Development of the China-Hong Kong CEPA and Its Impact on Taiwan

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Abstract

The Closer Economic Partnership Arrangement (CEPA) between China and Hong Kong was signed on June 2003. It went into force on January 1, 2004. The influence of the CEPA on the Hong Kong economy is much greater than was expected, both in terms of GDP growth and unemployment. Free trade with China not only helps Hong Kong businessmen to get rid of their tariff burden, but is also turning the former British crown colony into a depot for goods from other regions in Asia. On the other hand, Hong Kong's service sector also benefits much, because it now has easy access to China's domestic market. Moreover, the CEPA also allows more people from China to visit Hong Kong, a boom for its tourism industry. While it increases the competitiveness of Hong Kong's service sector, the CEPA reduces that of Taiwan's. If the government does not change its economic policy vis-à-vis China, Taiwanese firms will loss their international competitiveness in the long run.

Key words: CEPA, China, Hong Kong, Taiwan

I. Introduction

The Closer Economic Partnership Arrangement (CEPA) between China and Hong Kong took effect on January 1, 2004. It seems that Hong Kong has since benefited considerably, with its tourism industry reaping a very handsome profit. The Hong Kong Hang Seng index has increased from 9,746 at the end of June 2003 to reach 12,285 at the end of July 2004, while unemployment dropped from 8.3 percent in June 2003 to 7.1 percent in May 2004. Meanwhile, its gross domestic product (GDP) growth was estimated at 6.1 percent for 2004, a rise of 2.2 percent over the previous year. Though not necessarily the only reason for Hong Kong's economic recovery, the CEPA certainly has strengthened the confidence of the people of the special administrative region in their economic future.

Major points of the CEPA are treated in Section II of this paper. They include free trade of industrial goods, services, and procedures for trade and investment. Section III deals with the potential effect of the CEPA on the Hong Kong economy. Its impact on Hong Kong's GDP growth follows in Section IV. Section V describes the implementation of the CEPA since January 1, 2004. The potential impact of the CEPA on the Taiwan economy is summarized in Section VI. The conclusion is presented in Section VII.

II. Major Points

1. Trade in Manufactured Goods

(1)Hong Kong levies no tariffs on all manufactured goods from China, while 273 items it sells to China are tax-free. Among them are textiles, clothes, watches, and jewels. All other manufactured goods will also be duty free no later than January 1, 2006.

(2) Both China and Hong Kong agree to enlarge cooperation in identifying the origin of products to be traded. So far as China is concerned, the origin of a product is the place where at least 30 percent of the final value of that product is added. Hong Kong applies the manufacturing processes to the identification of the origin. China and Hong Kong have to work out a compromise.

2. Trade in Services

(1)China has to open seventeen lines in the service sector, including management consultation, advertisement, and certified public accountancy.[1]

(2)The terms on investment in China for Hong Kong's service industries are less restrictive than those for foreign firms prescribed by the World Trade Organization (WTO).

(3)The period of residence rather than the locally owned stock share is the basis for defining a Hong Kong firm.

3. Facility in Trade and Investment

(1)China and Hong Kong should strengthen cooperation in investment, customs service, commodity inspection, quarantine, measurement standardization, food safety, Chinese medicine, and development of small and medium businesses. Moreover, both sides have to simplify the operating procedures in the said seven fields.

(2)In the said seven fields, both sides will work together specifically to: a) promote bilateral investment, b) coordinate on common duties on

[1] Later, one more item is added, namely telecommunication industry. See Kao and Tseng (2003).

commodities from outside their territory as well as on their common international marketing, c) expedite customs clearance, d) strengthen quarantine and commodity inspection, and e) exchange business information.[2]

III. Potential Benefits to Hong Kong's Economy

The CEPA is expected to help Hong Kong increase exports to China, thank to the exemption of tariffs on its manufactured commodities. Service industries would become even more competitive, because the CEPA allows them to do business in China with much less restrictions than their international competitors. Moreover, the Hong Kong government could take advantage of the CEPA to attract foreign firms to invest in Hong Kong and then move to China as Hong Kong companies. It turns out that Hong Kong has better opportunities than Taiwan to become a regional operation center for multinational companies around the world.

