The Tale of Two Mega-Cities: Hong Kong in the Face of Shanghai’s Re-rise

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1. Introduction

The Hong Kong economy has been experiencing a strong recovery from the 1998-2003 economic slump, with its gross domestic product (GDP) growing at 7.3% in 2004, 8.6% in 2005, 7% in 2006, and 6.4% in 2007 (Hong Kong Yearbook, 1998-2007). China’s Free Individual Travel (FIT) policies which allow residents of rich Mainland cities to travel to Hong Kong with a convenient procedure boosted economic confidence and helped pull the economy out of the long recession. Also, the CEPA (the Close Economic Partnership Agreement between Mainland China and Hong Kong) rendered support to the strong recovery and added to the robust performance.

A question arises as to whether this momentum will be sustainable. Obviously, Hong Kong’s economy cannot rely on Beijing’s “big gifts” to maintain its long term development. As Shanghai and other Mainland cities have enjoyed long-lasting rapid growth, many people are concerned that Hong Kong will be overtaken by Shanghai sooner or later. The relative rise of Shanghai has triggered several popular worries about Hong Kong’s future: a) whether Shanghai’s catching up with Hong Kong is imminent; b) what the economic relationship between both cities is: complementary or rival; and c) how Hong Kong can keep its prominent status as an international financial center. This paper will address these questions in a broad perspective by putting stress on the impact of China’s economy on Hong Kong’s economic growth.

The rest of the paper is structured as follows. Section 2 reviews the previous discussions about Hong Kong’s economic growth. Section 3 examines the relative rise and fall of the Hong Kong and Shanghai economies in the past, and the implications of history for future development. Section 4 explores the likely evolution of relations between the two economies on the basis of their economic structures. Section 5 concludes the paper.

2. Optimism and Pessimism

There are various views in the literature on Hong Kong’s long term development prospects, which fall into two broad categories: pessimistic and optimistic. It seems that these views somewhat go to extremes one way or the other. The literature is reviewed in the following.

(1) The pessimistic view is that Shanghai could overtake Hong Kong in 10 years whereas the optimistic opinion is that there is such a wide gap between both cities that Hong Kong will continue to keep its lead over Shanghai indefinitely. Between 2000 and 2003, a research team from the Chinese University of Hong Kong and the Shanghai Academy of Social Sciences conducted a survey involving 204 CEOs of 187 multinational companies, professionals, and senior managers with operations in both cities. The survey asserted that Shanghai was lagging in competitiveness for now but would be on a par with Hong Kong in 10 years (Shen, 2004). This pessimistic view was shared by many Hong Kong worriers during the recession, but on the basis of Hong Kong’s 2004-2007 strong growth optimistic opinion again prevails that imminent catching-up is not foreseeable.

Shanghai is now trying to regain its economic paramountcy in Asia of the late 1800s and early 1900s by capitalizing on its splendid tradition and strategic location through massive investment projects and tremendous urban transformation. The pessimists see this construction boom starting in the 1990s in Shanghai as a reason for their worry that Hong Kong is likely to be eclipsed by Shanghai in the near future. However, the optimists believe that there still is a wide disparity between the two cities, not so much in the physical infrastructure, but in institutional infrastructure and economic system (Song, 2005). Hong Kong’s past prosperity was built largely upon these strengths, and Shanghai is steeped in its political structure and the arbitrary legal system not suitable for foreign business. Shanghai will not change easily, and quick catching-up is impossible. Presently, Hong Kong still fares far better

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than Shanghai in terms of economic base. In 2007, for example, Shanghai’s GDP per capita, foreign direct investment (FDI) and total exports were only 22%, 25% and 30% of Hong Kong’s, respectively (Hong Kong Yearbook 2007, Shanghai Statistical Yearbook 2007).

(2) As for the relationship between Hong Kong and Shanghai, the negative view is that after China joined the World Trade Organization (WTO), Hong Kong’s role as a gateway to China for international business would fade away, while the positive view is that the two economies are not necessarily mutually exclusive. With China’s accession to the WTO, foreigners can now deal directly with Shanghai and elsewhere in China. Shanghai is an obvious focus for foreign companies to benefit from the opening of China’s market, which will make Hong Kong irrelevant. Many worry that if Hong Kong’s role as an intermediary for China’s trade is seriously undermined, Shanghai will soon become a substitute for Hong Kong as regional or China headquarters of foreign companies. Also, Shanghai making quantum leaps in its institutional reform will eventually rob Hong Kong of competitiveness (Li, 2001).

