

THE IMPACT OF CHINA'S WTO MEMBERSHIP ON ITS TRADE

VIA HONG KONG

by

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Abstract

The objective of this study is to discuss the impact of China's World Trade Organization (WTO) accession on its trade via Hong Kong. To this end, this paper analyzes three important aspects: China's WTO accession and increasing Foreign Direct Investment (FDI), China's indirect trade with Taiwan, and changes in Hong Kong's comparative advantage. Theoretical discussions lead to the conclusion that China's WTO accession will adversely affect Hong Kong's intermediary role. Consequently, Hong Kong will eventually lose its comparative advantage in serving as China's middleman. In addition, this study conducts some empirical investigation regarding Hong Kong's re-export trade with China and its importance to economic growth. Following that, this paper addresses several policy options which, at least in the short-run, may have some positive effects.

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List of Abbreviations

APEC	Asian Pacific Economic Co-operation
CEPA	Closer Economic Partnership Arrangement
CGE	Computable General Equilibrium
CPG	Central People's Government
CPI	Corruption Perception Index
FDI	Foreign Direct Investment
FTCs	Foreign Trade Corporations
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
HKTDC	Hong Kong Trade Development Council
H-O model	Heckscher-Ohlin Model
IMF	International Monetary Fund
MFN	Most-favoured-nation
OECD	Organisation for Economic Co-operation and Development
PRC	People's Republic of China
PRD region	Pearl River Delta Region
SAR	Special Administration Region
SARS	Severe Acute Respiratory Syndrome
SEZ	Special Economic Zone
TEU	Twenty-foot Equivalent Unit
USA	United States of America

USCBC	United States - China Business Council
WTO	World Trade Organization
YRD region	Yangtze River Delta region

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Chapter 1: Introduction

1.1 The Issue and its Importance

As a former British colony with a population of 6.81 million,¹ Hong Kong became a Special Administrative Region (SAR) of the People's Republic of China (PRC) on 1 July 1997 under China's "One Country, Two Systems" policy. Greatly different from Mainland China, this metropolis is commonly regarded as one of the freest market economies in the world. It has long played the role of China's middleman, especially since China's adoption of an "Open Door" policy in 1978. For example, over the period of 1989-1999, an average of 54.5 percent of Chinese exports was routed through Hong Kong. During the same period, 41.2 percent of China's imports were via Hong Kong, with a peak of 46.1 percent in 1997. Only 5.8 percent was actually produced domestically, while the remaining 40.3 percent came from elsewhere.

China signed the agreements to join the World Trade Organization (WTO) on 11 November 2001, and became a full member of the WTO one month later. Its membership will have a profound influence on the world economy. Therefore, this question may arise: Will Hong Kong's intermediary role in China's foreign trade increase or decrease with China's WTO membership? In this study, intermediary role means Hong Kong serves as a middleman in conducting trade for China and the rest of the world. Those traded goods are not consumed in Hong Kong. Mostly, this paper adopts a relative measure of Hong Kong's intermediary role. It shows the changing importance of Hong Kong's role as middleman and China's reliance on Hong Kong. If China's reliance on Hong Kong decreases, Hong Kong will lose its importance as China's intermediary. This is why a relative share is better than the absolute amount in analyzing this topic. Focusing on Hong Kong's relative share in

China's total external trade, this paper will discuss Hong Kong's diminishing monopoly role in China's foreign trade. In order to examine China's trade via Hong Kong, analyses from both Hong Kong and China are required throughout the paper.

Hong Kong is an important player in the world economy. It is the world's ninth largest trading economy. Also, it is home to the world's busiest container port and airport for international cargoes, the seventh largest foreign exchange market, as well as the ninth largest stock market in the world. Hong Kong's nominal Gross Domestic Product (GDP) in 2003 was US\$158.3 billion; its GDP per capita was US\$ 23,300 (Hong Kong Trade and Development Council [HKTDC], 2004).

China is also very important in the world economy. With a population of 1.3 billion, China has a huge potential consumer market and also is one of the largest destinations for foreign investors. In 2003, it received US\$ 53.5 billion in Foreign Direct Investment (FDI). By the end of March 2004, China's foreign exchange reserve was US\$439.8 billion.² The country is also the world's fifth largest trading nation and its nominal GDP in 2003 was around US\$1.41 trillion.

Hong Kong's re-export trade with China is of great importance for both economies, but for different reasons. Serving as China's gateway, Hong Kong helped China intensively in contacting Western countries before the end of the 1970's and during China's early reform period. As well, Hong Kong companies, serving as China's middlemen, benefited from earning commissions and mark-ups. In addition, re-exporting with China created many job opportunities and contributed significantly to Hong Kong's economy. Statistical data have shown that the annual average of the value of Hong Kong's re-exports with China was as high as 84 per cent of Hong Kong GDP during the period of 1990 to 2001. In addition,

according to Hong Kong's Census and Statistics Department, the average contribution to GDP from import and export trade was about 15.3 percent from 1980 to 2001. These facts show that the re-export with China have had a significant impact on Hong Kong's GDP growth.

The reason for doing this research is very meaningful. China and Hong Kong, both being members of the Asian and Pacific Economic Co-operation (APEC) and the WTO, play very important roles in the Asia-Pacific region and in the world economy. China and Hong Kong's trading patterns can also affect world trade, including that of the United States of America (USA). The USA's high trade deficit with China can be partly explained by Hong Kong's re-exports to the USA, since most of the products were originally from Mainland China (Freenstra, Hai, Woo, & Yao, 1999). The three economies of China, Hong Kong, and Taiwan, are widely viewed as "Greater China", whose economic scale is very large and can have a significant influence in the world economy. Meanwhile, as China's middleman, Hong Kong's situation is not unique in the world, being similar to Singapore, New York, London, and so on. Hong Kong's experience may provide other existing and potential middlemen some useful suggestions. It is therefore important to examine the impact of China's WTO membership on its trade via Hong Kong. The results of this study are expected to shed some light on policy issues.

1.2 Current Discussions on this Issue

To the best of my knowledge, there are so far only a limited number of studies which focus on Hong Kong's intermediary role in China's foreign trade. There is no detailed analysis about this issue. There are different opinions about Hong Kong's future

intermediary role. This section will divide opinions into two groups about Hong Kong's future role after China's WTO accession: 'pessimistic' and 'optimistic'.

In the 'pessimistic' literature, many studies adopt a "Computable General Equilibrium" (CGE) model; such as, Francois and Spinanger (2001), Wang and Shuh (2000), and Wang (2002). From the methodological point of view, these authors adopt several regions and production sectors to represent the world economy; they reached their conclusions based on simulation results. According to Wang (2002), Hong Kong's intermediary role in China's foreign trade will diminish, especially in the trade across the Taiwan Straits. Wang's (2002) CGE model is based on the assumption that China will fully comply with its WTO commitments; the measurement of China's successful WTO implementation is the reduction in tariffs. Based on the percentage decline of Hong Kong's re-exports share in China's foreign trade, Warr (2000) pointed out that Hong Kong's role in relation to China's imports and exports will decrease. For example, China's total exports to Hong Kong declined from 45 percent in the early 1990's to 20 percent in 1999. For the same period, the proportion of China's imports derived from Hong Kong declined from 27 to around 5 percent (Warr, 2000). Wan and Weisman (1999) used a model for the middleman economy and argued that Hong Kong's role as a middleman for China may be quite fragile, and could disintegrate if corruption is allowed to creep into the system. Wong (2003) pointed out that "Hong Kong's role as a traditional 'middleman' for Mainland trade will likely diminish over time." He listed several reasons: China's port facilities are improving, the economy of the Yangtze River Delta (YRD) region is gaining importance, and China is increasing its direct access with the rest of the world.

Other literature is much more 'optimistic' about Hong Kong's future. In recent years, the HKTDC has published several articles to support Hong Kong's increasing, or at least not declining, intermediary role. The HKTDC pointed out that, "Upon China's entry into the WTO, this (intermediary) role is going to get bigger, making it more profitable for those who seize Hong Kong's comprador spirit and who have their business in Asia's World City"(Hong Kong SAR, 2001). The HKTDC (2001) also stated, "The expansion in China's trade and investment activities with the rest of the world should benefit Hong Kong as a hub." Sung (1998) argued that since China's trade with Hong Kong jumped after each wave of China's decentralization, China, especially after the WTO accession, will further decentralize its trading system; accordingly, Hong Kong's prospects look bright. Fung (1997) believed, "Given its geography and its expertise in finance, insurance, telecommunication, and transportation, Hong Kong will continue to serve as the gateway to and from Mainland China" (p. 28).

In brief, the existing studies about Hong Kong's future as China's middleman after China's WTO accession are diverse. Some researchers use the CGE model, arguing that Hong Kong's role will diminish. Others address Hong Kong's comparative advantage, such as market information and experience, and argue that Hong Kong's role will expand.

Regarding the existing studies, a few points must be made. These studies are either purely quantitative or too shallow and brief in qualitative analyses. The CGE model, which is purely quantitative, using tariff rates to measure China's successful WTO implementation, cannot capture the most important aspect of change in China's WTO accession, which is the improvement of China's business climate and investment environment.

China's WTO accession may bring a structural change to Hong Kong's economy, which has never happened before. Historical experience cannot support HKTDC's optimistic hypothesis. Without a detailed analysis, it is also pre-mature to say that Hong Kong's role is decreasing based solely on the percentage decrease of re-export trade in China's total external trade. The WTO framework is based on a market economy mechanism, while China is still a non-market economy. The contradiction of the two economic systems will bring fundamental changes to China's government mechanism, investment environment, economic structure, and so on. Purely quantitative studies cannot capture the essence of this change. Purely qualitative studies based on past experiences is also not convincing enough because of the essential changes in China.

Both of the above hypotheses are insufficient. This paper will seek to show that Hong Kong's intermediary role depends on changes in both China and Hong Kong, and sometimes even third parties. Focusing on the resulting essential changes from the WTO, this paper uses a detailed qualitative analysis from three mechanisms to formulate the discussion. Three factors are vital for Hong Kong's role: China's FDI, China - Taiwan trade, and Hong Kong's comparative advantage. Not basing itself on past experiences and data, this paper will adopt the most recent data to support its argument. Its main contribution will be to provide a better and deeper understanding of Hong Kong's changing intermediary role. The combination of quantitative data and qualitative analyses can portray this scenario more accurately.

1.3 Outline of the Paper

Chapter 2 of this study provides some background information on China's economic and trade development since the adoption of the "Open Door" policy, the important role that

Hong Kong has played in China's foreign trade, the history of China's WTO accession, and WTO's fundamental principles. China's opening up provided Hong Kong a great opportunity to relocate its sunset industries, and China's foreign trade policies created room for Hong Kong as its middleman. In view of China's vast amount of trade via Hong Kong, significant contributions have been made to the economies of both sides. Also, WTO features can help us better understand the impact of China's membership on its business and investment environment.

Chapter 3 examines comprehensively the impact of China's WTO membership on its trade via Hong Kong from three particular aspects: China's WTO accession and increasing FDI, China's indirect trade with Taiwan, and Hong Kong's comparative advantage. FDI inflows are critical because they have a strong influence on a country's foreign trade patterns. This project will also look at China's indirect trade with Taiwan, as to a large extent it is very important to Hong Kong's intermediary role. As the Chinese economy has become more integrated into the world economy and has grown more rapidly, great changes have occurred in both China and Hong Kong, thus Hong Kong's comparative advantage in serving as China's middleman has changed.

In Chapter 4, this research presents the results of empirical analyses, showing the importance of Hong Kong's role as middleman to its economy. Following that are discussions on policy options, which may have some positive effects, at least in the short-run, on economic growth in Hong Kong.

Chapter 5 provides a summary and concluding remark. It will also give directions for further studies in this area.

Chapter 2: Background

To understand the topic better, this project will provide some basic background information. First, this paper will give a brief history of China's foreign trade since 1949, but the focus will be on reviewing China's economic and trade development especially since the "Open Door" policy in 1978. Following that, this paper will address Hong Kong's important intermediary role in China's foreign trade during this period. This chapter will also analyze reasons for Hong Kong becoming China's middleman. Finally, there is a brief summary of the history of China's WTO accession and some principles of the WTO.

2.1 China's Economic and Trade Development since the "Open Door"

Policy

2.1.1 China's Foreign Trade History since 1949

In 1949, when the PRC came into being, privileges given to foreign countries due to unequal treaties were abolished. During the first thirty years of Communist rule, Mainland China's economy was largely isolated from the rest of the world. As Zhang (2000) said, "China was one of the world's most isolated economies prior to 1978, trading only about 0.75 per cent of the world's total exports and imports" (p. 5). China followed a planned Communist/Socialist economic system, and self-reliance was the main strategy. Foreign trade was centrally controlled by the Chinese government. The Ministry of Foreign Trade,³ established in 1952, solely negotiated with China's trading partners. Transactions were conducted through a dozen or so national foreign trade corporations (FTCs), which were affiliated with the Ministry of Foreign Trade. Each FTC was assigned the task of exclusively handling the export and import of particular commodities. The quantities and values of each commodity to be traded were also determined by the government's annual national plans

(Zhang, 2000). China's major trading partners were Soviet Russia and other communist countries, such as North Korea and some Eastern European countries. This was partly because of the trade embargo imposed by the West during the early years of the regime (Shen, 2000). China imported some materials in short supply, such as cotton and fertilizer, as well as some foreign equipment. This latter fact allowed China to obtain some of the more advanced technologies (Allrefer.com, 1987). In brief, foreign trade was unimportant and grew slowly during the first thirty years of China's regime.