The potential economic benefits to Hong Kong are summarized as follows:

1. More than 90 percent of commodities exported to China from Hong Kong are duty-free. Hong Kong has a great competitive edge on the commodity market in China.

2. Hong Kong will save HK$750 million in tariff a year on those 90 percent of the commodities it exports to China free of duty. Moreover, there would be more goods exported to China because they are duty-free. As a consequence, the total tariff saving would be more higher.

3. The CEPA enables Hong Kong firms to operate management consultation and other businesses in the service sector in China three to four years before their foreign competitors can under the WTO schedule. They would enjoy a large lead. In addition, Hong Kong law offices are allowed to operate jointly in China with their Chinese counterparts.

4. Hong Kong banks with a net asset of more than US$600 million are allowed to open branches in China. Foreign banks have a net asset of more than US$2 billion to do so. As a result, eight more Hong Kong banks are qualified to open their branches in China. Moreover, Hong Kong banks are allowed to do business denominated in the RMB (renminbi) two years after their branches are opened in China. Foreign banks have to wait for three years.

5. Hong Kong residents, licensed by the Chinese government, are allowed to serve as actuaries and insurance agents in China.

6. Hong Kong will be able to attract more foreign companies that desire to enter the Chinese market. They may invest first in Hong Kong and then move to China as Hong Kong firms. Hong Kong service industries have better access to China. Hong Kong, as a result, has a much better chance to become a regional operation center in Asia for foreign firms.[3]

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[2] Tsai (2003) and Chao (2003) have provided a good summary for the details about China-Hong Kong CEPA.

[3] According to the Investment Bureau of Hong Kong, there are 117 foreign firms forming local headquarters in Hong Kong for the first nine months in 2003, which is about the total number for the year of 2002. In 2004, it is estimated that there will have more than 200 foreign firms to choose Hong Kong as their local headquarter in Asia. See Tsai (2004).

IV. Impacts on Hong Kong's GDP Growth

Impacts of the CEPA on Hong Kong's GDP growth are estimated as follows:

1. According to the Hong Kong General Chamber of Commerce, the CEPA-generated domestic investment would total as much as HK$5.9 billion. That would make Hong Kong's GDP grow by 0.22 percent. Meanwhile, the new investment could also provide 10,000 to 30,000 jobs, an increase of five to 15 percent in employment among its manufacturing industries. Furthermore, more than a quarter of the Hong Kong businesses in China are considering moving their production lines back to Hong Kong.4

2. Applying an input-output model, Lien (2004) estimates that the total exports from Honk Kong to China will increase by US$385 million when there are 273 items free from duty. The total export volume of the top 20 items would increase by US$114 million. GDP would increase by HK$3 billion per annum, which will add about 0.2 to 0.3 percent to GDP a year.

3. According to an estimate by C. H. Wang (2003), the CEPA could generate HK$4 billion to HK$5.8 billion in production by the manufacturing sector in Hong Kong annually between 2004 and 2010, which would add about 0.3 to 0.46 percent to GDP per annum. On the other hand, there will be 20,000 to 30,000 jobs created in Hong Kong. Furthermore, the GDP growth rate will rise by 0.65 to 0.81 percent per annum between 2004 and 2010, if the service sector is included. Meanwhile, the job opportunities will increase by 30,000 to 40,000.

4. The Deutsche Bank estimates the GDP growth rate at 0.4 percent per annum, creating 5,000 to 50,000 job opportunities. The growth rate of exports from Hong Kong to China will go up 12 percent.[5] The estimated impact of CEPA on Hong Kong's economy is summarized in Table

[4] For details, see Yao (2003a,b).

[5] See Tsai (2003). Feng (2003) also provides a good analysis about the potential benefit of CEPA both for China and Hong Kong.