This view is not shared by other people. It is good for Hong Kong, as they argue, that international business community is focusing on China’s market after its joining the WTO. Although it is easier for Western companies to enter this market directly, they still need Hong Kong entrepreneurs, knowing Western business as well as Chinese culture, to help them navigate through intricacies of doing business with China. While 1,246 multinational enterprises resides their regional headquarters in Hong Kong, Shanghai only accommodate 174 in 2007 (Hong Kong Yearbook 2007, Shanghai Statistical Yearbook 2007). As Deng Xiaoping put it, China would need many Hong Kong’s entrepreneurs. In fact, the increased Chinese share in world trade will increase Hong Kong’s prosperity, and its huge and rising external trade produces enough business for several ports (Chan, 2002). Also, Hong Kong and Shanghai with non-overlapping hinterlands [the Yangtze River Delta (YRD) and the Pearl River Delta (PRD)] can pursue different regional development strategies.

(3) A few Hong Kong economists predicted that Shanghai would take over from Hong Kong as an international finance center in 5 or 6 years, if China were able to clean up its messy financial sector, and to permit a full convertibility of its currency Renminbi (RMB) (Cheung, 2001). Shanghai’s ambition has turned into quick actions during the past decade by building an expansive financial district of towering skyscrapers, with its new stock exchange twice as large as Hong Kong’s. Other people hold a different view based on the fact that Hong Kong is one of the world’s 10 largest banking centers, the 7th largest forex market, the 6th largest stock market, and the 10th largest merchandise trader. In fact, there are more foreign banks in Hong Kong than in Singapore or Japan (Hong Kong Yearbook 2007). Shanghai is now struggling to handle many tough problems of its financial infrastructure, such as weak financial research, backward finance education, the insensitivity of firm behavior to interest rate swings, the low business trustworthiness of economic agents, severe moral hazard and adverse selection in bank lending and stock listing, and the widespread corruption of government officials (Liu, 2002). These problems cannot be solved any time soon, implying that Shanghai cannot constitute a real threat in finance to Hong Kong which will remain firmly ahead of Shanghai in the foreseeable future.

(4) Pessimists fret that Hong Kong’s economic structure is too lopsided to be adjustable or that its manufacturing is too weak to grow. Optimists are confident that Hong Kong can develop such industries as IT, biology engineering and Chinese medicine products due to its wide commercial network and its ample source of capital. As a mini-open economy, Hong Kong is developed as an “independent” entity. But its growth rests largely on imported resources and outside markets. As its traditional manufacturing firms mostly moved northward to Guangdong for cost outsourcing, Hong Kong’s industry share in its economy has dropped to less than 5%. Services account for over 90% of the city’s aggregate output (Hong Kong Yearbook 2007); the economy of such kind is susceptible to speculative bubbles or outside fluctuations. People finding neither accumulated stock of advanced technology nor strong capacity of R&D to modernize Hong Kong’s industry, doubt if it would be able to compete with Shanghai which has solid technological foundations and pillar industries (Ji, 2001). However, optimists insist that Hong Kong should not be dispirited, but must try its best to realize its potential for developing its modern industry. They take Singapore for example. As a tiny open economy, Singapore succeeded in establishing the world’s 3rd largest petroleum refinery industry even if it does not have a single drop of oil deposit (Yu, 2004). The optimists believe that Hong Kong can do as well as Singapore to revive its industry by financing certain joint ventures, and attracting projects into Hong Kong.

3. History and Future

The above discussions on Hong Kong’s economic prospects are somewhat too extreme to keep to the point, for more extreme outcomes will be less likely to happen in the future. Hong Kong and Shanghai economies possess their comparative advantages and also have their own weaknesses, which will affect their respective developments in the long run. It is worthwhile to look back at their past relations, for a historic perspective indicates bearings for the future.

