8
Policy Issues

The integration of the trio has raised many policy issues. While this chapter discusses both Mainland–Hong Kong and Mainland–Taiwan policy issues, discussions of the latter issues are inevitably brief owing to the political deadlock after the election of Chen Shui-bian. As mentioned before, the economic performance of both Hong Kong and Taiwan have deteriorated greatly since the Asian financial crisis. Hong Kong has actively leveraged on its Mainland connections, leading to a sharp economic recovery since mid-2003. While economic difficulties have also spurred Taiwan towards closer economic links with the Mainland, the long-awaited breakthrough on direct transportation has yet to occur because of political animosity. As a result, Taiwan has not been able to utilize its Mainland connections to pull itself out of economic malaise.

This chapter will discuss five policy issues in the integration of the trio:

1. The impact of the Mainland's WTO entry.
2. The development of Mainland–Hong Kong policy coordination in various areas.
3. The impact of the Mainland–Hong Kong CEPA.
4. The further development of Taiwan–Mainland links.
5. The management of social and public health problems that arise in the duo from economic integration with the Mainland; for example, illegal migrant workers, and the transmission of SARS and other contagious diseases.

Impacts of the mainland's entry into the WTO

After 15 years of arduous negotiations, the November 2001 Ministerial Conference of the WTO held in Doha, Qatar, approved the accession of China, which was followed immediately by that of Taiwan. China became a member of the WTO towards the end of 2001, while Taiwan became a member at the beginning of 2002.

As Nicholas Lardy (2002:104) has remarked:

> China's WTO commitments, on market access and on rules-based issues, far surpass those made by founding members of the World Trade Organization and, in some cases, go beyond those made by countries that have joined the organization since its founding in 1995.

While China's commitments were very wide-ranging, they were scheduled to be implemented over six years ending in 2007. Most of the significant liberalizations in services would take place from 2005 to 2007. The more sensitive concessions in banking and *renminbi* business would not be implemented until the end of 2006.

It is widely recognized that entry into the WTO poses adjustment problems for some of China's major economic sectors, especially finance, banking, agriculture and heavy industries (steel, chemicals and automobiles) because they are heavily protected. As long as China can manage the transitional problems, the long-run benefits are large, as WTO entry will boost reform and opening in China. China is going through the most difficult phase of her reform process; namely, reform of state-owned enterprises (SOEs), banks and financial institutions. Entry into the WTO may well provide the decisive boost to China's reform and opening, assuming China can manage the pains of transition.

In the first two years of WTO accession from the end of 2001 to 2003, the Mainland managed the transition extremely well. In these two years, Mainland exports and imports grew very rapidly, by 65 and 70 per cent respectively. In 2003, the Mainland still had a large trade surplus of US$25.5 bn, though the share of the trade surplus to exports declined from 8.5 per cent in 2001 to 5.8 per cent in 2003. In anticipation of the Mainland's WTO entry, FDI in the Mainland recovered from the doldrums of the Asian financial crisis after 2000. Utilized FDI set a new record of US$46.9 bn in 2001, and grew by another 12.5 per cent in 2002. In 2003, utilized investment grew by only 1.4 per cent as a result of SARS, but contracted FDI grew by 39 per cent, indicating that there would be rapid growth of utilized investment in 2004.

Even the protected sectors were able to perform well. For instance, both foreign and local firms were able to increase sales in the rapidly expanding automobile market. The agricultural sector was also able to respond rigorously to opening. While imports of land-intensive crops such as grain increased, exports of labour-intensive commercial crops also grew rapidly. However, the threat to China's banking may be more worrisome when foreign banks are able to conduct *renminbi* business with local individuals in 2006. Thus far, China's reform of its debt-ridden state-owned banks has not been very successful. China has until 2006 to strengthen its banking system before the pressure of foreign competition.

Neither Hong Kong nor Taiwan is heavily involved in the Mainland's disadvantaged sectors; namely, agriculture and heavy industry. Hong Kong and Taiwan are heavily involved in the Mainland's export-oriented light industries, which stand to benefit directly from WTO entry. Hong Kong, as the service hub of China, is also heavily involved in the Mainland's services sector. WTO entry will speed up the opening of the Mainland's services, providing tremendous opportunities for Hong Kong.

Impacts on exports

Besides gaining NTR (normal trade relations) status from the USA, China also gained some protection against anti-dumping duties that are becoming more and more prevalent. The WTO has clear procedures on anti-dumping duties. A country that intends to levy anti-dumping duties has to notify the affected country beforehand and can impose such duties only after a process of consultation and investigation that establishes injury for the industry concerned. Before China's WTO entry, some anti-dumping duties were levied on China even without prior notification; for example, Mexico in early 1993. The average duty was a massive 300 per cent, with the highest rate exceeding 1000 per cent! Mexico admitted that such a course of action would not have been taken were China a member of the WTO.

The Mainland's textile and clothing exports will expand because the ATC (Agreement on Textiles and Clothing) will be phased out in 2005. The greater part of Hong Kong's remaining textile and clothing industries will relocate to the Mainland. While Hong Kong's industrialists will gain, as Hong Kong has expertise in marketing and organizing production in these industries, Hong Kong's workers in these industries will lose their jobs.

China's entry to the WTO reinforced the spectacular expansion of Mainland exports and boosted the relocation of the labour-intensive industries of Hong Kong and Taiwan to the Mainland. Such industrial relocation accelerated the structural transformation of Hong Kong into the service hub of China.

Impacts on industries selling to China's domestic market

While Hong Kong's outward processing industries will benefit from the Mainland's entry to WTO, the impact on Hong Kong's manufacturing companies selling in the Mainland's domestic market is uncertain. These companies will face a more open market, but there will also be more competition.

While the manufacturing sector in Hong Kong is small, Hong Kong has a strong manufacturing network in Guangdong. Hong Kong is strong in some niche products such as micro motors for automobiles. The Mainland's automobile industry is quite inefficient, and needs restructuring. To capitalize on the opportunity, Hong Kong has to upgrade the quality of its products and also forge strategic alliances with Chinese and foreign partners.

The industrial base of Taiwan is much more diversified than that of Hong Kong. Taiwan will gain more than Hong Kong from the opening of the Mainland market, especially in electronics, computer parts, auto parts and chemicals. Thanks to Taiwanese investments, Dongguan–Shenzhen and Suzhou–Shanghai have emerged to compete with Beijing as the 'silicon valley' of the Mainland.

Impacts on services trade

China's entry into the WTO will expand China's trade. Given the efficiency of Hong Kong as a trading centre, the expansion of Mainland trade will imply a bigger cake for service providers. However, Hong Kong's service providers will face keen competition from multinationals and also from the Mainland's domestic firms.

Despite stiff competition, Hong Kong has a strong comparative advantage in services, especially in the Mainland market. Services require people-to-people contacts. Geographic and cultural proximity are thus very important assets in services trade. Hong Kong residents do not need a visa to visit the Mainland. Hong Kong already has a head start in the services sector in the Mainland built upon its pioneering investments in outward processing. Hong Kong banks, including the Hong Kong and Shanghai Bank, the Bank of China Group with its 13 sister banks, and the Bank of East Asia, have long established branches in the Mainland. The Mainland's offshore markets in stocks, bonds, loans and foreign exchange are active in Hong Kong. Besides financial services, Hong Kong should be able to find opportunities in telecommunications, IT, e-commerce, advertising and freight forwarding. Moreover, the CEPA has provided Hong Kong firms with preferential access to the Mainland's market, as will be detailed later.

As many multinational service providers are large, smaller Hong Kong businesses may not be able to compete on their own. However, with their knowledge and experience of the Mainland market, Hong Kong firms can form alliances with foreign partners (Hong Kong Trade Development Council 2001).

The middleman role of Hong Kong

The Hong Kong stock market has reacted very positively to China's entry to the WTO. However, there are observers who worry that Hong Kong will lose its middleman role if the Mainland becomes more open because foreign businesses can deal directly with the Mainland.