Table 1 Estimated Impact of CEPA on Hong Kong

Estimating Institutes	Growth Rate (%)	Employment (persons)	Export (%)
Hong Kong General Chamber of Commerce	0.22%	10000-30000	—
Deutsche Bank	0.4%	5000-10000 (manufacturing)	increasing by 12%
Lien (2004)	0.2%-0.3%	—	increasing US$385 million
C. H. Wang (2003)	0.3%-0.46% (manufacturing)	20000-30000 (manufacturing)	—
	0.65%-0.81% (total)	30000-40000 (total)	—

V. Implementation of CEPA

The People's Republic of China and Hong Kong had launched a massive public information drive to make the CEPA understood by their citizens as well as foreign investors long before it went into force on January 1, 2004. The purpose is to familiarize the people with how they can benefit from the CEPA. There can be little doubt that China and Hong Kong can attract more investment, domestic as well as foreign.

1.Promotion for CEPA:

(1) Promotional Conferences

Hong Kong and Macao held a joint seminar in November 2003 to give promotion to their "Investment Environment and Business Opportunities under the CEPA." In the same month, China and Macao held a joint seminar on their commodity trade under the CEPA. In December, another seminar on opportunities for small and medium businesses under the CEPA was sponsored the Trade Development Bureau of Hong Kong. Between January and February 2004, an itinerant "Hong Kong and Macau Promoting Week" exhibition was held at Beijing, Shanghai, and Guangzhou. Moreover, the Trade Development Bureau of Hong Kong held a CEPA seminar in Taiwan in May 2004 to recruit investors. The seminar emphasized the importance of the Hong Kong-Pearl River Delta business structure.

(2) CEPA Service Centers:

Macao set up a CEPA information center in the Macao Business Center in November 2003. Hong Kong also plans to set up CEPA business opportunity centers in Beijing, Shanghai, and Guangzhou.

(3) Hong Kong and Macao Supply Centers

Hong Kong and Macao supply centers have been set up at major cities in Guangdong province – including Guangzhou, Chuhai, Chungshan, Foshan and Shengzhen – to promote sales of duty-free products.

(4) Industrial Zone

Hong Kong is planning to open an industrial zone in Shengzhen. It will enjoy a CEPA tax holiday. Low cost land is available. Hong Kong professionals will manage it. As a consequence, the industrial zone is expected to attract Hong Kong investors.

2. Free Trade

According to statistics compiled by the Chinese Ministry of Commerce, the duty-free imports from Hong Kong and Macao totaled only HK$330 million in the first five months of 2004. The volume accounted for about 10 percent of the total imports in the same period. On the other hand, the Guangdong provincial customs received 379 certificates of origin for duty-free merchandise from Hong Kong and Macao with a total value HK$164 million in the first three months of 2004. The Shanghai customs cleared 118 batches of commodities without tariff worth HK$100 million in the first four months of the same year. Though such exports from Hong Kong and Macao to China were not as large as had been expected, they would increase a great deal quickly in the future as exporters have learned to take advantage of the CEPA.

To promote tax-free exports, Hong Kong completed negotiations with China on the second stage tariff liberalization. On August 27, 2004, Hong Kong and China reached an agreement under which 713 items of export would be added to the zero-tariff list as from January 1, 2005. The duty-free items of export totaled 1,087 at the beginning of this year.

About the definition of the origin of merchandise, no final decision had been reached between Hong Kong and China as of October 31, 2004. According to Raymond Young, Hong Kong director of trade and industry, only about 7 to 8 percent of the 713 items of export newly added to the zero-tariff list in the second stage of liberalization would be subject to China's "value-added" definition of the origin. Such items of export accounted for 15 percent of the total of 374 in the initial stage of liberalization. Since the cases in the second stage are only half as many as those in the initial stage, it would be much easier for both sides to reach agreement on the definition of the origin. Furthermore, the origin of 60 to 70 percent of the items of export in the second stage liberalization will be defined on the basis of the manufacturing processes. The remaining 30 to 40 percent will be defined by tax incidence.

Hong Kong would request that its definition based on the manufacturing processes be applied to all new items of export, except 184 of them that are produced abroad. Hong Kong also insists that China's "value-added" definition be applied to not more than 30 percent of its total tax-free items of export. Hong Kong would also request that the Chinese definition be not applied to timepieces.

There is little doubt that the negotiations on the definition of the origin of merchandise would be successfully concluded.

