

From Market-Led to Institution-Based Economic Integration: The Case of the Pearl River Delta and Hong Kong*

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The market-driven regional economic integration of the Pearl River Delta (PRD) and Hong Kong, similar to most East Asian cases of economic integration, has occurred in the absence of a formal institutional framework. Since the late 1990s, however, institutions have been playing an active role in promoting economic integration in East Asia. In the context of the changing nature of regional integration in East Asia, this paper argues that institution-based economic integration has been emerging between mainland China (especially the PRD) and Hong Kong since the early 2000s—twenty-five years after the ever-increasing socioeconomic interplay between the two began. This transition has occurred despite the unique framework of "one country, two systems" adopted by transitional socialist China.

KEYWORDS: regionalization; economic integration; institution; Pearl River Delta; Hong Kong; mainland China.

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Concurrent with globalization, there has been a resurgence of political and economic regionalism around the world over the past two decades.¹ Regionalism implies global homogenization and takes different forms across time and space. It is a complex process of changes taking place simultaneously at various levels: the structure of the world system as a whole, interregional relations, and internal patterns of a single region—the last of which in turn can also be divided into the individual nations as well as sub-national and transnational micro-regions.² In consequence, the need for various approaches to integration becomes even more pressing with the simultaneous growth of complex supranational organizations and the burgeoning of small-scale regional entities.³

The European and North American experiences of cross-border integration have been primarily based on supranational institutions, namely the European Union (EU) and the North American Free Trade Agreement (NAFTA), respectively.⁴ Economic integration in East Asia, however, has by and large occurred without a formal institutional framework, and has been more market-driven.⁵ Policies such as preferential arrangements have traditionally not played much of a role in the integration of the region.

¹Shaun Breslin, Richard Higgott, and Ben Rosamond, eds., *New Regionalisms in the Global Political Economy* (London and New York: Routledge, 2002), 1, 20.

²Andrew Hurrell, "Explaining the Resurgence of Regionalism in World Politics," *Review of International Studies* 21, no. 4 (1995): 331-58. Despite the ongoing trend of regionalization in the global economy, some scholars have argued that free trade agreements will impose a double burden on business operations: one problem is the higher transaction costs of conforming to diverse requirements and the other is an inability to exploit economies of scale because of market segmentation. See Jagdish N. Bhagwati and Arvind Panagariya, *The Economics of Preferential Trade Arrangements* (Washington, D.C.: AEI Press, 1996), 3, 53-54.

³Jouni Häkli and David H. Kaplan, "Learning from Europe? Borderlands in Social and Geographical Context," in *Boundaries and Place: European Borderlands in Geographical Context*, ed. David H. Kaplan and Jouni Häkli (Oxford: Rowman & Littlefield, 2002), 1-17.

⁴For a full list of all acronyms used in this article, please see the Appendix.

⁵Chin Peng Chu, "Regionalism and Regional Integration in the Asia-Pacific and the European Union," in *Northeast Asian Regionalism: Learning from the European Experience*, ed. Christopher M. Dent and David W.F. Huang (London: Routledge/Curzon, 2002), 46-47.

This trend toward spontaneous regional integration has resulted from the progressive outward orientation of the trade and investment policies of individual economies and their unilateral liberalization of goods and capital markets.⁶ The 1990s witnessed a paradigm shift, however, from non-preferential to preferential routes to trade liberalization; at this time the Asia-Pacific region began to move toward more formal preferential agreements.⁷

Hong Kong manufacturing investment has, since the 1980s, moved out of the former colony and into the Pearl River Delta (PRD, 珠江三角洲) of south China. This regional division of labor between Hong Kong and the PRD has been labeled the "front shop, back factory" (前店後廠) model.⁸ In the absence of prior institutional arrangements such as a trading bloc, economic integration between Hong Kong and the PRD has thrived over the past two decades—a phenomenon that has been termed "non-institutional integration" given that the driving force of this integration has been cultural affinity and personal connections.⁹ The situation began to change after 1997 as a result of mutual official communication between the central government, the Hong Kong Special Administrative Region (HKSAR, 香港特別行政區) government, and the Guangdong (廣東) provincial government. China's accession to the World Trade Organization (WTO) at the end of 2001 and the Closer Economic Partnership Arrangement (CEPA, 更緊密經貿關係安排) signed between the Hong Kong government and Beijing (北京) in June 2003 marked a crucial turning point. There now exists a new style of economic integration based on emerging institutional arrangements and governmental involvement. This dramatic

⁶Wendy Dobson, "Deeper Integration in East Asia: Regional Institutions and the International Economic System," *World Economy* 20, no. 7 (1997): 995-1018.

⁷Zhaoyong Zhang, "Regional Integration, Trade, and Investment Expansion in the Asia-Pacific," *Papers in Regional Science* 82, no. 3 (2003): 303-7.

⁸Victor F. S. Sit and Chun Yang, "Foreign Investment-induced Exo-urbanization in the Pearl River Delta, China," *Urban Studies* 34 (April 1997): 656-57.

⁹Yung Wing Sung, *Non-Institutional Economic Integration via Cultural Affinity: The Case of Mainland China, Taiwan, and Hong Kong* (Hong Kong: The Hong Kong Institute of Asia-Pacific Studies, The Chinese University of Hong Kong, 1992), 6.

change has provided a salient case for exploring the transformation of economic integration at a sub-national level under the unique framework of "one country, two systems." Given that the conventional paradigm for the study of economic integration is based mainly on the empirical experience of Western Europe and North America, PRD-Hong Kong economic relations thus offer new research possibilities.

The paper is organized as follows. The first section reviews the changing nature of regional integration in East Asia. The second section describes the methodology and some of the terminology used in the study. The third section examines cross-border economic interaction between the PRD and Hong Kong over the past two decades. The fourth section then brings to light the transformation mechanisms of this economic integration. The conclusion summarizes both the main findings and the theoretical and practical implications of the research. The paper argues that regional economic integration between the PRD and Hong Kong has—despite the "one country, two systems" framework—transformed from being market-led to being institution-based. This transition is consistent with the increasing regionalism occurring in various parts of the world, especially East Asia.

Regional Integration in East Asia

Growing economic regionalism in the world economy since the mid-1980s is helping to push East Asia toward a regional grouping.¹⁰ Of the three global economic centers, however, East Asia is the only region

¹⁰According to Balassa, there are four main forms of regional economic integration: (1) the free trade area, in which members remove trade barriers among themselves but keep in place national barriers against non-member countries; (2) the customs union, in which members remove all barriers to trade among themselves but adopt a common tariff against imports from non-member countries; (3) the common market, in which members allow full freedom of factor flows (migration of labor or capital) among themselves in addition to having a customs union; and (4) the economic union, in which member countries unify all their economic policies—including monetary, fiscal, and welfare policies—as well as policies toward trade and factor migration. See Bela Balassa, *Theory of Economic Integration* (London: Allen & Unwin, 1965), 2.



that is not yet formally integrated: Western Europe is organized into the EU and North America has been joined together under NAFTA. Especially worrisome for East Asia is the prospect that not only the EU might expand to include East European countries, but also that NAFTA might enlarge to form a free trade area of the Americas by 2005. Given that the East Asian economies are not only heavily dependent on these two major markets but also have all adopted outward-oriented development strategies, the intensifying regionalism of other areas has raised concern among East Asian economies that extend beyond the diversion of trade and investment flows.¹¹ More recently, due to the emergence of a novel set of regional, inter-regional, and global factors during the late 1980s and 1990s, regional cooperation has gradually become one of the declared objectives of most East Asian nations. Singapore is a good example. In November 2000, the city-state ushered in the region's first bilateral free trade agreement (FTA) with the signing of the Singapore-New Zealand Closer Economic Partnership. This event was then followed in succession by Singapore's signing of the New-Age Economic Partnership with Japan in January 2002, and inking free trade agreements with both the European Free Trade Association in June 2002 and with Australia and the United States in February and May 2003, respectively.¹²

An institutionalized East Asian grouping is widely seen as resulting from the deepening and expansion of the EU and NAFTA, growing economic ties among East Asian economies, the impact of the Asian financial crisis in 1997-98, and the growing dissatisfaction of East Asian governments with the increasing apparent limitations of the Asia-Pacific Economic Cooperation (APEC) forum and the Association of Southeast Asian Nations (ASEAN) in defending and promoting the interests of East Asia.¹³ The Asian financial crisis of 1997-98 provided a direct and vigorous

¹¹Kevin G. Cai, "The ASEAN-China Free Trade Agreement and East Asian Regional Grouping," *Contemporary Southeast Asia* 25, no. 3 (December 2003): 387-404.

¹²Singapore Ministry of Trade and Industry, http://www.mti.gov.sg/public/FTA/firm_FTA_Default.asp?sid=27 (accessed May 1, 2004).