2.1.2 China's "Open Door" Policy in 1978 and its Ensuing Economic and Trade

Achievements

China adopted the "Open Door" policy in 1978. There are two important terms to consider: "Reform" and "Openness". The former means transformation of the central economic planning system, and the latter means the opening of China to the world market, as well as the reintegration of China into the world. As Lu (2000) pointed out, "Many others believe that China opted for economic openness because of the failure of the Maoist strategy of self-reliance" (p. 121). He also pointed out that moving from self-reliance to openness in the world market was simply the logical outcome of industrialization.

Readers need pay attention to the fact that China's openness and reform occurred in a particular political and economic environment. From 1966 to 1976, China experienced the ten-year Cultural Revolution. During these years, the Chinese economy had virtually no development. People were engaged in political struggles and the economy lagged. In the international arena, the Asian "Four Tigers" - Hong Kong, Taiwan, South Korea, and Singapore - experienced rapid economic growth. There is a disagreement as to the role their governments played in this growth. However, researchers do agree that the speedy

development can be partly attributed to the Export-Oriented Growth Strategy. As Kim (1998) said, “The economic growth realized by the rapid industrialization of the developing economies of the Pacific Rim (countries) was not driven by the growth of domestic consumption but by the rapid expansion of exports” (p. 66). China had even cheaper labour costs than the “Four Tigers”. Therefore, China decided to imitate them and adopt this strategy. The chief designer of China’s “Reform” and “Openness” - Deng Xiaoping - came into power after the Cultural Revolution, and strongly recommended that China take some positive action to enact reform. With his great effort, China began to implement the “Open Door” policy in 1978.

Since its opening up, China’s GDP increased from US\$242.8 billion in 1980 to US\$ 1,083 billion in 2003 measured in 1990 U.S. dollars. The annual average real GDP growth rate from 1980 to 2003 was 6.8 percent. This constant rapid GDP growth is regarded as a “miracle”. During this period, both China’s imports and exports increased significantly; the annual average import and export growth rates were respectively 11 and 11.2 percent. The percentage of imports and exports to GDP increased from 23.6 percent in 1980 to 51.9 percent in 2003. For details, see Table 1 (China’s Imports, Exports, and GDP).

2.1.3 Evolution of China’s Foreign Trade Policies since 1978

Since 1978, China’s foreign trade policies have gradually been changed in order to make full use of its cheap labour. This paper divides China’s foreign trade into three stages according to China’s most important policies: the “Open Door” policy in 1978, “Socialist Market Economy” reform in 1992, and WTO membership in 2001. Given the focus of this project, this paper will discuss the third stage in detail in Section 3.1 (China’s WTO Accession and Increasing FDI). This section will briefly summarize the first two stages.

During the first stage, from 1978 to 1991, China carried out trade policy reforms as part of general economic reforms (Wall, Jiang, & Yin, 1996). There were many trade barriers during this stage, and the Chinese central government had control over foreign trade. By issuing licenses and tariffs, the Chinese government firmly controlled the value and range of commodities being traded. These licenses and tariffs continued to increase during this period: Wall et al. (1996) pointed out that, by the end of 1991, China's average tariff rate was 43 percent, 5 percent more than the corresponding average rate in 1986. The Chinese government also adopted several export promotion measures, such as special programs of enhanced export credits, preferential interest rates on domestic currency loans to export firms, and subsidized domestic transport (Wall et al., 1996).

In the second stage (1992-2001), trade policies were increasingly liberalized. For the first time, since the benefits of market-oriented reforms became obvious, China's central government endorsed the "Socialist Market Economy" as China's goal of reform at the fourteenth National Congress of the Chinese Communist Party in 1992 (Zhang, 2000). During this period, foreign trade reforms were characterized by a process of decentralization and reduction of trade barriers such as licenses and tariff rates. In 1992, China abolished the command plans for both exports and imports (Wall, Jiang, & Yin, 1996). As a result, more enterprises and companies had the right to determine their own exports and imports. China also reduced import tariff rates substantially. Between 1992 and 1999, it had already cut tariffs five times, lowering the average import tariff level down from 43 to 17 percent. On January 2001, China reduced import tariff rates on 3,462 items (49 percent of all tariff items), which brought the average tariff rate from 16.4 to 15.3 percent (APEC, 2001). Unlike the first stage of the reform, the number of categories covered by export and import licenses was

reduced considerably as well. For example, since 1993, the number of export categories subject to licensing was reduced from 235 to 114, and correspondingly the proportion of export value covered by licenses was reduced from 60 percent to about 30 percent (Wall et al., 1996). Compared to the previous stage of reform, China's foreign trade became much freer during this period; China was moving toward trade liberalization.

2.2 The Important Intermediary Role Played by Hong Kong in China's

Foreign Trade

The previous section briefly summarized China's economic and trade reforms since 1978. This section will show Hong Kong's important intermediary role in China's foreign trade by analyzing three areas: outward processing, being an expert serving as middleman, and Hong Kong's general advantages.

2.2.1 Hong Kong's Important Intermediary Role in China's Foreign Trade

Hong Kong has played an important role in China's foreign trade since 1978. Hong Kong has re-exported a great proportion of Chinese goods, while at the same time, much of China's imported goods have been through Hong Kong. According to the Hong Kong government, re-exports are products which have previously been imported into Hong Kong and which are re-exported without having undergone a manufacturing process. A manufacturing process means the shape, nature, form or utility of the product has been permanently changed (Hong Kong SAR, 2002).

Table 2 (Hong Kong's Total Re-export Trade with China) and Figure 1 (Hong Kong's Re-export Trade with China) show the increasing amount of such trade from 1979 to 2003. In 2003, Hong Kong - China's total re-exports reached HK\$1.67 trillion. Illustrated in Figure 2(Ratio of Hong Kong - China's Re-export Trade to China's External Trade), such

reciprocal trade increased to a very high level from 1992 until 1996. As a result, it shared a yearly average of 48.2 percent of China's total external trade. Since 1996, this share has begun to decline. In 2003, the percentage was down to 29.3 percent, which was the lowest since 1989. China's WTO accession did not change this declining trend. Figure 3 (Composition of Hong Kong's Re-exports) provides a basic picture of the composition of Hong Kong's re-exports. Since most of Hong Kong's re-exports were carried out with China, this figure can also illustrate the composition of Hong Kong - China re-exports. For a long time, consumer goods, raw and semi-finished materials, and capital goods were the main items being traded. The share of consumer goods has been declining since 1993; while raw and semi-finished materials have accounted for about 30 percent of the total re-export trade since 1995. The increasing percentage of capital goods has been very steady, and in 2003 reached the all-time high of 28 percent.

The re-export trade with China is very important to Hong Kong's economy. Hong Kong companies earn commissions and mark-ups for serving Chinese and other companies. Hong Kong's re-exports with China contributes greatly to its GDP. The finding in Chapter 4, using two econometrics models, is also proof of this.

2.2.2 The Reasons for Hong Kong Becoming China's Middleman

Outward processing is one important feature involved in Hong Kong - China trade. According to the World Customs Organization (1999), outward processing is defined as "the customs procedure under which goods in free circulation in a customs territory may be temporarily exported for manufacturing, processing or repair abroad and then re-imported with total or partial exemption from import duties and taxes." From 1991 to 2003, an annual

average of 49 percent of Hong Kong's total exports to China was related to outward processing. What is more, during the same period, an annual average of 76.2 percent of Hong Kong's imports from Mainland China dealt with outward processing. The profits generated from this trade, including outward processing production itself, were estimated to be more than 10 percent of Hong Kong's GDP in 1992 (Chen, 2000).

Hong Kong's shift from an entrepôt (a place where goods are imported and re-exported without processing [Black, 2002, p. 146]) to a manufacturing enclave, and to a sophisticated provider of services and manufacturing activities, has been triggered by the continuously closing and opening of Mainland China's economy to the rest of the world in the past century (Enright, Scott, & Dodwell, 1997). In the 1980's, Hong Kong's severe lack of labour and land pushed up the cost of production, causing it to lose its comparative advantage in its traditional industries, such as clothing, footwear, and toys (Chen, 2000). Fortunately, China's opening up made cheap land and labour available for Hong Kong companies. In its early years of reform, China opened four Special Economic Zones (SEZs) which catered to foreign investors, and subsequently China opened more regions to the world. Moving factories to China became an effective and popular means for Hong Kong companies to maintain their products' competitiveness and profit (Chen, 2000). Many of these factories were moved to the nearby Guangdong province, especially the SEZs of Shenzhen and Zhuhai (Kim, 1998). The remaining activities in Hong Kong were to provide supporting services such as packaging, designing, and marketing of products manufactured in China (Chen, 2000). Hong Kong companies purchased raw materials from the world market, then processed these materials in Hong Kong or elsewhere (or left them un-processed), and exported the unfinished goods to China for further processing. Hong Kong traders then chose

to sort or package the re-imported products from China and sold them with a mark-up to foreign buyers (Hanson and Freenstra, 2001).

As previously noted, a few state FTCs firmly controlled China's foreign trade in the pre-reform period; state-planned imports and exports constrained the productive potential of economic subjects, alienating producers from the market (Shen, 2000). Therefore, the market was neither competitive nor efficient. As foreign trade reform began, many interest groups such as provincial governments, provincial branches of state trading companies, municipalities, and selected large state enterprises successively obtained trading rights (Shen, 2000). However, these new players did not know much about foreign markets, regulations, or how to trade with their foreign counterparts. For those foreign traders outside of Hong Kong, the situation was the same. They did not know much about Chinese regulations and markets, nor did they know how to trade with Chinese companies. Besides, they did not know whether or not their Chinese partners were able to fulfill their contracts. In other words, it was risky to trade with China. On the other hand, Hong Kong traders could meet the requirements of both Chinese and other foreign traders. As Chen (2000) pointed out: "Until the mid-1950's, the major source of Hong Kong's income was entrepôt trade" (p. 33). This was because the Hong Kong community had deeper practical knowledge of how to do business in the world's most populous market. Hong Kong was a free trade area and had a more transparent legal system. Foreign traders outside Hong Kong were more comfortable trading with Hong Kong companies. Thus, Hong Kong was a place where China met the West. Besides, there were many foreign companies who set up their headquarters in Hong Kong, which enabled the colony to have a market full of valuable information. Hong Kong

companies bought various goods in China and then shipped them to different destinations, the goods being priced according to their qualities (Hanson and Freenstra, 2001).

In addition to the features of outward processing and being an expert serving as middleman, Hong Kong also has had some other general advantages to serve as a middleman for China compared with other cities or economies: convenient geographical location, well-developed infrastructure, and a strong business climate.

Hong Kong has an ideal geographical location. It is adjacent to the Pearl River Delta (PRD) region. The people in Hong Kong have a similar culture and language as the people in the PRD region. These are all essential natural and cultural elements for Hong Kong in the matter of serving as a middleman for China. In the same way, these are also reasons why Hong Kong has been investing substantially in this region. Hong Kong is only 30 kilometres from its nearest city, Shenzhen, and just a few hours driving distance from another important southern Chinese city, Guangzhou. These two cities are in the PRD region and they easily connect with Hong Kong by air, the South China Sea or by highway. Hong Kong perhaps enjoys the best natural deep-water port on the Chinese coast. Located along many lucrative intra-Asian trading routes, it is almost in the geographical center of the fast-growing Asian Pacific region. The city is very close to most of the East and Southeast Asian economies, including South Korea, Taiwan, and Japan.

Hong Kong's modern and efficient infrastructure has supported its role as an entrepôt and regional financial and services center. The government has also pledged to push ahead with a number of major infrastructure projects to help Hong Kong maintain its status as a regional transportation and business hub. Its container port is one of the world's busiest. Hong Kong's old airport, Kai Tak, ranked sixth in the world in terms of cargo handled and

fifteenth in terms of passengers. The new airport at Chek Lap Kok was opened on 6 July 1998 as scheduled. The airport could handle 35 million passengers and 3 million tons of air cargo a year when it was first opened, and there are plans to expand in stages to reach 87 million passengers and 9 million tons of cargo a year by 2040 (HKTDC, 2004). Hong Kong's roads have one of the highest vehicle densities in the world. It also has highly developed railway networks. This well-developed infrastructure guarantees Hong Kong's efficiency in distributing goods and serving as a middleman for China.

The Hong Kong SAR government pursues certain economic policies: non-interference in commercial decisions, low and predictable taxation; competition subject to transparent laws (albeit without antitrust legislation), and consistent application of the rule of law (Trade Port Organization, 1999). With few exceptions, the government allows market forces to set wages and prices, and does not restrict foreign capital or investment. Hong Kong does not impose export performance or local content requirements, and allows free repatriation of profits. Furthermore, Hong Kong is a duty-free port, with few barriers to trade in goods and services. The Hong Kong Dollar is linked to the U.S. Dollar at an exchange rate of HK\$7.8 = US\$1. The link was established in 1983 to encourage stability and investor confidence in the run-up to Hong Kong's reversion to Chinese sovereignty in 1997 (Trade Port Organization, 1999). Hong Kong's personal and corporate tax rates remain low, and it does not impose import or export taxes. The government neither protects nor directly subsidizes manufacturers. It does not offer exporters preferential financing, special tax or duty exemptions on imported inputs, resource discounts, or discounted exchange rates (Trade Port Organization, 1999).

Hong Kong is also an important banking and financial centre in the Asia Pacific.

According to the Bank for International Settlements, Hong Kong is the seventh largest centre for foreign exchange trading in the world. Its stock market ranks the tenth largest in the world in terms of market capitalization. The city is also the second largest venture capital centre in Asia, managing 31 percent of the total capital pool in the region. In addition, it is a leading telecommunications hub for the Asia-Pacific region (HKTDC, 2004). All these advantages attract foreign investors, multinational companies, and regional headquarters or branches to Hong Kong. In 1997, there were 903 regional headquarters in Hong Kong; the top four countries of origin for the parent company were the United States, Japan, China, and the United Kingdom.