3. Service Industries

It takes more time to open up the market to service industries. Foreign firms have to apply for permission from Hong Kong and China. There were only 111 applications for permission from Hong Kong filed in January 2004. The number of applications rose to 196 in February, 262 in March, and 354 in May. Most of them were filed by shipping companies. Distributors and advertising agents followed.

Altogether 345 applications for permission from China were filed in the first five months of 2004. They were filed by Hong Kong firms. Of them 298 were accepted. Most of them were banks, mass communications media and distributors. Hong Kong banks with a net asset of US$6 billion can set up branches in China under the CEPA provision.[6] Eight of them are qualified. They include the Wing Lung Bank, Shanghai Commercial Bank, and Dah Sing Bank. On the other hand, 551 Hong Kong residents were allowed to set up businesses in Guangdong province in the first five months of 2004.

4. Trade and Investment

(1) China, Hong Kong, and Macao standardized customs clearance on January 1, 2004. Green locks are applied to the containers of merchandise after inspection, and the locked containers are exempted from any more customs inspection in China, Hong Kong and Macao.

(2) China, Hong Kong, and Macao have signed an

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[6] Under the rule of WTO, China allows foreign banks with total assets more than US$10 billions to set branches under joint venture with local banks in China and allows foreign banks with total asset more than US$20 billions to set wholly-owned branches.

agreement of cooperation in the prevention of contagious diseases and among service industries. Cooperation also covers tourism, environment protection, and infrastructure construction.

(3) China allows citizens of its major cities to visit Hong Kong and Macao. China, Hong Kong, and Macao signed an agreement on closer partnership in tourism cooperation in December 2003. As of March 15, 2004, a total of 3.04 million residents from Guangdong province had applied for permission to visit Hong Kong and Macao. Permission would be granted to any resident in Guangdong in May. Residents of Jiangsu, Zhejiang, and Fujian provinces were allowed to follow suit in July. As a result, an estimated 150 million Chinese would apply for permission to make "personal visits" to Hong Kong and Macao a year. These tourists are expected to increase Hong Kong's sale of apparel, footwear, jewelry and medicine.

5. Impact of CEPA on Hong Kong's Economic Growth

Table 2 shows the trend of economic growth in Hong Kong and Macao. The real GDP growth rate in the first quarter of 2004 in Hong Kong was 6.8 percent, higher than the previous quarter (4.5 percent). Moreover, the GDP growth rate in the second quarter was even higher (12.1 percent). The changes in GDP growth for Macao were spectacular. Its GDP growth soared 24.7 percent in the third quarter of 2003. It went up by 25.6 percent and 45.7 percent in the first two quarters of 2004.

Table 2 Trend of GDP Growth in Hong Kong and Macao Unit: %

	Hong Kong	Macao
2001 I	2.2	6.8
II	0.8	4.2
III	-0.4	-1.6
IV	-1.4	0.5
2002 I	-0.6	8.0
II	0.8	9.0
III	3.4	7.3
IV	5.1	15.4
2003 I	4.0	17.1
II	-1.0	-1.7
III	3.6	24.7
IV	4.5	21.1
2004 I	6.8	25.6
II	12.1	47.5

Source : (1) Hong Kong: Taiwan Economic Journal Data Bank.
(2) Macao: Government of Macao Special Adminstrative Region Statistics and Census Service.

Chinese tourists contributed to the rapid GDP growth in Hong Kong and Macao. Altogether 3.73 million Chinese visited Macao in the first six months of 2004. That number is about 8.3 times the population of Macao. Thanks to the influx of new visitors, more than 70 travel agencies are founded in Macao in 2004. Hong Kong received 2.3 million visitors from China in the first half of 2004. Their spending in Hong Kong was estimated at HK$8 billion, about HK$6,018 per visitor. It was a boon for tourism and related industries. Hotels, restaurants and retailers benefited from the tourist boom. About 50,000 new jobs were created in Hong Kong. The overall effect was much larger than that of the zero-tariff provision of the CEPA.

Moreover, there are more China residents coming to Hong Kong to purchase real estate. Since real estate is one of the major industries in Hong Kong, their purchases would have a significant impact on Hong Kong's economic growth. Hong Kong's real estate prices increased by 46.1 percent in the first eight months of 2004. A new one-month office space transaction record was set in September 2004. There were 446 transactions, which totaled HK$855 million in value, 81.9 percent over the previous month of August.

