Taiwan, not Hong Kong, because of the congruence between Taiwan and mainland cultures. Culturally, Taiwan companies are quite comfortable either in Shanghai, to which many Taiwan business families have historic ties, or in the Pearl River Delta. But Shanghai today offers special attractions, including "Taiwan City" in Pudong, a major country club surrounded by million-dollar Taiwan-style homes and a Taiwan-oriented red-light district in the northwest suburbs. Western manufacturing companies may be culturally more comfortable living in westernized Hong Kong and manufacturing in the Pearl River Delta.

As Taiwan can be a cultural bridge for foreign companies entering the mainland, so Hong Kong often is a cultural bridge for mainland companies moving business overseas. Hong Kong's 16 percent tax rate is half that of China's, and companies domiciled in Hong Kong can shift their mainland profits to their Hong Kong office. Many mainland companies seek to list on the Hong Kong stock market and function under Hong Kong law. Thus Hong Kong is consolidating its role as a place for foreigners to do business with the most internationalized and sophisticated mainland companies.

Strong business cultural differences also exist between Shanghai and Hong Kong. Many interviewees in both cities emphasized that the Pearl River Delta region governments have cultivated a business climate that is tougher, more competitive, more money-driven, and less interested in the environment and quality of life. Shanghai government planners, meanwhile, strenuously promote the city's beauty and quality of life, exemplified by Shanghai's Bund, its many gardens, and numerous environmental reforms. Hong Kong emphasizes Western freedoms; these freedoms have in fact mostly survived the transition to Chinese sovereignty.

Hong Kong executives characterize their Shanghai counterparts as crafty, overly tough bargainers who ignore rules and regulations, lack transparency, and are addicted to corrupt practices. Shanghai people characterize Hong Kong executives as overly controlling, myopic factory owners more interested in running sweatshops for short-term profit than in building long-term businesses. One American business leader complained that even in Shanghai some Hong Kong companies fire all their workers frequently to avoid upward wage pressures. One doesn't have to swallow all the caricatures whole to see that computer chip factories might be more comfortable in Shanghai and toy factories in the Pearl River Delta.

Hong Kong for exports, Shanghai for the domestic market

The preponderance of interviewees judged Hong Kong the place for smaller firms to manufacture for export and Shanghai the place for giant companies to tap the domestic market. One foreign government expert says, "Hong Kong doesn't position you for Chinese market insight, market experience, and market contacts." There certainly is a more national perspective in Shanghai (see the *CBR*, September–October 2002, p.7). Conversely, Hong Kong has a vastly superior overseas trade network. The overwhelming majority of the world's overseas Chinese come from the Pearl River Delta, and this diaspora has created a global business and marketing network tied to Hong Kong's superior logistics and supply chain management institutions.

One successful Asian business leader compares Shanghai to an IBM mainframe and Hong Kong to a network of small computers. For a large, focused long-term project like running a big credit card operation or a car factory, a powerhouse IBM mainframe (Shanghai) may be perfect. For a rapidly evolving, possibly risky operation with fast-changing products, a flexible, variable-cost network with a good cross-platform operating system (Hong Kong) may work better.

Yet there are many exceptions to the view that the big, China-market-focused companies like car manufacturers belong in Shanghai and the surrounding Yangzi River Delta, while the small and medium-sized export-oriented firms belong in Hong Kong and the Pearl River Delta. Many Taiwan and Japanese textile and electronics firms are located in the Yangzi River Delta, and Shanghai's car industry is spawning a supporting host of smaller, Hong Kong-style firms. Conversely, a new shift is also under way in Guangdong into sectors that serve the domestic market. Guangdong's determination to make the car industry a pillar industry of the Pearl River Delta may just be succeeding: Honda Motor Co.'s car operation in Guangzhou is a huge success, and both Toyota Motor Corp. and Nissan Motor Co. Ltd. are establishing major operations in Guangzhou.

A panoply of options

Meanwhile, other commercial centers are emerging in China. Beijing leads in software and, along with Tianjin, is favored by numerous businesses working in tandem with Japanese or South Korean partners. Beijing is also modernizing at lightning pace in preparation for the 2008 Olympics and, as China's capital, will always be the hub of government relations. Chongqing, too, enjoys government support and has recently welcomed the presence of Ford Motor Co., BP plc, and Eastman Kodak Co., which are no doubt looking at Chongqing's emerging role as a transport hub for inland China and the interior's yet-to-be-tapped consumer market. The government's new push to revitalize the Northeast and the appointment of Bo Xilai, former governor of Liaoning, as the minister of commerce may also augur a bright future for Dalian and Shenyang, although this will certainly be a long-term process. All in all, many cities are revamping their approach to welcoming foreign business, and it is clear that complementarity and competition, not dominance and defeat, define China's urban relationships. 完