2.3 The History of China's WTO Accession and Some WTO Principles

2.3.1 The History of China's Entry into the WTO

It took China 15 years to become a WTO member. China was one of the 23 founding members of the General Agreement of Tariffs and Trade (GATT) in 1947, but was not able to participate in GATT activities for more than 30 years due partly to the trade embargo imposed by the Western countries. It was not until July 1986 that China applied for the resumption of its GATT membership; it did not become one of the founding members of the WTO, which was established on 1 January 1995, as a result of the Uruguay Round of international trade negotiations. During the first several years of China's bid for WTO membership, the negotiations were dominated by rules-related issues. In June 1997, however, the focus of PRC - WTO discussions shifted from these protocol matters to market access schedules, especially the tariff and the services schedules (The United States - China Business Council [USCBC], 1998). After many rounds of negotiations, China signed a series

of bilateral trade agreements with the United States and Canada in November 1999, with the European Union in May 2000, and subsequently other countries. On 11 November 2001, the WTO's fourth ministerial meeting was held at Doha, capital city of Qatar, at which time the People's Republic of China signed the membership protocol with the WTO. On 11 December 2001, China officially acquired its full WTO membership.

2.3.2 Some Important Principles of the WTO

Like its predecessor organization, the GATT, the WTO is the institutional and legal foundation for a multilateral trading system, aiming to achieve objectives by reducing existing barriers to trade and by preventing new ones from developing. It seeks to ensure fair and equal competitive conditions for market access, and predictability of access for all traded goods and services. This approach is based on two fundamental principles: the most-favoured-nation (MFN) rule, and the rule of national treatment. Together, they form the critical "non-discrimination" at the core of trade law. The MFN rule is basic to the whole edifice to the GATT (WTO), which requires that if special treatment is given to the goods and services of one country, it must be given immediately and unconditionally to all other WTO members. No one country should receive favours that distort trade. The rule of national treatment is also of fundamental importance, and it complements the MFN rule. It requires that, in its simplest terms, the goods and services of other countries be treated in the same way as those in the home country. The MFN rule puts the products (services) of all of a member's trading partners on equal terms with one another, while the national treatment rule puts those products on equal terms also with the products of the importing country itself (Eglin, 2000).

Chapter 3: An Economic Evaluation of the Impact of China's WTO

Membership on its Trade via Hong Kong

As discussed in the previous chapter, Hong Kong has played an important intermediary role in China's foreign trade since the late 1970's. After China entered into the WTO, its economy has become more integrated into the world economy. Given this change, Hong Kong's role as a middleman will also be expected to change. The main task of this chapter is, therefore, to evaluate the impact of China's WTO membership on its trade via Hong Kong from three aspects: China's WTO accession and increasing FDI, its indirect trade with Taiwan, and analysis of Hong Kong's comparative advantage.

3.1 China's WTO Accession and Increasing FDI

3.1.1 China's Implementation of its WTO Agreements

China's implementation of its WTO agreements should be seen as neither surprising nor exceptional, according to the USCBC (2002). In the starkest of "glass half full/glass half empty" terms, it considers China's glass more than half full.

China has made extensive and visible efforts to fulfill its WTO agreements. Christian Murck, Chairman of the American Chamber of Commerce in China, observed there were two major "obvious accomplishments" of China: revising its existing laws and regulations, and reducing tariff rates. China has either abrogated or revised more than 2,000 laws, codes and regulations that were not in compliance with WTO rules. For instance, the Chinese legislature has amended the Chinese-Foreign Equity Joint Ventures Law and its implementing regulations, the Chinese-Foreign Contractual Joint Ventures Law, and the Wholly Foreign-Owned Enterprises Law and its implementing regulations. China has also cut its average tariff rate from 15.3 percent in 2001 to 12 percent in 2002 ("China Makes,"

2002). These are the most clearly defined and straightforward examples of where WTO implementation has occurred, but reform has not stopped. Widespread commitment to “capacity-building” and the development of WTO-trained personnel in central and sub-central government agencies are some ongoing examples. There are also ongoing efforts at public education about the WTO and its implications for the Chinese economy and commerce. The Chinese government has also done a great amount of work to open its service market in sectors, such as banking, telecommunications, as well as insurance to foreign investors in accordance with its WTO agreements (Jin, 2002).

Because of China’s significant trading power and the complexity of China’s WTO commitments, the WTO has created a transitional review mechanism. It calls for a detailed review of China’s WTO compliance annually for the next 8 years, with a final review in year 10, and China is required to submit its annual report accordingly. Thus, China’s WTO implementation is under strict monitoring by the WTO and other member countries (The U.S. Department of State's Office of International Information Programs, 2002).

It is generally accepted that no new WTO members have a perfect record of compliance in the beginning years. China faces many economic challenges, such as disparity of income levels between rural and urban populations, as well as regional disparities, unemployment associated with economic transition, and looming troubles in the banking and securities sectors. In spite of a daunting economic and social environment, as well as the numerous technical and operational difficulties, China’s fulfillment of its WTO commitments can be viewed as a success. Both the former WTO Director-General Mike Moore and Present Director-General Supachai Panitchpakdi hold that China is a qualified and responsible member (“China’s Performance,” 2002).

In October 2003, the USCBC (2003) voiced concern over China's loss of momentum in fulfilling its WTO agreements. There were several factors on China's side which could be responsible for the stalling of WTO progress: the outbreak of Severe Acute Respiratory Syndrome (SARS) and the change of Chinese government leadership at many levels. Potter (2001) argued that a higher degree of certainty about the reality of China's WTO behaviour is needed immediately. So far, China has shown this certainty. Rather than focus on full compliance, he pointed out that attention should be paid to the issue of "acceptable non-compliance" (Potter, 2001). Historically, China has had a good reputation for keeping its promise. For example, it has performed very well in implementing its International Monetary Fund (IMF) agreements. Together with the great efforts the Chinese government has put forth, the future of its full WTO complementation is bright.

3.1.2 The General Impact of China's WTO Accession

China's WTO accession will bring significant changes to China. As Eglin (2000) noted, "Accession will involve a substantial process to consolidate the replacement of state and bureaucratic control of trade transactions by market mechanism, and to consolidate China's legal and administrative framework that protects private property and private sector activity." China's WTO accession will provide a platform from which it can sustain its reform process into the future, and increase the returns from trade reform through reciprocal market access abroad.

A key aspect of joining the WTO is that the acceding government's legislation and domestic enforcement mechanism must be brought into conformity with WTO obligations (Eglin, 2000). China is still being considered as a "non-market economy" country, and the Chinese government still intervenes deeply in various economic activities even after more

than two decades' reform. These various interventions may violate WTO principles. In the long run, government interventions are to be phased-out except under some specific conditions. Besides, all the policies and regulations affecting trade must be transparent according to WTO's transparency principle. These mean that China must abolish those inconsistent rules and also make more policies and regulations open.

China's WTO accession will significantly influence its own foreign trade structure. Researchers usually agree that labour-intensive industries, such as textile, garment, and consumer goods will benefit from it. The WTO membership guarantees market access to those Chinese exports in which it has comparative advantage. At the same time, capital and technology intensive industries such as auto, iron and steel, as well as high-tech industries, will face severe competition. Competition will also come from the service sector, such as finance, insurance, telecommunications, and so on (Zeng, 2001).

3.1.3 Increasing FDI and the Resulting Declining Intermediary Role of Hong Kong in China's Foreign Trade

Since 1993, China has ranked first among developing countries in drawing foreign investment. Table 3 (China's Foreign Direct Investment) demonstrates the increasing FDI inflows from year 2000 to 2003. Although FDI flow to all developing countries fell from US\$240 billion in 2000 to US\$225 billion in 2001, there was still an huge increase in FDI going to China, where inflows rose from US\$41 billion in 2000 to US\$46.88 billion in 2001 (Washington International Business Group, 2003). According to the Organisation for Economic Co-operation and Development (OECD), China received US\$ 53.5 billion FDI in 2003, which was the highest in the world. Out of the world's Fortune 500, 400 have set up enterprises, or research and development institutions in China. FDI flows have moved from

general manufacturing to basic industries, to infrastructure facilities, and to new hi-tech industries, as well as to service sectors, such as finance, distribution and telecommunications.

There are two important reasons for the connection between China's increasing FDI and its WTO accession. One reason is that China is expanding its market access. This expansion exists not only in the service sectors but also the areas mentioned above. China has lifted many restrictions in these fields, which make increasing FDI flows possible. China's further opening of its service sectors in banking, telecommunications, insurance, trading, and so on also make foreign investors able to enter this previously closed market. In this regard, FDI flow to China has continued to grow with China's further opening of its market according to the WTO agreements.

The other reason is that China's WTO implementation accelerates its improvement in its investment environment, which is reflected in China's increasing FDI ("China More Attractive," 2001). Mr. Guangsheng Shi, former minister of China's Foreign Trade and Economic Co-operation,⁴ at a nationwide video conference in Beijing in August 2002, urged China to work harder to improve the country's foreign investment environment to attract more foreign funds. The services to foreign investors include efficient and transparent government service, reform of the administrative approval system and sound legal and business environments ("China Pledging," 2002). Although China's Corruption Perception Index (CPI) did not see a significant change after its WTO accession, Chinese government has improved its investment environment and business climate. These improvement are seen in: translating and publishing relevant documents and regulations which were not available previously, adoption of world standards in trade and investment, and enforcement of WTO regulations and laws. As the China Daily Hong Kong Edition pointed out, "China's WTO

membership boosted foreign investor confidence in the market with heightened expectations of transparency, stability and predictability in Chinese trade and investment policies and an improved business environment" ("FDI Increases," 2002). The improvement in the investment environment resulted in increasing FDI after China's WTO accession.

As discussed earlier, there were many newcomers in Chinese trading circles when China first adopted its "Open Door" policy. Most foreign traders did not know much about how to trade with the Chinese. In their views, there were not many transparent rules and regulations that they could follow. This situation provided a good opportunity to Hong Kong, since Hong Kong traders were experienced in conducting trade with both sides. Therefore, being an expert in trading, Hong Kong served as China's middleman, earning commission fees from both sides.

However, this situation is changing gradually with China's opening to foreign investment. The increasing FDI happens not only in the traditional but also new investing fields, such as the service sectors. The influence of China's opening of its service sectors to foreign investors is far-reaching, especially for Hong Kong's middleman role. Foreign investment companies in China will tend to choose the service provided by their own countries or by companies with which they are familiar. Hong Kong will lose some influence from this perspective. Increasing foreign investments in China provide direct communication and information channels for Chinese businessmen and their foreign counterparts. With these smooth direct channels, two sides can understand each other better, can learn about each other's markets, regulations, languages, and so on. This direct link of the two sides will break up the former business information asymmetry. Therefore, Hong Kong's advantage in market and business information will decrease. With the direct link,

both Chinese traders and their foreign partners will not need to pay Hong Kong commission fees, so the information costs for both sides will be reduced. Reduction of the costs for Chinese traders and their foreign partners is a win-win situation. Under the relatively symmetrical business information system, Chinese traders and their foreign partners will learn by doing. Indeed, both have already gathered much valuable experience from trading with the other. Therefore, Hong Kong will eventually become a less useful expert in the future.

3. 2 China's Indirect Trade with Taiwan

3.2.1 China's Indirect Trade with Taiwan through Hong Kong

In the past, Hong Kong also performed the role of conducting international business for China with third parties with which China did not have direct commercial relations, for example, South Korea and Taiwan, trading with Taiwan (the Chinese triangular trade) being the significant part. Table 4 (Trade between Taiwan and Hong Kong and transit trade to Mainland China) offers some statistics of this economic activity.

Since 1992, transit trade (cross-strait cargoes which do not need to be unloaded or reshipped to a third territory, providing the shipping documents reflect the trade's indirect nature) with Mainland China has taken more than 50 percent of Hong Kong's total trade volume with Taiwan, with the average annual amount being as high as US\$ 10 billion. Because of the complexity of this cross-strait trade, Taiwan's Mainland Affairs Council decided to estimate the total indirect trade between Taiwan and Mainland China. The results are shown in Table 5 (Estimation of Indirect Trade between Taiwan and Mainland China). They believe that data for Taiwan's exports to Mainland China are not accurate if these data take into account only the transit trade. They argue that the difference between Taiwan's

exports to Hong Kong and Hong Kong's imports from Taiwan is China's additional imports from Taiwan. Taiwan's actual exports to China include both this difference and transit trade from Taiwan to Mainland China via Hong Kong. Using this method, total indirect trade between China and Taiwan was around 2.6 times that of transit trade. For example, in 2000, Taiwan's transit trade with Mainland China was US\$9.6 million, while total indirect trade was US\$31.2 billion, which was about 3.25 times of the amount of transit trade. According to the data provided by Taiwan's Mainland Affairs Council, from 1991 to 2001, 16.39 percent of Taiwan's exports went to China and 10.08 percent of Taiwan's external trade was conducted with China. From 1991 to 2001, an annual average of 13.16 percent of China's imports was from Taiwan, and an annual average of 7.24 percent of China's external trade was conducted with Taiwan.⁵ Starting in 2001, Taiwan's Mainland Affairs Council and Board of Foreign Trade has used the formula $A + (B1 - B2) * 80\% + C - Ar$.⁶ This method portrays more closely the real trade situation between China and Taiwan. With the new method, the estimated trade volume between the two sides was as high as US\$46.3 billion in 2003. According to one survey done by HKTDC in 2002, 77.9 percent of surveyed Taiwan companies in Shenzhen and Dongguan (both in PRD region) use Hong Kong's transshipment service. Surprisingly, 61.4 percent of responding Taiwan companies in Shanghai, Suzhou, and Kunshan (all in YRD region) use Hong Kong as their transshipment port (HKTDC, 2002). This shows that Hong Kong plays an important role in doing transit trade for Taiwanese companies in the YRD region.

