Mainland / Hong Kong Closer Economic Cooperation Arrangement
- HKGCC's Position on the Consultation

April 2003

I. The Background

1. The Hong Kong General Chamber of Commerce released its report titled *"China's Entry into the WTO and its Impact on Hong Kong Business"* on 18 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 trade agreement (RTA) between China and Hong Kong SAR as a means to enhance further integration of trade and economic relations between Hong Kong and Mainland China.

2. In end 2001, the Chamber was very grateful to see that the HKSAR Chief Executive Mr Tung Chee Hwa has finally put forward the RTA proposal to the Central Government. The RTA was formally named "Mainland/HK Closer Economic Partnership Arrangement (CEPA)" at a meeting between the Financial Secretary of the HKSAR Government, Mr Antony Leung, and the Vice Minister of the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) of the Central People's Government, Mr An Min, on 25 January 2002.

3. The Chamber recognises that the negotiation for a RTA is no easy task and it calls for a concerted effort by all parties in the HKSAR and the Mainland. In the beginning of 2002, the Chamber conducted a study and submitted a 75-page Chamber paper to Financial Secretary Antony Leung on March 12, giving him the Chamber's views on the CEPA. The views were gathered from our members and from extensive interviews and research of documents. Since then, during the course of Consultation, various papers and letters were submitted to the Chief Executive and the Financial Secretary.

4. The purpose of this Chamber paper is to provide an up-to-date Hong Kong business sector's input into the CEPA Consultation.

II. The Context

Global trade policy

5. The Consultation was given a boost after Chief Executive Mr. C H Tung's visit to Beijing in December 2002. After the visit, it was announced that the talks would be concluded by June 2003. As the Consultation intensifies, it coincides with a number of developments in international trade policy.

   i. *China's WTO Implementation.* One full year has passed since China's entry into the WTO. China is now going through the first annual review under the WTO's Transitional Review Mechanism on implementation of the Protocol of Accession.

ii. *Doha.* Momentum is slowly building up in the WTO's negotiations on the Doha Development Agenda, although little concrete progress has been made so far.

iii. *RTAs.* Much lively discussion is going on in regional trade arrangements. US and Singapore recently struck a deal for a free trade agreement (FTA), while the EU and Chile have signed an ambitious trade accord. China and the ASEAN have begun exploring a FTA, and similar talks are being held between Japan and Mexico, and between the US and Australia.

6. For China, now that it is a WTO member, the above developments mean that globalisation has become a reality to contend with, not an aspiration or an external phenomenon. More and more cities will become doors to the outside world. Among them, Hong Kong will have a special place as the most globalised city on China's soil. This Mainland view of Hong Kong coincides with Hong Kong's own economic positioning. Following Mr Tung's Policy Address delivered on 8 January 2003, a consensus has now emerged of the SAR as an integral part of the Pearl River Delta.

Implications for CEPA Consultation

7. In the context of the above, a number of implications emerge for the CEPA Consultation:

i. *Using CEPA to gain experience on RTAs.* With RTAs becoming prevalent, RTA negotiations are increasingly becoming part of the mainstream of trade talks, instead of a marginal supplement to the WTO negotiations. Like it or not, WTO members will be partaking in more and more RTA negotiations. Thus it pays for both Hong Kong and China to use the CEPA Consultation to accumulate experience in RTAs and to prepare themselves for future encounters with other WTO members over other regional arrangements.

ii. *Using CEPA to effect integration and globalisation.* Whether or not there is CEPA or the WTO, Hong Kong must pursue closer economic partnership with the Mainland, especially the Pearl River Delta. China, on the other hand, should pursue closer economic relationship with Hong Kong in its own strategy in managing globalisation. But given that the CEPA Consultation is going on, it could become just the vehicle for China to manage globalisation, and for Hong Kong to effect economic integration with the Mainland.

iii. *Using CEPA to manage liberalisation.* The WTO's Transitional Review Mechanism of China's Protocol of Accession will, among other things, reveal the uneven nature of China's compliance with WTO commitments. It will also reflect an increasingly need to engineer the implementation process to ensure that China's trade liberalisation is in synch with the committed market openings. The CEPA will enable China to gain experience in managing liberalisation in a way that it is both WTO-compliant and in the country's interest.

III. The Principles

8. When the CEPA Consultation was launched, at the first meeting between Antony Leung and Vice Minister An Min on January 25, 2002, it was agreed that the consultation will be guided by the following five principles:

    i. The relevant WTO rules and the "One country, Two systems" principle should be observed.
    ii. The CEPA should be mutually beneficial, and take into account the trends of economic development in the two places.
    iii. The consultations should be progressive, starting with the less difficult areas.
    iv. The political, business and academic communities of the two places would be widely consulted in the process.
    v. Both sides will work actively together to take forward the proposal with a view to achieving continuous progress.