As mentioned before, though the gap in economic development between the Mainland and Hong Kong is narrowing, it is not likely that Hong Kong will rapidly lose its comparative advantage as a service hub. There are significant economies of scale and economies of agglomeration in trading and services activities, and it is very difficult for other cities to compete with Hong Kong because it is the established centre for the Mainland's trade and investment. For the same reason, other cities have found it very difficult to challenge the leading positions of New York and London in world finance. Of course, Hong Kong has to maintain its lead in high-quality service skills.

China is now well into the third decade of its reform era and many big multinationals have entered the China market and are dealing directly with China. Some of the prominent regional headquarters of multinationals in Hong Kong have moved the greater part of their operations to the Mainland. However, China's entry into the WTO will attract a wave of small and medium-sized enterprises (SMEs) into the China market. Most SMEs will not be big enough to enter the Mainland market directly on their own, and they will seek help from Hong Kong firms and partners. In this age of electronics and the internet, the average firm size in developed countries is becoming smaller and SMEs are proliferating. Moreover, even though big multinationals are dealing with the Mainland directly, they still source supporting services from Hong Kong.

Impacts on Taiwan–Mainland links

As mentioned in Chapter 3, WTO membership for the mainland and Taiwan does not imply automatic establishment shipping and air links, which will only be established after the diffusion of political tensions. However, Taiwan did liberalize its import and investment prohibitions against the Mainland in 2002 after WTO entry. The number of prohibited import items fell from 43.2 per cent of the total in November 2001 to 27.5 per cent in mid February 2002. Of the 108 items in Taiwan's services sector that would be open to other economies, 58 items would be open to Mainland capital. Such liberalizations still fall short of WTO requirements. Taiwan's decision in 2001 to liberalize its restrictions on large-scale investment in the Mainland (that is, the 'no haste, be patient' policy) was also implemented in 2002.

Under the stimulation of Taiwan's partial liberalizations and the Mainland's rapid economic development, Taiwan's Mainland-related trade and investment have grown rapidly since 2002. Taiwan's exports to the Mainland dropped by 7.6 per cent in 2001, but grew by 40 per cent and 30 per cent respectively in 2002 and 2003. Taiwan's imports from the Mainland likewise dropped by 5 per cent in 2001, but grew by 34 per cent and 38 per cent respectively in 2002 and 2003. Data on Taiwan's investment in the Mainland are not very accurate, but all signs point to rapid growth in 2002 and 2003 (Table 6.1).

Given the political tension between the Mainland and Taiwan, full liberalization of Taiwan–Mainland trade and investment will occur only after the political issues are resolved. If a political compromise is reached, the prospect of Taiwan–Mainland trade and investment is bright as the two economies are complementary as well as dynamic.

Impact of direct Taiwan–Mainland links on Hong Kong

The prohibition of direct air and shipping links is quite costly, as Taiwan is very close to the mainland and taking the route via Hong Kong is much more time-consuming, especially for business travellers. It should be noted that the official opening of direct trade between the two economies would affect Hong Kong's transhipment as well as re-exports. Over half of the existing Taiwan–Mainland trade is already 'direct', that is taking the route of transhipment or cargo in transit instead of re-exports via Hong Kong. At present, Taiwan–Mainland trade via Hong Kong amounts to around 1 million containers or 5 per cent of Hong

Kong's container throughput. In 2002, Guangdong accounted for over a third of Taiwan's trade with the Mainland. Even with direct links, the bulk of Taiwan's trade with Guangdong will still go through Hong Kong. With direct links, Hong Kong may lose around 3 per cent of its container throughput, which is not a great amount.[1]

The value of cross-Strait trade in 2002 was around US$42.7 bn, of which around US$31 bn went through Hong Kong. A third of this was Taiwan–Guangdong trade, the bulk of which would still go through Hong Kong with the establishment of direct links as Hong Kong is the natural hub of Guangdong. Direct links would imply a loss of trade for Hong Kong (in re-exports and also transhipment) of around US$20 bn. The rate of value added for such trade should be no more than 6 per cent (Sung 1998:123). This implies a loss in income of US$1.2 bn, or 0.74 per cent of Hong Kong's 2002 GDP.

The impact of direct air links on passenger traffic and tourism is likely to be significant. Taiwan has long been the second largest source of tourists for Hong Kong. In 2002, Taiwanese visitors to Hong Kong totalled 2.4 million (14.7 per cent of total tourist arrivals), of which around 1.1 million visited the Mainland via Hong Kong. After the establishment of direct links, if 70 per cent of these visitors were to bypass Hong Kong, Hong Kong's tourist expenditure (excluding expenditure on international transportation) would fall by US$85 m. and its GDP by 0.04 per cent.[2] The loss in passenger international transportation expenditure would be around US$236 m.,[3] and Hong Kong's GDP would fall by 0.12 per cent.

Summing up, direct losses from trade, transhipment and tourism would only be around 0.9 per cent of Hong Kong's GDP – that is, significant but not very large. Indirect losses that would occur are difficult to estimate, but could be large. In recent years, Jiangsu and Shanghai have replaced Guangdong as Taiwan's foremost destination of investment. Direct links would divert more Taiwanese investment from the Pearl River Delta to the Yangzi Delta. This can have serious consequences for Hong Kong.

Though indirect losses for Hong Kong can be large, indirect benefits can also be large. At present, exchanges across the Strait are very unbalanced because of Taiwan's restrictions on imports, investments and tourists from the Mainland. With the opening of direct links, Hong Kong will be able to capture a substantial share of such business, as it is the premier hub of South China. Even in the very long run, an appreciable portion of Taiwan–Mainland trade and investment may still go through Hong Kong, partly because Hong Kong is the foremost service hub of China, and partly because Guangdong will continue to be an important partner of Taiwan's trade and investment. For instance, though South Korea and China established direct commercial links in 1991, a substantial portion of China-South Korean trade and investment continues to go through Hong Kong.

It must be stressed that Mainland–Taiwan reconciliation is in the fundamental interest of the Asian region. Hong Kong would lose a significant amount of trade and tourists, but war in the Taiwan Strait would be a disaster for Hong Kong. Even a cold war would be very unsettling for investors. Reconciliation would mean peace and prosperity for the region. Though Hong Kong's share of Mainland–Taiwan trade would diminish, the long-run gains could be greater as the pie would grow faster.

The negotiation of direct air or sea links is often time-consuming in the best of circumstances. With political distrust on both sides, the negotiations will probably be protracted. The impact of the opening of direct links on Hong Kong will likely be gradual.

Development of Mainland–Hong Kong policy coordination

As mentioned in Chapter 3, Hong Kong's reversion to China has facilitated the process of integration, but progress was slow in the first five years of Hong Kong's reversion largely because the elites in Hong Kong were concerned about the possible adverse impacts of deep integration on Hong Kong's autonomy. Consensus on the necessity of deep integration was reached in Hong Kong only in 2002, and the pace of coordination accelerated in mid-2003 with the conclusion of the Mainland–Hong Kong CEPA.

Initial phase of Mainland–Hong Kong policy coordination

When Hong Kong reverted to China in 1997, 'one country, two systems' was an untried design. Beijing tried to interfere as little as possible, and Hong Kong had to take the initiative to shape its relations with the Mainland. Hong Kong's economic crisis triggered by the AFC had prompted Hong Kong to leverage on its Mainland connections, but elites in Hong Kong were deeply divided on the desirability of deep integration. Moreover, politicians and government bureaucrats in Hong Kong had very little experience in handling relations with Beijing. It was not surprising that progress was initially slow.

A Hong Kong/Guangdong Co-operation Joint Conference was established in March 1998, headed by Hong Kong's chief secretary and

Guangdong's vice-governor. In September 1998, the Joint Conference reached agreements on environmental protection, on minor extensions of working hours of border checkpoints, and on measures to boost cross-border tourism. The Joint Conference was supposed to meet twice a year, but it met only thrice in the three years from March 1998 to mid-2001. This was a sign that the Hong Kong government had not been very active in pushing for coordination with Guangdong.