Besides Taiwan's trade via third parties with China, Taiwanese companies also invest in China under the name of third parties, such as Hong Kong or the Cayman and British Virgin Islands through their tax havens (Sutter, 2002). Table 6 (Taiwan's Indirect

Investment in Mainland China) provides detailed information about Taiwan's investment in China. There is a great difference in the data provided by Taiwan and Mainland China. This difference is mostly because of the Hong Kong factor. Hong Kong companies serve as middlemen for Taiwanese enterprises investing in Mainland China.

A large number of Taiwanese tourists also visit China via Hong Kong. According to the statistics of Taiwan's National Police Administration, Ministry of the Interior, from 1990 to 2002, there were a total of 23.5 million visitors to Hong Kong from Taiwan, with an average of 1.8 million visits per year.⁷ There was a sharp increase from 340,000 in 1988 to 808,000 in 1989, to 1.24 million in 1990. The Mainland China factor can best explain this sharp increase. Taiwan allowed indirect trade with Mainland China in 1989. It was not a coincidence that these two phenomena happened simultaneously. Because there was no direct communication between two sides, many people from Taiwan chose Hong Kong as their transit port to visit China. These visitors from Taiwan contributed significantly to Hong Kong's tourism. Macau has attracted a proportion of visitors from Taiwan since November 1995, when the new airport was put into use.

Direct trade and investment relationships between China and Taiwan are beneficial for both parties. There is a great need for Mainland China and Taiwan to build a direct trade and investment relationship, or the "Three Links".⁸ The additional costs to Hong Kong or other third parties include: transportation, operation, transaction costs, commission earned by third parties, and so forth.

3.2.2 Evolution of the Cross-Strait Trade Policies

Taiwan is regarded as a rebel province by the People's Republic of China. This stance can be traced back to China's Civil War in 1949, when the Chinese Communist Party

defeated the Nationalist Party, and established the PRC. The defeated Nationalist Party fled to Taiwan and kept using the name of the Republic of China. The PRC insists that Taiwan is part of China and Taiwan can only play in the world forum under the name of Chinese Taipei. China refuses to have diplomatic relations with those countries which have diplomatic relations with Taiwan.

China's trade and investment policies towards Taiwan involve two periods: the pre-reform (before 1978) period and the post-reform period. Similar to China's attitude towards the West, during the pre-reform period, China did not have any kind of economic or trade relations with Taiwan due to political reasons. However, the situation has changed substantially since 1978 when economic development became the first and the most important concern to the Chinese government. Since then, China's attitude towards trade and investment from Taiwan has become very active and positive. The Chinese government has been showing a positive stance by welcoming trade and investment from Taiwan. This attitude results from the feeling that absorbing more investment from Taiwan is generally in the PRC's best interest (Mastel, 2001). The "Chinese-Foreign Joint Venture Law" in 1979 and the "Law on Foreign Capital Enterprises" in 1986 provided legal protection to investors for Mainland China to attract foreign investment (Lin, W. and Lin, P., 2001). In order to attract investment from Taiwan, Beijing's State Council enacted the "Regulations on Encouraging Taiwan Investment" in 1988 (Huang, 2002). In short, China's policy towards cross-strait commerce is constructive.

On the contrary, the scenario in Taiwan is totally different from Mainland China. There exist substantial barriers in the legal framework governing economic and trade relations with China (Kong, 2002). The Taiwan government's economic and trade policies

towards China are more conservative and cautionary. These policies have experienced several phases: “No Trade”, “Indirect Trade”, “No Haste, Be Patient”, “Mini Three Links”,⁹ and “Constructive Liberalization, Effective Management”. These policies are making progress. However, this sluggish progress cannot meet the business community’s fast-growing interests in investing and trading with China.

Due to political factors, economic exchange between Taiwan and China was essentially nonexistent before 1979. Taiwan’s policy was “No Trade”, and the “Regulations on Prohibition of Commercial Products from Bandit Controlled Areas” operated in 1977 by Taiwan reflected the tense situation (Huang, 2002). With the adoption of the “Open Door” policy by China in 1978, economic exchange across the strait began. Most trade and investment were via third parties. Taiwan promulgated regulations sanctioning indirect trade, investment, and technical cooperation with the mainland in 1989. The Taiwanese government clearly specified that economic interaction with the mainland should be achieved in gradual phases under the principles of reason, peace, parity, and reciprocity. The result of this policy was an exodus of Taiwan’s small and medium labour-intensive enterprises to invest in China (Huang, 2002). The period from 1987 to the present is characterized by the integration of Taiwan’s FDI and trade together in Mainland China (Lin, W. and Lin, P., 2001). The “No Haste, Be Patient” policy was introduced by former president Lee Tung-hui in 1996. The policy requires that no investment in either high-tech fields or ventures be worth more than US\$50 million. The provincial implementation of “Mini Three Links” between the offshore islands of Kinmen and Matsu and Mainland China started at the end of 2000. The adoption of this policy was an attempt to improve the cross-strait relationship through positive and constructive exchanges between the two sides (Kong, 2002). “Active Opening,

Effective Management” started on 1 January 2002, and this policy abolished the investment ceiling of US\$ 50 million. Direct investment in the mainland became legal in August 2002. From 2000 to 2002, China’s FDI from Taiwan has seen a sharp increase from US\$ 2.3 billion, to US\$ 2.98 billion, then to US\$ 3.97 billion (Table 3: China’s Foreign Direct Investment). However, the current policy still contains various restrictions and uncertain factors affecting Taiwanese investment in China (Kong, 2002).

Among all Taiwan’s economic and trade policies toward China, there is a common feature: they are far behind the business community’s need. The policies legitimize the existence of commercial relations but do not positively initiate any kind of commercial relations with China. Neither do they promote any investment activities in China.

3.2.3 The WTO Effects of the Cross-Strait Trade

When Taiwan applied for its GATT membership on 1 January 1992, the Chairman of the GATT Council announced three principles: all contracting parties (to the GATT) must recognize that there is only one China, Taiwan must enter the GATT under the name of Chinese Taipei, and Taiwan must not become member before the PRC (Harland, 2000). Consequently, although Taiwan met the WTO’s legal and economic requirements before China, it joined the WTO later. On 1 January 2002, right after China’s WTO accession, Taiwan became the 144th WTO member under the name of “Separate Customs Territory of Taiwan, Penghu, Kinmen, and Matsu,” or “Chinese Taipei” for short (Sutter, 2002).

The WTO is the only international forum in which Taiwan can express its voice equally with the PRC. The WTO allows the rest of world to know about Taiwan and grants Taiwan equal status with the PRC. WTO membership also enhances Taipei’s ability to work

with other governments, eroding Beijing's attempt to isolate Taiwan internationally (Sutter, 2002). Meanwhile, Taiwan also asks for parity and equality from China.

China still insists on recognition of the "One China" principle before starting any negotiations. The Chinese Government thinks that issues regarding Taiwan are only internal affairs. However, this is not true under the WTO principles: each WTO member, being a sovereign state or a separate customs territory, is equal in status and has proper rights and obligations. Both sides did not use any exception clause upon their WTO accessions. The current situation is very interesting and can be seen as a deadlock: Taiwan wants China to treat it equally though many restrictions and prohibitions exist on commercial relations with China, while China insists on the "One China" principle and does not want to resort to the WTO for trade dispute resolutions.

However, official discussions over trade disputes in steel, for example, may break the deadlock. The WTO's trade dispute settlement mechanism aims at providing security and predictability to the multinational trading system (Kong, 2002). Any WTO member can file a complaint against other members. Mainland Chinese steel companies filed complaints early in 2002, alleging that steel suppliers from five nations, including Taiwan, had been dumping their cold-rolled steel products on the mainland market. As a result, Taiwan and China finally sat down at the WTO to thrash out differences over the steel tariffs in December 2002, marking the first time the two sides consented to use this trade body to settle trade arguments (Taipei Times, 2003). This talk was also the first direct communication since 1999, when then President Lee Tung-hui declared that the relationship across the strait was "State to State."

Right before the Chinese Spring Festival in 2003, one special direct flight from Taipei to Shanghai was organized. This was the first time since 1949 that the two sides had such direct communication. Shanghai is a place where a large group of Taiwan business people live and work. This special direct flight came at the request of these business people for their needs. Although there is still no large scale implementation of direct "Three Links" for both sides so far, this special direct flight was definitely a good start.

On Taiwan's side, there are some concerns about the "Three Links" policy, mostly around the economy and security. As Sutter (2002) pointed out, many in the Taiwan government remain concerned about the acceleration and intensification of economic integration with the PRC. There is an increasing investment in China from Taiwan. Many think that this increasing outflow of capital and technology will worsen Taiwan's already-poor economic situation. This is also called the "hollowing out" effect. Taiwanese officials are further concerned about Taiwan's increasing dependence on China. They are afraid that Mainland China will try to control Taiwan's economy for its own political interest. The government encourages businesses to invest in the island, South East Asian or Latin American countries. However, in spite of this, China is still the hottest investment destination for Taiwanese capital.

The relationship between the two sides continues to be strained, and the situation could change very quickly depending on election results and future policies towards each other. However, against this background of uncertainty, the economic ties between the two sides are very tight now. The official discussions over steel and direct flights between the two sides are good indications of improving trade and investment relations. China will not initiate any military actions against Taiwan because of its business interests, unless Taiwan

formally declares its independence. As a forum for direct dialogue, the WTO creates a certain degree of insulation for political tensions. It provides mechanisms for direct communication, and it will certainly reduce the importance of political forces, and minimize the uncertainties, unless there are any other big changes across the strait. The future of direct trade and investment relations across the Taiwan Strait is somehow bright because of the obvious economic benefits for both parties. Therefore, Hong Kong's intermediary role between China and Taiwan is likely going to diminish in the future.

3.3 Analysis of Hong Kong's Comparative Advantage after China's WTO Accession

3.3.1 Theory of Comparative Advantage

The standard theory of international trade is based on the principle of comparative advantage, first described by David Ricardo (1772-1823). Unlike the concept of absolute advantage proposed by Adam Smith (1723-1790), which directly compares goods productivity in two countries, the comparative advantage deals with the opportunity cost of production of goods in two countries. Thus, comparative advantage of producing goods exists in a country when this country can produce this goods or service at a lower opportunity cost. The essential idea of comparative advantage is that a country should manufacture or export the goods that it produces relatively efficiently, not absolutely efficiently. Even though a country has no absolute advantages in all production sectors compared with another country, it can still trade with the other country and enjoy great gains from specialization and trade.

This case can be best explained by the Heckscher-Ohlin (H-O) model. In the 1920's, two Swedish economists, Eli Heckscher and his student Bertil Ohlin originally developed

this model. The standard H-O model refers to the case of two countries, two goods and two factors of production. It assumes that labour and capital are used in the production of two end products. The ratio of the quantity of capital to the quantity of labour used in a production process is defined as the capital-labour ratio. This ratio fluctuates across various industries in a country, and across different countries. For example, if the two goods that a country can produce are steel and clothing, and if steel production uses more capital per unit of labour than is used in clothing production, then the steel production is capital-intensive relative to clothing production. Also, if steel production is capital-intensive, then it implies that clothing production must be labour-intensive relative to steel. Some countries, like the USA, are well-endowed with physical capital relative to its labour force. In contrast, many less-developed countries have very little physical capital, but are well-endowed with large labour forces. The H-O model assumes that the only differences between countries are those differences in the relative endowments of factors of production. When these conditions are present, it is ultimately shown that trade will occur, and will be nationally advantageous.

China is a labour-abundant country and its comparative advantage can be easily explained by its lower labour cost since China has a very large pool of cheap and experienced workers. This is also the reason that China has succeeded in its Export-Oriented Strategy. The economic incentive that Hong Kong strongly pursued in its re-export trade with China can also be explained by the comparative advantage theory. For companies in Hong Kong, producing in China and then conducting re-export trade with China had a lower opportunity cost compared to producing in Hong Kong and selling the products directly. For Hong Kong companies, doing re-export trade with China was relatively more efficient than producing by

themselves, or, in other words, it was more profitable for Hong Kong companies to re-export with China. Therefore, Hong Kong became China's middleman.

3.3.2 Change of Hong Kong's Comparative Advantage after China's WTO Accession

Hong Kong can serve as China's middleman because Hong Kong has lower comparative cost in doing re-export trade with China. In other words, China needs Hong Kong to be its middleman because China has high opportunity costs when trading by itself. The question is, will this comparative cost change along with China's WTO accession?

China has been opening more and more to the outside world through more than two decades of economic reform and openness. At the same time, China's business climate is getting much better, as is proven by the evolution of China's trade policies. With WTO accession and implementation of its agreements, China is expecting a far better business climate. Its market has become more transparent, and all necessary regulations, rules, and economic laws are either already put in place or in development. Chinese and foreign companies can meet to exchange market information. Besides improvement in business climate and market information, it also has made great improvement in its basic infrastructure. China has built many roads, highways, and railways. Bank and telecommunication services have also been greatly developed. Container ports are being quickly expanded. Chinese companies have also gained substantial knowledge in trading with foreign companies through interaction with them. China's WTO accession definitely promoted these changes. In 2003, Chinese ports handled 48 million TEU (twenty-foot equivalent unit), which was the highest in the world; at the same time, Shanghai and Shenzhen both exceeded 10 million TEU, ranking them third and fourth respectively as the largest container ports in the world (Overseas Express Consolidators Group, 2004).