Foreign direct investment (FDI) in Hong Kong started to pick up in 2004. Most multinational firms want to use Hong Kong as a base to enter China under CEPA provisions. The inward DFI totaled US$13.8 billion in the first six months of 2004, higher than that registered for the entire previous year (US$13.6 billion).[7]

China would further open up its market for Hong Kong service industries. Eight more would be added to the 11 services already allowed. Real estate and trademark registration are among the new services to be added. The new addition is expected to attract more FDI to Hong Kong.

VI. Impact of CEPA on Taiwan's Economy

Most of the 273 tariff-free items of export from Hong Kong to China are labor-intensive manufactured products. They made up less than 10 percent Hong Kong's GDP. Their volume is unlikely to grow much larger than it is. The impact of the initial CEPA liberalization on Taiwan is minimal. The second stage liberalization, the opening of the Chinese market to service industries, is likely to impact Taiwan in a different way. Since the CEPA provides very strong investment incentives, Hong Kong is expected to attract more FDI and have a better chance to become a regional operation center in Asia for multinational firms around the world. Taiwan has been trying for years to serve as that regional operation center. Hong Kong, with CEPA advantages, is seriously challenging Taiwan. The impact of the CEPA on Taiwan in this sense may be much larger than is expected.

1. Impact on Taiwan's Macroeconomic Performance

The total value of the 273 items of export from Hong Kong to China was US$846 million in 2002. They accounted for 15.26 percent of Hong Kong exports to China in that year. The similar exports from Taiwan to China in the same year totaled US$7.95 billion and accounted for 20.86 percent. Taiwan exported 9.39 times as much as Hong Kong. The CEPA liberalization had no significant impact on Taiwan's exports to China.

However, free trade may make Hong Kong investors in China move their operation back to Hong Kong. Taiwan investors in China may also move to Hong Kong. As a result, Hong Kong may become a serious competitor of Taiwan in marketing the 273 items of export to China. Besides, all commodities exported from Hong Kong to China will be tax-free after 2006. Taiwan will face a serious challenge from Hong Kong to its export trade with China.

According to Lien (2004), the CEPA may produce: 1) direct substitution effect: Hong Kong replaces Taiwan after increasing production merchandise to be exported to China; 2) direct expansion effect: Taiwan's exports to Hong Kong increase because of the increased demand for its components and semi-finished products needed in Hong Kong production; 3) indirect substitution effect: Taiwan's component and semi-finished product exports to China decline because of the decreased demand for them by Taiwanese-owned

[7] Guangdon province also tries to use CEPA as a tool to attract DFI. See Bureau of International Trade (2003).

factories there, as Hong Kong exports increase; and 4) response effect: Taiwan's exports to Hong Kong increase, while those to China decrease, as a result of Hong Kong businessmen (and Taiwan businessmen) increasing their investment in Hong Kong.

Lien (2004) reviewed only the direct substitution effect and found that the 273 items of export could increase Hong Kong's exports to China by US$395 million, which makes up about 0.2 to 0.3 percent of its GDP. On the other hand, the direct substitution effect would reduce Taiwan's exports to China by US$52 million. The impact is minimal. To be affected would be the apparel and textile industries. The impact may be larger after China exempts all imports from Hong Kong from taxation in 2006.

2. Impact on Taiwan's Service Industries

(1) Banking and Insurance

It is easier for Hong Kong banks to open branches in China under the CEPA provision. On the other hand, Taiwan does not allow its banks to invest in China. Taiwan banks have little chance to compete in China. Those interested in the Chinese market have to invest in Hong Kong first. For instance, the Fu-Bon Bank of Taiwan spent HK$4.31 billion to buy 55 percent of the stock of the International Bank of Asia (IBA) in Hong Kong in November 2003 to pave the way for its venture in China. The First Commercial Bank of Taiwan has also announced its intention to buy a Hong Kong bank for the similar purpose. Furthermore, the Shanghai Commercial Bank of Taiwan, the Shanghai Bank of Hong Kong, and the Shanghai Bank of China are looking for joint investment in China. It is clear that Taiwan's banking industry is the one most seriously impacted by the CEPA.[8]

(2) Individual Services

Hong Kong is an internationalized society. Its lawyers, certified public accountants, management consultants and even retail business operators can offer service up to the high international standard. They are now allowed to operate in China. Their counterparts in Taiwan simply cannot compete with them in the Chinese market.

