CEPA : Hong Kong's new horizon in the China Market

(A special article written by Andrew K.P. Leung, Director-General, London, of the Hong Kong Special Administrative Government, for the China Britain Business Council, July, 2003)

Introduction

As Hong Kong is rebounding from SARS after being lifted from the WHO list of affected areas, a new vista of business opportunities has been unveiled with the signing of a historic Closer Economic Partnership Agreement (CEPA) between the Hong Kong Special Administrative Region and the Central People's Government on 29 June, 2003.

Main components

Consistent with the rules of the World Trade Organisation (WTO), of which Hong Kong and Mainland China are separate members, the agreement provides for greater and earlier liberalisation in the following areas(*):

(a) Exports in some 270 Mainland product codes of **goods of Hong Kong origin**, covering some 90% by value of Hong Kong's exports to the Mainland, will enjoy zero tariff treatment as from 1 January, 2004 while goods in other product codes meeting the origin criteria will be able to do so as from 1 January, 2006. These include electrical and electronic products, plastic articles, paper articles, textiles and clothing, chemical products, pharmaceutical products, clocks and watches, jewellery, cosmetics, metal products etc;

(b) A range of **services provided by Hong Kong companies** in 17 service sectors will enjoy earlier liberalised access to the Mainland market as from 1January, 2004. These include accounting, advertising, audiovisual, banking, convention, distribution, insurance, legal, logistical, management consulting, medical and dental, real estate and construction, securities, and tourism services;

(c) Both sides agree to promote cooperation and **facilitation** in the following areas:

(i) Custom clearance;
(ii) Quarantine and inspection, quality assurance and food safety;
(iii) Small and medium-sized enterprises;
(iv) Chinese medicine and medical products;
(v) E-commerce
(vi) Trade and investment promotion;
(vii) Transparency in law and regulations

Although the initial list of goods contains some 270 product codes, no product is automatically 'carved out'. Both sides have also agreed to pursue **further liberalisation** in services through consultations.

Qualifying criteria

To qualify for CEPA treatment, goods must satisfy certain **Origin Rules,** which are likely to take into account such factors as specified processes, change of tariff content, and local content. These rules are to be finalised by both sides before the end of 2003.

Care has been taken not to exclude foreign companies under the **definition of Hong Kong Companies**. The definition has no regard to nationality, ownership or shareholding structure. However, care has also been taken to avoid CEPA being used as the 'backdoor' to bypass China's WTO concessions. So to qualify a company must have substantive business operations in Hong Kong on the basis of

(a) its incorporation under the laws of Hong Kong;
(b) its payment of Hong Kong profits tax or legal exemption therefrom;
(c) its length of substantive operations in Hong Kong;
(d) its scope and nature of business;
(e) the proportion of staff employed in Hong Kong.

There are some variations as regards different service sectors. The definition would **exclude** representative offices or branches of companies not incorporated in Hong Kong as well as 'shell' or 'post-box' companies.

Some selected sectoral features

As regards **distribution** services,

(a) Hong Kong enterprises are permitted to supply commission agents' services and wholesale trade services in the Mainland on a wholly-owned basis without any geographic restrictions.

(b) Hong Kong investors are permitted to establish wholly-owned retail commercial enterprises in the Mainland, including the sale of motor vehicles (up to 30 chain outlets).

(c) Hong Kong permanent residents with Chinese citizenship are permitted to set up in Guangdong individually owned retailed stores (not exceeding 300 square metres in area) without prior approval applicable to foreign investments.

As regards **tourism**, the Mainland will allow residents in Guangdong to visit Hong Kong as individuals. This is to be implemented on a trial basis first in Dongguan, Zhongshan and Jiangmen, to be extended to the whole Province not later than 1 July 2004. The two sides will also strengthen cooperation in tourism promotion, including programmes centred around the Pearl River Delta.

As regards **audiovisual services**,

(a) Hong Kong companies are permitted to establish in the Mainland joint ventures with majority ownership (up to 70%) to engage in the distribution of audiovisual products, including motion pictures.

(b) Chinese language motion picture products by Hong Kong companies are permitted to be imported for distribution in the Mainland without any quota restrictions after approval by the relevant Mainland authorities.

(c) Motion pictures produced jointly by Hong Kong and the Mainland are to be treated as Mainland movies for distribution in the Mainland.

(d) Hong Kong companies are also permitted to construct and/or renovate cinema theatres on a joint venture or co-operation basis, and majority ownership by Hong Kong companies is allowed.

As regards **financial services**, the Mainland has agreed to support

(a) state-owned commercial banks and certain shareholding commercial banks in relocating their international treasury and foreign exchange trading centres to Hong Kong;

(b) the development of network and business activities in Hong Kong through acquisition;

(c) the full utilization of financial intermediaries in Hong Kong during the process of reform, re-structuring and development of the financial sector in the Mainland; and

(d) The listing of Mainland insurance and other companies in Hong Kong.