¹³Richard Stubbs, "ASEAN Plus Three: Emerging East Asian Regionalism?" *Asian Survey* 42, no. 3 (May/June 2002): 440-55.

catalyst for the most recent push toward establishing an East Asian grouping.¹⁴ As the most serious economic crisis in postwar Asia, the economic turmoil directly contributed to the momentum for an East Asian regional grouping in three major ways. First, the lack of a mechanism for close policy coordination and cooperation among the region's governments has been widely cited as being responsible for the rapid and unchecked spread of the crisis. East Asian leaders now increasingly realize the urgent need for the creation of a formal regional mechanism both to deal with similar crises in the future and to maintain economic growth in the region.¹⁵ Second, the crisis demonstrated the ineffectiveness of APEC and ASEAN, revealing how the current structures of APEC and ASEAN are unable to help East Asian states pursue their common interests in maintaining regional economic stability and promoting prosperity. Third, the Asian financial crisis is widely believed to have resulted from the financial liberalization that the International Monetary Fund (IMF) and Washington pushed on East Asian economies in the early 1990s. The crisis increased East Asian willingness to seek a vehicle for closer regional cooperation that would weaken American dominance in East Asia's political economy.¹⁶

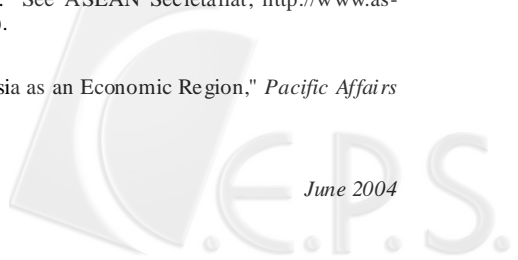
Another fundamental change following the Asian financial crisis has been the nature of regional integration in East Asia. Having no regional arrangement, East Asia is believed by some to be an economic region different from the EU and NAFTA. While cultural and economic diversity prevent formal integration, regional integration has been achieved by such informal means as regional production networks, ethnic business networks, and sub-regional economic zones.¹⁷ It is worthwhile to note, how-

¹⁴Fu-Kuo Liu and Philippe Régner, eds., *Regionalism in East Asia: Paradigm Shifting?* (London and New York: Routledge, 2003), xv.

¹⁵For example, Singaporean Prime Minister Goh Chok Tong and Thai Prime Minister Thaksin Shinawatra expressed their desire to assume a leadership role in setting up an ASEAN Free Trade Area (AFTA)—like France and Germany in Europe—at the ASEAN Summit in October 2003 in Bali, Indonesia. See ASEAN Secretariat, <http://www.as-eansec.org/15258.htm> (accessed May 1, 2004).

¹⁶See notes 11 and 12 above.

¹⁷Dajin Peng, "The Changing Nature of East Asia as an Economic Region," *Pacific Affairs* 73, no. 2 (Summer 2000): 171-91.



ever, that the pattern of informal integration in East Asia has undergone significant changes since the late 1990s. In recent years, there have been calls for institutionalized regional economic cooperation in East Asia. Two proposals in particular have attracted both regional and global attention. The first is a call for an East Asian Free Trade Area (EAFTA) to be constructed on the basis of the ASEAN Plus Three (APT) framework. An alternative proposal is looking for ASEAN to establish FTAs with China, Japan, and South Korea within the framework of an ASEAN Plus One (APO) forum.¹⁸ While the enthusiasm for an East Asian grouping has been mounting in the wake of the Asian financial crisis, existing obstacles continue to make regional integration in East Asia more of a problem than a practical possibility. Regional cooperation has been initiated and led by smaller players, rather than by major powers as is the case in the regional integration of Western Europe and North America. Moreover, while APT provides a forum for consultation and cooperation among ASEAN and the three Northeast Asian countries, specific dialogues for substantial cooperation are conducted largely through the three parallel mechanisms of APO forums: ASEAN Plus China, ASEAN Plus Japan, and ASEAN Plus Korea. As a result, specific cooperative projects are pursued largely between ASEAN and the three Northeast Asian countries on a bilateral basis within the APO framework.¹⁹ China is the first country with which ASEAN has reached a free trade agreement. In November 2001, ASEAN and China announced their intention to create an ASEAN-China FTA within a decade, and concluded the framework agreement in 2002.²⁰ In October 2003, when Premier Wen Jiabao (温家宝) attended the ASEAN summit (held that year in Bali, Indonesia), China signed the Northeast Asian tripartite cooperation agreement with Japan and Korea on the basis of ASEAN Plus Three.²¹ Taken together, it is easy to see that

¹⁸See note 12 above.

¹⁹Takashi Terada, "Constructing an 'East Asian' Concept and Growing Regional Identity: From EAEC to ASEAN+3," *The Pacific Review* 16, no. 2 (June 2003): 251-77.

²⁰ASEAN Secretariat, <http://www.aseansec.org/13197.htm> (accessed March 31, 2004).

²¹ASEAN Secretariat, <http://www.aseansec.org/15158.htm> (accessed March 31, 2004).

China's economy in recent years operates not only as a new engine of growth for its neighboring economies, but also as a catalyst for East Asian economic integration—i.e., with Japan and Korea in the northeast; "Greater China" (i.e., Hong Kong and Macao, and hopefully at some point Taiwan) in the middle via the CEPA;²² and the ASEAN economies to its south via the China-ASEAN FTA.²³

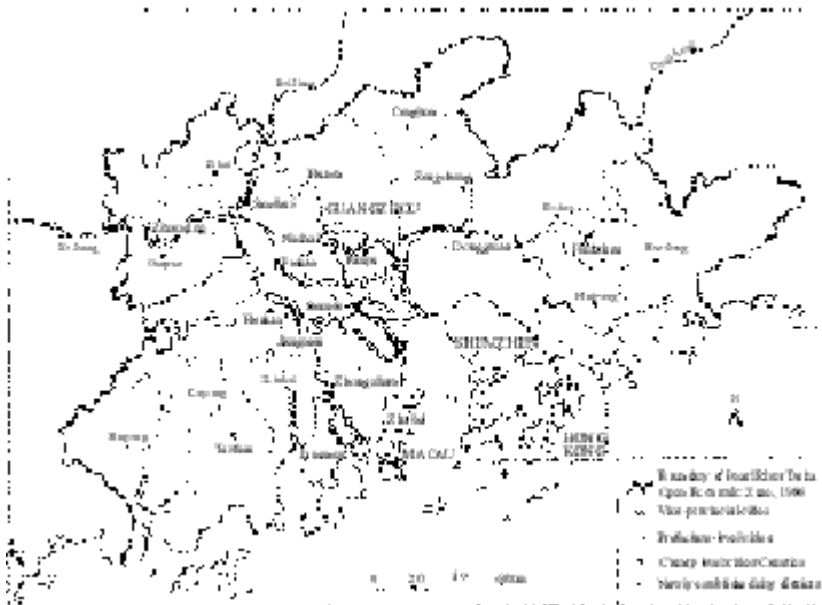
This is the broader context within which Beijing and Hong Kong completed their CEPA negotiations in June 2003. As a free economic entity, Hong Kong has never established bilateral free trade agreements with other WTO members. With the increasing pace of East Asian regionalism, Hong Kong actually faces the threat of marginalization in the region. China acceded to the WTO in 2001 when the Hong Kong economy was in one of its worst depressions in twenty years; Hong Kong businesses then for the first time proposed setting up an FTA with mainland China to help solve Hong Kong's economic recession in part by harnessing mainland China's huge market. Taking into account the special status of mainland China and Hong Kong—two independent members of WTO, one of which is a Special Administrative Region of the former, the original FTA idea was re-titled the "Closer Economic Partnership Arrangement." The agreement was concluded in June 2003, on the eve of the sixth anniversary of Hong Kong's return to Chinese rule. The establishment of the CEPA between the mainland and Hong Kong has provided a salient case of economic integration moving from an informal to a formal framework. More specifically, CEPA—as a free trade agreement signed between the two independent WTO members which belong to a single sovereignty country—is different from the conventional type of free trade agreement signed between two countries which are WTO members.

²²The Closer Economic Partnership Arrangement between mainland China and Macao was signed in October 2003 in Macao. See *China Daily*, http://www.chinadaily.com.cn/en/doc/2003-10/17/content_273164.htm (accessed November 15, 2003).

²³The author would like to thank one of the reviewers for calling her attention to this argument.

Map 1

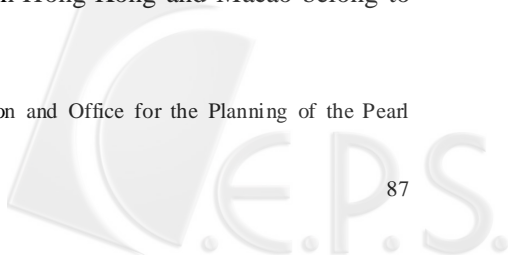
The Administrative Sphere of the Pearl River Delta and Hong Kong



Study Methodology and Terminology

The administrative sphere of the PRD discussed in this paper is composed of the Pearl River Delta Economic Zone (珠江三角洲經濟區) created by the Guangdong provincial government in October 1994.²⁴ The existing PRD region includes nine municipalities in Guangdong: Guangzhou (廣州), Shenzhen (深圳), Zhuhai (珠海), Foshan (佛山), Jiangmen (江門), Zhongshan (中山), Dongguan (東莞), the city proper of Huizhou (惠州), and the city proper of Zhaoqing (肇慶), with a number of county-level cities, counties, and city-districts under the jurisdictions of these municipalities (see map 1). Although Hong Kong and Macao belong to

²⁴Guangdong Provincial Planning Commission and Office for the Planning of the Pearl



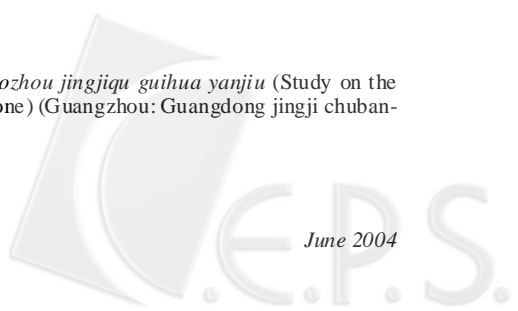
the PRD natural geographic sphere, their SAR status excludes them from the PRD administrative sphere. They are thus regarded in this paper as components of a Greater Pearl River Delta Region (Greater PRD).

This study is based on statistics officially released by governments on both sides of the Hong Kong border, including the annual statistical year-books of the central government and Guangdong Province, other statistical material related to the socioeconomic development of the PRD Economic Zone, the annual and monthly digests of Hong Kong, and relevant survey data on cross-border travel conducted by Hong Kong's Planning Department. Some information was collected by the author through documentary research and field investigations conducted in the late 1980s, mid-1990s, and early 2000s.