9. These principles largely coincided with the ones espoused in our paper entitled "Towards a Regional Trade Agreement between China and HKSAR", which we submitted to the Financial Secretary on January 21, 2002. The Chamber's principles were:

    i. *An Economic Integration Agreement:* The aim of the RTA should be closer economic integration between China and Hong Kong, a "Closer Economic Relationship" (CER) or "Closer Economic Partnership" (CEP) agreement covering trade and investment in both goods and services.

    ii. *Liberal And Pro-Free Trade:* The China/Hong Kong CEPA should be viewed as strongly pro-WTO and pro-multilateralism.

    iii. *Building On Existing Commitments:* The China/Hong Kong CEPA should be built upon existing WTO commitments, but with both parties being able to enjoy the benefits earlier.

    iv. *Further Liberalisation:* China and Hong Kong can both use the CEPA to discuss further, new liberalisation over and above that already committed to the WTO. China can offer further liberalisation through pilot schemes for Hong Kong traders, which can become test cases for possible offers in the new Doha Round of multilateral trade negotiations.

    v. *Wider Coverage than WTO:* CEPA should have wider coverage than the WTO and should cover investment, competition and government procurement.

    vi. *Balance of Rights and Obligations:* The benefits of the China/Hong Kong RTA should be mutual.

    vii. *Progressivity:* The CEPA should not be a one-time arrangement, but should provide the framework for ongoing, progressive liberalisation, especially for the many service industries.

10. Taking stock of the Consultation in the past year and the global development, we believe it would be very useful to re-focus ourselves specifically on the following two principles:

- *Principle 2 - mutually beneficial:* This principle provides the basis for arriving at a meaningful agreement. It implies that the substance of the agreement lies in the benefits for both sides. Given that a target time has now been set, the task for the officials from both sides is now much clearer, namely, to substantiate concrete benefits for an agreement.
- *Principle 3 - progressive, starting with the less difficult areas:* This gives rise to the first-easy-then-difficult approach in taking the talks forward. It also carries an implication of timeliness. Thus the talks do not have to be final and a first-phase for the easier issues can be concluded first.

11. Combining the above two principles, it follows that officials from both sides should aim for a first-phase agreement by concentrating on liberalisation and market opening which:
    - brings substantive benefits, and
    - is easy to achieve.

12. Thus the agreement may consist of:
    - changes in rules and regulations (trade policy liberalisation), or
    - immediate arrangements and concrete measures to implement economic cooperation (trade and investment facilitation);
    - more difficult subjects can be covered in the agreement under a broad "framework arrangement", leaving the detailed provisions to be taken up in a later phase.

Seizing the opportunity

13. Most of the issues and the more specific concerns arising from China's WTO implementation have been anticipated in the Chamber's earlier CEPA submission. The Chamber has, for instance, drawn attention to the importance of addressing regulatory reform in China's trade liberalisation, which is becoming a key concern of China's trading partners. As the closest economic partner with the Mainland, Hong Kong is the best partner for the Mainland to test-run some of its regulatory changes through CEPA.

14. Given the above context, June 2003 would be an excellent timing for the first-phase agreement on CEPA. It offers sufficient time for technical problems to be ironed out so as to enable a substantive agreement to be reached. It will offer a meaningful time-advantage for Hong Kong if the early liberalisation advocated by the Chamber can be agreed upon. In the broader picture, coming just before the WTO Ministerial Conference in Cancun scheduled for September, a conclusion for CEPA in June will help both economies establish a firm positioning in the Doha Development Agenda negotiations.

15. The full range of liberalisation that can be sought from CEPA has been detailed in the Chamber's submission of March 2002. In this paper we shall outline four aspects of the CEPA Consultation for which we believe agreement with concrete benefits is achievable in the coming months, namely:

- liberalisation of trade in manufactured goods
- liberalisation of services in some easy sectors
- infrastructure coordination
- trade and investment facilitation

IV. The Arrangement

Trade in manufactured goods

16. Even though more and more processes are being relocated to the Mainland, there are still good reasons to manufacture in Hong Kong, if a zero-tariff free trade area can be agreed upon. From the Chamber's research, there is a consensus among industrialists that zero-tariff will boost production locally, though to different degrees.

    i. *Competitive advantage from Mainland regulations.* Some room for Hong Kong manufacturers is created by Mainland regulation on trade in reprocessing materials. Chinese customs has classified commodities related to reprocessing industries into "prohibited", "restricted" and "permitted" categories. Hong Kong industry can thus engage in manufacturing processes that make use of the prohibited or restricted materials, e.g. manufacturing of furniture that makes use of hinges which are restricted products.

    ii. *Competitive advantage from lower tariff.* There is a purely economic reason for manufacturing to remain. Hong Kong producers are exporting a sizeable amount of tariffed goods to the Mainland. When tariff is removed, there is room for them to become more competitive in the market.

17. Thus a zero-tariff free trade area between Hong Kong and the Mainland will encourage local manufacturers to supply more, while their Mainland customers may demand more as prices adjust. The combined effect is to increase manufacturers' investment and thus employment in Hong Kong. Just to what extent this will be the case, has been the subject of a previous study by the Chamber.

Benefits of zero tariff for current industries

18. The Chamber identified and examined 462 "high-tariff" goods, i.e. those with tariff rate of 20% or higher even after China follows through on all its WTO tariff concessions. It includes 221 high-tariff products, for which there is currently no export from Hong Kong. A range of industries have been identified as being possible beneficiaries of the zero-tariff regime:

    - Textiles: overcoats, suits
    - Hats and headgear
    - Jewellery: design jewellery and imitation jewellery
    - Spectacles: lens, sunglasses and specialised spectacles
    - Foodstuffs: sauces and condiments
    - Leather and handbags: leather cases, bags, gloves and accessories
    - Metallic products: small iron cast design-articles

- Personal care and light appliances
- Clocks and watches
- Buttons and zips

19. These industries are all from traditional sectors. Job creation in these industries will be beneficial for "traditional workers", especially middle-aged semi-skilled workers. It should be noted, however, that the benefits may not materialise for all the above industrial sectors, and those most likely to benefit would be the ones with a bigger degree of design and innovation, e.g. jewellery, specialised spectacles, ensembles, designer hats.