The decreasing share of Hong Kong's re-export trade with China in China's total external trade is accompanied by an increasing share of the YRD region. As a result, the difference between PRD and YRD region's share in China's foreign trade has declined. Please refer to Figure 4 (Share of PRD and YRD Region in China's Total Trade) for details. The PRD region consists of Shanghai, Jiangsu, and Zhejiang, with Shanghai being the leading city of the region. Hong Kong's re-export trade with China is mostly transacted through the PRD region. For the rest of the regions in China, Hong Kong's role is trivial. Within the PRD region, the basic infrastructure is more developed than the national level. Besides Shenzhen, Guangzhou and Zhongshan are also China's top 10 container ports, with a total capacity of around 4 million TEU. All evidence shows that Chinese companies can now trade with foreign countries at a much lower cost than before the WTO accession.

Since the Asian Financial Crisis in 1997, Hong Kong's economy has been slowing down. From the aspects of basic infrastructure, business climate and market information, Hong Kong just barely remains at its original level, without any significant improvement. China has developed quickly in conducting trade with foreign companies, while Hong Kong remains at the same level. From the theory of comparative advantage, there is a change in the comparative cost which may cause China not to choose Hong Kong as its middleman in trading.

As Wan and Weisman (1999) pointed out, "If the business cost of trading with Hong Kong increases, then Hong Kong will no longer be China's middleman." This sentence can be interpreted in this way: If the business costs of trading directly with China decrease, China will no longer need Hong Kong as a middleman. This study will analyze this issue

from two aspects in foreign trade: imports and exports, to see if it is possible for individual foreign and Chinese firms to not choose Hong Kong from the perspectives of cost and profit.

Hong Kong's re-export trade with China is greatly related to outward processing. The other part can be seen as entrepôt trade, which means that Hong Kong companies sell the products directly abroad or to China without any change, packaging, sorting, and so forth. Hong Kong's role in this purely middleman trading will definitely decrease because of the simplicity of this trading method. It is becoming easier for Chinese companies to find foreign buyers and for foreign buyers to find the right Chinese companies with China's WTO accession. The cost of Chinese and foreign companies in finding trading partners is greatly reduced as discussed above. The reason foreign companies chose Hong Kong before was that Hong Kong was an efficient hub. The additional costs on trade via Hong Kong were the transportation cost, port fees, and so forth.

With China's WTO accession, as shown in Table 1 (China's Imports, Exports, and GDP), China's foreign trade is increasing dramatically and more foreign products can enter into China's formerly closed market. The projected growth of Chinese imports and exports will also decrease the direct transportation cost between Chinese and foreign ports due to the economies of scale. The cost of direct shipping from Guangzhou to America's West, for example Los Angeles, is about one-fourth to one-third of the shipping cost if traded goods are shipped via Hong Kong.¹⁰ The basic infrastructure of Chinese ports enables China to handle huge amounts of trade. Chinese professionals have accumulated much experience in trading with their partners. The customs clearance system has definitely been improved because of WTO requirements. Owing to the additional cost associated when trade is involved with Hong Kong, it is advantageous for Chinese and foreign companies to trade

directly. If Chinese and foreign companies can be more profitable from trading directly, they will no longer need Hong Kong as the middleman. If the information and shipping costs for direct trading are less than the commissions and re-exports fees which Hong Kong companies charge, Chinese merchants will choose to trade directly.

The above issue can also be seen from a different approach. Many Hong Kong companies have relocated their production factories into China since the 1980's, but the administrative system is still left in Hong Kong. In this case, packing, sorting, etc. are mostly done in Hong Kong by parent companies. Given the complexity and great involvement of Hong Kong companies in outward processing trade, Hong Kong's share in this part will not decrease significantly in the near future. However, there is a trend for Hong Kong companies to move the remaining industries to the mainland simply because of the high labour and rent costs in Hong Kong. Hong Kong companies re-invest their profits to enlarge their production scale in China. As shown in Figure 3 (Composition of Hong Kong's Re-exports), there has been an increase in the share of capital goods in Hong Kong's re-exports, and this trend has not changed since China's WTO accession. Raw and semi-finished materials, which are used for outward processing, the share of this part has remained at around 30 percent since 1995. With the abolition of some restrictions on imports and local contents requirements, China can buy production materials internationally. In this regard, this part may see a moderate increase. Concerning the share of consumer goods, the declining trend is unavoidable. Consumer goods have little relation to outward processing trade, and it is easy for Chinese merchants to trade directly with their foreign partners.

3.4 Summary

In brief, this chapter discussed the impact of China's WTO accession on its trade via Hong Kong from three main aspects. First of all, as China joined the WTO, Chinese companies were increasingly conforming to international trade practices, and more foreign companies were finding direct entry into China (HKTDC Research Department, 2000). Therefore, Hong Kong's middleman role in trading will decrease. Secondly, China and Taiwan, both being WTO members and driven by economic interests, have a bright future concerning the "Three Links". Hong Kong's intermediary role between China and Taiwan in trade and investment will diminish substantially. Finally, since China has considerably improved its basic infrastructure, as well as its business climate and market information, Hong Kong is eventually losing its comparative advantage in serving as China's middleman.

However, Hong Kong's future is not absolutely gloomy. It can still serve small businesses both in and outside of China. In regard to outward processing, since Hong Kong has been immensely involved in it, it will still play a very important role in the near future. The "creation effect" is suggested by Yam (2001); he believed that, "the business 'creation effect' stimulated by WTO accession will far outweigh the 'division effect'." According to the World Bank's projection, China will double its foreign trade within five years of WTO accession. Because of this significant increase, there should be enough work to keep Hong Kong busy (Yam, 2001).

However, even the absolute amount may increase, Hong Kong's share in China's foreign trade will decrease. Since this paper uses relative quantity to measure Hong Kong's role, this paper draws the conclusion that Hong Kong's intermediary role in China's foreign trade will decrease in the long run after China's WTO accession.

Chapter 4: Policy Implications for Hong Kong

As discussed in Chapter 3, Hong Kong is likely to eventually lose its comparative advantage in serving as China's middleman now that China has WTO membership. The question then arises: What kind of policies could possibly help Hong Kong to maintain and regain, if possible, its comparative advantage? In order to gain a better understanding of Hong Kong's possible policies, it is necessary to first examine the influence of re-export trade with China on Hong Kong's GDP. This study adopts two simple econometric models to analyze this influence. Seen from the empirical results, this re-export trade plays an important positive role in Hong Kong's GDP growth. Re-exports from China, mostly the outward processing part, contribute significantly to Hong Kong's GDP growth, while re-exports to China have no great influence. Based on these econometric findings, this paper will discuss policy options in part two.

4.1 An Empirical Investigation of the Impact of Hong Kong's Re-exports with China

The econometric models that are used for the empirical investigation are specified as follows:

$$y_t = \beta_0 + \beta_1 x_t + \varepsilon_t \quad (1)$$

$$y_t = \beta_0 + \beta_1 x_{1t} + \beta_2 x_{2t} + \varepsilon_t \quad (2)$$

where y denotes the growth rate of real GDP; x_{1t} and x_{2t} denote, respectively, the growth rate of re-exports to and from China; x_t denotes the growth rate of total re-exports with China; β_i , $i = 0, 1, 2$, denote the model coefficients; and finally, ε denotes the disturbance term.¹¹ Model (1) allows us to investigate the overall impact of Hong Kong's total re-export trade with China in respect to Hong Kong's economic growth, while Model (2) allows us to

examine, separately, the impact of re-exports from and to China. Since the focus is on the impact of Hong Kong's re-export trade with China, other variables, such as personal consumption, business investment, and government spending are not specified in the models. These impacts are aggregated and captured by the constant term in the models.

This empirical investigation uses annual data from 1978 to 2001. Most of the data was retrieved from the Census and Statistics Department of Hong Kong SAR government¹² and the Data Bank of the APEC Study Centre at Hong Kong City University.¹³ The GDP deflator (1990 = 100) is used to convert all nominal variables, and then the growth rates of each of these variables are calculated. Table 7 (Data for Empirical Investigation) shows all data used in estimation, and Table 8 (Empirical Results) presents the empirical results.

The results from Model (1), shown on Table 8, suggest that a 1 percent increase (decrease) in total real re-export with China has led to approximately 0.14 percent increase (decrease) in real GDP during the investigation period. However, this result shows only the aggregated impact of total re-exports with China, not the separate impacts of re-exports from and to China on Hong Kong's economic growth. Answers to the question whether or not both re-exports from and to China are significant can be found from the results of Model (2). The estimation results of Model (2) suggest that while the impact of re-exports from China is statistically significant, the impact of re-exports to China is not. This result is in fact consistent with our theoretical analysis on the mark-up of re-exports with China discussed in Chapter 3.

In order to evaluate the robustness of these estimates, three important figures are also reported in Table 8: the values of the Durbin-Watson statistic for serial correlation, the Breusch-Pagan test statistic for heteroscedasticity, and the Jarque-Bera test statistic for

normality. Based on the test statistics, the hypothesis of no heteroscedasticity and the hypothesis of normality are accepted at 5 percent level. The Durbin-Watson statistic indicates a very low degree of serial correlation.

In summary, Hong Kong's re-export trade with China since 1978 had a significant impact on Hong Kong's economic growth. If Hong Kong's intermediary role in China's foreign trade has weakened since China entered the WTO as discussed in the pervious chapter, it is obvious that Hong Kong's economic growth would be negatively affected. This requires the Hong Kong government to take some policy measures which can help it to maintain and regain its comparative advantage, and to create new motivation for economic growth.

4.2 Policy Implications for Hong Kong

This paper suggests four policy options for Hong Kong: co-operating with Mainland China's Central People's Government (CPG), shifting to other service industries, promoting offshore trade with Mainland China, and enhancing Hong Kong's competitiveness. These policies are designed to sustain Hong Kong's economic growth and to create new momentum for economic growth, given the possible negative economic influence of the decrease in Hong Kong's intermediary role in China's foreign trade.

4.2.1 Co-operating with the Central People's Government

Co-operating with the CPG is an important task for the Hong Kong SAR government. The PRD region is commonly regarded as the "world factory" because of its huge exports of manufactured goods. Since most of Hong Kong's re-exports with China go through the PRD region, co-operating with the local Guangdong province is very important. This co-operation is usually called "*Yue-Gang*" co-operation.¹⁴

An efficient and fast flow of goods between Hong Kong and the PRD region is important for the re-export trade. "The biggest challenges facing Hong Kong are its need to increase land, sea, and rail links with the PRD Region in Guangdong; and to streamline customs and immigration procedures to allow larger volumes of people and cargo to cross between China and Hong Kong" (Anonymous, 2001).

Co-operation between Hong Kong and the local Guangdong government was almost nonexistent until Hong Kong and China signed the Closer Economic Partnership Arrangement (CEPA) on 29 June 2003. It was under certain conditions that China and Hong Kong concluded the CEPA. China's fast economic growth contrasts Hong Kong's slow development. As China's Special Administration Region, it has been seeking economic help from Mainland China. The creation of the CEPA was to show the Chinese government's support of Hong Kong in both economic and political aspects. Economically, the CEPA is to provide Hong Kong companies new opportunities and preferential policies, thus promoting Hong Kong's economy. Politically, the CEPA shows China's stance in supporting the current HKSAR government.

The CEPA includes the following three aspects: trade in goods, trade in services, as well as trade and investment facilitation. Trade and investment facilitation is very important for the promotion of Hong Kong's re-export trade with China. Among the seven areas covered,¹⁵ customs clearance is the most important issue to Hong Kong and China's re-export trade. Of the whole trade process, customs clearance is the most time-consuming. Future co-operation in customs clearance can accelerate the flow of goods between Hong Kong and the PRD region. For China, simplifying its long procedure of customs clearance is crucial. Mainland customs could make some special provisions towards those goods to and

from Hong Kong. Establishing a customs information exchange system between the two sides is also necessary. With the sharing of information, it will be easier for both sides to trace the flow of goods. It can also help Mainland China monitor and prevent tax and tariffs evasion and smuggling. Border control has restricted the flow of products and services between Hong Kong and Guangdong. Express lanes should be opened in the Shenzhen West Corridor for those regular shuttles.

Most of Hong Kong's investment has gone to the PRD region since China's adoption of the "Open Door" policy in 1978. In the past, the Hong Kong government responded to this policy positively by improving road, railway, and air links with the PRD region. Hong Kong also upgraded seaport and airport facilities to ease the outward processing trade (Lin, W. and Lin, P., 2001). At the present, with China's WTO accession and the conclusion of the CEPA, co-operation between Hong Kong and China in trade-related logistical facilities is of great need and important for both sides. The construction proposal of the Hong Kong-Macau-Zhuhai Bridge is a good example of government co-operation. This bridge can connect to the less developed western PRD region. The Hong Kong-Shenzhen Western Corridor, due for completion in 2006, will contribute significantly to easier border crossing. In regard to railway links, more direct trains between Hong Kong and Guangzhou are also necessary.

Hong Kong and China have agreed to establish a joint steering committee, which will comprise senior representatives, or officials, designated by both sides. A liaison office will be set up under the steering committee. The functions of this committee include: supervising the implementation of the CEPA, resolving disputes that may arise, dealing with any other business relating with implementation of the CEPA, and so on (Trade and Industry

Department of Hong Kong SAR, 2003). This committee provides both Hong Kong and China a channel of communication, in order to negotiate and to deal with any economic problems at all levels.