Before exploring the economic integration of the PRD and Hong Kong, several points need to be clarified. As Peng has pointed out, formal integration refers to integration through regional integrative organizations and comprehensive legal agreements.²⁵ Comprehensive legal agreements refer to those that cover a dominant portion of the international exchange among all member economies, such as free trade areas and customs unions. For informal integration, in contrast, neither formal organization nor comprehensive legal agreement is required; operations are determined mainly by economic factors, with the private sector playing a major part (though in many cases governments do play an important supporting role). In general, informal cooperation in East Asia has been based on three factors: ethnic ties, industrial links, and geographical proximity. These three factors form the basis of the three major types of informal cooperation in East Asia: ethnic ties for ethnic business networks, industrial links for regional production networks, and geographical proximity for sub-regional economic zones. All three types of informal integration share several features. First, they are all market-driven. Whatever the links are, their economic

River Delta Economic Zone, *Zhujiang sanjiaozhou jingji qu guihua yanjiu* (Study on the planning of the Pearl River Delta Economic Zone) (Guangzhou: Guangdong jingji chubanshe, 1996), 5.

²⁵See note 16 above.

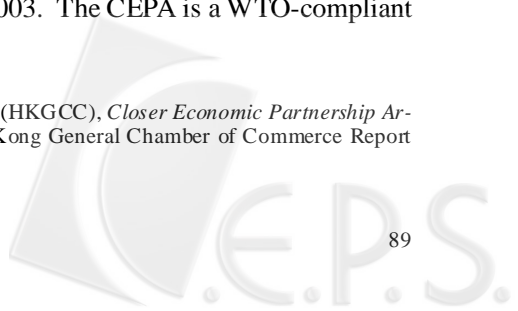


returns are what ultimately lead to the formation of the informal integration. Other factors only facilitate the integration. This is different from formal integration, where many decisions are driven by politics. Second, all types of informal integration are privately-sponsored—the actual integrative activities have been conducted by private firms. Third, this type of integration is network-based. East Asia is a region where, despite inter-governmental cooperation having been quite weak, all kinds of private networks have still managed to develop. At the macro-level, these private links include production and ethnic business networks; at the micro-level, these micro networks consist of numerous sub-networks formed through long-term cooperation. Fourth, informal integration is non-institutional, not relying on formal international organizations. In many cases, such integration is even non-contractual.

Most previous regional trade agreements (RTAs) known to the WTO are "free trade areas" limited to trade in goods only. Increasingly, however, modern RTAs tend to go beyond mere tariff cutting to the formulation of increasingly complex regulations governing standards, safeguard provisions, and customs administration, as well as trade in services. The newer type of RTAs is called either "closer economic relations" (CER) or "closer economic partnership" (CEP).²⁶ Examples include the Australia-New Zealand Closer Economic Relations Agreement signed in 1988 and the Agreement between New Zealand and Singapore on a Closer Economic Partnership in 2000.

Market-led integration between the PRD and Hong Kong during the 1980s and 1990s, similar to the informal economic integration of other cases in East Asia, has been market-driven based on the cultural affinity, geographical proximity, and personal contacts of businesses. The institution-based integration in this paper refers to the emerging economic integration pattern seen in the establishment of the CEPA between mainland China and Hong Kong in June 2003. The CEPA is a WTO-compliant

²⁶Hong Kong General Chamber of Commerce (HKGCC), *Closer Economic Partnership Arrangement: Business Assessment*. A Hong Kong General Chamber of Commerce Report (Hong Kong: HKGCC, 2003), 3-5.



free trade agreement: it covers substantial trade in both goods and services, and will not make any other WTO member worse-off.²⁷ Furthermore, the mainland China/Hong Kong CEPA reached between the central government and the Hong Kong government is a CER or CEP-type agreement which goes beyond the terms of a "free trade agreement." Like traditional RTAs, the new agreement provides for a zero-tariff free trade area (not a customs union given that Hong Kong is a zero-tariff free port to the outside, while China is not). Covering trade in services as well as trade and investment facilitation, the CEPA is thus much broader than a conventional free trade agreement. Therefore, the measurement of economic integration between the PRD and Hong Kong will here involve not only the traditional areas of investment and trade of goods, but also the cross-border movement of residents, tourists, vehicles, and other related activities.

Cross-Border Economic Interaction Between the PRD and Hong Kong

Cross-Border Investment and Trade

Since the late 1970s, economic cooperation between the PRD and Hong Kong has been initiated spontaneously by both Hong Kong entrepreneurs and PRD local governments. Economic interaction between the two sides mainly involves cross-border investment and trade of goods.

As the largest source of foreign investment both for mainland China and Guangdong, Hong Kong accounted for 45 percent and 65 percent of total inflows during 1987 and 2003, respectively (see table 1). Mainland China was Hong Kong's largest trading partner, accounting for 43.1 percent of the former colony's total trade in 2003. Hong Kong's role as an entrepôt has revived since the 1980s thanks to Hong Kong's export-oriented manufacturing. China accounted for 59.7 percent of all goods for re-export from Hong Kong in 2003: 40-50 percent of exports from main-

²⁷Ibid.

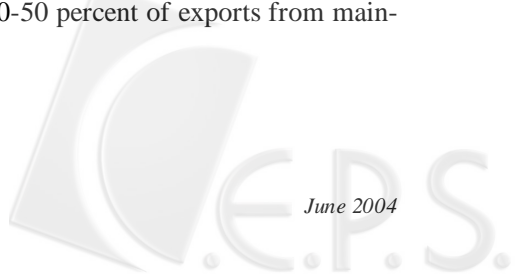


Table 1
Hong Kong's Share of Total Actualized FDI in Mainland China and Guangdong Province, 1987-2003 (in US\$ million)

Year	Total actualized FDI			Among which from Hong Kong		Hong Kong's share (%)	
	Mainland China	Guangdong	Guangdong's share (%)	Mainland China	Guangdong	Mainland China	Guangdong
1987	2,314	1,217	52.6	1,588	884	68.6	72.6
1988	3,194	2,440	76.4	2,068	1,538	64.7	63.0
1989	3,393	2,399	70.7	2,037	1,545	60.0	64.4
1990	3,487	2,020	57.9	1,880	1,258	53.9	62.3
1991	4,366	2,580	59.1	2,405	1,623	55.1	62.9
1992	11,008	4,750	43.2	7,507	3,454	68.2	72.7
1993	27,515	9,840	35.8	17,275	7,372	62.8	74.9
1994	33,767	10,930	32.4	19,665	8,704	58.2	79.6
1995	37,521	10,670	28.4	20,060	8,990	53.5	84.3
1996	42,135	13,260	31.5	20,852	9,388	49.5	70.8
1997	52,387	12,640	24.1	21,551	9,790	41.1	77.5
1998	45,463	15,099	33.2	18,508	9,998	40.7	66.2
1999	40,319	14,474	35.9	16,363	8,562	40.6	59.2
2000	49,356	12,237	24.8	16,729	7,448	33.9	60.9
2001	49,672	15,755	31.7	17,935	8,647	36.1	54.9
2002	55,011	16,590	30.2	19,170	8,618	34.8	51.9
2003	53,505	18,941	35.4	20,800	8,646	38.9	45.6
1987-2003	514,413	165,842	32.2	226,393	106,464	44.0	64.2

Sources: *Zhongguo tongji nianjian* (China statistical yearbook), 1985-2003 editions; and *Guangdong tongji nianjian* (Statistical yearbook of Guangdong), 1986-2003 editions.

land China and 60-70 percent from Guangdong reached the world market via Hong Kong. The increase of both PRD production capacity and the region's imports and exports has brought about tremendous growth in Hong Kong's re-export trade—a change which might not necessarily have occurred if Hong Kong had invested in other places. Goods manufactured in the PRD are brought to Hong Kong for inspection, packaging, or consolidation, and also flow back to the region due to Hong Kong's developed transportation system and market networks with the rest of the world. The total volume of re-exports from Hong Kong increased from HK\$30.1

billion in 1980 to HK\$1,620.7 billion in 2003, while those from Hong Kong to the mainland rose from HK\$4.6 billion in 1980 to HK\$705.8 billion in 2003. The two show an annual average growth rate of 19.2 percent and 24.5 percent, respectively. The share of re-exports to China as a proportion of total re-exports jumped from 15.4 percent in 1980 to 43.5 percent in 2003 (see table 2).

The most salient feature of the trade relationship between Hong Kong and the PRD is the export-oriented processing trade. The PRD has been the most important destination for Hong Kong's outward processing activities in China since the 1980s. Guangdong accounted for 98 percent of the value of Hong Kong's total imports from the mainland that were related to outward processing. In 2003, 72 percent of the value of Hong Kong's total imports from mainland China was related to outward processing. Seventy-nine percent of Hong Kong's re-exports of mainland origin to other places were processed through outward processing in the mainland. Forty-four percent of Hong Kong's total exports to the mainland were for outward processing. The figures were 68 percent for domestic exports and 43 percent for re-export. Within the PRD, Dongguan and Shenzhen—the two cities directly neighboring Hong Kong by road—have been the main locations for outward processing, attracting over 50 percent of total inflows during the past two decades.²⁸ During these twenty years, outward processing has accounted for the bulk of total trade between Hong Kong and China. The economic relationship between the PRD and Hong Kong that is based on outward processing investment has brought about a regional division of labor, the "front shop, back factory" model mentioned above. This term means that Hong Kong serves as the controlling center for finance, sourcing, marketing, and professional services while the PRD serves as the processing base with ample and cheap land and labor.²⁹

²⁸Hong Kong Census and Statistics Department, "Hong Kong's Trade Involving Outward Processing in Mainland China, 1991-2001," *Hong Kong Monthly Digest of Statistics*, November 2002, FD9.

²⁹See note 8 above.

