Hong Kong-owned manufacturers in Guangdong must innovate or face failure in a challenging environment, writes **Naubahar Sharif**

Age of change

Hong Kong-owned manufacturers in Guangdong are struggling in a challenging business environment caused by the global recession and recent policy changes on the mainland. Many Hong Kong firms are striving to avoid shutting down their operations in Guangdong or relocating them elsewhere in China. There is hope, however, for firms that enter new markets or collaborate with mainland partners in innovation, and research and development.

Many of Hong Kong's entrepreneurs have expertly operated as traders in Hong Kong and as manufacturers in nearby Guangdong, with its abundant land and cheap labour, importing low-cost goods from the province and re-exporting them abroad – demonstrating how to be Chinese and modern at the same time.

Hong Kong's proximity to Guangdong is a cultural and geographical advantage, reinforced by government policies during the post-1979 reform era. Guangdong has by far been the preferred investment destination for Hong Kong.

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Now these entrepreneurs must adjust to dramatic change in Guangdong's manufacturing environment, in part because of the recession but also because of recently implemented policies that have raised the cost of imported raw materials, eliminated or reduced tax rebates for low-end export goods, and raised costs with new employee benefits and amenities. These regulatory developments and eco-friendly trends in global markets have eliminated most of the cost advantages of operating in Guangdong, while cancelling out advantages in expertise.

A stronger yuan has also handicapped export businesses, resulting in an extremely challenging environment within which to do business if you are running manufacturing operations in Guangdong from your base in Hong Kong.

Many of these firms face the prospect of failure unless they adopt forward-looking strategies that produce more globally attractive goods and services. The potential repercussions of a major collapse of these regional economic sectors or a widespread shift in the manufacturing base would probably be very difficult to manage. Even though the cost of doing business in China's hinterland provinces is lower than it is now in Guangdong, relocation may be prohibitively expensive for some firms, and it would eliminate the competitive edge of cultural familiarity that Hong Kong-owned manufacturers enjoy in Guangdong.

Relocation is a long-standing survival tactic that often depends on two sets of factors: the so-called "pull" and "push" factors. That is, does a firm move because another location offers strong advantages (thereby pulling the firm to the new location) or because its current location challenges it with strong disadvantages (thereby pushing it out of its old location)?

Historically, Hong Kong-owned manufacturing firms have been pulled into Guangdong by cost and cultural advantages as well as favourable policies targeting Guangdong for development. The problem is, in today's China, key factors that pulled businesses into Guangdong from Hong Kong have evaporated, while factors that threaten to push them out are now saturating the landscape.

Economists and analysts have long recognised the advantage of innovation. Unfortunately, few Hong Kong firms that have moved their manufacturing operations into Guangdong have bothered to innovate, preferring to exploit the cost advantages of operating in traditional industries in traditional ways.

A colleague and I recently conducted a study of this situation, and concluded that firms that emphasise the development and marketing of new products or engage in collaborative innovation or R&D activities with partners on the mainland were more likely than innovation laggards to maintain their operations in Guangdong.

How can Hong Kong encourage innovation among these firms? First, by emphasising policies strengthening links between research institutions, universities and industry. Ramping up support for innovation would not represent a radical policy shift, and increasing innovation would not only increase the rate of survival among these firms, it would also help them create more valuable – and profitable – products and services. Hong Kong needs to build or strengthen innovation-promoting institutions while also creating new links among them.

The economic forces of innovation cannot be truly unleashed without a strong innovation system, and creating such a system depends crucially on forming and maintaining active links among key players. More broadly, policymakers in Hong Kong and Guangdong should work together to strengthen the regional innovation system to harness their combined innovation resources and more thoroughly integrate the region's innovation resources.

As the pioneering economist Joseph Schumpeter observed, capitalism thrives on creative destruction. And I would argue that the destruction of a business model whose impending obsolescence in a hi-tech world might doom it anyway creates opportunity.

If Hong Kong and Guangdong can jump on an innovation bandwagon, they could generate intellectual capital, improve production skills, streamline customer service processes, and accumulate unique proprietary assets that will drive growth for the foreseeable future and position them for success when the world emerges from the recession.

Naubahar Sharif is assistant professor in the Division of Social Science at the Hong Kong University of Science and Technology