(1) According to the history, the rise of Hong Kong coincided exactly with the fall of Shanghai, and this relative rise/fall had to do with the wars inflicted on China. Hong Kong has emerged as a modern metropolis
from a fishing village in South China, and its fortunes have varied with its changing relations with the Chinese Mainland. Its relationship with the Mainland in general and with Shanghai in particular is more interesting after WWII than before it. The small population inflow from the Mainland to Hong Kong before WWII suggested that there had been no significant difference in living standards between both areas. Although some Chinese families made fortunes in this British colony, life for the majority of the small Hong Kong population was far less exciting than that in Shanghai, one of the most advanced industrial and commercial centers in Asia (Wong, 1998). A dramatic upturn of Hong Kong’s fortunes occurred when refugees escaping the 1946-1950 Civil War flooded into Hong Kong and numerous firms shifted from Shanghai and other Mainland cities. Northern capital entering Hong Kong, worth billions, was a big impetus to the territory's development (Zhu and Liu, 1997). The refugees coming from Guangdong were mainly laborers, but there were many industrialists and bankers arriving from Shanghai. These entrepreneurs carried to Hong Kong not only capital and technology, but also a large number of skilled workers, marketing knowledge and sales network. Their businesses covered various sectors such as manufacturing, retail, banking, movies, shipping and professions; this concentration of businesses, much broader than the simple trading activity that had existed in Hong Kong, spurred the rapid growth of its economy.

Hong Kong’s fortunes still rose after the Civil War and during the worldwide Cold War, while Shanghai continued its falling and eventually lost its pre-eminent status as an Asian business hub. Following the Korean War, the U.S. imposed a trade embargo against China so that Hong Kong’s traditional advantage of entrepot trade came to a halt. During this difficult period of time when Hong Kong’s tie with the Mainland was greatly weakened, a number of businessmen of Shanghai origin pioneered the shift of the Mainland economy to export-oriented manufacturing. In 1959, domestic exports exceeded re-exports for the first time in Hong Kong history, taking up 70% of its total trade. This labor-intensive, outward-looking manufacturing later became the engine for Hong Kong’s lasting growth, which reached 11.7% in the 1960s and 9.2% in 1970s (Mei, 2003).

Up to the 1997 return of Hong Kong to China, the colonial government had pursued a light-handed approach to economic policy. Governing Hong Kong in this way allowed its businessmen to dodge the U.S. sanctions, and consequently the Mainland had remained the 2nd largest source of Hong Kong imports by 1978. Serving as a middleman between China and the world market, Hong Kong reaped numerous gains from re-exports. While most of China’s external trade was carried out through Hong Kong, Shanghai sank to the bottom of a trade hierarchy acting only as a producer of goods. China’s closed-door policy put Shanghai like a big lion in a tight cage of the planned economy and effectively insulated Hong Kong from Shanghai’s competition.

Hong Kong’s fortunes have expanded explosively since China opened to world trade in 1978. Hong Kong enjoys huge re-exports benefits, which have been rising at an increased pace thanks to the fast growing Chinese economy. For example, trade between Hong Kong and the Mainland exceeded 200 billion USD in 2007, more than 100 times that in 1978. In fact, 90% of Hong Kong’s re-exports involved the Mainland as a source or destination, and the trade between both sides accounted for nearly half of Hong Kong’s total trade value (Hong Kong Yearbook 2007). By contrast, from 1978 up to mid 1990, Shanghai subject to the heavier inertia of planned economy than other parts of the country experienced drops in its share of external trade in national total, dropping from 1/6 in early 1980s to 7.8% in 1995 (Zhu and Liu, 1997).

Part of Hong Kong’s fortunes has arisen from China’s Taiwan problem. Hong Kong plays a role of the entrepot for much of trade between Taiwan and the Mainland, because the ‘Cold War’ (the extension of the 1946-1950 Civil War) still exists across the strait and direct trade or transport with the Mainland is banned by Taiwan. Hong Kong along with neighboring Macao has benefited from this cross-strait situation, with political separation and economic connection coexisting. For example, Taiwan visitors made more 2 million trips to Guangdong via Hong Kong in 2007 alone (Hong Kong Yearbook 2007). Once direct links are allowed across the strait, it is Shanghai not Hong Kong which will become Taiwan’s first port of call.