The retirement of Anson Chan as Chief Secretary in 2000 removed an influential detractor of deep integration. Moreover, the Hong Kong economy continued to perform badly in the global economic slowdown of 2001, and the Hong Kong government wanted to speed up the coordination with Guangdong as a long-run strategy of economic development. In July 2001, the fourth meeting of the Joint Conference reached agreements on further cooperation on border checkpoints, environment and tourism. The two sides also agreed to cooperation on e-commerce, cooperative arrangements between the Hong Kong and Zhuhai airports, and the development of logistics and high-tech industries in Nansha, an economic and technological development district in the Pearl River Delta approved in 1993.

In December 2001, right after China's WTO membership was approved by the November 2001 Ministerial Conference of the WTO held in Doha, the Hong Kong government proposed to Beijing the conclusion of a free trade agreement between the Mainland and Hong Kong. Hong Kong businesses have long complained that Mainland–Hong Kong economic relations are unfair to Hong Kong because Hong Kong's market is very open while the Mainland's market is highly restricted. While negotiations were started in late 2001, progress was slow till late 2002 (Sung 2003). However, with the deepening economic crisis in Hong Kong, Beijing decided to act decisively to shore up the Hong Kong economy. Beijing's policy became increasingly clear after the sixteenth party congress of the Communist Party of China held in the autumn of 2002, when Hu Jintao succeeded Jiang Zemin as party secretary. Tung Chee-hwa, chief executive of the HKSAR, announced that agreement on the CEPA would be reached in June 2003.

Acceleration of Mainland–Hong Kong policy coordination

After the signing of the CEPA in mid-2003, Beijing announced in rapid succession three other measures highly beneficial to the Hong Kong economy. First, Mainlanders would be allowed to visit Hong Kong individually, rather than in group tours as in the past. This gave a tremendous boost to Hong Kong's tourist industry. Second, the Mainland would allow banks in Hong Kong to conduct offshore *renminbi* business. Third, Beijing gave the green light to building the Hong Kong–Zhuhai–Macau bridge, which would reinforce the role of Hong Kong as the transportation hub of the Pearl River Delta (PRD). These measures, together with the favourable global economic environment, led to an abrupt turnaround in investor sentiment towards Hong Kong. Hong Kong's heavy net capital outflows in 2002 and the first three quarters of 2003[4] turned into a net inflow in the fourth quarter of 2003, and the Hong Kong dollar has strengthened above its official rate since September 2003.

Given the desire to push for deeper integration in Hong Kong and Beijing, the sixth meeting of the Hong Kong/Guangdong Cooperation Joint Conference on 6 August 2003 announced the intention to turn the PRD into one of the world's economic super-zones. Under the blueprint, Hong Kong will continue to be a centre for logistics, shipping, trade, finance and high value-added services, while Guangdong will be a manufacturing hub. The Conference involved over a hundred officials from both sides, led by Hong Kong's Chief Executive Tung Chee-hwa and Guangdong's Governor Huang Huahua. The Conference agreed to expand cooperation in 12 areas, including infectious-disease notification, intellectual property rights and overseas promotion of the region. 15 taskforces were formed under the Conference to pursue matters of mutual interest (*South China Morning Post*, 6 August 2003:A1). Besides the taskforces established previously on environmental protection, tourism, cross-border infrastructure and border checkpoints, new taskforces were established on infectious-disease notification, intellectual property rights, implementation of CEPA, overseas promotion of the PRD and cooperation on education. A joint task force involving Hong Kong, Guangdong and Macau would start preparatory work on the bridge linking Hong Kong with Zhuhai and Macau.

Summing up, besides CEPA, which is discussed separately below, effective policy coordination was achieved in seven areas:

1. Regional infrastructure,
2. Border area issues,
3. Tourism,
4. Technology policy,
5. Integration of financial markets,
6. Coordination to stabilize the exchange rate, and
7. Coordination on China's WTO entry.

Besides the above issues, effective coordination has also been achieved in social and public health issues such as cross-border crime and fighting contagious diseases. However, economic issues will receive more attention. Many of the issues involve coordination with Guangdong.

Coordination in regional infrastructure

It has been pointed out that there are too many seaports and airports in the Zhujiang Delta. Within just a couple of years after Deng's 1992 southern tour, Beijing approved the construction of three deep-water ports adjacent to Hong Kong; namely, Yantian in Shenzhen, the Huizhou port in Daya Bay and Gaolan port in Zhuhai. This is in addition to the existing Guangzhou port and Shekou port in Shenzhen (Sung *et al*. 1995:193–8). As mentioned before, a successful international port must have sufficient freight to attract shipping companies to make frequent calls. A minimum freight volume of 1.5 million containers a year is needed for the efficient operation of a container port (Sung *et al*. 1995:196). Though the Hong Kong port is congested and there is the need for another port in the Zhujiang Delta, there will be inadequate freight to supply so many deep-water, ocean-going ports.

As with port construction, there is also duplication in airport facilities. Within a region of 200 square kilometres in the Pearl River Delta there are four international airports (Hong Kong, Macau, Shenzhen and Guangzhou) and four local airports, including the large Zhuhai airport, which is designed to be an international airport (Sung *et al*. 1995:198). Each local government looks after its own interest and wants a seaport or an airport as a showpiece. The result is excess capacity and the duplication of facilities.

Coordination and competition

Though improvements in planning and coordination can avoid some duplication of facilities, a certain amount of excess capacity and duplication is essential for competition. Planners may be able to rule out the more obvious failure cases, but they may not have enough information to pinpoint the successful ones. A certain amount of trial and error is necessary and no amount of feasibility studies can replace the market test. The problem with ports and airports in the Pearl River Delta is not excess capacity *per se*, but the ability of local governments to subsidize ports and airports from the public purse. Public subsidy implies that there is no real market test, as a loss-making port or airport can continue to operate.

It has been pointed out that the participation of foreign capital in infrastructure development will imply more efficient resource use, as foreign investors will help government officials to evaluate the cost-effectiveness of infrastructure projects (Sung *et al*.1995:202).

Coordination of infrastructural development after 1997

The Sino–British dispute on the Patten proposals for constitutional reform in Hong Kong had hindered coordination of infrastructure development between Hong Kong and China. For instance, the construction of both Hong Kong's new airport and container terminal number 9 had been held up for a while by the Sino–British dispute. The reversion of Hong Kong to China has led to better coordination of infrastructural developments in the Pearl River Delta. A Hong Kong–Mainland Cross-Boundary Major Infrastructure Coordinating Committee was established in October 1997, taking over the agenda of the predecessor established in December 1994.

However, it should not be assumed that Hong Kong's reversion would solve the problem of coordination. For instance, neither Beijing nor the provincial government of Guangdong have been able to rationalize the many airports and seaports put forward by the local governments of the Pearl River Delta. Bureaucratic coordination may not be powerful enough to override local interests. Even if bureaucratic coordination is powerful enough, it is unlikely to be highly rational and efficient. Market coordination will give better results as long as the local governments refrain from giving undue subsidies to infrastructure. The participation of private capital and foreign investors in infrastructure should be encouraged as much as possible.

Recently, China has allowed the increasing participation of foreign capital in infrastructure projects, including seaports. Hong Kong International Limited (HIT) has invested in the ports of Yantian, Shanghai, Gaolan and other feeder ports in the Zhujiang Delta (Cheng and Wong 1997:61). Swire Pacific and Peninsular & Oriental Stream Navigation Co (P&O) has acquired 50 per cent of the Shekou Container Terminal. The rapid growth of Yantian is largely due to the efforts of HIT.

Unlike the case of seaports, it is more difficult to rationalize the many airports in the Pearl River Delta because private participation is much more restricted for airports. With the strengthening of the desire for deep integration in both Hong Kong and the Mainland, the Hong Kong Airport Authority is exploring ways to participate in the airports of the PRD.