China and Hong Kong are negotiating another round of liberalization. When an agreement is reached, Hong Kong professionals and managerial personnel would be allowed to offer individual services in China after January 1, 2006. It is likely that the Chinese market might be all but closed to their Taiwanese counterparts after 2006.

3. Impact on Taiwan's Regional Operation Center Chance

According to the CEPA provisions, Hong Kong banks can engage in RMB-denominated business two years after they start operation in China. Most Hong Kong banks can start their RMB-denominated business now because they have been in operation in China for more than two years. More importantly, China allows Hong Kong banks to operate RMB clearing business in Hong Kong, which makes them the first official RMB offshore banking center. That alone assures Hong Kong of becoming the regional financial center in Asia for world businesses. Taiwan is losing its chance to become Asia's financial center.

Additionally, since it is more convenient for Taiwanese firms in China to move their capital in and out of China, there is a strong incentive for them to get listed in the Hong Kong stock exchange. Taiwan's Solomon Systech in China was listed in Hong Kong of late.[9] Many Taiwan companies in China may follow suit. According to press reports, more than forty of

[8] About the details of the potential impact of CEPA on Taiwan's financial development, see Lin(2004) and Chao (2004a, b).

[9] Solomon Systech is a subsidiary owned by Foxconn who is one of the largest Taiwanese firms in China.

them applied for listing in Hong Kong.

No mutual financial deregulation is possible between Taiwan and China. Since there is no MOU agreement between China and Taiwan, it is almost impossible for banks to set branches in each other. Moreover, for lack of a "bilateral exchange clearing agreement," Taiwan has to clear international settlements with China through Hong Kong. It means that the RMB cannot be exchanged with the New Taiwan dollar freely either in Taiwan or in China. With so much constraints, Taiwan cannot possibly serve as a regional financial center. In the meantime, Taiwan has failed to induce its businesses in China to get listed in the Taipei stock exchange. Under such circumstances, Taiwan businessmen may even have difficulties raising capital in Taipei for their businesses in China.[10]

VII. Conclusion

The CEPA covers free trade in commodities, the opening of the market to service industries, and easier investment. Hong Kong has benefited a great deal from it. It has a favorable impact on the Hong Kong economy in terms of GDP grow, employment, and stock market gains.

Only 273 items of export from Hong Kong to China are tariff-exempted. Since their exports are only one tenth of those from Taiwan to China, the zero-tariff provision of the CEPA has little impact on Taiwan's export trade with China in the short run. However, after 2006 when the exemption is applied to all items of export, free trade between Hong Kong and China will affect Taiwan's exports to China in the long run.

On the other hand, the impact of the CEPA on Taiwan's service industries is more serious. For one thing, Hong Kong banks can enter China with much less restrictions and can engage in RMB-denominated business. Hong Kong can easily become a regional financial center in Asia because its banks are allowed to do RMB clearing business. Furthermore, Hong Kong residents are allowed to open independently owned law firms, accounting houses, managerial consulting firms, and retail stores. Their Taiwanese counterparts have little chance to compete against them.

In the meantime, quite a few Taiwanese businesses in China are applying for listing in the Hong Kong stock exchange because the CEPA has made capital movement from Hong Kong to China much freer. On the other hand, it is more difficult for Taiwan to attract Taiwanese-owned firms in China to get listed in Taipei. It means that Taiwan could not become a regional financial center in Asia. It may even have difficulty serving as a capital market for Taiwanese firms in China. In other words, the CEPA may not marginalize the Taiwan economy, but it certainly can reduce Taiwan's chance to become a regional operation center in Asia.

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[10] About the details of the impact of CEPA on Taiwan's chance as a regional operational center, see Huang (2003) and F. S. Wang (2003).

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