As is seen from above, the rise of Hong Kong is highly correlated with the fall of Shanghai, and both events are associated with various ‘hot’ and ‘cold’ wars inflicted upon China. Although Hong Kong historically has adapted well to critical changes like wars, it can no longer rely opportunistically on such situations. From 1978 to the early 1990s, Shanghai was largely neglected due to the central government’s focus on opening up Shenzhen and Guangdong, while Shanghai as a national asset continued being over-exploited by the whole country. Deng Xiaoping realized this with regret in his final days of life, and Shanghai was then liberated. In 10 years after its taking off, Shanghai grew at a fantastic pace and Hong Kong felt unprecedented pressure. The Asian tiger now scents the enormous strength of the big lion released out of its cage. Yet, it is better for Hong Kong to respond positively than passively to this new, exciting challenge presented by the re-rise of Shanghai.

(2) Historically, the fall of Shanghai implies the rise of Hong Kong; but in the future, the re-rise of Shanghai needs not spell the demise of Hong Kong.

**Economic Position**

A sensible opinion is that given the larger economic size and the smaller population of Hong Kong than its Shanghai counterparts, it is certain that Shanghai cannot
surpass Hong Kong in terms of real GDP per capita in the near future. Presently, we see no possibility of there to be a successful, quick catching-up by Shanghai unless Hong Kong plunges into a prolonged, deep recession like Japan. It is too early to seriously predict the long run relative prospects of the two economies, since prediction for a long horizon becomes extremely unreliable under great uncertainty. Let us look at future prospects in about 20 years. Assume that Shanghai and Hong Kong continue to maintain their respective GDP growth between 2004 and 2007, Shanghai’s GDP would match Hong Kong’s in 10 years and its GDP per capita would catch up in 20 years (Hong Kong Yearbook 2004-2007, Shanghai Statistical Yearbook 2004-2007). However, Shanghai’s double-digit growth will be very hard for it to sustain in 20 more years. In fact, in the face of the ongoing financial tsunami, Shanghai’s GDP growth only recorded 5.6% in the first half of 2009. Additionally, Shanghai is subject to a constantly flowing population amounted to multi millions that adds to its large population of permanent residents. The faster Shanghai’s economy grows, the larger population inflow it will attract and hence the more difficult it may be for Shanghai to close its gap with Hong Kong per capita GDP.

The future prosperity of both Hong Kong and Shanghai depends largely on the long-term growth of the Chinese economy. During the past two decades, China’s macroeconomic management has achieved a resounding success in spite of large microeconomic distortions. Hence, China’s economy is widely believed to grow at a fast pace at least the next 10-15 years, and this will generate huge external economies to Hong Kong. This high growth of Hong Kong makes it difficult for Shanghai to catch up at a reasonably higher growth rate. Both Shanghai growth and Hong Kong growth are positively correlated with China growth, and the three economies affect each other complementarily.

Financial Status

While some people doubt about Hong Kong’s lead over Shanghai in finance for a long time, we hold that it will be very hard for Shanghai’s finance to outstrip Hong Kong’s in scope and level in a short time. Shanghai’s finance is in its infancy and cannot be regarded as a serious rival to Hong Kong. Few financial practitioners and bank employees in the Mainland know much about financial innovations, modern derivatives or asset securitization. In recent years, some factor costs (e.g., real estate prices) in Shanghai rose substantially and added to its high transaction costs; this reduces the low-cost advantage of doing business in Shanghai. With its impressive finance center housed in the world’s tallest building, Shanghai’s advantage of ‘hardware’ is nonetheless far from being enough to make up for its weakness of ‘software’. Experts point out that Shanghai cannot be expected to catch up with Hong Kong in at least 10 years. In fact, the central and local governments are planning to complete the rebuilding of Shanghai as an international finance center in 15-20 years (Jao, 2004).

Hong Kong’s finance can continue to grow by benefiting from China’s financial liberalization. In fact, Hong Kong has been helping China’s state-owned enterprises with overseas listings raised more than USD 800 billion worth of funds (Hong Kong Stock Exchange Website). Currently 111 Mainland companies are listed in Hong Kong, counting for over half of Hong Kong Stock Exchange’s capitalization. Even if Shanghai were to fulfill its ambition, Hong Kong’s role as China’s financier would not be eroded nor eliminated. Until the RMB becomes fully convertible, which may take decades, will China need Hong Kong to tap international finance.