In 2001, Hong Kong's airport began discussions on cooperation with those of Zhuhai and Shenzhen. Fast ferries have been established between the Hong Kong and Shenzhen airports. As the biggest player in the region, the Hong Kong airport is in the best position to initiate such cooperation. The July 2001 Hong Kong/Guangdong Cooperation Joint Conference gave the green light to the cooperation of the financially insolvent Zhuhai airport with Hong Kong. As Zhuhai has very few flights, cooperation has brought few immediate benefits, though it may pay off in the long run when the Hong Kong airport gets saturated with the expected rapid growth of traffic. Cooperation with the busy Shenzhen airport is more important. While the Hong Kong airport has many more international flights, the Shenzhen airport has more domestic connections and the synergy can be exploited to mutual advantage. However, Guangzhou had a new airport in operation in 2004 with an ambitious plan to become the hub in south China. Guangzhou also wants to strengthen its position by cooperation with Shenzhen. The rivalry between Hong Kong and Guangzhou may take time to resolve.

Coordination in border area issues

Border area issues involve border checkpoints, environmental protection and the coordination of cross-border infrastructure, especially the construction of the Hong Kong–Zhuhai–Macau bridge. These issues involve coordination with Guangdong, though cross-border infrastructure involves the State Council (the Ministry of Transport and the Planning Commission) as well.

Environmental protection

To protect the environment, the two sides in the Hong Kong/Guangdong Cooperation Joint Conference of September 1998 agreed to subject all large-scale public works in the border areas to environmental evaluation and mutual consultation. The two sides would undertake a joint study of air quality in the Pearl River Delta in 1999 as pollutants in the delta have led to a substantial deterioration in air quality in Hong Kong. In the fourth joint meeting of July 2001, the two sides agreed to study emission standards of vehicles, and also the possibility of releasing more data on the water quality of the Dongjiang, the major river supplying water to Hong Kong.

Border checkpoints

Congestion of border checkpoints has long been a source of complaint. Passenger crossings often take an hour or more, and large numbers of commuters suffer as a result. There have long been proposals to allow

24-hour operation of the major passenger checkpoints since Hong Kong's reversion, but the agreement reached in late September 1998 after long negotiations was disappointing, as the opening hours of the four land crossings would be extended by only one to two hours. Even after the extension, no checkpoint would be open from 11.30 pm to 6.30 am.

In the July 2001 meeting, the Hong Kong government agreed to extend the opening hours at Lowu, the largest checkpoint, by another 30 minutes during holidays. The feasibility of Joint immigration and customs facilities at the Western Border Crossing would be studied. The crossing, a bridge linking Hong Kong and Shenzhen, scheduled to be completed by the end of 2005, will double the possible rate of vehicular traffic between Shenzhen and Hong Kong.

The Hong Kong government had reservations about 24-hour operation of passenger checkpoints as retail sales in Hong Kong have plummeted since the Asian financial crisis, partly because Hong Kong shoppers have swarmed to Shenzhen, where prices of goods and services are much lower. It was feared that greater ease of passenger crossing would have adverse impacts on retail sales and employment in Hong Kong, and might also depress real-estate prices in the northern New Territories. Vested interests in Shenzhen also have reservations about 24-hour crossing. As a result, a very small and easy step in integration has been delayed for a long time. With the strengthening of the desire for deep integration in both Hong Kong and Beijing, 24-hour operation of the passenger border checkpoint at the Lok Ma Chau–Huanggang crossing was eventually implemented on 27 January 2003, more than five years after Hong Kong's reversion.

Construction of the Hong Kong–Zhuhai–Macau bridge

Besides the Western Crossing scheduled for completion in 2005, there are two big cross-border projects being planned. The Guangzhou–Hong Kong express railway will cut commuting time between Guangzhou and Hong Kong to less than an hour. However, it is only at the drawing-board stage. The Hong Kong–Zhuhai–Macau bridge has received more attention as its planning has entered the final stage.

There have been numerous proposals to link Zhuhai and/or Macau with Hong Kong by a bridge since the 1980s. Hong Kong, which is on the eastern flank of the PRD, is separated from the cities on the western flank (Macau, Zhuhai and Zhongshan) by the Pearl River estuary. Transportation from Hong Kong to the western flank is quite inconvenient. Cities on the eastern flank (Shenzhen and Dongguan) have better communications with Hong Kong and they have developed much faster than the cities on the western flank in the reform era. The bridge would be around 30 kilometres long and would cut the driving time from Zhuhai to Hong Kong from around three hours to an hour. The bridge would bring substantial benefits to cities on the western flank of the PRD and would also be very important for the status of Hong Kong as the transportation hub of the PRD.

While the bridge has long been supported by Zhuhai, Hong Kong was not enthusiastic up until mid-2002. With the worsening economic crisis in Hong Kong, the attitude of the Hong Kong government towards integration with the PRD then changed, and the Hong Kong government came out in support of the bridge. However, to make real procedure, the bridge has to receive the blessing of Beijing and Guangdong. Shenzhen, not surprisingly, wants a bridge linking Zhuhai with itself rather than with Hong Kong. The mainland's transportation authorities also prefer this, as the bridge is an important link in the Mainland's southeastern coastal highway. A bridge going to Hong Kong would not be able to serve such a link because Hong Kong is a separate customs territory with immigration and customs controls. There is thus a proposal to build a bridge with separate links to Hong Kong and Shenzhen on the eastern side, and also separate links to Macau and Zhuhai on the western.

With the strengthening of the desire for deep integration on both sides, a breakthrough on the project was reached in the third meeting of the Hong Kong/Mainland Cross-Boundary Major Infrastructure Coordinating Committee in Shanghai in September 2002. The two sides agreed to start detailed studies of the bridge. Though planning and construction of the bridge may be time consuming, the two sides have agreed that the project should be given a high priority.

Coordination in tourism

Hong Kong's tourist industry has been severely hit by the Asian financial crisis because the Hong Kong dollar did not depreciate. At the end of May 1998, the government announced a package of seven measures to stimulate the sagging economy. One of the measures involved a 30 per cent increase in the quota allocated to Mainlanders joining the Group Tour Scheme to visit Hong Kong. (Such tours were started in the early 1980s and the quota was instituted to avoid illegal immigration.) Another measure was to simplify visa formalities for Taiwanese tourists who tour Hong Kong on their way to the mainland. These measures brought an upturn.

In January 2002, the quota system for the Hong Kong Group Tour Scheme was abolished. As a result, tourists from the Mainland rose by 53 per cent in 2002 to 6.8 million, accounting for 41 per cent of tourist arrivals in Hong Kong.

Individual tours

Starting late July 2003, Mainlanders in selected cities in Guangdong were allowed to visit Hong Kong on an individual basis, rather than joining group tours as in the past. The measure was extended to Beijing and Shanghai on 1 September 2003, and would be further extended to other regions of the Mainland.

The World Tourism Organization projected that by 2020 the Mainland will generate 100 million outbound tourists a year. Moreover, it will attract 130 million international arrivals a year and will surpass France to become the world's leading tourist destination (*South China Morning Post*, 21 October 2003:B1). As Hong Kong is China's foremost hub of air traffic, a substantial portion of these tourists may pass through Hong Kong and tour Hong Kong on their way to the final destination. The Mainland can generate almost an unlimited number of tourists for Hong Kong. In the light of this projection, the report that individual tours would bring another 4 million tourists a year for Hong Kong (*Sing Tao Daily*, 20 August 2003:A6) appears to be quite modest.

It is estimated that individual tourists would generate income of $13.7 billion or 1.1 per cent of the 2002 GDP if they spend the same amount as the average Mainland tourist (Sung 2004). However, the expenditures of tourists on individual tours may be quite different from those on group tours. One survey indicates that they spend an average of $8652 per person trip, much more than the average expenditure of the Mainland tourist of $5000 in 2002 (*Ming Pao*, 24 November 2003:A10). They are more likely to buy insurance and open securities and bank accounts in Hong Kong. They also spend less on hotels and more on shopping. Without a good survey, it is not possible to be more precise.

