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A regional free trade agreement between Hong Kong and China

Concept Paper

Hong Kong General Chamber of Commerce

A. A RTA between Hong Kong and China

After a year-long study, the Chamber released its report titled “*China’s Entry into the WTO and its Impact on Hong Kong Business*” in January 2000. The study was about how important sectors of Hong Kong can position themselves after China’s entry to the WTO. The study report contained suggestions on how the SAR government can assist Hong Kong companies in the face of the challenges ahead. One of the key suggestions was to explore the possibility of a regional free trade agreement between China and Hong Kong SAR.

China’s application for WTO membership was adopted at the WTO Ministerial Conference in Doha on 10 November 2001, and it formally became a WTO member on 11 December, 2001. One of the first tasks of the Chamber immediately after approval of China’s accession, was to continue to pursue the concept of a RTA between the two economies. Accordingly, we wrote to HKSAR Chief Executive Mr Tung Chee Hwa on 20 November, and discussed the subject with him at a meeting two days later.

That was against the background of increasing pressure on the Central and the Hong Kong SAR governments by some Hong Kong SME sectors for the Mainland to grant special preferential treatment. Their expectation was reinforced by an earlier speech in October by the Beijing Mayor, who would reportedly be “granting special preferential treatment to Hong Kong companies”. As clarified by MOFTEC later, this turned out to be misinterpretation as such preferential treatment is not allowed under the WTO framework. Nevertheless, the Chamber sees, in accordance with the WTO rules, a possible solution to legitimately gain some advantage for Hong Kong by negotiating a RTA between the Mainland and Hong Kong.

At the Chamber luncheon on 29 November, MOFTEC Vice-Minister Mr. Long Yongtu confirmed to the Chamber audience that the HKSAR Government has proposed to the Central Government the possibility of a RTA, and that this was welcomed and being positively studied. We were very pleased and encouraged that the Chamber proposal was being actively taken up by both the HKSAR and the Central government.

B. The nature of regional trade agreements

A “Regional Trade Agreement” (RTA) is an arrangement among a few economies to effect closer trade and economic relationship. Of these the commonest form is a “free trade area”, in which all barriers to trade among member economies are removed and goods are freely traded. No discriminatory taxes, quotas, tariffs, or other trade barriers are allowed among members; nevertheless, each economy continues to set its own trade policies in relation to non-members, such as tariffs, quotas, or other trade restrictions. Some examples of such RTAs are the *European Free Trade Area* (EFTA) and the *North America Free Trade Agreement* (NAFTA).

The WTO provides for the formation of RTAs through Article XXIV of the General Agreement on Tariffs and Trade (GATT). The Article is further supplemented by an “Understanding on the Interpretation of Article XXIV of the GATT 1994”, which clarifies the criteria and procedures for the assessment of RTAs. While Article XXIV of GATT applies to trade in goods only, similar clauses for trade in services is

provided for in Article V of the General Agreement on Trade in Services (GATS).

Nearly all of WTO's current 144 members are party to some form of RTAs. Many of these apply to goods only, but increasingly services is also covered, e.g. NAFTA. Hong Kong has not entered into any RTA yet but is negotiating a "closer economic partnership" agreement with New Zealand, which is intended to cover both goods and services. Elsewhere, WTO member economies are formulating more and more RTAs among themselves, e.g. Singapore with New Zealand, Japan with Singapore. Premier Zhu Rongji has indicated that China might enter into a free trade agreement with the ASEAN countries.

Although free trade is the ultimate aim for many RTAs, the WTO allows for this to happen progressively rather than from the beginning. In practice, therefore, trade restrictions may remain among members of a RTA, as long as the spirit of the RTA is that of non-discrimination and that it is not used to disguise ad hoc or partial discrimination. To ensure that, two major principles are laid down in Article XXIV of GATT and Article V of GATS, namely, that the RTA must cover *substantially all trade*, and that others must *not be worse off* as a result of the RTA.

The "substantially all trade" requirement ensures that a RTA is not misused as cover for narrow sectoral discriminatory arrangement. It also helps governments head off protectionist pressures within their own economies. The same concept as applied to services means that there should be substantial coverage of service sectors traded among members of the RTA. The "not worse off" requirement is to ensure that non-participating economies are not harmed by the RTAs. In practice problems may be encountered by third countries when a RTA brings about different ways of designing and administering rules of origin.

To ensure WTO consistency, all RTAs are required to be notified to the WTO. Notification is followed by formation of a working party to examine the RTA in detail and to determine its compliance with WTO principles. Out of the total of 238 RTAs notified to the WTO, 150 are presently in force. WTO dispute settlement procedures may be invoked if a WTO member is aggrieved by a RTA.

