

The Future of Hong Kong as a Global Aviation Hub

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In addition to being one of the world's leading financial centers, Hong Kong serves as a major gateway to both China and Asia and plays an important role as a transit center between China and Taiwan. Hong Kong is the leading international air hub in Asia, both in terms of passengers and cargo. In 2005, Hong Kong's Chek Lap Kok Airport served 40.3 million passengers (16th in the world) and processed 3.4 million metric tonnes of cargo (2nd in the world).¹ Hong Kong is projected to pass Memphis this year and claim the title of the world's leading air cargo center. Much like Hong Kong's history, today's achievements had humble beginnings.

Hong Kong's original airport, Kai Tak, opened in 1925 and was named after its previous landowners, Ho Kai and Au Tak. The airport became famous for its thrilling and dangerous approach. Aircraft would descend over Hong Kong Harbor (today is the world's leading seaport) and the crowded apartments of Kowloon before turning 47 degrees at an altitude of less than 700 ft. in order to land. The first commercial air service to the city was in 1931 by China National Airways Corporation (CNAC), a U.S.-owned company that was later bought by Pan American Airways.² The CNAC purchase was part of Pan American's plan to develop an airline network on both sides of the Pacific, a goal that was not reached without difficulty. The British were loath to grant access to Hong Kong, so Pan American countered by extending its San Francisco-Manila route to Macau instead, serving it for a year until local pressures finally forced the British to relent.³ Because Pan American's British counterpart, Imperial Airways, did not serve Hong Kong (they only flew as far east as Singapore), only Pan American and Air France (flying to

¹ Airports Council International, *Annual Traffic Data* (17 July 2006), http://www.airports.org/cda/aci/display/main/aci_content.jsp?zn=aci&cp=1-5-54-190_9_2__.

² R.E.G. Davies, *Pan Am: An Airline and its Aircraft* (New York: Orion Books, 1987), 34.

³ P. St. John Turner, *Pictorial History of Pan American World Airways* (London: Ian Allan, 1973), 70.

French Indochina and on to Paris) served Hong Kong internationally prior to World War II.⁴ Kai Tak was attacked by the Japanese on December 8, 1941, resulting in the loss of the Pan American Clipper stationed there and the decimation of the runway.⁵ Canadian prisoners of war (sent to help defend Hong Kong) rebuilt and extended the runway for the Japanese, who used it as a small airbase.

Following the end of the war, aviation developed rapidly in Hong Kong. Cathay Pacific Airways was founded in 1946 by Roy Farrell and Sydney de Kantzow in 1946, an American and an Australian who had flown together for CNAC during the war. The airline expanded from its single DC-3 to a fleet of 100 aircraft serving five continents today.⁶ Swire Pacific acquired a majority stake in Cathay Pacific and later merged it with Hong Kong Airways, a competitor owned by Jardines and BOAC (the successor to Imperial Airways).⁷ Hong Kong's belief in the virtues of the free market made Cathay Pacific's ascent difficult in an era of state-owned flag carriers, but its labor cost advantage, strong balance sheet, and outstanding service produced one of the most respected airlines in the world. Hong Kong's unique political status created an interesting issue for Cathay Pacific. The international aviation system is dominated by bilateral agreements which require that an airline be substantially owned and managed by nationals of the state they serve. As a result, Hong Kong's bilateral agreements always used the criteria that an airline be incorporated in and have their principal place of business in Hong Kong.⁸ Despite Hong Kong's status as the most open economy in the world, it has always maintained strong protection of its own airlines, a legacy of its British heritage.

⁴ Neil Farley, *Imperial Airways: The Company and its Aircraft*, http://www.imperial-airways.com/Ops_main_route_map_1935.html.

⁵ Turner, 102-103.

⁶ "Airline of the Year: Cathay Pacific Airways," *Air Transport World* (February 2006), 38.