On 1 September 2003, the Mainland raised the limit on the amount of foreign currencies that Mainland residents travelling abroad are allowed to carry from US$2000 to US$5000. This eases the pressure on the *renminbi* to appreciate, and also gives a further boost to the Hong Kong economy. It is important to stress that the contribution of individual tours goes far beyond tourism. Individual tours lower the transaction cost of business between Hong Kong and the Mainland. It is more convenient for Mainlanders to conduct businesses in Hong Kong; for example, to open security accounts for the trading of securities, to search for investment property or to undergo medical operations and so on. Like the CEPA, individual tours improve access for Hong Kong's services industries to the Mainland market.

Moreover, individual tours facilitate and hasten opening and economic reforms in the Mainland. As services are performed on people, there are two alternative ways to export Hong Kong services to the Mainland. One is to allow Mainlanders to come to Hong Kong, the other to allow Hong Kong's services firms to set up outlets in the Mainland. The two ways interact and reinforce each other. For instance, individual tours facilitate the trading of H shares in Hong Kong by Mainlanders.[5] This may hasten the relaxation of the Mainland's restrictions on outward investment. Moreover, individual tours imply more tourists bringing more *renminbi* to Hong Kong. This hastens the liberalization of *renminbi* business for Hong Kong banks.

Hong Kong Disneyland, scheduled to open in 2005, is projected to attract 3.4 million overseas tourists. By 2020, the park will reach full capacity, attracting 7.5 million overseas tourists. The bulk of the overseas tourists will be from the Mainland and this will necessitate further coordination between Hong Kong and China.

Coordination in technology policy

Hong Kong, despite its lagging technical capacity in comparison with Singapore, Taiwan and South Korea, is uniquely positioned to utilize the research and engineering capability of the Mainland. Moreover, in comparison with its rivals, Hong Kong has the advantage of close links with the Mainland's vast internal market. The government announced new measures to promote technology in October 1998, including the establishment of an applied science and technology research institute. The importation of skilled professionals from the Mainland without quota started in early 2000.

Upgrading Hong Kong's technology is perceived to be in the interest of Guangdong and the Mainland, as the labour-intensive processing industries in Guangdong need upgrading. In July 1999, China's State Council designated Shenzhen a pilot hi-tech development area to promote hi-tech jointly with Hong Kong. Beijing has already approved the setting up of around 50 hi-tech institutions in Shenzhen, where they can cooperate with Hong Kong businesses.

The July 2001 Hong Kong/Guangdong Joint Conference agreed jointly to develop logistics and hi-tech industries in Nansha at the heart of the Pearl River Delta. Nansha was approved as an economic and technological development district in 1993.

Integration of financial markets

As mentioned before, H-shares and Red Chips account for more than a quarter of the capitalization of the Hong Kong stock market. The Mainland's rapid development would imply a huge demand for foreign funds. As more Mainland enterprises seek listing in Hong Kong, Hong Kong could become one of the world's largest stock markets.

While Hong Kong's comparative advantage in funding the Mainland's development could help Hong Kong develop into a truly first-rate international financial centre, managing the Hong Kong currency will be increasingly difficult as it is used for the transaction of the shares of Mainland enterprises listed in Hong Kong. The volume of such transactions will be exceedingly large and the Hong Kong currency would be vulnerable to speculative attack. In the long run, it is better to trade such stocks in US dollars to insulate the local economy from the flow of funds involved in offshore financial activities (Liu 1998:23–4).

The Hong Kong Monetary Authority has secured the help of HSBC, a private bank, to assume the risk of clearing US dollars in Hong Kong. An RTGS (real time gross settlement) clearing system in US dollars was established in the third quarter of 2000. This would promote US-dollar-based financial transactions in Hong Kong and also enhance Hong Kong's status as an international financial centre. At present, the bulk of syndicated loans and bonds in the Hong Kong market are denominated in foreign currencies (mostly US dollars). However, stocks are quoted and traded in Hong Kong dollars, though more and more of them are likely to be quoted and traded in both US and HK dollars in the future.

A Growth Enterprise Market Board was established in Hong Kong in November 1999 to facilitate new companies to raise capital. Many new technology companies raise capital through the Board, including technology companies in China. From 1993 to 2002, Mainland enterprises raised a total of US$18 257 m. in the Hong Kong stock market (Prasad 2004:53).

Fostering offshore renminbi business

In mid-November 2003, the People's Bank of China and the Hong Kong Monetary Authority signed a Memorandum of Cooperation on the operation of *renminbi* (RMB) business in Hong Kong. Banks in Hong Kong are allowed to conduct RMB business in a limited way starting in 2004. The scope of business is limited to personal accounts and four areas; namely, deposits, remittances, currency exchange and credit cards.

RMB deposit accounts are restricted to Hong Kong residents, but not for businesses. Holders of RMB deposit accounts are permitted to convert RMB into Hong Kong dollars and vice versa, up to a limit of RMB20 000 per day. RMB account holders are permitted to remit RMB from their Hong Kong accounts to accounts under the same name in the Mainland subject to a limit of RMB50 000 per person per day. Mainlanders are permitted to use Mainland-issued RMB debit and credit cards in Hong Kong, with no ceiling on spending (HSBC *Monthly Report*: 10, December 2003).

While the volume of business involved is relatively small because deposit accounts are restricted to individuals with daily limits, the long-term implications for the Mainland and Hong Kong are significant. First, the measures signify the commencement of partial convertibility for offshore RMB, and the volume of business will grow with progressive relaxations of restrictions. Mainland authorities can gain experience through current measures for further capital account liberalization. Second, the measures give Hong Kong a first-mover advantage in offshore RMB business, and the RMB has the potential to become a major international currency. The measures, together with the CEPA, strengthen Hong Kong's status as an international financial centre. Third, the measures facilitate other Mainland–Hong Kong economic links; for example, tourism, cross-border business deals and trade in services.

Besides fostering offshore RMB business in Hong Kong, since 2003 Mainland authorities have discussed relaxing the Mainland's restrictions on outward investment through a QDII (qualifed domestic institutional investor) scheme; for example, allowing domestic mutual funds to invest overseas. In February 2004, China's State Council decided in principle to allow the Mainland's Social Security Fund to invest overseas, though the details have yet to be worked out (*Sing Tao Daily*, 21 February 2004: B3).

Coordination to stabilize the exchange rate

Unlike other East Asian economies, the Mainland and Hong Kong have maintained their exchange rates against the US dollar during the AFC. Both governments have reiterated their determination to keep their exchange rates stable. Coordination in exchange rate policies between the Mainland and Hong Kong have contributed to financial stability in East Asia (Sung 1998:165–7). President Clinton acknowledged the importance of the economic roles of the Mainland and Hong Kong in the Asian financial crisis in his visit to the Mainland and Hong Kong in late June and early July 1998.

As Hong Kong has a small economy in which the volume of international transactions is relatively large, it should peg its exchange rate to an international currency. This would facilitate international transactions. At present, Hong Kong cannot peg its currency to the RMB because it is not convertible. Even when the RMB becomes convertible, it may be advantageous for Hong Kong to continue its peg to the US dollar as this would distinguish Hong Kong from other financial centres in the Mainland. However, by the time the RMB becomes a major international currency it may be preferable for Hong Kong to switch its peg to the RMB.

Though the *renminbi* and the Hong Kong dollar are at present two separate currencies, their exchange rates are interdependent because the two economies are closely tied to each other in many ways. For example, a revaluation of the RMB would make Hong Kong more competitive. Moreover, because of China's foreign exchange controls, international investors often take advantage of opportunities in the China market by investing in Red Chips and H-shares in the Hong Kong market. An expected revaluation of RMB would lead to capital inflow into Hong Kong.