Since the CEPA has only been in operation since January 2004, its influence is difficult to judge. There are still a few uncertainties. However, the CEPA broke the deadlock when Hong Kong was unable to co-operate with the local Guangdong government. With co-operation at the national level, it is easier for Hong Kong and cities in Guangdong Province to avoid unnecessary competition and repetition of basic infrastructure construction. Hong Kong and cities in Guangdong will definitely benefit from this co-operation.

4.2.2 Shifting to Other Service Industries

Since Hong Kong will eventually decrease its intermediary role in China's foreign trade, it must update its economic structures by continuing to invest in Mainland China and to focus on finance and trade related services in which it has comparative advantage.

The contribution of the manufacturing sector to Hong Kong's GDP kept decreasing from 6.4 percent in 1997, to 5.8 percent in 2000 and 5.2 percent in 2001. Because of Hong Kong's high cost of labour and land, it is not competitive for companies to do labour-intensive manufacturing in Hong Kong. Although the CEPA has agreed on zero tariffs for exports from Hong Kong since 1 January 2004, the resulting economic effect is modest. The few commodities that Hong Kong manufacturers may benefit from are jewellery, clocks and watches, eye glasses, and so on. Hong Kong may also attract some investment in fields such as production of brand-name goods, as well as products with high intellectual property content. Most of Hong Kong's industries such as garments and electrical products, are already intensively invested in China; further relocation is still a good choice in order to

compete in the world market. Following China's WTO accession, former quota restrictions on China's exports of textiles and garments will decrease significantly or no longer exist. Without the quota concern, Hong Kong companies should relocate all their remaining textiles and garments factories to Mainland China. Driven by profit, factories will move out of Hong Kong even without any government preferential policies. The Hong Kong SAR government should take some positive actions to absorb investment in the manufacturing sectors which can benefit from the CEPA. In addition, the government can adopt some preferential fiscal policies to attract investors, for example, tax reduction. Hong Kong can also consider building a special industrial park for manufacturing purposes. In addition, the government can lower the different kinds of administrative fees for manufacturers.

The CEPA agrees that Hong Kong can take some first-mover advantage in China's seventeen service sectors. Hong Kong companies can enter into China's service markets ahead of the WTO's time schedule with fewer restrictions. Hong Kong companies can also invest in the lucrative field of the exhibition industry, which China's WTO agreements do not cover. The CEPA provides a great incentive for Hong Kong companies to invest in China's service sectors. Service-related industries are more important for a developed economy, such as Hong Kong's. On the contrary, service industries are still under development and compose only a small percentage of China's GDP. As a regional finance and service centre, Hong Kong obviously has advantages in the service sectors. In the mean time, Hong Kong companies can help China to implement the WTO agreements.

As discussed above, Hong Kong's previous economic transformations were all highly associated with China. Now, the conclusion of the CEPA and China's WTO accession provide Hong Kong another great opportunity to transform its economic structure. The Hong

Kong government should encourage local companies to invest in China, especially in the service industry, to take the opportunity of first-mover advantage. The government can give those companies which have invested in China some tax preferences and at the same time provide guidance and suggestions. The HKTDC and the Hong Kong General Chamber of Commerce can make full use of their already established offices and branches to offer services to local Hong Kong companies. The government should also help businessmen to negotiate with local Chinese governments and even with the CPG.

4.2.3 Promoting Offshore Trade with Mainland China

Offshore trade, in its simplest terms, means trade done outside one's own country or port. It covers the services of both "merchanting"¹⁶ and "merchandising for offshore transactions".¹⁷ Earnings from offshore trade include the gross margin from merchanting and the commission from merchandising services for offshore transactions. In 2000, the earnings from offshore trade, in terms of gross margin or commission thus earned, grew remarkably by 21.2 percent in 1999 to HK\$84.6 billion. Within this total, the gross margin from merchanting surged by 31.6 percent to HK\$70.7 billion, while the commission from merchandising services for offshore transactions fell by 13.5 percent to HK\$13.9 billion. Mainland China was the largest destination for the goods sold under the merchanting arrangement, accounting for 41.6 percent of the total value of goods sold under such arrangement in 2000 (Census of Statistics Department of Hong Kong, 2002).

With the expansion of offshore trade, more goods originating outside of Hong Kong are being dispatched to overseas markets through direct shipments or transshipments. Re-exports through Hong Kong may not be necessary. This can offset Hong Kong's disadvantage in shipping costs. "In the long run, the future of Hong Kong as the region's

most important trading hub rests largely on whether companies will continue to use Hong Kong as their operational base", argues HKTDC's Chief Economist Edward Leung (HKTDC, 1998). Offshore trade can stimulate the demand for certain trade-supporting services, such as trade finance and insurance. Hong Kong should emphasize services in these fields. The contribution of offshore trade to Hong Kong's economy is very significant. In order to promote offshore trade, it is more important for Hong Kong to adsorb more investment from outside companies, including, of course, Mainland China, to keep Hong Kong as their controlling headquarters.

Mainland China is one of Hong Kong's most important foreign investors. Its investment in Hong Kong has focused on four major groups: banking, resources, tourism, and shipping. The amount of China's FDI in Hong Kong has increased rapidly in recent years. The growing importance of this enhances Hong Kong's position as the gateway to China (Lin, W. and Lin, P., 2001). If more Chinese companies invest in Hong Kong, they will make it their springboard to the outside world. Hong Kong still has the obvious advantage of attracting multinational companies to establish their headquarters or regional headquarters. If Chinese companies want to establish links with outside, it is a better choice to set their headquarters or regional headquarters in Hong Kong, to make full use of Hong Kong's cluster advantage in information, finance, insurance, low taxation, professionals, and so on. In doing so, re-export and offshore trade with China will probably increase.

4.2.4 Enhancing Hong Kong's Competitiveness

Besides the three aspects discussed above, Hong Kong also needs to enhance its competitiveness in serving China and the rest of the world. There are three main areas in which Hong Kong can focus on improving: a better political and economic environment,

better language skills and tertiary education, and easing the flow of people from Mainland China.

Hong Kong is one of the best free market economies in the world, and has a great economic environment. China agreed that Hong Kong could keep its system and policies unchanged for at least fifty years from the time of Hong Kong's return to China. If it fails to provide a better political environment, the free flow of information will become impossible, and Hong Kong will not differ from any other mainland city. The CPG should also maintain Hong Kong's political stability because this is beneficial for both sides.

Hong Kong, as the regional financial and business hub, also needs to improve its residents' language skills, especially English and Mandarin. Hong Kong has done relatively well in its English education but not in Mandarin education. Sharing the same language with people in the PRD region is one of Hong Kong's advantages. With the opening of China's service markets, Hong Kong will do a lot of business with people outside of the PRD region. Mandarin is broadly used outside of the PRD region and is also the official language of China. Therefore, it is imperative for Hong Kong business people to learn how to speak, or at least to understand Mandarin. To facilitate this, the government could provide free Mandarin courses to those businessmen. Hong Kong's local television and radio programs are overwhelmingly in Cantonese. Broadcasting more Mandarin programs will be necessary to facilitate language learning. The government can give subsidies to those schools which offer regular Mandarin classes. It is perhaps also necessary for the Hong Kong government to set Mandarin as a required course in primary or even middle and high schools. The government should also encourage exchange programs with schools in Mainland China.

Easing the flow of people from Mainland China is another important task for the Hong Kong government. With the increased integration of Hong Kong and Mainland China, there will be more business trips between the two. Hong Kong also needs experienced specialists from China. Current restrictions hinder further integration of the two sides. Opening up to people from Mainland China will also attract more travelers to Hong Kong, and thus foster Hong Kong's tourism industry. However, easing the flow of people from Mainland China may create problems of illegal immigrants. The Hong Kong government can co-operate with the CPG to solve this problem. Hong Kong may also need to simplify the requirements of issuing visas for travel between Hong Kong and China.

Chapter 5: Conclusions

Hong Kong's re-export trade with China has played significant roles in both economies. With China's WTO accession, the issue of Hong Kong's future role becomes more interesting to study. This paper has first reviewed the background of Hong Kong's role in China's economic reform and development, including China's "Open Door" policy and its subsequent great economic and trade performance, the intermediary role that Hong Kong has played in China's foreign trade, and the impact of China's WTO accession. Chapter 3 of this paper has analyzed Hong Kong's possible future role as the middleman for China from three main aspects: China's increasing FDI, China's indirect trade with Taiwan, and analysis of Hong Kong's comparative advantage. The empirical study in Chapter 4 has shown that Hong Kong's re-exports from China is important for Hong Kong's economic growth. Based on the findings, this paper has also discussed policy implications and possible policy options.

One of the main contributions of this study is that it has combined three different aspects to formulate the discussions, which provides a unique perspective in literature. In analyzing the intermediary role of Hong Kong in China's foreign trade, this paper has focused on three areas: China's increasing openness providing direct communication channels to the rest of the world, the great economic benefits driving Taiwan and Mainland China to establish direct economic links, and Hong Kong's decreasing comparative advantage. From a detailed discussion of these aspects, this study has provided a solid foundation for understanding the whole situation. It has concluded that Hong Kong will eventually decrease its intermediary role in China's foreign trade in the long term, due to the reasons discussed above. This conclusion is consistent with several other studies. In addition, this paper has argued that Hong Kong can still serve as middleman to some small

business in the short term. Hong Kong can also play an important role in the outward processing trade part. However, as the economic environment changes, some policy shifts are necessary.

China's WTO accession, along with the conclusion of the CEPA, provides Hong Kong a great opportunity to invest in China. Whether Hong Kong can seize this opportunity or not, depends on how hard and efficiently Hong Kong corporations work. Based on the possibility that Hong Kong may eventually lose its comparative advantage in serving as China's middleman, new policies are necessary to maintain Hong Kong's comparative advantage and to create new momentum for economic growth. These policies include co-operating with the CPG, shifting to other service industries, promoting offshore trade with Mainland China, and enhancing Hong Kong's competitiveness.

It is important to point out that China, to date, has been a full member of the WTO for only two years. Therefore, the influence of China's implementation of WTO agreements is still difficult to examine. In addition, due to the data constraints, this paper used annual data for the empirical study. The adoption of annual data may not provide detailed results of the short-term fluctuations, thus preventing us from a better understanding of both short-term and long-term situations. Finally, it is not clear to what extent CEPA's first-mover advantage will influence Hong Kong's economy and its re-export trade with China. All the above-mentioned points suggest that in order to better understand this issue and to design more appropriate policies, more comprehensive studies are still required.

Endnotes

¹Unless documented elsewhere, data adopted in this article come from or are calculated from different statistics issues of the Census and Statistics Department of Hong Kong, from <http://www.info.gov.hk/censtatd/home.html>

²State Administration of Foreign Exchange, China, Retrieved May 5, 2004, from www.safe.gov.cn

³Now the Ministry of Commerce (MOFCOM).

⁴Now the Ministry of Commerce (MOFCOM).

⁵Calculated from <http://www.chinabiz.org.tw/maz/Eco-Month/129-2003-05/129-09.xls>, Retrieved December 20, 2002

⁶Please refer to Table 5 (Estimation of Indirect Trade between Taiwan and Mainland China); “r” represents the average ratio of the import from Taiwan in Guangdong to all of China according to China Customs Statistics. The “r” from 1999 to 2002 is 36 percent.

⁷Mainland Affairs Council, Taiwan, Hong Kong & Macao Statistics on Exchanges, Retrieved November 11, 2002, from <http://www.mac.gov.tw/english/english/csexchan/890124/table8.gif>

⁸“Three Links” means links in mail, transportation and trading between Taiwan and Mainland China

⁹“Mini Three Links” means links of mail, transportation, and trading between the offshore islands of Kinmen and Matsu and Mainland China

¹⁰Department of Foreign Trade and Economic Co-operation of Guangdong Province, Guangzhou Ports, Retrieved February 11, 2004, from <http://www.gddoftec.gov.cn/wjmdt/Detail.asp?ID=862>

¹¹The technical reason for using the growth rates rather than levels in the econometric work is to avoid possible spurious results in estimation, since these macroeconomic time series are non-stationary during the investigation period.

¹²Statistics and Census Bureau of Hong Kong, Retrieved November 11, 2002, from <http://www.info.gov.hk/censtatd/home.html>

¹³APEC study Center, City University of Hong Kong, Retrieved November 11, 2002, from <http://fbweb.cityu.edu.hk/hkapec/APEC-pages/APEC-Data-HongKong.htm>

¹⁴“Yue” is the abbreviation of Guangdong province; “Gang” means Hong Kong.

¹⁵The seven areas include: trade and investment promotion, customs clearance, quarantine and inspection of commodities, food safety and quality assurance, electronic commerce; transparency in law and regulations, small and medium-sized enterprises, Chinese medicine and medical products. ---CEPA. Retrieved August 21, 2003, from <http://www.tid.gov.hk/english/cepa/fulltext.html>

¹⁶Merchanting is defined as “services associated with the trading of goods which are purchased from a party outside Hong Kong and then sold to another party outside Hong Kong, without the goods ever entering and leaving Hong Kong. Also included are transactions of goods manufactured through sub-contract processing arrangement, yet sold directly to a party outside Hong Kong without the goods entering and leaving Hong Kong.”

----*Hong Kong's Offshore Trade Statistics for 2000*, Retrieved December 15, 2002, from http://www.info.gov.hk/censtatd/eng/press/annual_survey/off/off2000_index.html

¹⁷Merchandising services for offshore transactions are defined as “arranging on behalf of buyers/sellers outside Hong Kong the purchase/sale of goods according to their specifications (e.g. multiple sourcing, marketing, contract and price negotiation, volume and sample procurement, shipment, inspection and arrangement of follow-up order). Again, the goods involved do not enter or leave Hong Kong. Unlike in merchanting, the Hong Kong entity, in its capacity as an agent or broker, does not take ownership of the goods involved.”