⁷ Anthony Sampson, *Empires of the Sky: The Politics, Contests, and Cartels of World Airlines* (New York: Random House, 1985), 90-91.

⁸ Rigas Doganis, *The Airline Business in the Twenty-first Century* (London: Routledge Publishing, 2001), 47-48.

Cathay Pacific's growth was aided by the unwillingness of China and the Soviet Union to allow foreign airlines to fly over their territory. As a result, flights between Europe and the Far East originally had to fly via the Middle East. With the advent of longer-range aircraft, airlines could fly via Alaska, but it was not until the 1990s that the direct route over Siberia and Eastern China could be exploited.⁹ In addition, Hong Kong developed into an important gateway between Taiwan and China. Because direct flights between Taiwan and the mainland were not allowed, Hong Kong served as the primary interchange between the two countries, a market that Cathay Pacific took full advantage of. In 1998, Cathay Pacific helped found oneworld, an airline alliance which included other global players such as American Airlines, British Airways, and Qantas. While Cathay Pacific had previously been unwilling to enter comprehensive alliances, preferring route-specific joint ventures, the East Asian Financial Crisis prompted Cathay Pacific (and other Asian airlines) to enter alliances to maintain yields despite deteriorating economic conditions.¹⁰

Hong Kong's second largest airline, Dragonair, was founded in 1985 and soon received exclusive rights on the Hong Kong side to fly to China, routes that Cathay Pacific was forced to cede until 2004, preventing the airline from tapping in to the growing Chinese market. Here again is another instance of Hong Kong's violation of its free market mantra: the territory established a de facto "one route, one airline" policy in 1986.¹¹ Today Dragonair operates flights to twenty-four Chinese cities from Hong Kong. By comparison, Cathay Pacific services three (Beijing, Xiamen, and soon, Shanghai). Cathay Pacific and the China International Trust Investment Company (CITIC), a branch of the Chinese government, bought 89% of Dragonair in

⁹ Sampson, 11-15.

¹⁰ Doganis, 59-64.

¹¹ John T. Bowen, Jr. and Thomas R. Leinbach, "The State and Liberalization: The Airline Industry in the East Asian NICs," *Annals of the Association of American Geographers* 85, no. 3 (September 1995): 484.

1990 to try to integrate their complementary route networks and achieve lower costs through cooperation. A further ownership reshuffling occurred in 1996, with Cathay Pacific reducing its stake to 25.5%, CITIC holding 28.5%, and the China National Aviation Corporation (the modern CNAC), the parent company of the PRC-owned Air China, holding 35.86%.¹² At the same time, as part of the reversion of Hong Kong, the Chinese government insisted that Cathay Pacific's ownership align with Hong Kong's political status, leading to Swire reducing its ownership stake from 53% to 44%.¹³

Hong Kong's long-term status as the primary center of trade to/from China spilled over into the air cargo arena as well. The primary factor in Hong Kong's favor was not its location, but rather its willingness to be far more open to foreign competition than other potential Chinese gateways. Cathay Pacific and Dragonair today both operate dedicated freighter fleets to supplement space on their passenger flights. Like the clippers of the nineteenth century, cargo airlines today face the same trade imbalance that Hong Kong has traditionally presented: freighters depart Hong Kong fully loaded but arrive only half-full.¹⁴

In addition to Cathay Pacific and Dragonair, Air Hong Kong has operated as a cargo-only airline since 1986. Cathay Pacific bought a 75% stake in 1994 and made it a wholly-owned subsidiary in February 2002, but later that year, announced a joint venture with DHL under which DHL eventually acquired 40% of Air Hong Kong and served as DHL's regional air shipper. In contrast to Cathay Pacific and Dragonair's freighter networks, Air Hong Kong flies exclusively within Asia.¹⁵

¹² Dragonair, *History*, <http://www.dragonair.com/icms/servlet/template?series=63&lang=eng>.