4. Structure and Relationships

The economic relationship between Hong Kong and Shanghai is affected by their geographically non-overlapping hinterlands and by the large difference in their economic structures that are difficult to change. The economic relationship and structural shifts suggest certain bearings for Hong Kong’s long term development. We believe that the relations between Hong Kong and Shanghai are largely complementary rather than substitutable, with more or less competition in their structural adjustments.

4.1. Economic Structure

Hong Kong has grown more closely tied to the Mainland economy since 1997, owing to the city’s ability to develop an advanced service economy. This put Hong Kong in an ideal position to benefit from structural shifts going on in the neighboring Mainland. China’s capital, resulting from external trade and earnings of its huge manufacturing sector, has been growing fast and will be spent on tourist trips, world-class restaurant dinners, brand-name products, stock listings, etc. Hong Kong is most suitable for meeting this high consumption demand of newly moneyed Mainlanders. The purchase of these visitors to Hong Kong accounted for over 30% of the city’s retail sales in 2007, and this figure has been keeping rising (Hong Kong Yearbook 2007).

Shanghai’s economic structure is more balanced than Hong Kong’s. Under planned economy, Shanghai put emphasis on the capital-/engineering-intensive heavy/chemical industries. Emphasis has been shifted to technology-intensive or high-tech industries since the reform. Although it promoted its tertiary sector intentionally over the past two decades, Shanghai has not ignored the growth of its secondary sector. The contribution of the tertiary sector to Shanghai output growth was 60.1% while the secondary sector still contributed to 39.5% in 2007. Thus, unlike Hong Kong, Shanghai does not rely on services alone for growth. Such a big difference in economic structure implies that
there will be no direct competition between the two cities (Hong Kong Yearbook 2007, Shanghai Statistical Yearbook).

4.2. Regional Competition

Given high factor costs in Hong Kong, it may lose its competitiveness to Shanghai unless it speeds up integration with the thriving PRD. This is necessary, not only because the PRD provides for Hong Kong a hinterland with cheaper/skilled labor and less expensive land comparable to Shanghai’s, but also because the PRD with advantages of primary and secondary industries can complement Hong Kong that has advantages of capital and services and low transaction costs. This economic fusion will make the Greater Hong Kong’s economic structure more balanced and generate a strong synergy effect on its long run growth.

Many believe that competition between the two cities is actually between the PRD area centered on Hong Kong and the YRD area centered on Shanghai. Although Hong Kong still benefits from the cross-strait ‘cold war’, it cannot lean on this political crutch indefinitely. Shanghai and its hinterland have now become a hot new favorite for Taiwan investors, and more and more Taiwanese live and work in the Greater Shanghai. This change not only hurts Hong Kong but also the whole PRD where much of Taiwan’s over USD 100 billion investment in the mainland is based (China Statistical Yearbook 2007). Once direct cross-strait links are permitted, regional competition will be rising as Taiwan investors continue to shift northwards.

4.3. Dominant Relationship

The PRD and the YRD are non-overlapping geographical regions, so that the role played by each city for its own hinterland is not substitutable. But competition may arise and get stronger if both regions’ economic structures become more similar. Taiwan’s investment in the Mainland high-tech industry is making the YRD the hub of China’s IT economy, leaving smaller room for Hong Kong’s ambitious plan to become a regional cyberport. Currently, competition between the two Deltas is not fierce due to their differing economic structures. Also, each hinterland’s economic structure has assimilated with that of its own central city (Zhou, 2005).

Such cross-region difference and within-region similarity would mitigate competition between the two areas and leave more room for complementarity. In fact, both cities can cooperate to extract complementary benefits since what is weak in Hong Kong is what is strong in Shanghai, and vice versa; this is the source of complementary efficiency. Hong Kong may assist Shanghai in its development of financial sector while Shanghai can help Hong Kong in its effort to modernize manufacturing. The result from doing so will be a substantial rise in the combined competitiveness of both cities. To accomplish this requires strong inter-government coordination.

