

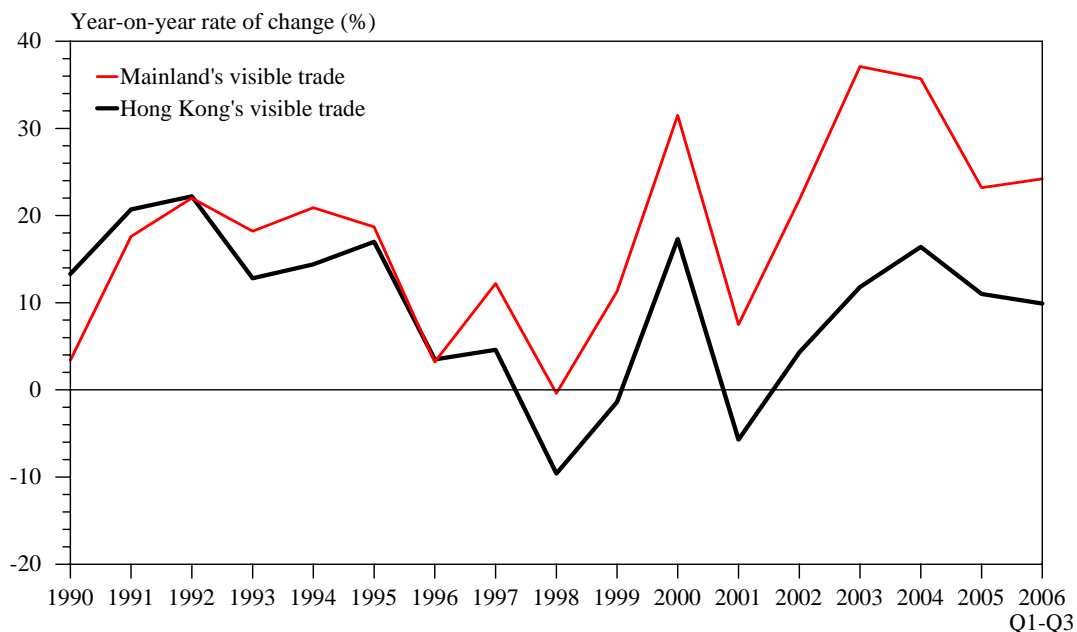
Box 2.1

Offshore trade and the Mainland's external trade

Over the past decades, the middleman role of Hong Kong as a conduit of trade between the Mainland and the rest of the world has been evolving, from a simple entrepôt to a sophisticated trading and logistics hub, supporting direct trade, re-exports, as well as the increasingly important transshipment and offshore trade activities. Notwithstanding the structural shift to different modes of operation, Hong Kong's external sector performance continues to hinge significantly on the Mainland's external trade flows. This could be seen from the high correlation between Hong Kong's visible trade and exports of trade-related services on the one hand and the Mainland's total trade on the other.

Although the movement of external trade in Hong Kong and the Mainland are highly synchronised, the growth momentum of Hong Kong's visible trade was not as strong as the Mainland's in recent years. During 1991-95, the Mainland's and Hong Kong's visible trade grew at broadly comparable average annual rates, at 19.5% and 17.4% respectively in US dollar terms. Visible trade growth in Hong Kong however set back to a modest 2.5% annual growth during 1996-2000 mainly due to reduced demand in the aftermath of the Asian financial turmoil, yet the Mainland's visible trade still maintained an average 11.0% growth per annum. The Mainland's accession to the WTO coupling with continued trade liberalisation measures saw a strong pick-up in its visible trade, by 24.6% per annum during 2001-05. By comparison, visible trade growth in Hong Kong averaged at only 7.3% per annum during the same period.