¹³ Jim Glab, "A Pearl of the Orient: Cathay Pacific Celebrates 60 Years," *Air Transport World* (September 2006), 68.

¹⁴ Ian Putzer, "Balancing Out," *Air Cargo World*, http://www.aircargoworld.com/features/0306_1.htm.

¹⁵ Air Hong Kong, *History*, <http://www.airhongkong.com.hk/ahk/en/F300/History/index.jsp>.

Among foreign cargo carriers, those in the U.S. have been the most keen to improve their access to China. The two largest, FedEx and UPS, both have their primary Asian operations in the Philippines due to its strategic location. UPS later added a Hong Kong hub to enter the Chinese market, and after both received additional rights to serve China, FedEx began constructing a logistics hub in Guangzhou, while UPS is doing the same in Shanghai.¹⁶

The plan to construct Hong Kong's new airport, Chek Lap Kok, was announced by Governor David Wilson in 1989 as a much-needed replacement for Kai Tak. Kai Tak was both the busiest single-runway airport in the world (despite being open to commercial traffic only) and the most dangerous. Kai Tak's design capacity was 24 million passengers per year; it handled 29.5 million in 1996.¹⁷ Furthermore, a new airport was viewed by the British as being critical to ensuring Hong Kong's future competitiveness with other aviation hubs in the region. However, Chinese officials viewed the project as a final way to exploit Hong Kong prior to reversion by awarding contracts to American and British companies and raiding the treasury. A 1991 agreement between Beijing and London resulted in partial control by the Chinese over the project: some voice in contract awards, veto control over construction bonds, and a guarantee that at least \$25 billion HK would be in the treasury upon reversion.¹⁸ Because of the limited land available in Hong Kong proper and the mountainous terrain of the New Territories, the new airport would have to be constructed through a land reclamation project. Constructing airports from the sea was a growing trend in Asia, with similar projects underway in Osaka (1994 opening), Seoul (2001), Nagoya (2005), Kobe (2006), and Kitakyushu (2006). A site off the north shore of Lantau Island was selected, which merged the islands of Chek Lap Kok and Lam

¹⁶ "UPS China growth continues with new flights," *Atlanta Business Chronicle*, 6 April 2006, <http://atlanta.bizjournals.com/atlanta/stories/2006/04/03/daily42.html>.

¹⁷ Civil Aviation Department (Hong Kong), *Kai Tak Airport 1925-1988*, <http://www.cad.gov.hk/english/kaitak.html>.

¹⁸ William McGurn, *The Perfidious Albion: The Abandonment of Hong Kong* (Washington: Ethics and Public Policy Center, 1992), 102-104.

Chau, the name of the former being retained. The new airport opened on July 6, 1998 after an overnight relocation from Kai Tak.¹⁹ Chek Lap Kok's passenger capacity today is 45 million passengers, expandable to 87 million in the future, and routinely competes with Singapore's Changi Airport for the title of the best airport in the world.²⁰

Until recently, Hong Kong has been able to preserve its status as the leading gateway to China due to both the uncompetitiveness of Chinese airlines and Beijing's unwillingness to expose its national airlines to foreign competition; because air service agreements were traditionally on a *quid pro quo* basis, Chinese airports were largely closed to foreign carriers. As part of China's restructuring of its public sector enterprises, the majority of the nation's airlines underwent government-forced mergers in 2002 into the "big three": Air China, China Eastern, and China Southern, based in Beijing, Shanghai, and Guangzhou, respectively. A fourth major airline, Hainan Airlines, was given permission to remain independent as a "stock-sharing experiment."²¹ The intent of this rationalization was to create economies of scale, improve industry profitability, decrease irrational capacity and competition, and improve the competitive position of Chinese airlines on the international stage.²² Following these mergers, China began renegotiating its bilateral agreements to allow additional flights, but insisting that all new services be phased in over a period of several years.