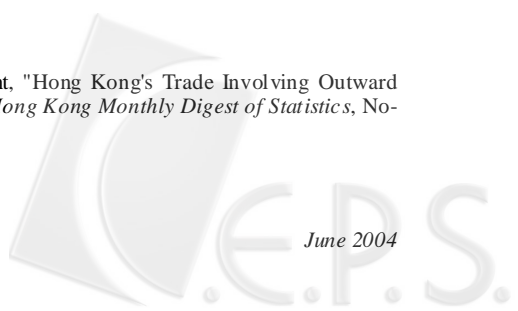


Table 2
Hong Kong's Trade Relationship with Mainland China, 1980-2003 (HK\$ billion)

Year	Hong Kong's total imports	Imports from China	Share (%)	Hong Kong's exports	Exports to China	Share (%)	Hong Kong's re-exports	To China	Share (%)	Hong Kong's total trade	With China	Share (%)
1980	111.7	22.0	19.7	68.2	1.6	2.4	30.1	4.6	15.4	209.9	28.3	13.5
1981	138.4	29.7	21.5	80.4	2.9	3.6	41.7	8.0	19.3	260.5	40.7	15.6
1982	142.9	33.1	23.2	83.0	3.8	4.6	44.4	8.0	18.0	270.3	44.9	16.6
1983	172.4	42.8	24.8	104.4	6.2	6.0	56.3	12.2	21.6	336.1	61.2	18.2
1984	223.4	55.5	24.8	137.9	11.3	8.2	83.5	28.1	33.6	444.8	94.9	21.3
1985	231.4	58.0	25.1	129.9	15.2	11.7	105.3	46.0	43.7	466.6	119.2	25.6
1986	377.9	80.0	29.0	154.0	18.0	11.7	122.5	40.9	33.4	552.5	138.9	25.1
1987	377.9	115.2	30.5	195.3	27.9	14.3	182.8	60.2	32.9	756.0	203.3	26.9
1988	498.8	151.5	30.4	217.7	38.0	17.5	275.4	94.9	34.5	991.9	284.4	28.7
1989	562.8	190.6	33.9	224.1	43.3	19.3	346.4	103.5	29.9	1,133.3	337.3	29.8
1990	642.5	230.0	35.8	225.9	47.5	21.0	414.0	110.9	26.8	1,272.4	388.4	30.5
1991	779.0	285.3	36.6	231.0	54.4	23.5	534.8	153.3	28.7	1,544.9	493.0	31.9
1992	955.3	342.0	35.8	234.1	62.0	26.5	690.8	212.1	30.7	1,880.2	616.1	32.8
1993	1,072.6	402.2	37.5	223.0	63.4	28.4	823.2	274.6	33.4	2,118.8	740.1	34.9
1994	1,250.7	470.9	37.6	222.1	61.0	27.5	947.9	322.8	34.1	2,420.7	854.7	35.3
1995	1,491.1	539.5	36.2	231.7	63.6	27.4	1,112.5	384.0	34.5	2,835.2	987.1	34.8
1996	1,535.6	570.4	37.1	212.2	61.6	29.0	1,185.8	417.8	35.2	2,933.5	1,049.8	35.8
1997	1,615.1	608.4	37.7	211.4	63.9	30.2	1,244.5	443.9	35.7	3,071.0	1,116.1	36.3
1998	1,429.1	580.6	40.6	188.5	56.1	29.8	1,159.2	407.4	35.1	2,776.7	1,044.0	37.6
1999	1,392.7	607.5	43.6	170.6	50.4	29.6	1,178.4	399.2	33.9	2,741.7	1,057.1	38.6
2000	1,658.0	715.0	43.1	181.0	54.2	29.9	1,391.7	488.8	35.1	3,230.7	1,258.0	38.9
2001	1,568.2	682.0	43.5	153.5	49.5	32.3	1,327.5	496.6	37.4	3,049.2	1,228.1	40.3
2002	1,619.4	717.1	44.3	130.9	41.4	31.6	1,429.6	571.9	40.0	3,179.9	1,330.3	41.8
2003	1,805.8	785.6	43.5	121.7	36.8	30.2	1,620.7	705.8	43.5	3,548.2	1,528.2	43.1

Sources: Hong Kong Census and Statistics Department, *Hong Kong External Merchandise Trade, 1981-2003* editions. Note that the average annual growth rate of: HK's total imports was 12.9%; of HK's imports from China, 16.8%; of HK's exports, 2.6%; of HK's exports to China, 14.6%; of re-export, 18.9%; of re-export to China, 24.4%; of HK's total trade, 13.1%; and of trade with China, 19.1%.

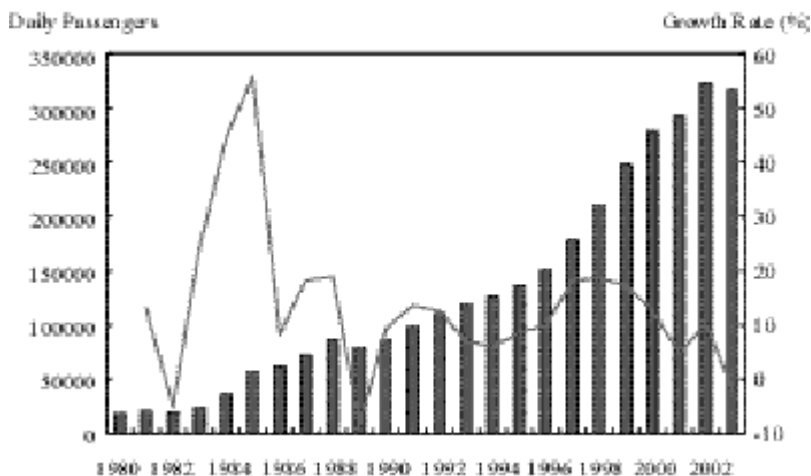
Since the 1990s, the "front shop, back factory" regional division of labor established in the 1980s has been expanded to include the increasing cross-border movement of low value-added services from Hong Kong to the PRD. A survey conducted by the Federation of Hong Kong Industries found that by the end of 2001, over 10 million workers in Guangdong (mainly in the PRD) were employed in the 53,300 manufacturing operations of Hong Kong-based companies. At the same time, 1.5 million workers—or 43 percent of total Hong Kong employment—were either directly (1 million) or indirectly (one-half million) employed in manufacturing, import-export companies, and services-related jobs that were linked to cross-border manufacturing activities.³⁰

Cross-Border Movement of People and Vehicles

Movement of people: Since the mid-1990s, increasing cross-border interaction has gone beyond the movement of manufacturing investment and trade of goods to include intensive socioeconomic links through the cross-border flow of people, vehicles, and other related activities such as shopping, leisure, and the purchasing of flats. On average, daily total of two-way cross-border passengers increased from 18,904 in 1980 to 316,461 in 2003 (see fig. 1). Since 1997, the number of cross-border passengers has been increasing at a faster pace; the annual growth rate between 1997 and 2003 was 10.8 percent, much higher than the 8.9 percent rate between 1990 and 1996. Due to the existence of the border and the "one country, two systems" principle, however, the free northward movement of Hong Kong residents to the mainland stands in sharp contrast to the restricted, strictly regulated southward movement of mainland residents to Hong Kong. The number of mainland visitors to Hong Kong has increased at a faster pace than the Hong Kong resident departures for the mainland, with annual average growth rates reading 20.5 percent vs. 10.5 percent respectively during the period 1990-2003. Mainland visitors have

³⁰Federation of Hong Kong Industries, *Made in PRD: The Changing Face of Hong Kong Manufacturers*. Part II: *Full Report* (Hong Kong: Federation of Hong Kong Industries, 2003), 17-25.

Figure 1
Increase of Movement of People between Hong Kong and Mainland China, 1980-2003

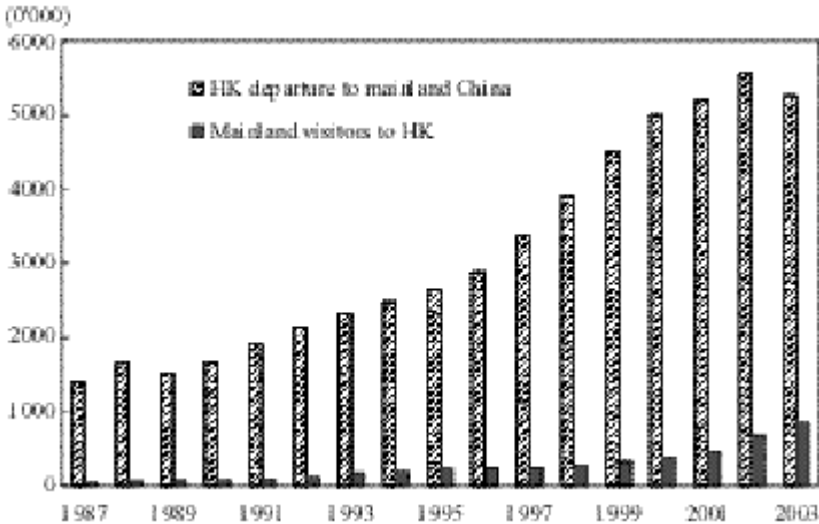


Sources: Hong Kong Census and Statistics Department, *Hong Kong Monthly Digest of Statistics*, 1980-2003 editions.

become the largest source of visitors to Hong Kong since 1997. The total number of mainland visitors to Hong Kong has soared from 0.75 million in 1990 to 8.5 million in 2003, with the share of total tourists sharply increasing from 9.9 percent to 54.5 percent during the same fourteen-year period. The numbers are, however, still only 16.1 percent of the number of Hong Kong residents traveling across the Hong Kong-Shenzhen border to mainland China (see fig. 2).