The Mainland recovered from the AFC very rapidly and its foreign exchange reserves swelled with persistent surpluses in both the current and capital accounts. In early 2003, the USA led a new round of international calls on China to revalue its currency as the US bilateral deficit with China continued to soar. China did not revalue, but liberalized the restrictions on imports and outgoing tourism, especially allowing Mainlanders to visit Hong Kong individually.

The prospect of the revaluation of the *renminbi* and the weakness of the US dollar led to large capital inflows into Hong Kong in September 2003, and the exchange rate of the Hong Kong dollar strengthened above the official rate. The Hong Kong Monetary Authority reiterated its long-standing policy of maintaining a fixed exchange rate against the US dollar, and effectively contained the rise of the Hong Kong dollar through intervention in the foreign exchange market.

In early 2004, China's imports rose sharply due to import liberalization, and China's persistent trade surplus turned into a deficit in the first two months of 2004. As a result, speculative pressure on both the RMB and the Hong Kong dollar eased.

Unlike Hong Kong, the Mainland's long-run interest is best served by a flexible rather than a fixed exchange rate because the Mainland economy is large. While many small economies have pegged their currencies to those of their major economic partners, most large economies allow their exchange rates to float. For large economies, the burden of a fixed exchange rate system usually outweighs the gains. However, China has to reform its financial system before it can adopt a floating exchange rate system. In particular, China has to reform its insolvent state-owned banks before it can open its capital account. With success in financial and banking reforms, China will be able to allow more flexibility in its exchange rate.

Coordination on the Mainland's WTO entry

Hong Kong had long supported the Mainland's entry into the WTO. Hong Kong government officials and politicians had also lobbied the US government and the US Congress to grant NTR status to China in early 2000.

In October 1999, the Hong Kong government set up an interdepartmental group chaired by the financial secretary to liase with Mainland authorities on matters related to China's WTO entry. Its purpose was to become acquainted with the arrangements for the opening up of the Mainland market, and to enable Hong Kong businesses to capitalize on the emerging opportunities. Additionally, the Mainland's Ministry of Foreign Trade and Economic Cooperation (MOFTEC) and Hong Kong's Trade and Industry Bureau set up a joint committee in November 1999 to strengthen communication on economic and trade issues. Coordination on such issues was later subsumed under the Mainland–Hong Kong CEPA.

The Mainland and Hong Kong CEPA

The Mainland and Hong Kong CEPA was signed on 29 June 2003 and took effect on 1 January 2004. It covers three broad areas; namely, trade in goods, trade in services and trade and investment facilitation. The CEPA grants zero tariffs to Hong Kong manufactures in 273 product categories. It gives preferential access to Hong Kong companies in a wide range of service industries above and beyond the Mainland's WTO commitments. It also provides opportunities for Hong Kong professionals and residents to establish business or work on the Mainland.

The Mainland and Hong Kong CEPA is unprecedented in many ways. As mentioned before, it is the first FTA formed between two separate customs territories within the same nation. Another peculiarity of the CEPA is that it involves two economies that are quite asymmetric in size, in openness and in level of development. The Hong Kong economy is small, highly developed and very open, while the Mainland is large, less developed and relatively closed. The benefits of the CEPA for Hong Kong are obvious, as it involves the preferential opening of the vast Mainland market to Hong Kong. There are few gains for the Mainland in terms of market access as the Hong Kong market is small and already very open. However, as Hong Kong is by far the foremost investor in the Mainland, the Mainland is likely to gain from an increase in investment from Hong Kong through investment and trade facilitation. Moreover, by opening its highly protected services sector selectively to Hong Kong ahead of WTO commitments, the Mainland would help its service industries to adapt and adjust to face the rigours of world competition. Lastly, the Mainland–Hong Kong CEPA of course symbolizes the union of Hong Kong to its motherland. The arrangement has considerable attraction for Taiwan.

Trade in goods

The Mainland agreed to apply a zero import tariff for Hong Kong manufactures in 273 Mainland product categories, starting 1 January 2004. This went beyond China's WTO commitments, which will cut the average tariffs for industrial products to 8.9 per cent by 2005. The product categories cover the main manufacturing industries of Hong Kong; namely, electrical and electronic products, textiles and clothing, plastic articles, watches and clocks, jewellery and metal products. Tariff exemption will be extended to other product categories upon application by local manufacturers no later than 1 January 2006.

As production costs are high in Hong Kong and Hong Kong manufacturing has declined for two decades, the CEPA is not expected to bring a massive revival of Hong Kong manufacturing. However, Hong Kong has better protection of intellectual property rights than the Mainland and the CEPA will benefit high-value-added manufacturing, especially industries in which intellectual property rights protection is crucial. It will help Hong Kong to develop brand products targeting the Mainland's middle-class consumer market.

Trade in services

The CEPA gives preferential market access to 18 service sectors; namely, three sectors under financial services (banking, securities and insurance), four sectors under transportation (logistics, freight forwarding, storage and warehousing, and transport services), one sector under trade-related services (distribution), one sector under travel services (tourism), five sectors under professional and business services (management consulting, advertising, accounting, legal, and medical and dental services), and four sectors of other services (telecommunication, construction and real estate, exhibition and convention, and audio-visual services).[6]

The preferential access takes one of more of the following forms:

1. *Lower market access requirements* – The high-entry thresholds set under China's WTO commitments are reduced for Hong Kong firms. For instance, the asset requirement of banks is reduced from US$20 bn to US$6 bn; the annual sales and asset value of retailers are lowered from US$2 bn and US$200 m. respectively to US$100 m. and US$10 m.; the trading and capital requirements of import and export trade are also lowered. As service providers in Hong Kong tend to be small, the lowering of market access requirements allows many more Hong Kong companies to enter the Mainland market.
2. *Broader business scope* – The geographic restrictions set under China's WTO commitments are relaxed for Hong Kong firms under the CEPA. For instance, in retail trade, only major cities (mostly provincial capitals) are open to foreign companies in 2004, while the CEPA permits Hong Kong companies to operate in all cities at the prefectural level, and all cities at the county level in Guangdong province. In tourism, the geographical restrictions on foreign companies are lifted for Hong Kong companies.
3. *More corporate autonomy* – Hong Kong companies can establish wholly-owned ventures while other foreign companies are restricted to joint ventures in convention and exhibition and in real-estate services (architecture, engineering, surveying).
4. *Earlier market entry* – Hong Kong companies can establish wholly-owned ventures (as opposed to joint ventures) ahead of other foreign companies in logistics, freight forwarding, transport services, management consulting, tourism and advertising. (Hong Kong Trade Development Council 2003:ii)

There are many other significant concessions that cannot be captured by the above categorization. For example, imported films are restricted to 20 foreign films per year on a revenue-sharing basis, but Hong Kong-produced Chinese-language films are free from the import quota. The requirements for the co-production of films have also been relaxed significantly for Hong Kong.

Besides Hong Kong companies, Hong Kong professionals and residents will also benefit from the CEPA. For instance, Hong Kong professionals in the securities and insurance industries can apply to practise on the Mainland and Hong Kong permanent residents are permitted to sit Mainland's legal qualifying examination (Hong Kong Trade Development Council 2003:iv).

The CEPA has several provisions that aim to strengthen Hong Kong's cooperation with Guangdong. For instance, Hong Kong lawyers' residence requirements for operating in Guangzhou and Shenzhen are waived. Qualified Hong Kong retailers are allowed to set up operations in all cities at the county level in Guangdong, while Hong Kong residents are allowed to set up individually owned retail stores in Guangdong.

Impact of the CEPA on the Hong Kong economy

As mentioned before, the Mainland's service sectors will develop faster with liberalization after WTO entry, and Hong Kong's status as the premier service hub of China will face more competitive pressure. In the production chain of processed exports, the Mainland will increasingly source producer services locally rather than from Hong Kong, and Hong Kong's rate of re-export margin may decline further. However, WTO entry and economic development will open up new markets for high-end services in which Hong Kong has a comparative advantage; for example, financial services. Hong Kong will lose out in low-end entrepot services, especially trade-supporting services that are directly related to the physical movement of cargo (for example, shipping, trucking and warehousing), and Hong Kong has to look for opportunities in high-end niches such as logistics, financing, insurance, arbitration, company headquarter functions, and high-quality personal services. In other words, Hong Kong has to face the challenge of rapid structural change in its service sector, and can succeed only if it maintains its lead in skills and service quality.