Despite Hong Kong's stellar growth, there have been few Hong Kong-based competitors to Cathay Pacific and Dragonair until recently. CR Airways began operations in 2003, flying to secondary cities. Following the sale of a 45% stake to Hainan Airlines, CR Airways ordered

¹⁹ Airport Authority Hong Kong, *Key Dates and Events*, <http://www.hongkongairport.com/eng/aboutus/key.html>.

²⁰ Airport Authority Hong Kong, *Hong Kong International Airport Master Plan 2020* (October 2001), <http://www.hongkongairport.com/eng/aboutus/pdf/MP2020.pdf>

²¹ Jae Ho Chung, "The Political Economy of Industrial Restructuring in China: The Case of Civil Aviation," *The China Journal* no. 50 (July 2003): 80.

²² *Ibid*, 74.

larger aircraft with the intention of expanding its niche markets and eventually partnering with major carriers.²³ A second new entrant, Hong Kong Express, switched from local helicopter operations to airline service to major cities in China and Southeast Asia in 2005.²⁴ Finally, Oasis Hong Kong is due to begin low-fare longhaul service in October 2006 from Hong Kong to the U.S. and Europe, starting with London. All of its overseas destinations are bases for low-fare carriers, allowing for feed from beyond their gateway markets and opening the possibility of future cooperation.²⁵

Hong Kong's future status as a global hub for Asia is being threatened by the impressive growth of Middle East carriers such as Emirates (Dubai), Etihad (Abu Dhabi), and Qatar Airways. Annual growth for these airlines ranges from 20% from the largest (Emirates, founded only in 1985 but now the 16th largest in the world vs. Cathay Pacific's 14th) to 50% (Etihad and Qatar Airways, smaller carriers but rapidly growing).²⁶ These carriers have achieved their success through the same strategies that Cathay Pacific and other East Asian carriers used during their major growth phases in the 1970s and 1980s. Qatar and the U.A.E. are both shifting their economies away from their dependence on oil and towards international business and tourism. Because airline costs are for the most part constant across companies, the most controllable cost segment is labor. Asian carriers used their low labor costs to create an absolute cost advantage while at the same time providing better in-flight service, spurring their growth. However, as the East Asian economies developed, this cost advantage against Western competition began to lessen; the Gulf carriers today use this same strategy for their own growth. Finally, Middle East airlines are geographically situated between four continents and have used this prime location to

²³ CR Airways, *About Us*, <http://www.crainways.com/eng/aboutUs/intro.html>.

²⁴ Hong Kong Express, *Corporate Background*, <http://www.hongkongexpress.com/?structure=001&content=1&rnd=15227>.

²⁵ Oasis Hong Kong, *Our Growth Plans*, <http://www.oasishongkong.com/gb/en/aboutus/plans.aspx>.

²⁶ "The Airline Rankings: Passenger analysis," *Airline Business* (August 2006), 78-84.

erode the market shares of both European and Asian airlines on services not just between Europe and Asia, but also between Europe and Oceania, which European airlines retreated from following the ascent of Asian airlines.²⁷

Partially as a response to the Gulf carriers and its new Hong Kong-based competition, but also to ensure its future growth, Cathay Pacific announced a complicated ownership restructuring on June 8, 2006 with Air China and Dragonair, under which it would wholly acquire Dragonair, double its stake in Air China to 20%, and sell 10.16% of its shares to Air China. The entire deal also involved CITIC, CNAC, and Swire Pacific, and was approved that September 28. As part of the reorganization, Air China and Cathay Pacific began codesharing on all flights between Hong Kong and China, a joint venture profit-sharing scheme on several such routes, establishing a joint venture cargo hub in Shanghai, and aligning their routes and schedules. While the primary objective of the partial merger was to increase Cathay Pacific's access to China by acquiring Dragonair, it also sought to increase the competitiveness of Air China, Cathay Pacific, and their respective hubs of Beijing and Hong Kong (unstated but implied was the need to compete against a growing Shanghai), and to increase profits through revenue and cost synergies.²⁸ As part of the merger, Cathay Pacific made it clear that Dragonair will retain its independent identity for at least six years.