Another example of the asymmetric pattern of cross-border movement is the strictly regulated flow of mainland talent into Hong Kong. Hong Kong has traditionally made it easy for skilled people from North America, Europe, and Japan to live and work in the territory, but the territory's rulers have never been as welcoming to such workers from the mainland. Efforts have been made, however, to loosen some of these restrictions. For instance, a program to increase the admission of mainland professionals was introduced in 1994 and again in 2001 (after being discontinued in 1997). This program was restricted to workers in information

Figure 2
Comparison of Hong Kong Departures to Mainland China and Incoming Mainland Visitors, 1987-2003



Sources: Hong Kong Census and Statistics Department, *Hong Kong Monthly Digest of Statistics*, 1987-2003 editions.

technology and finance sectors who were not allowed to take their families with them to Hong Kong. A second program, established in 1999, was nicknamed the "Einstein" scheme and was limited to mainlanders with doctorates. Given the generally strict rules, however, an annual average of 16,700 foreign professionals arrived to work in Hong Kong between 1997 and 2001; by the end of 2002, the Einstein scheme had attracted only 256 people, and the professionals scheme just 12 more. The situation has just recently changed. The Hong Kong Immigration Department issued a new Admission Scheme for Mainland Talent and Professionals (輸入內地人才計劃), effective from July 15, 2003. The new arrangement aims to align (as far as possible) the conditions for admitting mainland residents for employment with those applicable to foreign nationals. More importantly, in contrast to the former two schemes, there is no sectoral restriction or quota; the only requirement is that the candidate must possess professional

Table 3
Cross-Border Vehicle Trips, 1990-2003 (by type)

Year	Cargo transport	Share (%)	Private car	Share (%)	Coach	Share (%)	Shuttle bus	Share (%)	Total
1990	4733034	95.9	130922	2.7	71819	1.5	–	–	4935775
1995	7999376	94.5	304490	3.6	161630	1.9	–	–	8465496
1997	8540474	89.8	698830	7.3	224012	2.4	44937	0.5	9508253
2000	9397115	83.6	1419865	12.6	303792	2.7	122750	1.1	11243522
2001	9139230	80.7	1685889	14.9	370721	3.3	132017	1.2	11327857
2002	9699610	78.6	2064813	16.7	390709	3.2	189819	1.5	12344951
2003	9816086	79.5	2434276	19.7	544452	4.4	266143	2.2	13060957
Annual average growth rate (%)									
	5.8		25.2		16.9		34.5		7.8

Sources: Hong Kong Transport Department, *Monthly Traffic and Transport Digest*, 1990-2003 editions.

skills or knowledge either not readily available or in short supply locally. Unlike the previous schemes, the newest scheme also allows the candidate's spouse and unmarried dependent children under eighteen years of age to be admitted as well.³¹

Movement of vehicles: Concerning the cross-border movement of vehicles, trucks have made up around 80 percent of the total. Due to the tighter restrictions, the cross-border movement of passenger cars has accounted for less than 20 percent. The cross-border movement of private cars, for example, increased from 130,922 in 1990 to 2,434,276 in 2003, accounting for the rise in percentage of passenger cars in the total number of vehicles from 2.7 percent to 19.7 percent (see table 3). Due to insufficient cross-border infrastructure, the existing quota system—which requires that cross-border private vehicles hold licenses issued by both mainland China and Hong Kong—has lasted for two decades. There are more than 9,000 private cars in Hong Kong holding mainland China

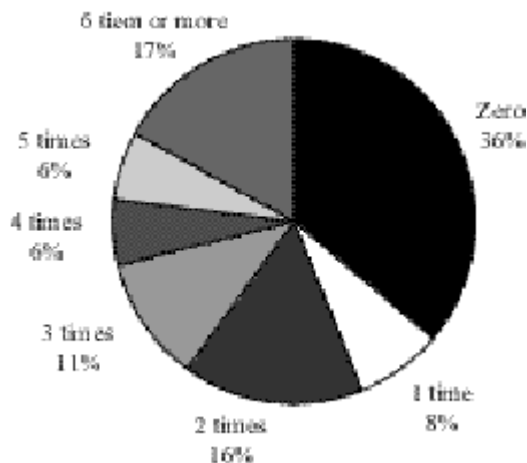
³¹Hong Kong Immigration Department, "Admission Scheme for Mainland Talent and Professionals," http://www.immd.gov.hk/ehhtml/hkvisas_3.5.htm (accessed March 22, 2004).

licenses, while hundreds of China private cars in mainland China have Hong Kong licenses. Due to the difficulty of obtaining cross-border vehicle licenses, the black market price for mainland China licenses has reached HK\$200,000 to HK\$500,000. This restriction seems unreasonable if compared with the free cross-border movement of the private cars in North America, Europe, and even between Singapore and Malaysia. Moreover, private cars are required to cross the border at specific border control points; this lack of flexibility has further reduced the growth in the number of private cars that cross. The quota system urgently needs to be reconsidered; a fee system should be put into effect in its place. The fee reflects the license and infrastructure maintenance costs of each side and can be adjusted according to traffic demands. With the relaxation of the quota system on private cars, such traffic will play an increasingly important role in cross-border exchanges, and dramatically reduce the railway's present overwhelming share in cross-border passenger transportation.

One should note that the intensive cross-border interaction, especially the increasing movement of people and vehicles between the PRD and Hong Kong, has been accomplished despite traffic congestion and customs delays. According to a survey conducted by the Federation of Hong Kong Industries in 2002, 64 percent of companies experienced delays and financial losses from traffic congestion and customs delays in 2001 when transporting goods across the Hong Kong-Shenzhen border. Such financial losses might be due to the use of airfreight in order to avoid missing delivery deadlines or the cancellations of overseas orders. A reported 73.4 percent of those companies experienced one to five such incidents, and 16.6 percent experienced six or more incidents in that year. The financial losses incurred as a result of such incidents ranged from a minimum of HK\$3,000 to a maximum of HK\$4 million. The median value of the financial loss was HK\$100,000 (see fig. 3).

In summary, the economic interaction between the PRD and Hong Kong has expanded from the traditional areas of investment and trade in the 1980s to increasing cross-border movement of people and goods since the mid-1990s. This economic integration has been driven by market factors, with entrepreneurs from Hong Kong and local PRD governments as the

Figure 3
Number of Occurrences of Traffic Congestion or Customs Delays while Transporting Goods across the Hong Kong/Shenzhen Border, 2001
(% of surveyed companies)



Source: Federation of Hong Kong Industries, *Made in PRD: The Changing Face of Hong Kong Manufacturers. Part II: Full Report* (Hong Kong: Federation of Hong Kong Industries, 2003), 30.

main actors. This situation did not change until the return of Hong Kong to Chinese sovereignty in 1997.

From Market-Led to Institution-Based Economic Integration

Increasing Governmental Communication during the Post-1997 Period

In the run-up to the 1997 handover, there were close economic ties but few official contacts between Hong Kong and the PRD. Only after the 1984 Sino-British Joint Declaration was signed did China allow talks to take place between Hong Kong and Guangdong officials on such practical matters as water supply, electricity transmission, and train services. There were only three inter-governmental cooperation channels: (1) the Sino-British Infrastructure Coordination Committee on Major Cross-Border

Infrastructure between Hong Kong and Mainland China, which was set up in 1994 to speed up infrastructure development and prevent conflicts over cross-border projects and then changed into the "Hong Kong/Mainland Cross-Border Major Infrastructure Coordinating Committee" (ICC) in October 1997; (2) the Hong Kong-Guangdong Environmental Protection Liaison Group, which was established in 1990 to further enhance cooperation and coordination on environmental management and pollution control issues; and (3) the Cross-Border Liaison System, an effective mechanism for Hong Kong and Guangdong to discuss and resolve practical issues of mutual concern, including the fight against cross-border crime and the regulation of the Shenzhen River.

Confined to such narrow areas as infrastructure and environmental protection, the pre-1997 inter-governmental communication and cooperation institutions were insufficient, given the close economic relationship that was being established between the PRD and Hong Kong by the massive Hong Kong manufacturing investment in the PRD. On the eve of the return of Hong Kong to Chinese sovereignty in 1997, the Guangdong provincial government undertook a comprehensive study of the state of economic cooperation between Guangdong (the PRD in particular), Hong Kong, and Macao. The report presented two conclusions: economic cooperation based on outward processing trade could meet the needs of the region's rapid development, and governmental coordination and communication had lagged behind economic cooperation and development. The report suggested that Guangdong, Hong Kong, and Macao should develop into a modern metropolitan area with complementary functions after 1997.³²

The most dramatic transformation of the regional integration in the post-1997 period has been the establishment of inter-governmental communication between the Hong Kong government and the Guangdong

³²Guangdong Provincial Development Research Center, *Kuayue shiji xin jiyuan: Yue Gang Ao jingji hezuo lunwenji* (Across the new era: a collection of essays on economic cooperation among Guangdong, Hong Kong, and Macao) (Guangzhou: Guangdong Provincial Government, 1999), 15.

provincial authorities. The most striking example is the annual Hong Kong-Guangdong Cooperation Joint Conference (HGJC, 粵港合作聯席會議), held in Guangzhou for the first time in March 1998.³³ The conferences have considered such ad hoc issues as the selective expansion of border control point operations, the improvement of air and water quality, and an increase in the quota of mainland visitors permitted to enter Hong Kong. Strategic vision and region-wide planning to further economic integration have not been discussed.

Since the 1997-98 Asian financial crisis, public opinion in Hong Kong has held that Hong Kong's future is closely linked with China, particularly with the PRD. The attitude of Hong Kong senior officials has also become much more enthusiastic about Hong Kong-mainland cooperation in recent years.³⁴ In August 2001, the Hong Kong-Guangdong Cooperation Coordination Unit (HGCCU, 粵港合作統籌小組) was set up directly responsible to Hong Kong's Chief Secretary for Administration and Financial Secretary; this unit coordinates cross-border cooperation and economic development with Guangdong, especially the PRD.³⁵ The HGCCU assists the Chief Secretary and Financial Secretary in monitoring the implementation of initiatives endorsed at the HGJC. The HGCCU also reviews cross-border policies and arrangements for passengers and freight of all transportation modes, and is exploring—in consultation with relevant bureaus and departments—short-, medium-, and long-term measures sufficient to meet growing traffic demands. The third task of the HGCCU is to coordinate administration efforts to map out agendas at both

³³Note that there was no conference in 1999 due to the unenthusiastic attitude of the Hong Kong government.