----*Hong Kong's Offshore Trade Statistics for 2000*, Retrieved December 15, 2002, from http://www.info.gov.hk/censtatd/eng/press/annual_survey/off/off2000_index.html

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Table 2

Hong Kong's Total Re-export Trade with China

Year	Hong Kong's Re-exports from China	Hong Kong's Re-exports to China	Hong Kong's Total Re- export Trade with China	Hong Kong's Total External Trade	Percentage of Hong Kong - China re- export trade to Hong Kong's total external trade
1979	14,297	3,335	17,633	408,775	4.3%
1980	18,404	10,159	28,563	460,041	6.2%
1981	25,556	16,013	41,569	517,547	8.0%
1982	26,814	14,538	41,351	491,700	8.4%
1983	34,111	21,051	55,162	581,914	9.5%
1984	44,449	44,316	88,764	702,377	12.6%
1985	51,865	68,891	120,756	698,619	17.3%
1986	74,349	58,984	133,333	796,150	16.7%
1987	111,500	79,575	191,075	1,000,332	19.1%
1988	158,924	114,704	273,629	1,197,381	22.9%
1989	202,469	111,387	313,857	1,218,757	25.8%
1990	240,410	110,952	351,362	1,282,404	27.4%
1991	289,010	140,523	429,533	1,414,311	30.4%
1992	336,952	176,999	513,951	1,569,048	32.8%
1993	364,550	211,160	575,710	1,629,568	35.3%
1994	392,819	232,335	625,155	1,742,127	35.9%
1995	446,556	269,483	716,040	1,989,494	36.0%
1996	452,899	276,804	729,703	1,943,749	37.5%
1997	453,011	277,961	730,973	1,923,119	38.0%
1998	430,917	253,959	684,876	1,731,067	39.6%
1999	474,608	263,090	737,697	1,806,962	40.8%
2000	599,030	344,689	943,719	2,278,067	41.4%
2001	572,703	351,806	924,509	2,160,242	42.8%
2002	644,345	426,500	1,070,845	2,371,591	45.2%
2003	760,403	554,938	1,315,341	2,789,841	47.1%

Note: These data are measured in millions of 1990 Hong Kong dollars,

Source: Calculated from different statistics issues of Census and Statistics Department of Hong Kong,

Retrieved March 11, 2004, from <http://www.info.gov.hk/censtatd/home.html>

Table 3

China's Foreign Direct Investment

Unit: US million, %

Year	2000		2001		2002		2003	
Country (Area)	Amount	Ratio (%)	Amount	Ratio (%)	Amount	Ratio (%)	Amount	Ratio (%)
Hong Kong & Macau	15,847.26	38.92	17,038.42	36.35	18,329.31	34.75	18,116.70	33.86
Virgin Islands	3,832.89	9.41	5,042.34	10.76	6,117.39	11.60	5,776.96	10.80
Japan	2,915.85	7.16	4,348.42	9.28	4,190.09	7.94	5,054.19	9.45
USA	4,383.89	10.77	4,433.22	9.46	5,423.92	10.28	4,198.51	7.85
South Korea	1,489.61	3.66	2,151.78	4.59	2,720.73	5.16	4,488.54	8.39
Taiwan	2,296.28	5.64	2,979.94	6.36	3,970.64	7.53	3,377.24	6.31
Singapore	2,172.20	5.34	2,143.55	4.57	2,337.20	4.43	2,058.40	3.85
Germany	1,041.49	2.56	1,212.92	2.59	927.96	1.76	856.97	1.60
Others	6,735.34	16.54	7,527.00	16.06	8,725.62	16.55	9,577.16	17.90
Total	40,714.81	100.00	46,877.59	100.00	52,742.86	100.00	53,504.67	100.00

Note: All data are in constant terms

Source: Cross-Strait Economic Statistics Monthly, Mainland Affairs Council, Taiwan

Retrieved March 11, 2004, from <http://www.chinabiz.org.tw/maz/Eco-Month/137-2004-01/137-29.xls>

Table 4

Trade between Taiwan and Hong Kong and Transit Trade to Mainland China

Year	Taiwan's Exports to H.K.			Taiwan's Imports from H.K.			Total Trade between Taiwan and Hong Kong		
	Amount	Re-exports to Mainland China	As % of Exports to H.K.	Amount	Imports from Mainland China	As % of Imports from H.K.	Amount	Transit Trade with Mainland China	As % of External Trade with H.K.
1979	1,998.9	35.6	1.8	573.0	93.2	16.3	2,572.4	128.8	5.0
1980	2,414.8	356.4	14.8	676.1	115.6	17.1	3,090.9	472.0	15.3
1981	2,666.0	533.0	20.0	599.4	104.3	17.4	3,265.4	637.3	19.5
1982	2,183.1	254.0	11.6	569.9	109.7	19.2	2,752.9	363.7	13.2
1983	2,142.5	198.3	9.3	594.5	113.0	19.0	2,737.0	311.2	11.4
1984	2,693.8	515.4	19.1	755.9	154.8	20.5	3,449.7	670.0	19.4
1985	3,145.8	1,158.8	36.8	651.1	136.1	20.9	3,796.9	1,294.7	34.1
1986	3,531.3	932.0	26.4	874.7	165.7	18.9	4,406.0	1,097.8	24.9
1987	4,767.1	1,368.0	28.7	1,385.0	322.2	23.3	6,152.1	1,690.4	27.5
1988	6,134.6	2,418.7	39.4	1,954.1	516.4	26.4	8,088.7	2,935.1	36.3
1989	6,871.8	2,981.5	43.4	2,195.1	609.8	27.8	9,066.9	3,619.4	39.9
1990	7,446.7	3,278.3	44.0	2,724.1	765.4	28.1	10,170.8	4,043.6	39.8
1991	9,228.3	4,503.9	48.8	3,063.9	1,086.6	35.5	12,292.2	5,590.4	45.5
1992	10,646.5	5,923.7	55.6	3,200.1	1,054.2	32.9	13,846.7	6,977.8	50.4
1993	11,227.2	6,978.4	62.2	3,365.8	1,015.3	30.2	14,593.0	7,993.7	54.8
1994	12,559.4	7,675.7	61.1	3,334.7	1,164.6	34.9	15,894.1	8,840.3	55.6
1995	14,616.3	8,716.2	59.6	4,039.9	1,388.4	34.4	18,656.2	10,104.5	54.2
1996	13,666.2	8,407.8	61.5	3,698.6	1,369.1	37.0	17,364.8	9,777.0	56.3
1997	13,551.5	8,245.1	60.8	3,983.5	1,479.9	37.2	17,535.0	9,725.0	55.5
1998	11,186.0	7,012.0	62.7	3,640.7	1,387.4	38.1	14,826.7	8,399.4	56.6
1999	10,641.0	6,756.4	63.5	3,492.4	1,345.6	38.5	14,133.4	8,102.0	57.3
2000	12,885.6	7,764.9	60.3	4,130.1	1,603.1	38.8	17,015.8	9,368.0	55.1
2001	10,941.1	6,967.3	63.7	3,585.2	1,338.9	37.3	14,526.3	8,306.2	57.2
2002	11,618.1	8,062.3	69.4	3,466.3	1,335.5	38.5	15,084.4	9,397.7	62.3
2003	12,333.5	9,058.5	73.4	4,163.9	1,660.5	39.9	16,497.4	10,442.3	63.3

Note: These data are measured in millions of 1990 U.S. dollars, seasonally adjusted

Source: Cross-Strait Economic Statistics Monthly, Mainland Affairs Council, Taiwan

Retrieved March 11, 2004, from <http://www.chinabiz.org.tw/maz/Eco-Month/137-2004-01/137-01.xls>

Table 5

Estimation of Trade between Taiwan and Mainland China

Year	A Taiwan Exports to Mainland China	B1 Taiwan Exports to HK (F.O.B.)	B2 HK Imports from Taiwan (C.I.F.)	B1-B2 Difference between (B1) and (B2)	C Transit trade from Taiwan to Mainland China via HK	Estimation of Taiwan Exports to Mainland China	Taiwan Imports from Mainland China	Estimation of Total Indirect Trade between Taiwan and Mainland China
1983	--	2,065.1	2,010.3	54.8	198.3	253.0	113.0	366.0
1984	--	2,527.9	2,685.9	-157.9	515.4	515.4	154.8	670.2
1985	--	2,982.0	3,149.5	-167.6	1,158.7	1,158.7	136.1	1,294.7
1986	--	3,355.9	3,530.0	-174.0	932.0	932.0	165.7	1,097.7
1987	--	4,599.1	4,768.4	-169.3	1,368.0	1,368.0	322.2	1,690.3
1988	--	6,027.0	6,129.8	-102.8	2,418.7	2,418.7	516.4	2,935.1
1989	--	7,317.2	6,864.8	452.4	3,009.6	3,461.9	609.8	4,071.8
1990	--	8,556.2	7,439.9	1,116.3	3,278.3	4,394.6	765.4	5,160.0
1991	0.1	11,995.5	9,268.9	2,726.6	4,503.9	7,231.3	1,086.5	8,317.8
1992	1.0	14,522.0	10,510.0	4,012.0	5,923.7	9,936.6	1,054.2	10,990.8
1993	14.9	16,976.1	11,083.2	5,892.9	6,978.4	12,873.4	1,015.3	13,888.7
1994	118.6	19,161.6	12,398.4	6,763.1	7,675.7	14,439.5	1,675.1	16,114.5
1995	332.1	23,024.2	14,616.3	8,407.9	8,716.2	17,139.7	2,726.5	19,866.2
1996	539.4	23,177.1	13,666.2	9,510.9	8,407.8	17,933.6	2,647.4	20,581.0
1997	531.7	24,347.3	13,551.5	10,795.8	8,245.1	19,057.5	3,323.0	22,380.4
1998	699.8	20,639.9	11,186.0	9,453.9	7,012.0	16,633.6	3,446.0	20,079.6
1999	2,096.7	21,498.4	10,641.0	10,857.3	6,756.4	17,614.3	3,737.5	21,351.7
2000	3,413.8	25,364.4	12,885.6	12,478.8	7,764.9	20,243.7	5,037.3	25,280.9
2001	3,752.2	21,318.6	10,941.1	10,377.6	6,967.3	17,352.7	4,666.9	22,019.6
2002	7,780.8	24,126.7	11,665.4	12,461.3	8,070.7	23,022.5	6,213.7	29,236.2
2003	16,479.9	21,801.3	12,333.5	9,467.8	9,058.5	27,167.5	8,422.8	35,590.3

Note: 1. These data are measured in millions of 1990 U.S. dollars, seasonally adjusted
 2. A negative figure in column (B2-B1) will be treated as zero.
 3. Before 2001, Mainland Affairs Council (MAC) used this estimation method: (B1-B2) +C. But in 2002, MAC and Board of Foreign Trade (BOFT) decided to change the formula to $A + (B1-B2) * 80\% + C - r * A$. "r" represents the average ratio of the import from Taiwan in Guangdong to all of China according to China Customs Statistics. The "r" from 1999 to 2002 is 36%.

Source: Cross-Strait Economic Statistics Monthly, Mainland Affairs Council, Taiwan, Retrieved March 11, 2004, <http://www.chinabiz.org.tw/maz/Eco-Month/137-2004-01/137-06.xls>

Table 6

Taiwan's Indirect Investment in Mainland China

Period	Approved by Ministry of Economic Affairs, ROC			Official Data from Mainland China				
	Cases	Amount	Average Amount	Projects	Contracted Amount	Average Amount	Realized Amount	Realization Ratio
1991*	237	168.1	0.71	3,446	2,685.6	0.78	814.5	30.3%
1992	264	232.7	0.88	6,430	5,221.9	0.81	989.2	18.9%
1993	1,262	1,049.1	0.83	10,948	9,167.6	0.84	2,887.8	31.5%
1994	934	867.1	0.93	6,247	4,862.0	0.78	3,056.0	62.9%
1995	490	963.7	1.97	4,778	5,095.0	1.07	2,788.7	54.7%
1996	383	1,063.6	2.78	3,184	4,448.1	1.40	3,006.6	67.6%
1997	728	1,370.2	1.88	3,014	2,388.2	0.79	2,791.3	116.9%
1998	641	1,273.6	1.99	2,970	2,500.0	0.84	2,443.8	97.8%
1999	488	1,035.4	2.12	2,499	2,788.9	1.12	2,147.8	77.0%
2000	840	2,110.0	2.51	3,108	3,271.2	1.05	1,858.5	56.8%
2001	1,186	2,201.8	1.86	4,214	5,468.0	1.30	2,356.6	43.1%
2002	1,490	3,014.2	2.02	4,853	5,268.3	1.09	3,103.3	58.9%
2003	1,837	3,530.6	1.92	4,495	6,575.5	1.46	2,594.9	39.5%

Note: 1. These data are measured in millions of 1990 U.S. dollars, seasonally adjusted

2. * Figures for 1991 include data before 1991

3. Growth rate is on a yearly basis.

Source: Cross-Strait Economic Statistics Monthly, Mainland Affairs Council, Taiwan,

Retrieved March 11, 2004, from <http://www.chinabiz.org.tw/maz/Eco-Month/137-2004-01/137-10.xls>