Because the Chinese government has allowed increased rights to foreign airlines, Hong Kong began to slip as the primary transportation gateway to China in recent years, especially with the opening of new airports in Guangzhou and Shanghai, and the construction of a new airport for Beijing (designed by the same architect as Chek Lap Kok) in time for the 2008

²⁷ Doganis, 101-106.

²⁸ Cathay Pacific Airways, "Analyst Presentation" (9 June 2006), 2-14.

Summer Olympics.²⁹ Beijing recently passed Hong Kong as the busiest passenger airport in China, and Shanghai is projected to take the cargo lead in the next decade.³⁰ Even across the Taiwan Strait, Beijing and Taipei began to undermine Hong Kong's traditional monopoly in 2005 by allowing direct flights between the two countries, but only around Chinese New Year. Taiwan had previously not allowed such flights, ostensibly for security reasons.³¹ If the program is broadened as expected, Hong Kong would lose a considerable source of traffic, much of it to Xiamen, the ideally located city for cross-strait travel and trade.

One serious concern in Hong Kong at the time that turned out to be a mere hiccup was the SARS outbreak of 2003. While passenger traffic fell by 20% that year, cargo throughput was unaffected. Passenger and cargo traffic recovered strongly in 2004, increasing by 8.2% and 24.6%, respectively, above their 2002 levels.³² Because some flights were flying with more crew than passengers as a result of the epidemic, Cathay Pacific asked its workers to take a month of unpaid leave (later reduced to three weeks) and temporarily grounded twenty-two aircraft. After posting a profit for the year despite the downturn, the carrier thanked its employees for its loyalty by paying them for the extra holiday.³³

The Cathay Pacific-Dragonair merger was predicted several times since Cathay Pacific acquired its initial stake in 1990 and only now has been finally consummated. This merger will give Hong Kong the ability to reach its full potential as a transit link between China and Taiwan, making it a more efficient hub for travel and trade across the strait. The inability of Cathay

²⁹ Richard Spencer, "New Beijing airport to be world's biggest," *The Daily Telegraph*, 29 November 2004, <http://www.telegraph.co.uk/news/main.jhtml?xml=/news/2004/11/29/wbeij29.xml>

³⁰ Hong Jiang, Liling Ren, and R. John Hansman, *Market and Infrastructure Analysis of Future Air Cargo Demand in China* (Cambridge: Massachusetts Institute of Technology, 2003), 9, <http://web.mit.edu/airlines/www/research-publications/articles/china-cargo.pdf>.

³¹ "Direct China-Taiwan flights start," *BBC News*, 29 January 2005, <http://news.bbc.co.uk/2/hi/asia-pacific/4215889.stm>.

³² Airport Authority Hong Kong, *International Air Traffic Statistics at HKIA*, <http://www.hongkongairport.com/eng/aboutus/statistics.html>.

³³ "Airline of the Year: Cathay Pacific Airways," 39.

Pacific and Dragonair to effectively cooperate in the past has contributed to the decline of Hong Kong as the dominant transportation gateway to China, with nearby cities such as Seoul becoming increasingly popular transit points.³⁴ Hong Kong's future as the leading aviation hub of the region is also tenuous due to increasing competition from Beijing, Guangzhou, and Shanghai, all of which have superior connections for cargo transport. The current merger can help to slow these trends, but not prevent them. Although Hong Kong has had a successful past and faces a prosperous present, it faces intense competition to maintain its present position as the foremost aviation hub of the region. Whether or not Hong Kong can overcome these obstacles and continue as the region's leader will depend on its ability to adapt to its ever-changing relationship with China and the outside world.

³⁴ Geoffrey Thomas, "China's Runway Challenge," *Air Transport World* (February 2006), 34.