³⁴Since the former Financial Secretary Donald Tsang (曾蔭權) replaced Mrs. Anson Chan (陳方安生) as the Chief Secretary for Administration in May 2001, Hong Kong government officials have become more proactive in promoting economic integration with Guangdong. See Yung Wing Sung, "Hong Kong Economy in Crisis," in *The First Tung Chee-Hua Administration*, ed. Siu Kai Lau (Hong Kong: The Chinese University Press, 2002), 136.

³⁵Hong Kong-Guangdong Cooperation Coordination Unit, *Hong Kong-Guangdong Cooperation Coordination Unit*. Paper submitted to Legislative Council Panel on Commerce and Industry, November 2001.

policy and operational levels in order to facilitate further cooperation between Hong Kong and Guangdong so that Hong Kong can reap the full benefits of the PRD region's economic development. However, there exists no counterpart department in either Guangdong Province or in other local governments in the PRD to negotiate with the HGCCU. Given that the unit's administrative level is under the Chief Secretary and Financial Secretary, HGCCU has not been able to coordinate successfully with other bureaus and departments of the Hong Kong government on cross-border issues.

For its part, the Chinese central government has striven to preserve the "one country, two systems" principle and defend Hong Kong's autonomous status. On the eve of Hong Kong's return to Chinese rule in 1997, the State Council's Hong Kong and Macao Affairs Office (HKMAO, 國務院港澳辦公室) forbade local governments from communicating directly with either the Hong Kong government or the territory's business sector. The HKMAO facilitates and assists the Hong Kong government in developing official contacts with mainland authorities. Article 22 of the Basic Law provides that no department of the central government and no province, autonomous region, or municipality may interfere in the affairs which the HKSAR administers on its own in accordance with the Basic Law. The HKMAO continues to play the role of "gate-keeper" to ensure that mainland authorities at all levels conduct business with Hong Kong in line with this principle. This office has been criticized, however, for doing its job so well that official communication between mainland China and Hong Kong has actually been more difficult after 1997. Mainland scholars and officials have unexpectedly argued that the poor implementation of the "one country, two systems" principle, especially the misunderstanding of what constitutes the "two systems," has hampered further cooperation.³⁶ Due to their high expectations for more fluent and far-reaching inter-governmental communication and cooperation after 1997, both officials

³⁶Xiaoyun Feng, "Quyu zhenghe: Zhujiang sanjioazhou jingzhengli de ruanle" (Regional integration: the shortcomings of the competitiveness of the Pearl River Delta), *Mingbao yuekan* (Ming Pao Monthly), February 2003, 23-25.

and scholars in mainland China—especially in the PRD—have been very disappointed with the post-1997 lack of progress in cooperation and integration. These failures have resulted from the central government's strict management of communication between the provincial and local governments of the PRD, as well as from the sluggish response of the Hong Kong government to such cooperation. Inter-governmental communication seems to have improved in the post-1997 period, but the actual pace of cross-border integration and development has not made any breakthroughs when compared with the pre-1997 period.

Insufficient communication and coordination induced both unhealthy competition and duplication of construction and development in the PRD and Hong Kong in the late 1990s, especially in terms of such infrastructure as ports, airports, and logistic centers. Within the 200 square kilometer area of the Greater PRD, there are now five international airports—Hong Kong, Shenzhen, Guangzhou, Zhuhai, and Macao, all of which vie for the trade and passengers of south China. Competition has been especially keen in the container ports. Comparing Hong Kong and neighboring Shenzhen is illustrative: total container throughput of Shenzhen ports reached 10.5 million TEU in 2003, nearly half that of Hong Kong; although Hong Kong still remains the busiest container port in the world, Shenzhen's rank has risen from eighteenth in 1998 to fourth in 2003.³⁷ In the face of increasing, fierce competition among the cities of the Greater PRD, a new institution called the "Mainland and Hong Kong Large-Scale Infrastructure Coordination Meeting" (內地與香港大型基礎設施協作會議) was established in order to coordinate the region's development of infrastructure.³⁸ Furthermore, competition between the PRD and Hong Kong has gone far beyond infrastructure projects, with major players in the region struggling to become the region's economic center. Hong Kong's function of "front shop"

³⁷Hong Kong Census and Statistics Department, *Hong Kong Shipping Statistics*, December 1998, 78; and *ibid.*, December 2003, 74.

³⁸The first meeting was held in Beijing in January 2002. The mainland team at that meeting was led by the deputy director of the State Development and Reform Commission, Zhang Guobao (張國寶); the Hong Kong team was chaired by the Chief Secretary, Donald Tsang.

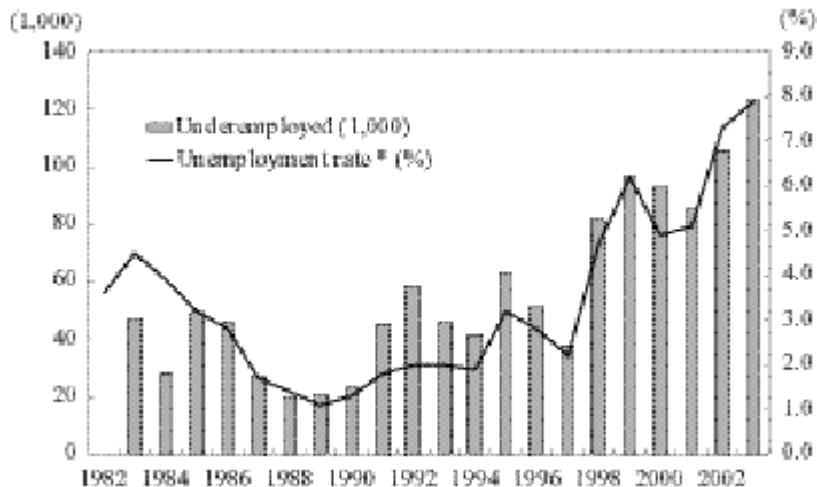
is being challenged by the PRD's (especially Guangzhou and Shenzhen) developing services. Notable is that at the sixth session of the HGCJC held in August 2003, the two sides agreed to create a new operations mechanism. The group is chaired by the heads of the two administrations—the Chief Executive of HKSAR and the Governor of Guangdong Province. Moreover, each side has set up its own "Hong Kong/Guangdong Cooperation Joint Conference Liaison Office" (粵港合作聯席會議聯絡辦公室). Nevertheless, except for a few areas such as infrastructural development, there is no effective organizational structure to resolve problems or provide visionary and coordinated leadership for the whole region.

CEPA: Emergence of Institution-Based Economic Integration

With China's resumption of sovereignty over Hong Kong, there have been many proposals made by the mainland to forge closer economic relations between the two sides. When the economy was prosperous, the idea was not particularly attractive to the people of Hong Kong, who feared a blurring of their identity would occur with the colony's further integration into the mainland. Faced with a very worrying economic downturn since the early 2000s, however, many Hong Kong people are now less hesitant to embrace the idea. In 2001 when Hong Kong's economy was in one of the worst depressions in its history (with an annual growth rate of 0.5 percent), some small- and medium-sized enterprises put pressure on the Hong Kong government to persuade the mainland government to grant them preferential treatment. Following the Asian financial crisis in 1997 and 1998, Hong Kong's economy has faced a dramatic recession, with the annual growth rate of gross domestic product (GDP) having dropped down to -5 percent in 1998 and 0.5 percent in 2001. Hong Kong's unemployment rate reached 7.3 percent and 7.9 percent in 2002 and 2003, respectively—the highest figures of the past two decades. The total number of unemployed amounted to 123,500 persons when based on statistics not seasonally adjusted, or 277,600 persons according to seasonally adjusted statistics (see fig. 4).

The mainland's accession to the WTO, the continuous growth of the mainland domestic market, and the upsurge of the Shanghai (上海)-

Figure 4
Unemployment Rate and Total Unemployment in Hong Kong, 1982-2003



Note: Unemployment rate and total number of unemployed are based on statistics not seasonally adjusted.

Sources: Compiled from Hong Kong Census and Statistics Department, *Hong Kong Monthly Digest of Statistics*, 1980-2003 editions.

centered Yangtze River Delta (長江三角洲) will open up new opportunities for Hong Kong. These same factors will, however, also expose Hong Kong to fierce competition from the outside. Hong Kong businesses will continue to encounter many barriers and operational restrictions in the mainland. There is also an anxiety that Hong Kong's middleman role will inevitably diminish given China's WTO entry and increasingly globalized outlook. In order to better position Hong Kong for the change, and in anticipation of the increasing competition from the Shanghai-led Yangtze River Delta cluster economy and other neighboring competitors, many feel that Hong Kong must embark on strategic cooperation with the PRD. At the same time, the early 2003 outbreak of severe acute respiratory syndrome (SARS) highlighted the fact that Hong Kong and the PRD are inextricably linked. The central government has decided that assisting Hong Kong's economic development is a necessary step to provide more stability

to Hong Kong; providing such economic assistance should also foster increased economic integration between Hong Kong and the mainland.³⁹

Following China's December 2001 accession to the WTO, Hong Kong's business sector soon recognized the importance of closer economic cooperation with the mainland. The Hong Kong General Chamber of Commerce proposed a "free trade agreement area" with the mainland in June 2000.⁴⁰ Following China's accession to the WTO, the Chief Executive of the HKSAR government, Tung Chee-hua (董建華), formally submitted proposals to the Beijing government concerning closer economic and trade relations. The proposal was later changed to a CEPA, which was considered to be more suitable given that the mainland and Hong Kong are independent customs territories and WTO members under the "one country, two systems" principle. After eighteen months of consultation, the agreement was concluded and signed on June 29, 2003, and came into force on January 1, 2004.