20. In any case, a zero-tariff free trade area will bring immediate benefits to Hong Kong to the tune of 4,500 to 9,000 new jobs, as estimated by the Chamber.

    - *4500 jobs.* Free trade with the Mainland will enable Hong Kong to make an annual saving of HK$4.3 billion in tariffs. Assuming that Hong Kong manufacturers will increase output by the same tune of $4.3 billion, using the average percentage value-added in manufacturing (0.31) and average value-added per manufacturing worker ($294,600), we estimated that a total of 4,500 jobs may be created.
    - *Or 9000 jobs.* Another method of estimation yielded a figure of 9000 jobs. This was based on China's total imports, currently at HK$1,812 billion. The Chamber estimated that tariff abolition for Hong Kong goods could enlarge this value by up to $102 billion. While the original share of Hong Kong's domestic exports among Chinese imports is about 3%, tariff reduction could enable Hong Kong manufacturers to gain 8.4% from the increase of import by China. This would generate an additional output of around $8.6 billion in Hong Kong, which is equivalent to about 9,000 jobs.

21. Taking the 9,000 jobs figure, it would be equivalent to 0.28% of the labour force, or 3.9% of the manufacturing workforce. They would contribute to a modest increase of 0.22% in GDP, not counting the additional economic benefits from more support services in trade, transport and logistics, which could be substantial.

22. The above benefits, though modest in magnitude, represents substantive benefits which would follow as a result of zero tariff. However, through CEPA there would be an opportunity to bring bigger benefits to Hong Kong and China by introducing some structural changes to the Rules of Origin.

Restructuring the Rules of Origin

23. According to the recent "Made in PRD" study by Hong Kong University, Mainland factories working for Hong Kong firms generate a total output worth $800 billion. Only 10% of this were sold domestically, involving 33% of the firms. In other words, a large market potential exists for these companies, as the Mainland's internal market is opened up. The other 67% firms which do not yet sell in the Mainland market may also join in.

24. In reality, despite the big potential of the Mainland domestic market, the tax system remains a formidable barrier. This is because the foreign investors producing products

for internal distribution is required, despite recent tax liberalisation, to pay full VAT upfront on import content of all production. They can only claim back the non-taxable VAT (on products for export) afterwards. The uncertainty and cash flow problems have combined to force the Hong Kong manufacturers to engage in (or appear to engage in) all-export production, and this gives rise to gray-area practices for those interested in selling to the Mainland market.

25. The value of CEPA to these manufacturers will be to open up China's domestic market by simplifying the tax regime for made-in-Hong Kong products. Thus after being processed in the Mainland, the goods can first be exported to Hong Kong, then undergo re-processing to become Hong Kong-origin products, before re-exporting to China for internal distribution. Hong Kong will be the final loop in production. For the production in the Mainland, the tax on raw material and equipment is exempt. All the cumbersome processes of upfront payment and tax refund negotiation will be avoided.

26. They key to this lies in the Rules of Origin to be agreed to: the easier it is for products to be certified as "made in Hong Kong", the bigger the incentive for manufacturers to retain existing processes or develop new processes in Hong Kong. To facilitate that, the Chamber has advocated a structural change to the ROO regime, by combining both the Mainland-origin with the Hong Kong-origin content in the calculation. This means that to satisfy the ROO, the products do not have to be all made in Hong Kong. Provided that they satisfy a certain minimum Hong Kong content (say 25%), they will enjoy zero tariff as long as they are "made in the CEPA free trade area". Such a formula will make it easier for Hong Kong origin (or CEPA-origin) to be established, thus encouraging more operations to come back here. Without such combined calculation, fewer industries would benefit as not many may be able to have all the substantial production content to take place in Hong Kong.

27. Thus a free trade agreement coupled with a combined ROO regime could, through the interplay with China's tax system, encourage manufacturing industries to relocate back to Hong Kong. This will open up the Mainland's domestic market for Hong Kong industry, by creating a number of possibilities for Hong Kong manufacturers:

   i. *Restructuring the division of labour.* The combined ROO regime is especially important for products for which the import tariff is not a big item in the cost structure. For these products, the competitive advantage from zero tariff may well be offset by the high labour cost in Hong Kong. But if a combined ROO regime is in place, the labour-intensive components can be moved across the border, leaving only the high-value process in Hong Kong, with the final products still enjoying zero-tariff.

   ii. *Tax-exempting imported raw materials.* An added attraction from the combined ROO regime is the possibility of raw materials being exempt from import tax. According to the HKU study, 78% of the factories in China controlled by Hong Kong firms import some raw materials through Hong Kong. Of these, 15% transported nearly all (90-100%) of the raw material through Hong Kong port. In terms of overall content, 50% of raw materials were imported. With the ROO regime as proposed, the possibility is created of the final product being deemed "made in the CEPA free trade area" and hence tariff-free. There is thus an incentive for the manufacturer to consider undertaking some processes in Hong

Kong as the raw material passes through the SAR, since the Hong Kong content will be counted in the ROO for CEPA.