As regards **banking** services,

(a) the asset requirement for both Hong Kong banks and finance companies wishing to enter the Mainland market is reduced to US$ 6 billion. Banks can choose to set up branches or body corporates, while finance companies can only set up the latter.

(b) The requirement for conducting RMB business by Mainland branches of Hong Kong banks is lowered as follows:

(i) The minimum requirement of prior business operation in the Mainland is reduced from 3 years to 2 years.
(ii) Profitability assessment is made on the basis of the overall position of all branches instead of individual branches.

As for **insurance** services, groups formed by Hong Kong insurance companies through strategic mergers are permitted to enter the Mainland insurance market subject to established market access conditions.

An Assessment

The average import tariff of existing Hong Kong domestic exports of **goods** to the Mainland is about 11%, but some are currently subject to higher tariffs e.g. jewellery (35%), micro-motors for toys (24.5%) and clocks and watches (23%). Given the substantial cost differentials between the Mainland and Hong Kong, CEPA is unlikely to result in relocation of the majority of manufacturing processes from the Mainland to Hong Kong. Nor is it going to work magic in boosting Hong Kong's employment. It would, nevertheless, be attractive to manufacture in Hong Kong those **higher tariff products** as well as those with higher value added or substantial **intellectual property** input, e.g. high-end brandnames

On the **services** front, however, while CEPA is unlikely to dramatically transform the Hong Kong economy overnight, the liberalisation framework would provide a new dynamic platform with which to gain easier and earlier access to the relevant sectors in the fast growing Mainland market, both for Hong Kong companies and foreign partners alike.

Mega trends in the Mainland Market

The vastness and dynamism of this market can only be partially glimpsed in consideration of the following 'mega trends':

(a) China has become the **Factory of the World**, accounting for half the world's cameras and photocopiers, a third of the world's air-conditioners, and a quarter of the world's refrigerators. It has overtaken Japan as the second global electronics manufacturing superpower with an IT hardware output rising to US$35 billion this year, riding increasingly on the synergy created with Taiwanese electronics investments. China has already overtaken France as the world's 4th largest manufacturing exporter. Much of this manufacturing is in the Pearl River Delta where Hong Kong is involved in the management and operation of some 90% of the factories with 11 million workers, and accounts for

70% of the Foreign Direct Investment as well as 70% of the exports of goods.

(b) A fast growing **critical mass of 'middle-class' consumers** has sprung up in the Pearl River Delta, the Yangtze River Delta (including Shanghai and its neighbouring provinces) as well as the coastal areas. Though only about one sixth of China's population, it already comprises over 200 million people, whose lifestyle and consumer habits have become more urbanised and westernised. This is evident from the inroads of, e.g. Starbucks, Ikea furniture, chain stores like Carrefour and B & Q, and the recent dramatic growth of demand for private cars, which is supported by the expansion of motorways from some 500 km 12 years ago to some 25,000 km now. Hong Kong businesses and operatives are heavily involved in this growing consumer market, estimated at over US $560 billion and growing at 10% p.a.

(c) A number of gigantic **infrastructural projects** have been launched in China, including the Three Gorges Dam, the Water Diversion Project linking the Yangtze with the Yellow River, the gas and electricity pipe-lines linking the West with the Easter region, and the Tsinghai-Tibet Railway. Coupled with the infrastructural requirements of the Beijing Olympics in 2008 and the Shanghai World Expo in 2010, a great deal of business opportunities will be created for international input in terms of technical, engineering, management, financial and other expertise. Hong Kong, as an international business hub, is well poised to leverage them.

(d) As China is increasingly linked with the global economy following its entry to WTO, its **outward investment** has been growing in such sectors as energy, minerals, and retail network. Again, Hong Kong as a leading financial centre is well placed to take advantage of this development.

New Horizon with CEPA

With new political imperatives to build an all-rounded 'well-off' society for the people, China is addressing its many challenges including the problems of State Owned Enterprises, non-performing loans, the need for financial reforms, corporate governance, fighting corruption, developmental polarisation and the need for sustained rapid economic growth to absorb unemployment. The above mega trends are solid grounds for optimism.

Hong Kong has long been playing a vital role in the development of the China market, accounting for 47% of the total Foreign Direct Investment and some 90% of the total syndicated loans for the whole of Mainland China. Notwithstanding Hong Kong's own many challenges, CEPA as a new and powerful springboard will unfold new horizons in this exciting growth market of the 21st century for Hong Kong's legendary spirit of enterprise.

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(*)This article contains my own selection of some of the features of CEPA and is by no means comprehensive. Please visit the website www.tid.gov.hk/english/cepa/. for more information.