Under the Basic Law of the HKSAR, Hong Kong enjoys full autonomy in all affairs other than foreign relations and defense. Economic affairs—including external economic relations—are completely within the powers of the HKSAR. As a separate customs territory, Hong Kong is free to enter into trade agreements with any country or region, including mainland China; Hong Kong has, however, never signed a bilateral free trade agreement before.⁴¹ Some have even argued that it would be impossible for Hong Kong and the PRD (or the mainland as a whole) to form a formal trade bloc on the model of the European Union.⁴² China has been wary of

³⁹Eden Y. Woon, "Introduction," in *The Pearl River Super Zone: Tapping into the World's Fastest Growing Economy*, ed. Edith Terry (Hong Kong: South China Morning Post, 2003), 1-4.

⁴⁰Hong Kong General Chamber of Commerce, *China's Entry into the WTO and the Impact on Hong Kong: A Business Perspective* (Hong Kong: HKGCC, 2000), Appendix 9-15.

⁴¹Sinpor Shiu and Chun Yang, "China's Accession to World Trade Organization and Its Implications for Economic Cooperation Mechanism between Hong Kong and Mainland China," in *The Hong Kong & Macao Economy Yearbook 2001* (Beijing: Hong Kong & Macao Economy Yearbook Publishing House, 2001), 342-51.

⁴²Yung Wing Sung, "Economic Integration of Hong Kong and the Zhujiang Delta," in *Resource Management, Urbanization and Governance in Hong Kong and the Zhujiang Delta*, ed. Kwan Yiu Wong and Jianfa Shen (Hong Kong: The Chinese University, 2002), 9-32.

entering into bilateral arrangements (including a free trade agreement) with Hong Kong, however, because an "agreement" is customarily understood as a legal instrument between two or more states, and hence suggests the equality of the parties to the agreements. As a matter of fact, existing bilateral arrangements between mainland China and Hong Kong are usually the result of Hong Kong's initiatives.⁴³

CEPA is the first bilateral free trade agreement for both mainland China and Hong Kong. It consists of three parts: trade in goods, trade in services, and trade and investment facilitation. In terms of trade in goods, the most significant provision is to create a zero-tariff free trade area between Hong Kong and the mainland. A zero-tariff rate has been applied to 273 products under the mainland's tariff code from January 1, 2004, and will apply to other products no later than January 1, 2006. The annual savings in tariffs are estimated to be HK\$750 million.⁴⁴ The CEPA provisions in the trade in services include four categories: (1) the early liberalization of committed market openings, giving Hong Kong a time advantage; (2) the lowering of thresholds, making it easier for smaller Hong Kong firms to enter the mainland market; (3) regulatory changes to facilitate trade in services (including mutual recognition between professions) and relaxation of regulations for service suppliers; and (4) new liberalization measures not specified in the WTO Protocol of Accession. These provisions involve liberalization in eighteen sectors, including business and professional services, retail distribution and logistics, travel and tourism, and telecommunications and audio-visual services (see table 4). CEPA is a WTO-plus package, because smaller Hong Kong companies are to benefit from the opening-up and liberalization on the mainland beyond China's commitments under the WTO. In a number of key service sectors, what Hong Kong business is able to secure in CEPA goes far beyond what China has committed. In the banking sector, for example, without CEPA the asset

⁴³Qingjiang Kong, "Closer Economic Partnership Agreement between China and Hong Kong," *China: An International Journal* 1 (March 2003): 133-43.

⁴⁴Hong Kong Trade Development Council, "A Tentative Analysis of its Impacts on Hong Kong," *Trade Watch*, July 2003, 4.

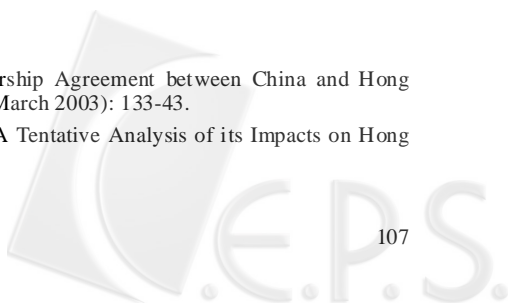


Table 4
Market Access Liberalization for Hong Kong Services under CEPA

Sectors	Earlier liberalization	Lower requirements	Additional liberalization
Management consulting	✓		
Convention and exhibition		✓	✓
Advertising	✓		
Accounting			✓
Construction			✓
Medical and dental			✓
Distribution			
1) Retail	✓	✓	✓
2) Foreign trade		✓	
3) Wholesale	✓	✓	
Logistics			✓
Freight forwarding	✓	✓	
Storage and warehousing	✓	✓	
Transport			
1) Land	✓		✓
2) Maritime			✓
Tourism			✓
Audio-visual			✓
Legal services			✓
Banking		✓	✓
Securities			✓
Insurance		✓	✓
Telecommunication services	✓		

Source: Compiled according to Hong Kong General Chamber of Commerce, *Closer Economic Partnership Arrangement: Business Assessment*. A Hong Kong General Chamber of Commerce Report (Hong Kong: HKGCC, 2003), 89-94.

requirement for the headquarters of foreign financial institutions wishing to enter the mainland market is US\$20 billion, a requirement which the majority of Hong Kong's small- and medium-sized financial companies cannot meet. Under CEPA, the asset requirement for both Hong Kong banks and Hong Kong financial companies wishing to enter the mainland market is reduced to US\$6 billion. A similar concession applies to the dis-

tribution service sector. Hong Kong films may now enter the mainland market completely quota-free. Hong Kong law firms with a representative office in the mainland will be permitted to conduct business jointly with their mainland counterparts. In order to facilitate trade and investment, measures will be adopted to simplify procedures, increase transparency, and eliminate such problems as irregular collection of fees by some local governments; the overall goal is thus to make the mainland a better place for investment. In general, CEPA's impact on services is likely to be greater than on manufacturing. This is particularly true when services, accounting for only 34 percent of China's GDP and 45 percent of the PRD's GDP, have become a constraint on the country's economic development. Services already contribute 87 percent to the Hong Kong domestic economy, and will therefore be able to contribute more to the modernization of the country under CEPA.⁴⁵

CEPA was signed just as Hong Kong was emerging from the SARS outbreak, and thus gave a timely boost to Hong Kong's morale. Visitor arrivals reflect this change of attitude. Between April and July of 2003, Hong Kong received 2.34 million fewer visitors than in 2002. Arrivals from some areas were down as much as 90 percent, with average hotel occupancy having dipped as low as 18 percent.⁴⁶ With the relaxation of restriction on travel, permanent residents with household registration in Foshan, Zhongshan, Jiangmen, Dongguan, Guangzhou, Shenzhen, and Zhuhai, together with Beijing and Shanghai, have been allowed to visit Hong Kong individually since the end of July 2003. As a result, visitor arrivals in Hong Kong have rebounded to an increase in August (see fig. 5). The number of mainland visitors soared from 6.8 million in 2002 to 8.5 million in 2003, with the share of total visitor arrivals increasing from 41.2 percent to 54.5 percent in the same period.⁴⁷ The figure is expected to

⁴⁵Ibid.

⁴⁶Hong Kong Trade Development Council, *CEPA and Opportunities for Hong Kong* (Hong Kong: HKTDC, 2003).

⁴⁷Hong Kong Census and Statistics Department, *Hong Kong Monthly Digest of Statistics*, February 2004, 116.

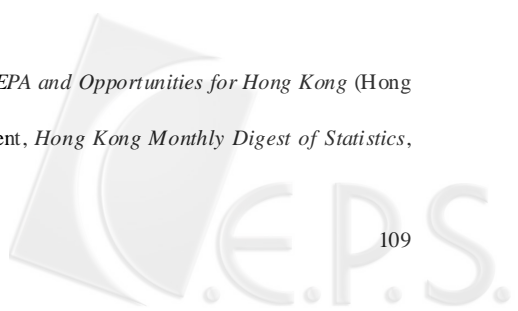
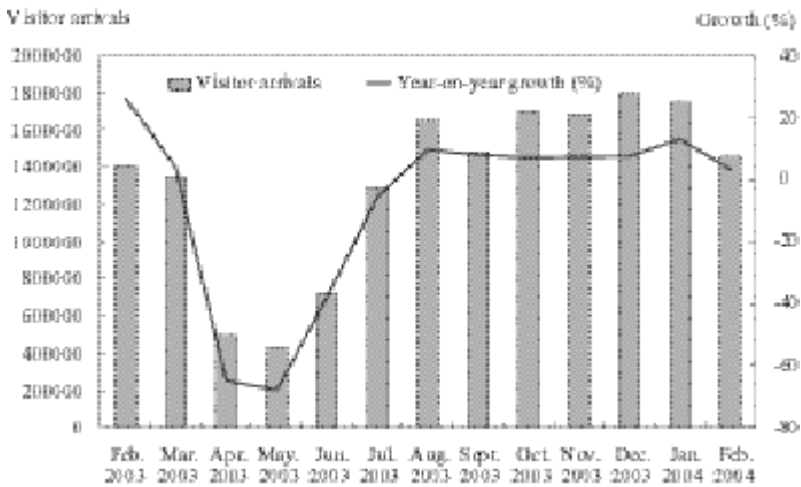


Figure 5
Decrease and Increase of Visitor Arrivals from Mainland,
February 2003-February 2004



Sources: Compiled from Hong Kong Tourism Bureau, *News Release*, March 2003-February 2004.

surge again with the expansion of individual tours to the whole province of Guangdong and to more coastal cities—including Nanjing (南京), Suzhou (蘇州), Hangzhou (杭州), Ningbo (寧波), Wuxi (無錫), Xiamen (廈門), Fuzhou (福州), and Quanzhou (泉州).⁴⁸

At this stage, it seems too early (and too difficult) to quantify the impact of CEPA on the economic development of the two areas. While the PRD's development was heavily reliant on Hong Kong for investment, trade, and capital, the economy of Hong Kong has become increasingly dependent on mainland Chinese visitors, goods, and markets to maintain its status as an international logistics and financial center. Under CEPA, moreover, the integrated Hong Kong-PRD region is likely to become oriented more inwardly toward the mainland market than it was oriented

⁴⁸<http://unn.people.com.cn/GB/14800/21806/2477844.html> (accessed May 1, 2004).