iii. *Sourcing raw materials from the Mainland.* Another implication of the combined ROO regime is that there will be an incentive for factories to source more raw materials from the Mainland. At present, only one third of the factories do. By sourcing from the Mainland, the likelihood of the final product being compliant with the "made-in-CEPA" ROO would increase, thus providing some further flexibility for the manufacturer. Since it is unlikely for all raw materials to come from the Mainland, Hong Kong could become the hub for raw materials from various sources to converge, thus creating more room for the manufacturers to move or retain, or develop new processes in Hong Kong. They can thus sharpen their competitive edge and concentrate on processes of a higher value-added content like design. Furthermore, the increase in sourcing of Mainland raw material can clearly be billed as a benefit for China.

iv. *Diversification and brand building.* With a combined ROO regime, manufacturers will have more freedom to restructure the production process to take advantage of zero tariff. Thus far the Mainland market is more oriented towards the general mass consumer, e.g. in general household goods and mass-appeal apparel. Zero tariff and combined ROO will enable manufacturers to build brands in Hong Kong for the Mainland market in the rapidly growing premium and luxury sectors.

v. *Flexible production processes.* Using the garment industry as example, Hong Kong's advantage lies in designer-label manufacturing, with fabrics being sourced from the outside. Zero tariff and combined ROO will provide an added incentive to source from China and elsewhere and concentrate on brand building in Hong Kong for high-end products. This means that the process of relocation to the Mainland will be slowed down. More positively, more employment will be created in design, research and development, and management. Hong Kong factory operations will shift to brand building, with a differentiation between products made solely in the Mainland and those "made in Hong Kong".

28. The implication of the combined ROO arrangement is that there may be some burden on the Hong Kong side in certifying origin of Hong Kong-made goods, and the Chamber must declare an interest as a certification agent. We believe, however, that the benefits from industrial relocation back to Hong Kong should far outweigh the additional work on Hong Kong in certifying origin.

Economic benefits of the free trade arrangement

29. According to the HKU study, 52% of all manufacturing and trading firms in Hong Kong have operations in the Mainland. Already these companies are employing a total of 477,000 workers in Hong Kong, i.e. 14% of labour force. The opening of the Mainland's internal market could potentially expand their operation and hence expand employment in Hong Kong. Such potential is independent of CEPA, but CEPA can surely facilitate it especially if a zero tariff and combined ROO regime can be put in place.

30. The precise economic effect of CEPA is difficult to estimate but there are industrialists who are confident that a suitably agreed CEPA could boost their businesses by up to 20-30%. An even more upbeat forecast is given by the jewellery industry which predicts a doubling of business, from the current $1 billion to $2 billion or more. At least 1,500 to 2,000 more jobs were anticipated for jewellery workers in addition to the current 5,000. Adding other white-collar jobs, total increase in employment will be more than 2,500 for the jewellery industry alone. This would be in addition to the increased tourism spending on jewellery, which is expected as Hong Kong becomes a centre of designer jewellery.

31. Increased activities in higher-end manufacturing could also mean a bigger pressure for importation of the necessary labour in some sectors. On the other hand, there will be many more jobs created from spin-offs in related service industries. The service industries that are likely to benefit include:

    i. *Traders.* Their business is to source materials from various places and then arrange their trade into or out of China through Hong Kong. Even though they do not engage in manufacturing themselves, they stand to benefit from the greater throughput of materials and finished products, as well as from the easing of border and customs procedures.

    ii. *Logistics.* According to statistics issued by Shenzhen, the "Processing Trade Export" amounted to US$25.2 billion in the first 10 months of 2002. It is believed 20-30% of this was based on semi-finished material imported for further processing in China, but not necessary through Hong Kong. Under CEPA, our improved logistics and trade services capabilities coupled with a freer border and customs administration, will create a good opportunity for Hong Kong to capture the import and re-export of these semi-finished parts. That could mean an additional throughput of up to HK$47 billion to HK$70 billion annually, even though these are not made-in-Hong Kong products.

Other related regulatory changes

32. Whatever the outcome of tariff and ROO arrangements, the administration of trade between Hong Kong and the Mainland should be made easier through CEPA. The CEPA negotiations should thus cover the related concerns of traders and manufacturers. The following are some of the regulatory issues which have been reflected to us:

    i. *Domestic distribution.* Obtaining the license for domestic distribution more easily is an oft-quoted issue. Jewellery manufacturers, for instance, can only sell to mainland companies licensed by the Bank of China for import/export, reprocessing and retailing of jewellery. If these licenses are also open to Hong Kong businesses, they can offer one-stop through service and hence expand business considerably.

    ii. *Import license.* Another concern that has been reflected to us is that of the requirement of import license for some categories of products, especially those that are technology oriented. If such licenses must be retained then the procedure should be simplified.

iii. *Product regulation.* Over-stringent regulations such as redundant testing has been named as a barrier for certain products. These should all be part of the CEPA negotiations.

Product exceptions

33. We consider that a zero-tariff free trade area would be relatively simple and straightforward to agree to. However, it is possible that China may have reservations over certain products of particular interest to the country, such as automobiles or some agricultural products. We suggest that these can be listed as specific exceptions to the CEPA treatment. Two approaches can be considered.

    i. *Exclusion.* The specific list of goods can be excluded from the zero-tariff arrangement. In other words, CEPA does not apply to these goods at all.

    ii. *Alternative ROO.* Alternatively, the goods may still be covered under CEPA but with a separate set of rules of origin, i.e. maintaining zero-tariff but increasing the ROO requirement to cover more principal processes or a bigger local content. Under this arrangement, it is assumed that the combined ROO calculation proposed by the Chamber still applies. An additional safeguard can be introduced by imposing an "anti-surge" mechanism into the CEPA.