Table 7

Data for Empirical Investigation

Year	Real GDP	Real total re-exports with China	Real total re-exports from China	Real total re-exports to China	Real GDP growth rate	Growth rate of Real total re-exports with China	Growth rate of Real total re-exports from China	Growth rate of Real total re-exports to China
1979	282,388	17,633	14,297	3,335	--	--	--	--
1980	310,787	28,563	18,404	10,159	0.1006	0.6199	0.2873	2.0457
1981	339,187	41,569	25,556	16,013	0.0914	0.4553	0.3886	0.5762
1982	348,362	41,351	26,814	14,538	0.0270	-0.0052	0.0492	-0.0921
1983	368,171	55,162	34,111	21,051	0.0569	0.3340	0.2721	0.4480
1984	405,014	88,764	44,449	44,316	0.1001	0.6092	0.3031	1.1052
1985	406,761	120,756	51,865	68,891	0.0043	0.3604	0.1669	0.5546
1986	450,411	133,333	74,349	58,984	0.1073	0.1042	0.4335	-0.1438
1987	508,763	191,075	111,500	79,575	0.1296	0.4331	0.4997	0.3491
1988	549,302	273,629	158,924	114,704	0.0797	0.4321	0.4253	0.4415
1989	563,368	313,857	202,469	111,387	0.0256	0.1470	0.2740	-0.0289
1990	582,549	351,362	240,410	110,952	0.0340	0.1195	0.1874	-0.0039
1991	612,016	429,533	289,010	140,523	0.0506	0.2225	0.2022	0.2665
1992	650,347	513,951	336,952	176,999	0.0626	0.1965	0.1659	0.2596
1993	690,223	575,710	364,550	211,160	0.0613	0.1202	0.0819	0.1930
1994	727,506	625,155	392,819	232,335	0.0540	0.0859	0.0775	0.1003
1995	755,833	716,040	446,556	269,483	0.0389	0.1454	0.1368	0.1599
1996	789,752	729,703	452,899	276,804	0.0449	0.0191	0.0142	0.0272
1997	829,018	730,973	453,011	277,961	0.0497	0.0017	0.0002	0.0042
1998	785,073	684,876	430,917	253,959	-0.0530	-0.0631	-0.0488	-0.0864
1999	808,657	737,697	474,608	263,090	0.0300	0.0771	0.1014	0.0360
2000	892,557	943,719	599,030	344,689	0.1038	0.2793	0.2622	0.3102
2001	894,214	924,509	572,703	351,806	0.0019	-0.0204	-0.0439	0.0206

Note: All GDP and re-exports are measured in millions of 1990 Hong Kong dollars.

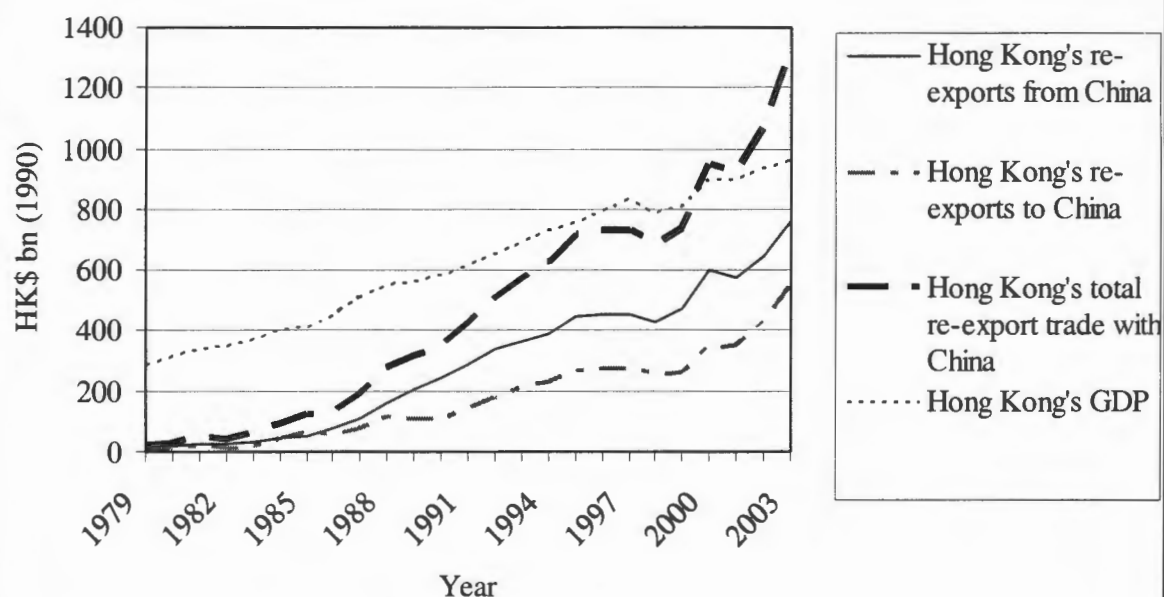
Table 8

Empirical Results

Model 1			Model 2		
$y_t = \beta_0 + \beta_1 x_t + \varepsilon_t$			$y_t = \beta_0 + \beta_1 x_{1t} + \beta_2 x_{2t} + \varepsilon_t$		
$\hat{\beta}_0$	0.2555*	(0.0102)	$\hat{\beta}_0$	0.0139***	(0.0092)
$\hat{\beta}_1$	0.1368*	(0.0352)	$\hat{\beta}_1$	0.0157	(0.0131)
			$\hat{\beta}_2$	0.1870 *	(0.0401)
$R^2 = 0.4307$			$R^2 = 0.6286$		
$DW = 2.2266$			$DW = 2.0687$		
$J - B: \chi^2(2) = 1.4453$			$J - B: \chi^2(2) = 1.4713$		
$B - P: \chi^2(2) = 0.3200$			$B - P: \chi^2(2) = 2.4100$		

Note: Standard errors are in parentheses. * and *** denote, respectively, significance at 1% and 10% levels. DW is the Durbin-Watson statistic for serial correlations; $B - P$ is the Breusch-Pagan test statistic for heteroscedasticity; $J - B$ is the Jarque-Bera asymptotic LM test statistic for normality.

Figure 1: Hong Kong's Re-export Trade with China

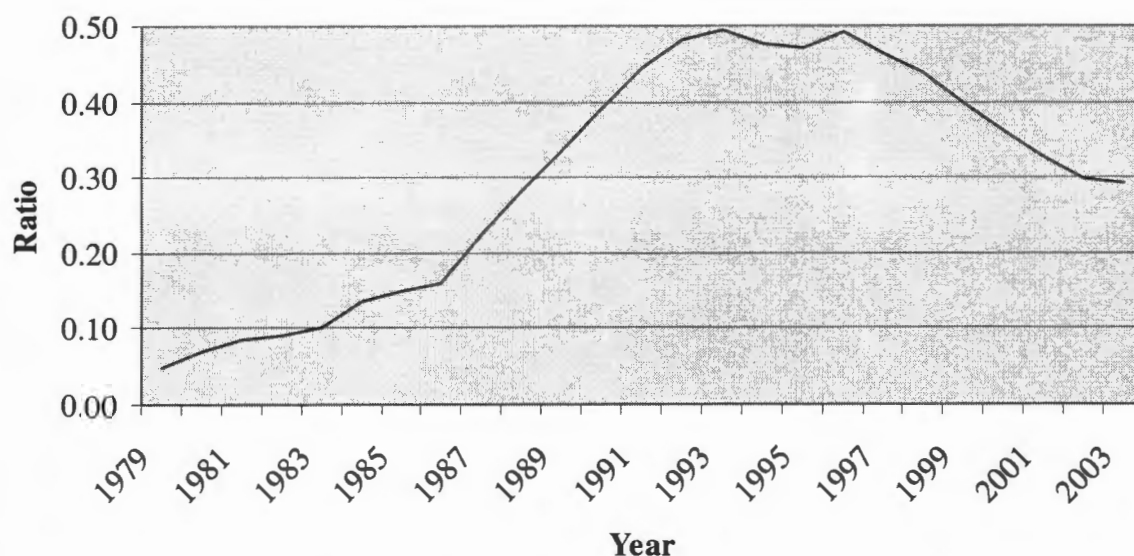


Note: These data are measured in billions of 1990 Hong Kong dollars,

Source: Calculated from different statistics issues of Census and Statistics Department of Hong Kong,

Retrieved March 11, 2004, from <http://www.info.gov.hk/censtatd/home.html>

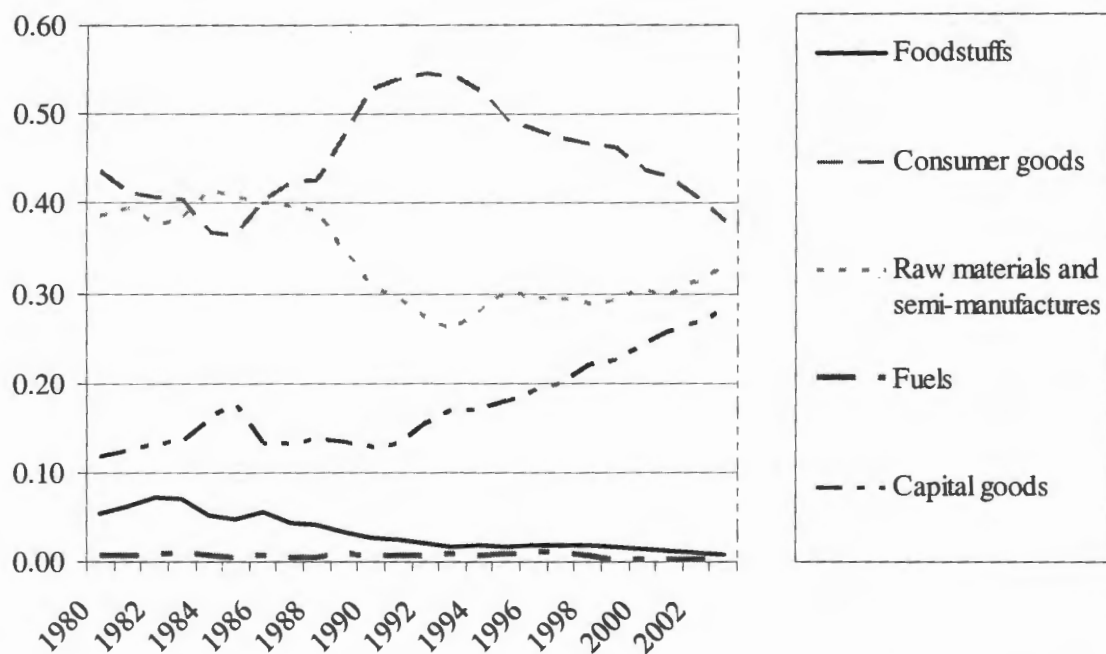
Figure 2: Ratio of Hong Kong - China's Re-export
Trade to China's External Trade



Source: Calculated and drawn from different statistics issues of Census and Statistics Department of Hong Kong, Retrieved March 11, 2004, from <http://www.info.gov.hk/censtatd/home.html>

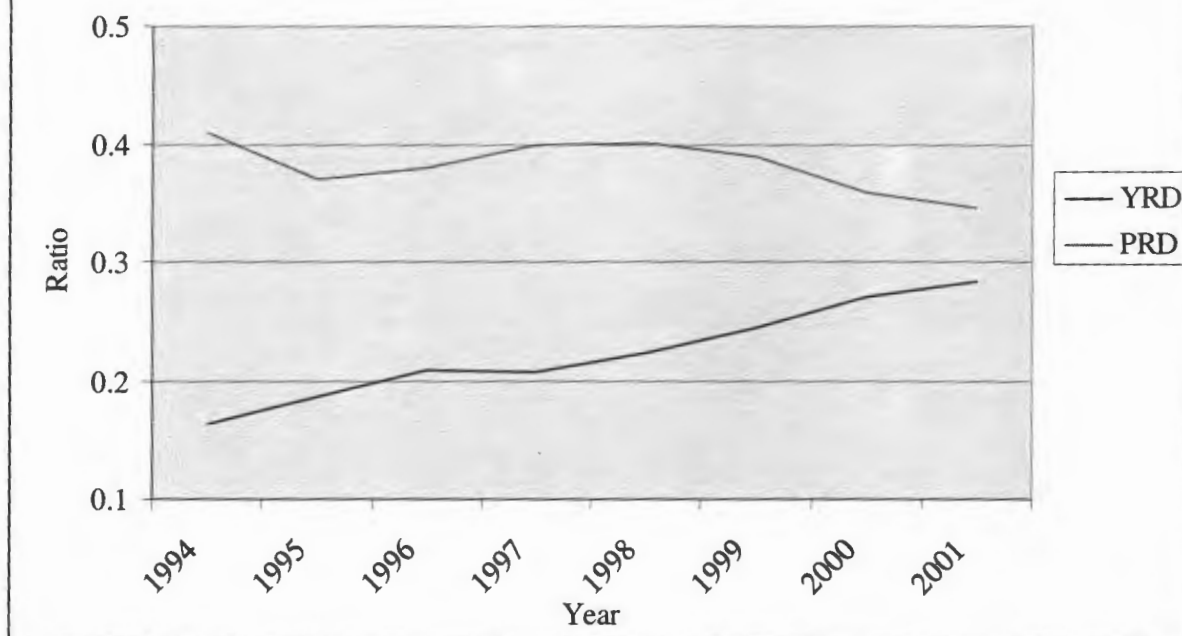
Note: Ratio = Hong Kong - China's total re-exports trade/China's external trade

Figure 3: Composition of Hong Kong's Re-exports



Source: Calculated and drawn from different statistics issues of Census and Statistics Department of Hong Kong, Retrieved March 11, 2004, from <http://www.info.gov.hk/censtatd/home.html>

Figure 4: Share of PRD and YRD Region in China's Foreign Trade



Source: Various years of China's Statistical Year Book

Note: For convenience, PRD region refers to Guangdong province and YRD region consists of Shanghai, Jiangsu, and Zhejiang province.