5. Concluding Remarks

This paper has examined a few popular worries about Hong Kong’s future from a historic perspective, and discussed Hong Kong’s long-term development in the face of Shanghai’s re-rise. The main points we may reach are as follows: (1) The rise of Hong Kong coincided exactly with the fall of Shanghai, but the re-rise of Shanghai need not spell the demise of Hong Kong whose growth rests on China’s development. (2) Shanghai cannot surpass Hong Kong in terms of per capita income in the near future, nor will it replace Hong Kong as an only Chinese international finance hub. (3) Due to non-overlapping hinterlands and economic structure differences, the two cities are not a substitute for each other in regional development; their relationship is largely complementary, having no direct competition since unlike Hong Kong, Shanghai does not rely on services alone for growth. (4) Through further integration with the low-cost PRD economy, Hong Kong can stay competitive by shielding itself from low-cost competition posed by Shanghai and the YRD. To extract complementarity requires the two cities to cooperate with strong inter-government coordination.

The renowned entrepreneurial spirit of Hong Kong people may be due to the minimalist policy of the colonial government. Under new competitive conditions, Hong Kong government will, however, have to provide its businessmen with enough services in order to achieve steady growth. In fact, Hong Kong’s relations with the Mainland are fundamental in determining its socio-economic destiny. The easiest cooperation with the Mainland has been exploited by Hong Kong private sector, and further integration requires the Hong Kong government to take critical actions. For this purpose, we would like point two crucial points for Hong Kong long-term development.

(1) Hong Kong should make full use of CEPA and provide high value-added services to the Mainland. The Mainland is making great efforts to improve its government regulation, legal infrastructure, financial system, corporate governance, external trade promotion, and professional practices and standards. Many in the Mainland believe they have much to learn from the outside world, and this creates a continuous demand for high-end services. The U.S. has already captured the largest share of this potentially immense market; so, it is the U.S., not Shanghai, which competes with Hong Kong. Actually, Shanghai needs to receive rather than provide high-end services; so, treating Shanghai as a rival is a misleading way to plan out Hong Kong’s growth. Hong Kong has to be innovative in service skills and attractions to cope with American challenges. It can add high-value to its services to satisfy the needs of the Mainland market and the international business community that is also looking for a foothold there.

To promote Hong Kong’s service business, Beijing signed up the CEPA in 2003. With confidence soaring,
Hong Kong saw rapid growth since 2004. The CEPA lowers Hong Kong’s entry barrier to the mainland market. For example, capital requirements for Hong Kong banks to branch in the mainland are reduced from USD 20 billion to USD 6 billion. This gives Hong Kong the first-mover advantage before China opens up its financial market as stipulated by the WTO agreement. The waiting foreign institutions are upset, since they feel unfairly treated under the CEPA. The question for Hong Kong is how to take advantage of fast-growing mainland demand for services by quickly making full use of the CEPA.

(2) Hong Kong should make efforts to develop itself as a RMB offshore center, which is crucial for reinforcing its status as an international finance hub. Singapore used to be viewed as a financial competitor of Hong Kong, but serious challenges were later found to come from Shanghai whose capital market had engaged in fast expanding RMB business. Shanghai finance, once well developed, will become a real rival to Hong Kong whose banks had no privilege to enter RMB markets. Beijing has now permitted Hong Kong financial institutions under the CEPA framework to engage in certain RMB businesses, laying the foundation for the possible establishment of Hong Kong as an offshore trading hub for the RMB whose inconvertibility will remain in years to come. But, Shanghai wants to do this, too, as voiced by northern academics and Shanghai government officials. Therefore, the Hong Kong government and businessmen should strengthen its lobbying activity in Beijing to expand the scope of offshore RMB business for Hong Kong banks.

To become an offshore RMB trading hub may be very important for Hong Kong finance future and economic growth. Similar to Hong Kong, London has a service sector making up 84% of its economy. In early 1960s, American banks set up a Eurodollar market in London to escape their domestic banking regulation, and today, London has become the world’s largest finance center due to its Eurodollar market, in which about USD 462 billion are sloshing around each day, greater than USD 236 billion in the U.S. domestic market (Jun, 2003). If Beijing can be persuaded to choose Hong Kong as an offshore RMB center, then today’s London finance status may mirror Hong Kong’s position in the tomorrow’s world of finance.

Notes:
1 See a news report, “Evaluating the Comparative Advantages of the Two Cities: Shanghai will Overtake Hong Kong in Terms of GDP in 10 Years”, China Times, 13th December 2004.

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5. Jun, Ming (2003). If Hong Kong’s Economy is Transformed, the Oriental Pearl will be More Prosperous. People. 27th December 2003.