Liberalisation of some services sectors

Consultation objectives

34. The CEPA Consultation on services is complicated and will take more time to produce results. To achieve agreement in the coming months, we maintain our view that the services package should be limited to a few modest liberalisation measures which are easy to achieve. This will help maintain momentum for the ongoing talks in the second, more difficult phase. Given the clear aim now to achieve agreement by June, we believe it useful to set out clearly the negotiating objectives.

    i. What we are looking for is, principally, early liberalisation of already committed market openings, to give Hong Kong enterprises a first-mover advantage.

    ii. Service sectors that are deemed sensitive by certain Chinese ministries can have a short period of early liberalisation versus a longer time advantage for non-sensitive service sectors.

    iii. If it was felt that even this modest package might be too difficult, one solution would be to limit it to Guangdong, particularly the Pearl River Delta, as an "experimental point" on a pilot basis. This will help boost our relationship with the Pearl River Delta, as well as enable a reasonable transition ultimately to the whole country.

35. The full range of services proposed for first-phase liberalisation have been detailed in the Chamber's submission last year. We shall highlight three sets of issues for the Hong Kong government to pursue in the current Consultation:

i. First, there is a cluster of related service sectors which we believe it realistic for agreement to be reached, namely, trading, retail and distribution, and exhibition and tourism.

ii. Second are some sectors for which agreement may not be so straightforward, but nevertheless we believe it still possible to address these in the first phase agreement. We would urge both sides to reach agreement on a best-effort basis.

iii. Likewise, the best efforts should be made to establish some agreement on a few across-the-board issues, such as transparency and regulatory reform.

The easy sectors

36. The trading, retail and distribution, and exhibition sectors share a number of similar characteristics:
- Firstly, they are less sensitive for China to open up.
- Secondly, they are all part of the wider "logistics" sector which is one of Hong Kong's pillar industries.
- Thirdly, many service providers in these industries are typically small and medium enterprises.

37. The importance of the trading and logistics sectors can be put in perspective by considering our trade figures with the Mainland.
- Currently this trade is valued at $1,200 billion – almost the same as Hong Kong's entire GDP (which is $1,280 billion).
- Of this $650 billion is import, $50 billion domestic export, and $500 billion re-export.
- In overall terms, trade with the Mainland has grown by 17% in the three years between 1998 and 2001 – and this was achieved without CEPA.
- With liberalisation in the trading and logistics sectors in the Mainland, Hong Kong's trade with China will no doubt be given an additional boost, to the tune of $12 billion more throughput for every one per cent increase.

38. *Trading rights.* China has already begun liberalisation in accordance with its commitments, with trading licenses beginning to be issued to minority-owned foreign trading firms.
- What Hong Kong seeks is the early application of the Mainland's commitments, to give Hong Kong traders full trading rights 18 months ahead of schedule.
- Currently, the liberalisation is undertaken through the introduction of new regulations for application of trading rights. Under the new regulations both *備案* (filing for record) and *審批*(examination and approval) systems are used for new applications. But foreign traders would prefer *備案* as the predominant mode, with *審批* limited to only the most sensitive items.
- There may be difference of perception over what items to be considered sensitive. This is precisely the type of issues that can be ironed out using Hong Kong as pilot.

39. *Retail and distribution.* The "easy sectors" are franchising, retail, storage and warehousing and freight forwarding.

- We propose that early liberalisation apply to these sectors, thus giving Hong Kong operators a time advantage of no more than a few years.
- Many administrative issues may arise in the course of implementing China's commitments. An example is that of a recent MOFTEC Circular on "Issues Relating to the Experimental Establishment of Foreign Invested Logistics Enterprises" (FILEs). The FILE as defined embodies a number of businesses in the trading and distribution sectors, and the some of the regulations stipulated in the Circular appear to differ from those provided in the schedule of commitments, thus giving rise to some concerns by China's trading partners. Had CEPA been in operation, the regulations could be legitimately included as part of the CEPA package on an experimental basis. This will give China flexibility while at the same time helping Hong Kong.

40. *Exhibition services.* Hong Kong's exhibition industry will be a beneficiary of expanding trade. Exhibition being a relatively non-sensitive sector, its liberalisation should not present too much problem for China, although it is not in China's schedule of commitment.
    - Hong Kong exhibition service providers should be given the same treatment which MOFTEC accords to their counterparts in the Mainland, both in terms of access to the market and in the licensing process.
    - Since exhibition is a "producer service" industry, the benefits of liberalisation applies not only to employment and business of the industry itself, but to the range of trade and logistics services it supports.

41. *Tourism.* Tourism is a sector where the benefits of liberalisation are highly visible, as evidenced by increasing flow of tourists between Hong Kong and the Mainland. CEPA can contribute to this in two ways:
    - By applying early liberalisation for Hong Kong travel agents and tour operators, in terms of geographical coverage, ownership and registered capital.
    - By permitting Hong Kong operators to organise tours for Mainland tourists to Hong Kong as well as other parts of the world.

