

Key Challenges Facing Hong Kong Companies
Located in the Pearl River Delta

1) Enforcement of Labour Contract Law

- Written employment agreement is to be concluded not later than 1 month after commencement of work/establishment of labour relationship.
- Terms on social security insurance and relevant labour benefits/welfare become indispensable terms in the employment agreements.
- One-month of wage will be paid to an employee for every year of his service with the company as financial compensation upon termination.
- According to the “PRD Business Environment Survey” by FHKI in March 2008 (the FHKI survey),
 - The implementation of the Labour Contract Law had led to a varied degree of increase in labour costs for most enterprises. 51.2% of the enterprises said their labour costs had increased by over 20%.

2) Appreciation of RMB

- By March 2008, the RMB exchange rate had crept up 17% against the US dollar since 2005.
- According to the FHKI survey,
 - Enterprises estimated that the production cost had increased by 5 to 10% due to the appreciation of RMB in the past 2 years.
- According to a study by HKTDC conducted in September 2007 (the HKTDC study),
 - A 10% appreciation of the RMB against the USD would translate into a rise of production costs by 2-4.5% on top of other increases.

3) Policy Adjustment on Processing Trade

- After two rounds of expansion, as of April 2007, 1,140 products were put under the “prohibited” category of processing trade. Production of such items can no longer enjoy the preferential treatment of bonded import of materials and parts. Imports will be subject to import tariffs and VAT.
- The “restricted” category of processing trade was expanded from 394 items to 2,247 in July 2007. Companies engaging in the processing trade of the restricted category are required to pay a deposit either equivalent to 50% or 100% of the amount of tariffs and VAT payable.
- According to the FHKI survey,
 - 46.9% of the surveyed enterprises responded that the further expansion of restricted catalogue for processing trade and the deposit-guarantee requirement would squeeze their profit margins and may even cause their business to lose money.
 - 36.4% of them responded that it would cause their cash flow to suffer.

4) Removal or Reduction of Export VAT Rebates

- For enterprises processing with imported materials, the locally produced materials and parts used by them as well as the value-added portion carried out within the mainland are subject to VAT “exemption, deduction and rebate”. For instance, in garment processing, as the export VAT rebate rate of textiles has been reduced from 13% to 11%, the amount of export tax not eligible for exemption, deduction or rebate would, thus, go up from 4% (i.e. 17% - 13%) to 6% (i.e. 17% - 11%). This difference would translate into a higher amount of tax payable by the enterprises.
- According to the HKTDC study,
 - Assume a 30% local content as the value-added portion carried out within the mainland, a reduction in VAT rebate by 2% would mean the profit margin to be eaten up roughly by 1%.

5) Shortage of Labour Supply

- In 2006, a shortage of 2.5 million workers was recorded by the Guangdong's Labour and Social Security Office as total demand in the labour market in the province reached 7.3 million, but supply registered at 4.8 million only. The shortage has expanded further in 2007 as the demand for ordinary workers and technicians in Guangdong has estimated to increase by 9.5% and 20.4% respectively.
- According to the HKTDC study,
 - Labour costs that comprise wages, social security contributions and other welfare benefits have increased by some 25% in the past two years. While the average wages of staff and workers in the PRD rose by a norm of 20%, social security contributions that roughly equal to 18% of the wage income represent an extra 4% increase in staff expenses.

6) Shortage of Electricity and Water Supply

- There have been signs of deterioration in Guangdong's power supply situation. In certain locations, electricity supply may be suspended once a week or every four days. Besides, due to rising emphasis on environmental protection, Guangdong will be gradually raising its sewage treatment charges in the next few years in accordance with the principle of "recovering cost at a small profit".
- According to the HKTDC study,
 - Utilities costs had also gone up in the past two years. In Dongguan, for instance, the off-peak and peak-hour electricity tariffs for large industrial users soared by 10% and 27% respectively. Sewage treatment charges more than tripled from RMB 0.25 per tonne to RMB 0.8 per tonne.
 - Many Hong Kong manufacturers have invested in their own power generators, so as to ensure smooth production in times of blackouts. However, high oil prices are pushing up the cost of self-generated electricity. Some manufacturers estimated that the cost of using their own power generators could be as much as 50% more than local electricity tariffs.

7) Rising Raw Material Prices

- According to the HKTDC study,
 - Prices of raw materials in the world market have risen rapidly in recent years. According to *The Economist* commodity-price index, the general metal price level has almost doubled in the last two years. The average price of major metals such as aluminium alloy increased by 45% in July 2007 compared with two years ago, and the prices of copper and zinc even surged by 130% and 190% respectively for the same period of comparison.

8) Inflation

- China's inflation in January 2008 rose 7% and CPI was 6.5% higher than December 2007, hitting a record high for the past decade. The recent severe winter storms also aggravated the inflation.
- According to the FHKI survey,
 - 40.7% of enterprises reported an average cost increase of 17.2% due to inflation in the past year.

9) Economic Downturn

- In 2008, the global economy will witness the continued transition of advanced economies to a slower lane of growth. In the US, growth is expected to decelerate markedly, because of further housing corrections and the sub-prime fallout.
- Under China's macro-control, further policy would be in place in response to signs of overheating.