Growth in Hong Kong's visible trade was not as strong as that of Mainland's visible trade in recent years



Box 2.1 (cont'd)

Yet the slower growth in Hong Kong's visible trade than the Mainland's over the recent decade has to be viewed against the stronger performance of Hong Kong's sustained robust growth in offshore trade, underscoring the shift of Hong Kong towards a more sophisticated trading and logistics centre. These offshore trade activities in the form of merchanting or merchandising have become an increasingly important growth driver for the Hong Kong economy^(#).

Average annual growth in Hong Kong's :
(% per annum in real terms)

	<u>Visible trade</u>	<u>Gross margin from offshore trade</u>
1991 – 1995	15.5	5.3
1996 – 2000	4.7	15.8
2001 – 2005	8.5	14.2

Since early 1990s, exports of merchanting and trade-related services (in which offshore trade constituted the bulk of 90% in 2004) have maintained notable double-digit growth, except in 1998 and 1999 in the aftermath of the Asian financial turmoil and amidst the fall back in global demand in 2001 and 2002. During the 10-year period from 1996 to 2005, the gross margin from offshore trade grew markedly by 12.8% per annum in value terms or 15.0% per annum in real terms. In recent years, the value of goods involved in offshore trade has reached a level comparable to or even larger than the value of re-exports.

**Value of goods involved in
re-export trade and offshore trade**

	<u>Re-export of goods</u> (HK\$Bn)	<u>Offshore trade</u> (HK\$Bn)
2002	1,430	1,458
2003	1,621	1,667
2004	1,893	1,836

Further analysis indicates that merchanting activity takes up a dominant share (86%) of the total gross margin and commission earned from offshore trade. Around 60% of merchanting activity are sourced from the Mainland. A considerable and also rising proportion of these merchanting activities are conceivably related to export processing undertaken in South China, but they no longer need to route through Hong Kong as re-exports, now that China's port infrastructure has substantially improved. Specifically, in 2004, around 65% of the goods sourced from the Mainland were sold under merchanting either involving manufacturing through sub-contract processing arrangement or sourcing from affiliated companies in the Mainland, up from 55% in 2000.

(#): Merchanting refers to services associated with the trading of goods which are purchased from and then sold to parties outside Hong Kong, without the goods ever entering and leaving Hong Kong. Merchandising for offshore transactions refers to services of arranging on behalf of buyers/sellers outside Hong Kong the purchases/sales of goods according to their specifications (including for example marketing, contract and price negotiation, shipment, etc). Also see Box 2.1 in 2005 Half-yearly Economic Report.

Box 2.1 (cont'd)

In fact, Hong Kong companies reaped higher profit margin in offshore trade for goods sourced from the Mainland, another manifestation of the significance of the Mainland as Hong Kong's production hinterland. In 2004, the trade margin of merchanting for goods sourced from the Mainland stood at 10.8%, more than doubled that of 4.9% for goods sourced from other places.

When analysed by destination, sales of goods involved in merchanting to long-haul destinations such as the US and the UK generally have higher trade margins than to Asia.

Trade margin of merchanting (%)

	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
Origin of goods :				
- from the Mainland	11.4	10.8	11.0	10.8
- from other places	5.6	5.3	5.9	4.9
Destination to :				
- The US	11.4	10.6	11.6	10.8
- The UK	9.2	10.4	10.7	8.7
- The Mainland	8.4	8.3	7.6	8.0
- Japan	9.3	8.0	7.6	5.1
- Taiwan	8.3	6.7	6.5	7.4

While the overall trade margin of merchanting, at 8.6% in 2004, was smaller than the 17.3% margin for re-exports, offshore trade should have a greater potential for further rapid expansion. Indeed, growing prosperity of the PRD and eventually the whole Pan-PRD is generating substantial demand for services in Hong Kong, enhancing our position as a regional business and trading hub and prompting Hong Kong's economic restructuring towards high value-added activities. As the trading and logistics sector moved up the value chain, and with increasing use of supply-chain management, the share of trading and logistics in Hong Kong's GDP has actually been on the rise in recent years, from 23.8% in 2000 to 27.6% in 2004.