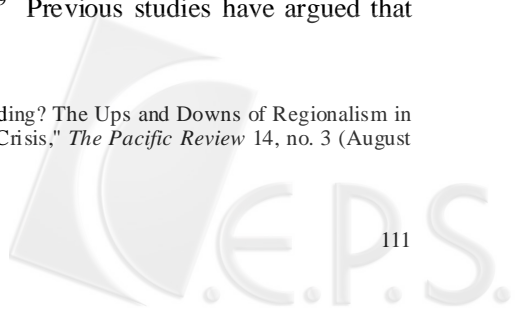
outwardly toward foreign exports during the past two decades. The CEPA agreement marked a new milestone in the relationship and will have a fundamental impact on the further economic integration of the mainland, especially the PRD and Hong Kong. The functional regional integration between the PRD and Hong Kong spontaneously initiated by both entrepreneurs and local governments has been transforming into an institution-based integration via the CEPA.

Obviously, the conclusion of the CEPA agreement represents a pioneering intervention by the central government to coordinate cross-border economic integration more directly. The CEPA agreement (which also applies to Macao); the decision to proceed with the bridge between Hong Kong, Zhuhai, and Macao; and the relaxation of restrictions on individual tourism from the mainland to Hong Kong and Macao, all have helped to break the impasse in cross-border cooperation during the past few years and have dramatically changed the previous informal spontaneous integration that was driven by market forces, the private sector, and lower-level PRD governments.

Conclusion

Since the late 1990s, East Asia has been witnessing the emergence of a new, as yet embryonic body, the APT; at the same time, ambitious projects implying closer economic integration between Northeast and Southeast Asia are being mooted. The Asian financial crisis, in particular, has been instrumental both in undermining ASEAN and APEC and in fostering the rise of the APT. The APT's development has been fueled by the greatly strengthened perceptions of the economic interdependence and vulnerability of East Asia, as well as by the region's resentment against the West (especially the United States).⁴⁹ Previous studies have argued that

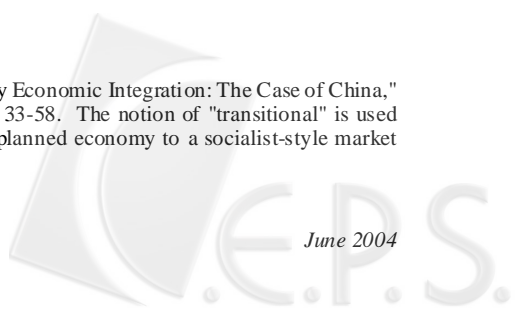
⁴⁹Douglas Webber, "Two Funerals and a Wedding? The Ups and Downs of Regionalism in East Asia and Asia-Pacific After the Asian Crisis," *The Pacific Review* 14, no. 3 (August 2001): 339-72.



sub-national economic integration has resulted in issues of intra-country economic integration being largely neglected in current research, especially in transitional socialist China.⁵⁰ This paper has investigated the sub-national economic integration of China under the "one country, two systems" framework, taking the PRD and Hong Kong as a case study.

Most cases of economic integration have been based on the prior establishment of formal free trade agreements and institutions (such as the EU, NAFTA, and APEC) or inter-governmental negotiations (such as the Growth Triangle of Singapore, Malaysia, and Indonesia). The regional integration of the PRD and Hong Kong was, however, spontaneously initiated since 1978 by the manufacturing entrepreneurs of Hong Kong and by the local governments of the PRD. Inter-governmental communication began only after Hong Kong's return to Chinese rule in 1997. The formal institutionally-based mechanism of integration emerged only in mid-2003, however, after twenty-five years of ever-increasing socioeconomic interaction. The extent and pace of regional integration is expected to accelerate once the CEPA agreement comes into full effect. Economic integration between the PRD and Hong Kong was regarded as informal, being propelled by cultural affinity, geographical proximity, and personal contacts during the 1980s and 1990s. This study points to a new type of integration based on institution-building that has occurred since the signing of the CEPA. This change is in line with the increasing regionalism of various parts of the world, especially East Asia. So far, almost all East Asian economies—with the notable exception of Taiwan—are engaged in multiple or bilateral free trade agreements. Since Hong Kong and Macao signed Closer Economic Partnership Arrangements with mainland China, a Greater China Free Trade Agreement is expected to be established once cross-Strait political barriers to economic integration between the mainland and Taiwan are overcome.

⁵⁰Jiawen Yang, "Inter-National and Intra-Country Economic Integration: The Case of China," *Issues & Studies* 38, no. 3 (September 2002): 33-58. The notion of "transitional" is used here to describe the transition from centrally-planned economy to a socialist-style market economy in China.



In the context of East Asia's increasing regionalism, Hong Kong actually faces the threat of marginalization in the region. The former colony is a latecomer to the new economic integration process that has been occurring in East Asia since the late 1990s. With keen competition both inside and outside the region, the PRD and Hong Kong recognize the need for further economic integration. Following the establishment of the CEPA, the Guangdong provincial government proposed the creation of a "Pan-Pearl River Delta" (泛珠江三角洲) region in September 2003; this new group would include Guangdong, Guangxi (廣西), Guizhou (貴州), Sichuan (四川), Hunan (湖南), Jiangxi (江西), Fujian (福建), Hainan (海南), and Yunnan (雲南), as well as Hong Kong and Macao.⁵¹ The first Pan-Pearl River Delta Regional Cooperation and Development Forum (泛珠江三角洲區域合作與發展論壇) was held in June 2004 in Hong Kong. The goals of this Forum are to expand the Delta's hinterland and to participate more actively in both regional integration and economic cooperation. Another of China's objectives is to use Guangdong to strengthen cooperation with ASEAN. Under the framework of the WTO-compliant CEPA, institution-based integration will have a far-reaching influence on the further integration of Hong Kong and the PRD, and on further expansion of integration to other parts of mainland China. Under the Pan-Pearl River Delta proposal, Guangdong is now shifting attention to the hinterlands, seeking greater cooperation with neighboring provinces in transport, energy, tourism, and other areas. Guangdong has advantages in terms of capital, information technology, and a huge market; the province's neighbors are rich in natural and human resources. With the emergence of regional economic integration (especially with EAFTA and APT), Hong Kong needs to promote, and participate actively in this new proposal; such an aggressive policy can help prevent the threat of the former colony's marginalization.

The development and transformation of the mechanism of economic integration between the PRD and Hong Kong has characteristics distinct

⁵¹Southcn.com, <http://www.southcn.com/news/gdnews/hotspot/fzsj/pl/200311150647.htm> (accessed March 31, 2004).

from those of such existing institutional arrangements as the EU and NAFTA. In the latter, the emergence of cross-border regions has usually resulted from deliberate attempts (particularly by central governments) to insert, on favorable terms, "development pockets" into the changing global division of labor. In contrast, regional integration was initiated spontaneously by the local governments of the PRD. Since Hong Kong's return to Chinese rule in 1997, cross-border economic integration has not moved as fast as expected, partly because of the constraints on implementation of the "one country, two systems" principle. Although a formal inter-governmental communication channel—i.e., the Guangdong-Hong Kong Cooperation Joint Conference—has been established between Hong Kong and the Guangdong provincial government, the State Council's Hong Kong and Macao Affairs Office continues to have the final say on cross-border issues. The central government has intervened after allowing integration to proceed spontaneously for more than twenty years; this sudden change in policy has occurred because the increasing intensive interaction and integration without formal inter-governmental communication had led to unhealthy competition, duplication of construction, a waste of resources, and an insufficient vision of region-wide thinking and planning.

The regional integration between the PRD and Hong Kong has developed even despite restricted flows of people and goods, especially those from the mainland and PRD into Hong Kong. Many new measures will likely be taken, however, to promote easy cross-border connections. Under institution-based integration, previously ad hoc and reactive coordination is expected to change to a common vision, and strategic region-wide planning will become more realistic. Despite the unique framework of "one country, two systems," the transformation of the mechanism of integration of the Pearl River Delta and Hong Kong—as a salient case of cross-border region at a sub-national level—suggests that there exists a trend toward institution-based integration in East Asia.



Appendix: A List of Acronyms

- AFTA:** ASEAN Free Trade Area
APEC: Asia-Pacific Economic Cooperation
APO: ASEAN Plus One
APT: ASEAN Plus Three
ASEAN: Association of Southeast Asian Nations
CEP: closer economic partnership
CEPA: Closer Economic Partnership Arrangement (更緊密經貿關係安排)
CER: closer economic relations
EFTA: East Asian Free Trade Area
EU: European Union
FTA: free trade agreement
GDP: gross domestic product
HGCCU: Hong Kong-Guangdong Cooperation Coordination Unit (粵港合作統籌小組)
HGCJC: Hong Kong-Guangdong Cooperation Joint Conference (粵港合作聯席會議)
HKMAO: Hong Kong and Macao Affairs Office (港澳辦公室)
HKSAR: Hong Kong Special Administrative Region (香港特別行政區)
IMF: International Monetary Fund
NAFTA: North American Free Trade Agreement
PRD: Pearl River Delta (珠江三角洲)
RTA: regional trade agreement
SARS: severe acute respiratory syndrome
WTO: World Trade Organization

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