Liberalisation of other sectors

42. In the Chamber's submission last year we put forward a number of liberalisation measures for Phase I of CEPA, such as opening up the legal examination to Hong Kong, allowing wholly-owned subsidiaries for some professional firms, early liberalisation for insurance services, more liberal movement of personnel for hotel training, etc. Even if the range of services is very diverse, we are hopeful that some results can be achieved, and we encourage the Hong Kong government to continue to pursue these with the Central Government on a best-effort basis. In light of the Transitional Review of China's WTO implementation, we would highlight two sectors of particular interest to us, namely, financial services and telecommunications.

43. *Financial services.* We appreciate the view of some of China's trading partners that the standard of prudential supervision imposed by the Mainland's regulatory authorities is often much higher than international norm, for example, an unusually high capital requirement. Through CEPA, such requirements could be lowered for Hong Kong operators. In particular:

- The asset requirement threshold for Hong Kong local banks should be lowered from US$20 billion to US$7.5 billion.
- Hong Kong local banks should be allowed to accept deposits in RMB and fund their Mainland branches.

44. *Telecommunications and information industries.* There are clear and reasonable requests which, if acceded to, will help strengthen Hong Kong as the centre for telecommunications services as well as film and entertainment.
    - We have asked that the definition of value added services be extended, for instance, to cover Internet Protocol virtual private networks (IP-VPN). This will enable multinationals to link global operations via seamless global networks.
    - More generous market opening is also sought for audio-visual services, specifically, an expansion of the 20-films quota.

Regulatory changes

45. For the service sectors there are many areas where new regulations will have to be drawn up and applied and it is only natural that implementation problems will surface. This is becoming a key concern of China's trading partners. Hong Kong being an advanced service economy, our service providers appreciate the regulatory concerns of China's trading partners; at the same time, we are the closest economic partner with the Mainland. Hong Kong is thus the best partner for the Mainland to test-run some of its regulatory changes through CEPA.

46. Some regulatory problems arise in the administration of licenses, for instance, the requirement for foreign express delivery providers to apply for entrustment from provincial governments, or for an "economic needs test" to be conducted by local governments before granting licenses for legal firms. Such regulatory measures arise in the course of China fulfilling its commitments, but questions arise as to whether they are undermining the commitments themselves. What is needed, again, is a partner – needless to say, Hong Kong through CEPA – who can act as a willing pilot.

Infrastructure cooperation

Growing demand for cross-border transport

47. The flow of people and cargo across the border is growing at tremendous pace:
    - The Hong Kong/mainland boundary is a very busy one by any standard. In terms of people movement, already the daily person-trips across the border exceeds 300,000, equivalent to 5% of the population. This figure could double in ten years time.
    - In terms of vehicles, according to Transport Department figures, more than 33,000 cross the border everyday. Of these the great majority (80%) are goods vehicles or container trucks. The daily capacity is now being upgraded at the crossings but even when it increases to the planned 42,500, demand will exceed capacity by 2006.

48. There is now much pent-up demand in cross-border transport, restrained either by administrative procedure at the border, or by lack of capacity. The solution to this demand lies in the integration of Hong Kong's infrastructure with that of the Pearl

River Delta. We commend the SAR government for the rapid progress it made in recent years – witnessed the Shenzhen Western Corridor, the recent positive developments in the bridge link to Macau and Zhuhai, and the plan for a high-speed link to Guangzhou. The Chief Executive's recent Policy Address has given another boost to Hong Kong/Guangdong cooperation in transport. The CEPA provides an excellent medium to formalise this cooperation.

Transport and infrastructure coordination

49. Cooperation in transport planning and construction is a best example of "closer economic partnership". We propose that a number of infrastructure cooperation can be put into the CEPA framework, including the Shenzhen Western Corridor, the bridge to Macau and Zhuhai, freight rail lines, and port cooperation.

    i. *Shenzhen Western Corridor.* When completed by 2006, the bridge to Shekou will provide an additional capacity of 28,000 vehicles per day. Other than providing relief to the near-capacity crossings, it will bring economic benefits to Hong Kong of the order of $175 billion over 20 years, or an increase of 0.5% to Hong Kong's GDP every year. This is closer economic partnership in action, and should be reflected in CEPA.

    ii. *Bridge across the PRD.* We support the concept of the bridge to the Western part of the Pearl River Delta. The feasibility and various impact studies should be conducted promptly, with a view to implementing the project. While we believe a crossing to both Zhuhai and Macau would be reasonable, at this stage we draw no conclusions on detailed arrangements such as alignment options. Subject to the findings of the strategic and policy studies currently undertaken by State Development Planning Commission, we believe a few key parameters can be specified in the CEPA, so as to provide the basis for ongoing work of this major project.

    iii. *Railways links.* We welcome more through trains between Hong Kong and Guangzhou, which can be put into practice relatively easily. More importantly, for the medium term we urge planning for the Port Rail Line of West Rail to be speeded up. The opening up of trade and distribution in the Mainland, and the modernisation of the logistics sectors are likely to combine to boost demand for rail-based freight transport in the Mainland, hence there might be a need to bring the Port Rail Line forward. Strategic planning for the longer term also needs to begin now, such as the possibility of an "outer western corridor" link to Shekou. Again, CEPA can help establish a firmer basis for closer cooperation in railway planning.

    iv. *Port cooperation.* China's WTO market openings will result in more freight throughput, hence an increase in transshipment, river trade and rail-based cargo trade. This means there would be more interaction between Hong Kong traders and port operations, both with ocean ports like Huangpu, Ma Wan and Chi Wan, Yantian, Shekou and Gaolan, as well as river ports such as Huangtian, Humen, Nansha and Panyu. This is especially so for ports of the Western part of the PRD, traditionally the river trade catchment area, which has a big potential for growth in anticipation of more nearby crossings and linkages.