C. Principal subjects for consideration

The negotiation for a RTA between the SAR government and the Central government will not be easy. On the other hand, with many RTAs now in force, there should be ample examples for reference.

In the Chamber's view, the talks should be guided by these principles:

- (i) The Agreement must be formulated within the WTO framework.
- (ii) The Agreement should be beneficial to the economies of both Hong Kong and the Mainland.
- (iii) The Agreement should be reached quickly—preferably before the end of 2002. Its content should be simple and its implementation transparent.
- (iv) The Agreement should not bring additional difficulties to China in its implementation of WTO commitments and in its relationship with other WTO members.

The most important part of the RTA will be the substance of trade and investment liberalisation it covers. While free trade is the ultimate goal, we believe that a time-advantage would be the most immediate benefit for Hong Kong companies. This means that we need to identify, as a matter of priority, what are the areas and sectors which should form the substance of the immediate discussions between the two sides.

- (1) **Early Liberalization of Agreed Market Opening**—The liberalization will be implemented according to timetables for each of the sectors of telecommunication, banking, insurance, distribution, retail, consulting, advertising, tourism, legal services, etc. These timetables cover forms of investment, percentage of investment, number of branches and licenses, areas of service and others, and usually range from two to five years after accession. As described above, a RTA with China may enable Hong Kong companies to obtain these same liberalizations earlier, say one year after accession, i.e. beginning 2003. China can also benefit from having this "experimental" opening and by partnering with Hong Kong companies to get ready for the onslaught of companies from other WTO members at a later date. It is important, however, to identify the sectors of

priority for Hong Kong and to examine the details of the possible arrangements for early liberalisation in a manner that would benefit both Hong Kong and China.

- (2) **Further Lowering/Removal of Barriers**—In many sectors, there are barriers to investment or operation which are not covered by the current China WTO accession document. An example is the exhibition services sector, where wholly foreign owned operations are not allowed. Government procurement is not covered at all in the accession document. Another example is that of the asset barrier of USD20 billion for setting up foreign bank branches. A RTA with Hong Kong could open up a wide range of opportunities by lowering some these barriers or removing prohibitions for Hong Kong companies. Obviously, any such additional opening may become the subject of requests by other WTO members, so the Central Government will look very carefully before granting these to Hong Kong. But since China will be involved in the new round of trade liberalization anyway – the new Doha Round which was successfully launched a month ago – there must be room for additional liberalizations, previously not covered, to be made available in the future. Even though those may eventually be enjoyed by all WTO members, Hong Kong will, again, gain a time advantage. The question, then, is which sectors and in what aspects.
- (3) **Tariffs for Manufactured Goods**—The benefits described above for service sectors may also be applicable to industrial tariffs, that is, there may be an opportunity to seek early reduction or further reduction of tariffs. This could help attract some high value-added manufacturing operations back to Hong Kong, especially those with a high design content, or others where the original components would encounter a stiff tariff in China or where technology transfer rules prohibit these components from entering China unassembled. Again, we need to examine which products or product ranges are of particular interest to Hong Kong and to what extent they will benefit our manufacturing industries.
- (4) **Hong Kong's offers** - A free trade agreement by definition is two-way. The Central government appreciates that a benefit of the RTA is faster economic integration between Hong Kong and China in accordance with the “One Country Two Systems” principle. The “experimental” early opening described above can help China better prepare for the wider opening that it promised. Similarly, a RTA can be used to provide a framework for “pilot liberalization”, i.e. further liberalization on a voluntary and non-binding basis, thus enabling China to manage its own liberalization program. On our part, we shall have to be prepared to offer some specific benefits for the Mainland. What are the benefits or concessions which Hong Kong can offer the Mainland?
- (5) **Rules of origin** – One important issue which would have to be addressed is that of what constitutes a “Hong Kong company”. Hong Kong is an international city, so a narrow definition of what is a “Hong Kong company” would not be in keeping with its tradition. But a definition which is too wide may open too big a door too soon for China and also dilute the time-advantage for Hong Kong SMEs. How should we strike the balance?

Among all issues covered under a RTA, the following practical questions should be considered first:

1. What barriers can be reasonably lowered through an RTA that is consistent with WTO principles?
2. What time advantage can Hong Kong get and for which sectors?
3. What can Hong Kong reasonably offer the Mainland in return?
4. What tariff reductions could be sought and in which manufacturing sectors, and what benefits that could bring to Hong Kong industries?
5. What would constitute a “Hong Kong company”?
6. Is Government procurement policy a possible area of discussion?

These and other questions will be deliberated by the Chamber in detail.