The CEPA helps Hong Kong to rise to the challenge of structural change in services, as it gives preferential access for Hong Kong firms to the Mainland's services sector. The rapid conclusion of the CEPA signifies that China's new leadership gives a high priority to Hong Kong, and this is one of the main factors that reversed investor sentiment towards Hong Kong in late 2003. The CEPA also strengthens Hong Kong's role as an international financial centre, trading centre and services hub. For instance, the 'Financial Services Cooperation' provisions in the CEPA encourage the Mainland banks to relocate their international treasury and foreign exchange trading centres to Hong Kong and to develop networks in Hong Kong through acquisition (Hong Kong Trade Development Council 2003:29). The CEPA also includes a clause that encourages more Mainland companies to seek listing in Hong

Kong. The CEPA will strengthen the Hong Kong–PRD nexus, enabling the industrial powerhouse of the PRD to utilize the sophisticated supporting services of Hong Kong in logistics, distribution, financial services and business services. In a nutshell, the CEPA will strengthen Hong Kong's position as the premier service hub of China.

The CEPA will attract more foreign investment into Hong Kong, and it will also increase Hong Kong's Mainland-related exports. The CEPA will attract foreign investment in Hong Kong in both manufacturing and services. For manufacturing, the CEPA rules of origin are quite liberal, following mostly existing rules of origin used in Hong Kong. For products in which a value-added criterion is used, no more than 30 per cent of the value added is required to be generated in Hong Kong. For services, the definition of a Hong Kong service company is quite liberal. The company must be registered in Hong Kong and have operated substantively in Hong Kong for the past three to five years. It must be liable to pay Hong Kong profit tax and must employ at least 50 per cent of its staff locally. Foreign investors can easily acquire control of local companies to fulfil the above definition. It is difficult to estimate the amount of investment that the CEPA will attract because the CEPA was only implemented in 2004. However, Taiwan's approved FDI in Hong Kong had already quadrupled in 2003 in anticipation of the CEPA, and Hong Kong surpassed the USA to become Taiwan's second destination of outward FDI after the Mainland. Ultimately, the amount of investment attracted will be dependent on the export opportunities that the CEPA can generate.

The effects of the CEPA on Hong Kong are very wide-ranging and difficult to quantify. However, it is easier to assess the impact of the CEPA on Hong Kong's Mainland-related exports, as Sung (2004) has conducted a detail study on the income generated by Hong Kong's Mainland-related exports (decomposed by exports of goods and different kinds of services exports), and the study gives a convenient framework to gauge such impacts. As mentioned before, Hong Kong's Mainland-related exports were huge, generating 32 per cent of Hong Kong's GDP in 2002. For reasons that will be explained below, it is unlikely that the CEPA will have considerable effects on Hong Kong's Mainland-related exports in the short run, but the long-run effects can be extensive.

CEPA gives tariff exemption for Hong Kong's domestic exports to the Mainland, but the income generated by such exports in Hong Kong's GDP declined rapidly from 3.1 per cent in 1995 to only 1.8 per cent in 2002 (Sung 2004). Moreover, more than two-thirds of Hong Kong's domestic exports to the Mainland involve components and inputs used in outward processing (Table 4.6), which are tariff-exempt. The CEPA would thus only benefit around a third of Hong Kong's domestic exports to the Mainland. Given the high production costs in Hong Kong, the impact of the CEPA on Hong Kong's domestic exports will not be great in the short run. The Federation of Hong Kong industries estimated that the CEPA will create 5000 new jobs in manufacturing in 2004 (*Hong Kong Economic Times*, 17 March 2004: A5), which is only 2.6 per cent of Hong Kong's 2002 manufacturing employment, and only 0.15 per cent of Hong Kong's 2002 total employment. In the long run, however, it is certainly possible that Hong Kong may be able to capture some significant niches of the Mainland's vast and expanding consumer market. The Federation of Hong Kong Industries surveyed its members in mid-2003 and concluded that the CEPA will create 20 to 30 thousand new jobs in Hong Kong manufacturing in the coming three years (*Hong Kong Economic Times*, 27 June 2003: A6). In the long run, if Hong Kong entrepreneurs can exploit the market opportunities of the CEPA to the full, the CEPA may be able to stabilize or even reverse the decline of Hong Kong manufacturing.

The CEPA will stimulate exports in the 18 services sectors mentioned, but the short-run effects will be small except for tourism. The income generated by Mainland-related exports in the three sectors in financial services (banking, securities and insurance) and in the nine sectors in professional and business services and other services were only 0.1 per cent and 0.5 per cent of Hong Kong's 2002 GDP respectively. The income generated was small because such service exports were small. The income generated by Mainland-related exports in the four sectors in transportation services (logistics, freight forwarding, storage and warehousing, and transport services) was more significant, but still only 1.4 per cent of Hong Kong's 2002 GDP. The increase in transportation services in the short run cannot be very large.

The income generated by Hong Kong's exports of Mainland-related tourism was 1.9 per cent of Hong Kong's GDP, which was not insignificant. As mentioned before, 6.8 m. Mainlanders visited Hong Kong in 2002, accounting for 41 per cent of Hong Kong's tourist arrivals. It was estimated that individual tours would bring another 4 m. Mainland tourists (*Sing Tao Daily*, 20 August 2003: A6). This would generate income of US$1.8 bn or 1.1 per cent of Hong Kong's 2002 GDP, which is not insignificant.

The big items in Hong Kong's exports of Mainland-related services were related to trade: entrepot services and services involving offshore trade. The two items generated respectively 20.5 per cent and 2.6 per cent of Hong Kong's 2002 GDP. The CEPA should stimulate services involving offshore trade, as Hong Kong traders and forwarders have better access to the Mainland market under the CEPA. However, it would have very little impact on entrepot trade, which is suffering from rapid cargo diversion to Shenzhen owing to higher costs in Hong Kong. In 2002, Mainland-related entrepot trade generated nearly three times as much value added as Mainland-related offshore trade. On the average, it takes $2.1 of offshore trade to compensate for $1 decline in entrepot trade because the latter has a higher rate of value added. While the CEPA may slow the cargo diversion to Shenzhen marginally, it is unlikely to reverse such diversion.

In a nutshell, in the short run, it is unlikely that the CEPA will have large beneficial effects on Mainland-related exports except for tourism. In the long run, however, the effects of the CEPA on Mainland-related services exports can be large. Though exports of financial services to the Mainland are still small, the Mainland's financial liberalization can turn Hong Kong into an offshore centre for *renminbi* business. The share of income generated by all Mainland-related services exports (mostly composed of offshore trade, tourism and transportation services) to GDP has risen rapidly from 3.8 per cent in 1995 to 10 per cent in 2002, while the share of income generated by Mainland-related entrepot trade to GDP has declined slightly from a peak of 21.7 per cent in 2000 to 20.5 per cent in 2002. With the help of the CEPA, Mainland-related services exports may rival or exceed Mainland-related entrepot services in the long run. The CEPA will help to transform Hong Kong's structure of exports away from low-end entrepot services to high-end services.

There is a fear that the CEPA will increase the flow of Hong Kong entrepreneurs and professionals to the Mainland, leading to further hollowing out in Hong Kong. However, increased flows of Hong Kong entrepreneurs and professionals northward will enlarge Hong Kong's business network in the Mainland, which is a great asset for Hong Kong as it strengthens its position as the foremost hub of China's commerce. Moreover, the CEPA will also increase the flow of Mainland skills southward.

Ultimately, Hong Kong must maintain its lead in skills and service quality in order to retain its position as the premier service hub of China. Otherwise, China's WTO entry and the CEPA will lead only to the further hollowing out of Hong Kong services.