Trade and investment facilitation

50. The benefits of trade and investment facilitation, like "more efficient procedures", is difficult to quantify, yet they can be easily visible and are well appreciated by the general public. The immediate benefits brought by the recent implementation of 24-hour crossing at Lok Ma Chau is a case in point. There are many other areas of trade and investment facilitation which can bring real and immediate benefits to the business community at a practical level, and a formal statement of trade and investment facilitation in CEPA will naturally help strengthen these efforts. Some examples are as follows.

    i. *Convenience.* For many business people, a priority issue is not long-term liberalisation but the day-to-day problems of health, security, information, transport, etc. in the Mainland. Even if there are to be no changes "in the system", CEPA can help by creating an environment which makes things work more conveniently for Hong Kong people.

    ii. *Access to government.* For business people in particular, CEPA can help by encouraging more convenient and business-friendly access to Mainland government and regulatory offices, i.e. Hong Kong people can get priority access, or at least more attention, much like the concept of an "APEC desk" for APEC member economies.

    iii. *Helping business.* Hong Kong government has its own Efficiency Unit and Helping Business Programme. The SAR can explore with the Mainland with a view to extending a similar concept to benefit both Hong Kong and Mainland users of government services.

    iv. *Transparency.* The Mainland has committed to greater transparency of Mainland rules and regulations, but in implementation the typical Hong Kong SME still encounters an information barrier, since they are not as well-resourced as their multinational counterparts in making use of the information. Some form of processing to add value to the public information issued by the Mainland, will be useful for Hong Kong people. This can be a form of business facilitation which CEPA can cover.

    v. *Promotion.* Hong Kong and the Mainland can jointly promote trade to, and investment from, the outside. They are already doing that but CEPA can provide a further boost.

    vi. *24-hour crossing.* CEPA can also facilitate the further rationalisation and streamlining of boundary and customs procedures, including extension of 24-hour boundary crossing to other border points.

51. *HK/PRD integration.* An important effect of CEPA's trade and investment facilitation would be to contribute to the integration between Hong Kong and the Pearl River Delta. Although CEPA is not limited to any geographic region in the Mainland, by virtue of the PRD's proximity to Hong Kong, it cannot help but become the most intimate partner of Hong Kong in terms of closer economic partnership with the Mainland. In

addition, HK/PRD integration can be given a further boost if, through CEPA, a closer relationship with Guangdong can be established as a pilot arrangement under a regional trade agreement. This is also consistent with the SAR's broad economic policy for Hong Kong, as clearly elucidated by Mr CH Tung's recent Policy Address.

V. Definition of a Hong Kong Company

52. This has emerged as one of the most contentious regulatory matter and it has been dealt with at length in the Chamber's earlier submission.

53. For goods, how to determine country of origin has been well-established, with accepted criteria in use. But for services, "nationality" of companies comes into play. Therefore, a difficult issue that arises in the China-Hong Kong CEPA Consultation is the definition of Hong Kong companies since our CEPA should address services sector liberalisation to a large degree. The dilemma is that a narrow definition may undermine Hong Kong's reputation as an international city, while a definition which is too wide may open a back door for a large number of foreign companies to gain earlier than expected access to China.

54. The Chamber has always believed that any CEPA definition of "Hong Kong company" must take into account Hong Kong's international character and be in accordance with WTO. Any company, including foreign, which contributes to the local economy with substantive business here, should be able to qualify.

55. The WTO recognises that the determination of "origin" of service is difficult. GATS Article V provides for non-RTA member companies to be given the same treatment if they have "substantive business", but that only shifts the difficulty to determining what "substantive business" is. There are no rules to follow although the WTO itself recognises some common-sense criteria, such as place of incorporation, nationality of ownership, headquarter location or principal place of business. In practice, incorporation for tax purpose, diffuse international ownership of publicly traded enterprises, multinationals and joint ventures etc. all make it very difficult to determine nationality. "National law" ends up to be referenced in some of the RTAs.

56. Whatever definition is adopted, it is important that the WTO provisions are complied with. To be consistent with GATS Article V, any criteria used to define Hong Kong companies should be so applied for the purpose of CEPA only, in a non-discriminatory manner, and not as a "nationality test". In other words, we would not be setting a new legal definition of what a Hong Kong company is, but merely determining a company's eligibility to be qualified as a "Hong Kong company for the purpose of CEPA". What this means is that all companies, irrespective of claimed nationality, will be subject to the same eligibility criteria for "Hong Kong company" adopted in CEPA.

57. In our early consultation with our members, we have identified a number of factors that have been raised as possible criteria for what constitutes a "Hong Kong company." Broadly, these criteria can be divided into four groups: those based on legal definition; those based on ownership and control, with legal backing in Hong Kong permanent residents; objective but arbitrary criteria, based on the substantiality of the business in Hong Kong; and qualitative and more subjective criteria.

58. We are very pleased that with the open-minded attitude adopted by the government and the business community. There now appears to be more consensus than disagreements on the way forward. The view championed by the Chamber, which we believe is emerging as a consensus, is that a balance needs to be struck between meaningful liberalisation and broad coverage to include foreign companies with substantive business in Hong Kong. This can best be achieved through a focused sectoral approach in defining eligibility, in compliance with WTO rules.

59. The Chamber recommends that operating eligibility criteria be devised for individual service sectors. This is to bypass the “nationality” definition, by turning these “nationality criteria” into more specific, sector-by-sector qualifications. That is, instead of determining whether a company is a “Hong Kong company”, the question becomes whether a company meets the qualifications and requirements specified in the CEPA for that specific sector, thus making it eligible to enjoy the benefits of the CEPA.

60. By adopting this approach, the problem of “Hong Kong company” is shifted from one of legal definition to that of regulatory implementation by China. What this will do is to provide flexibility, by enabling eligibility to be determined from sector to sector.

61. The advantage of this option is that China will feel much more comfortable as the gate-keeping role will remain in their hands. It could, if it chooses, have the liberty to use the CEPA to create a back door deliberately for certain industries, by specifying it in its market access commitment. There will be no pressure to change Hong Kong laws, and no requirement on Hong Kong government to determine nationality of companies.

62. There may be some disadvantage in that the option may be more complicated, but it will give China more control over eligibility by sector, and is certainly an option to be explored.

63. In conclusion, we believe the problem of Hong Kong company definition is by no means insurmountable. Some formula can be found which can benefit sufficient companies here but yet not open a huge unintended back door for China. If handled correctly, this will have the effect of boosting investment and expansion of business—including more employment—in Hong Kong by eligible companies.

64. Finally, even with the best endeavours, some company may be left out who are going to be unhappy. What these companies should realise is that most of the China liberalisation are soon to be available to everyone, and the growth of the Hong Kong economy will be beneficial to all who operate here.

VI. Mutual benefits

65. In the foregoing paragraphs we have outlined CEPA’s substantive benefits for Hong Kong. But CEPA would benefit Mainland China as well. It will help China adjust to the challenges of WTO implementation, through capacity building, pilot-testing market openings, and gaining regulatory experience.

66. *Transitional Review Mechanism.* The benefits for China are particularly relevant in the context of the Transitional Review Mechanism on China's WTO implementation, which is ongoing. The current indication is that the WTO is generally content that satisfactory progress in implementation has been made. Even the US, the most vociferous critic of China's trade regime, has given China credit although it has also, predictably, highlighted problems in agriculture and services. The US high-tech industry, for instance, has described China's implementation of WTO commitments as "a net positive and moving in the right direction" (submission of the Beijing-based US Information Technology Office to USTR.) Nevertheless, a lot of issues still remain, and CEPA provides the mechanism for China to address these issues without acceding to them in the multilateral context until it is ready.

   i. *Industrial goods.* China's tariff reduction has largely been implemented. However, there is a concern that an end-user certificate on import is required for a number of products, which is regarded as a trade barrier, e.g. 15 IT products listed by the Ministry of Information Industry and the Ministry of Finance. ("Some Information Technology Products Certification Temporary Methods", January 2002.).

   ii. *Service sector regulation.* Good progress has been made in transparency of regulations, a major concern of China's trading partners. Even the US private sector is generally satisfied, although they have observed that the commitment to allow reasonable periods of comment before implementation of new regulations is not always complied with. A wish has also been expressed of China extending the transparency commitments to regulatory processes outside of WTO commitments – which China has not committed to. All these indicate that the concern over regulations has now gone beyond transparency to the *quality* of regulations. There are two such concerns, firstly, that the regulations do not fulfil China's commitments even though they are transparent; secondly, that they are confusing, vague and allow excessive bureaucratic discretion.

   iii. *New concessions.* In the course of the Transitional Review Mechanism, there will be increasing pressure for further concessions from China in areas which it has not committed. In government procurement, for instance, China has agreed to begin negotiations within two years of accession while making no specific commitments. Involving Hong Kong through the CEPA will help China maintain its cautious position while at the same time exploring possible avenues for liberalisation to the country's benefit.

67. *Institutional change.* A recurrent theme for China in WTO implementation is that of institutional change. The USCSI has suggested, among other things, the creation of an entity of the State Council that would possess the authority to ensure compliance. Obviously, many careful considerations are needed in making any such major structural changes. A CEPA with Hong Kong will enable China to focus more clearly on possible ramifications of various compliance problems and thus help MOFTEC and other ministries develop solutions to the wider issue of institutional change.

68. *Doha Round.* It is not clear yet what role China is prepared to play in the Doha Development Agenda; what is clear is that there is increasing expectation from its trading partners that China take on a more active role. CEPA will open an avenue for

China to use Hong Kong companies as test entries to prepare it for possible further concessions for the Doha Round of negotiations.

69. *Free trade with ASEAN.* Experience gained from CEPA will help China negotiate similar trade arrangements with the ASEAN countries. The same applies to Hong Kong, which can seek to develop a new economic relationship with ASEAN countries in future.

70. *Specific benefits.* Besides the "macro" benefits, CEPA will also bring specific benefits to China, as outlined in the Chamber's earlier submission. Among them is an increase in foreign direct investment, especially from SMEs in the service sector. There is also the opportunity for more export to third countries, as well as greater access for China's own service sectors in professional and business services, education, culture, entertainment, and aviation and related industries.

VII. Conclusion

71. The Chamber is confident that CEPA will turn out to be a win-win arrangement. But given the short time frame, we realise that a lot of dedicated effort is required from both sides. Once again, timing is of the essence, and we believe that a good agreement before June is achievable. We wish to emphasise that the SAR government has the solid backing of the business sector in the CEPA Consultation.