Breakthrough in Taiwan–Mainland links?

The policy choice for Taiwan is much more complex, as it is an autonomous entity and Taipei does not want to be relegated to the status of a provincial government if it has other options. With rapid economic development on the Mainland and lethargic economic performance in Taiwan, there is an emerging consensus in Taiwan that its prohibitions on economic links hurt itself more than they do the Mainland.

As mentioned before, in 2002, Taiwan liberalized on its outward investment in the Mainland and on imports from the Mainland, and began to allow investment from the Mainland. Taiwan also allowed direct trade, investment and remittances. While the liberalizations have led to a jump in Mainland-related trade and investment, the remaining restrictions are still severe and costly for Taiwan. For instance, there is no direct flight between Taiwan and the Mainland, which is costly to Taiwanese businessmen pressed for time. Direct shipping is limited to the offshore islands and the highly circumscribed shipping links between Kaohsiung's 'offshore transhipment centre' and the two Mainland ports of Xiamen and Fuzhou. Despite the consensus to allow more visitors from the Mainland, the number of such visitors was not only small but also has fallen from 199 000 in 2002 to 188 800 in 2003.

As mentioned in Chapter 6, both Taiwan–Mainland trade and the flow of visitors are highly unbalanced. Moreover, Taiwan's investment in the Mainland's service sector appears to be unusually low as a result of Taiwan's restrictions. The share of investment in services in Taiwan's investment in the Mainland was only 8 per cent (cumulative approved investment up to January 2004), as compared with 64 per cent for Taiwan's investment elsewhere, 35 per cent for the Mainland's cumulative contracted FDI, and 70 per cent for Hong Kong's stock of investment in the Mainland (Table 6.11). Taiwan's gross under-investment in the Mainland's service sector will be very costly for Taiwan as the Mainland's services liberalization scheduled from 2005 to 2007 is the focal point of Mainland's coming wave of opening.

While Taiwan wishes to enter into negotiations on direct transportation links without preconditions, the Mainland stresses that such links should be treated as domestic rather than international links. The Mainland stresses that the principle of 'one China', which is not accepted by Chen Shui-bian, is a precondition for talks. Though Chen was re-elected in 2004, he only won the election by a margin of less than 0.5 per cent. The election result reflected the bitter division within Taiwan over its relationship with the Mainland. Given this fundamental division and also the Mainland's deep distrust of Chen, full-scale establishment of direct transportation links will not materialize soon.

However, there are many restrictions that Taiwan can liberalize unilaterally without much cooperation from the Mainland. For instance, it can further relax the restrictions on imports of Mainland products and on investing in the Mainland. Even without the establishment of more direct shipping links, Taiwan can expand the size and functions of Kaohsiung's 'offshore transhipment centre' to include export processing. More fundamentally, Taiwan can allow direct trade through its present shipping links between Kaohsiung's 'offshore transhipment centre' and the two Mainland ports of Xiamen and Fuzhou.

Taiwan can also lift its present stipulation that container cargo must change vessels in third ports. This would allow container cargo to be shipped across the Strait in chartered vessels (which must stop in a third port) in the same way as bulk cargo. This would lower the costs of Taiwan–Mainland shipping considerably.

Of course, Taiwan can also relax its stringent restrictions on visitors from the Mainland and investment from the Mainland. However, relaxation of such restrictions has sensitive social, political and security implications. Given the stalemate in cross-Strait relations, the relaxation of such restrictions will probably be very gradual. This will hamper the growth of trade in services, which requires close personal contacts.

Social problems of economic integration

While the economic integration of the trio has brought major economic benefits, it has also brought social and public health problems such as illegal migrant workers, crime and contagious diseases.

Two opposite approaches can be taken to manage such problems. One approach is isolation; that is, severing the ties of integration. The opposite approach is management through deep integration; that is, coordination and cooperation on both sides of the border to manage the problems. While a full discussion of the two approaches is beyond this book, the well-known SARS episode can be taken to illustrate the two approaches.

Taiwan took the isolationist approach. All passengers, including Taiwanese, from the Mainland and from Hong Kong, must be quarantined for 10 days on arrival in Taiwan. While there had been proponents in Hong Kong of taking the isolationist approach by sealing the border with the Mainland, Hong Kong eventually took the approach of deep integration to manage the crisis. Cooperation between Hong Kong and the Mainland to fight SARS developed along many fronts, including border monitoring, provision of medical supplies and equipment, and joint efforts in medical research and clinical treatment.

Taiwan's isolationist approach turned out to be quite ineffective. Taiwan was the last region in the world to be removed from the list of infected areas of the World Health Organization. Taiwan's refusal to purchase medical supplies from the Mainland exacerbated the scramble for masks in Taiwan. More seriously, Taiwan's isolationist approach hampered learning from SARS outbreaks in Hong Kong and the Mainland, which occurred before the outbreak in Taiwan. If Taiwan had adopted the best practices then used in Hong Kong or the Mainland, its hospital outbreaks might have been avoided.[7]

Though Hong Kong was slow in its effort to cooperate with the Mainland to fight SARS, the belated approach of deep integration has shown encouraging results. For example, the cooperation of Hong Kong and Guangdong medical experts has led to the discovery of the coronavirus as the cause of SARS. Joint research on the animal carriers of the coronavirus and the testing of SARS vaccines have made significant progress. Hong Kong has also invited Mainland specialists in Chinese medicine to treat SARS patients in Hong Kong, and the efforts have been fruitful.

The rapid spread of the avian or bird flu throughout East Asia and the Mainland in early 2004 again demonstrated that coordination through deep integration can be an effective strategy against contagious disease. The avian flu did not spread to Hong Kong despite the fact that it spread to most parts of the Mainland and East Asia, including Korea, Japan, Taiwan, Vietnam, Thailand, Cambodia, Laos and Indonesia. Importation of poultry from the Mainland was suspended for a few months, and was resumed only after thorough precautions. For instance, Hong Kong health officials were able to inspect poultry farms in the Mainland that supplied poultry to Hong Kong.

To manage the social problems arising from integration in the trio, a strong case can be made that isolation is not only economically inefficient but also ineffective. Deep integration can be a much more effective strategy to control such social problems. For instance, Hong Kong has been quite successful in its coordination with the Mainland to fight cross-border crime. The same case can be made for illegal immigrant workers. For example, the Mainland authorities have restricted the right to apply for individual permits to travel to Hong Kong to the more prosperous regions as people in the Mainland's poorer areas are more likely to work illegally in Hong Kong.

Conclusion

Hong Kong and Taiwan have played very important roles in the Mainland's process of reform and opening. The integration of the trio started with export processing, but has since been moving towards deep integration in services. Through the reform process, the Mainland gradually shed its many practices that were inconsistent with the WTO.

The deep integration of Hong Kong with the Mainland cumulated in the milestone of the CEPA. The Mainland opened its highly protected services sector selectively to Hong Kong ahead of WTO commitments. This would help the Mainland's services industries to adapt and adjust to face the rigours of world competition. Thanks to deep integration with the Mainland, Hong Kong's economic performance has improved decisively.

Taiwan has partially liberalized its restrictions on Mainland-related trade and investment in 2002 after WTO entry. This has led to a dramatic increase in Taiwan's Mainland-related trade and investment. However, political animosity has prevented the establishment of direct transportation links. The lack of direct transportation links, together with Taiwan's other restrictions, has greatly limited the development of services trade between Taiwan and the Mainland. Such restrictions also have unfavourable effects on Taiwan's investments in services in the Mainland, which are unduly small. Such restrictions are very costly for Taiwan, as services liberalization is the focal point of the Mainland's coming wave of opening.

While the economic integration of the trio has brought major economic benefits, it has also brought social and public health problems. To manage such problems, close coordination may be a more effective strategy than isolation. Unfortunately for Taiwan, the approach of close coordination is precluded by political animosity.