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CHINESE OUTWARD INVESTMENT IN HONG KONG: TRENDS, PROSPECTS AND POLICY IMPLICATIONS

by

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RÉSUMÉ

Depuis une dizaine d'années, la Chine est le premier investisseur parmi les pays en développement, et Hong Kong la première destination des investissements chinois. Toutefois, en raison de la sous-déclaration liée à la fraude du contrôle des changes, les statistiques officielles sous-estiment largement les flux d'investissement extérieur de la Chine. Ce document technique tente d'évaluer le montant de ces flux d'investissement et d'en décrire la nature.

Il recense les nombreuses estimations des investissements chinois vers Hong Kong, en identifiant leurs sources, ainsi que les informations sur lesquelles elles sont fondées. Il apparaît que la plupart de ces estimations sont des approximations grossières, établies sur la base de données très incomplètes. Néanmoins, il est possible d'évaluer le niveau de ces investissements d'après la valeur des actifs des entreprises chinoises à Hong Kong et leur capitalisation boursière, ainsi que sur la base d'entretiens avec des interlocuteurs informés. De plus, ce document évalue le poids des entreprises chinoises dans l'économie de Hong Kong. Il analyse la répartition de leurs investissements par secteur et selon la nature des investisseurs (ministères centraux, gouvernements locaux ou provinciaux, organismes militaires). Enfin, il analyse les déterminants économiques et politiques des flux d'investissement de la Chine vers Hong Kong, et présente des conclusions de politique économique pour les deux économies.

SUMMARY

Over the last decade, China has been the leading investor among developing countries and Hong Kong is the foremost destination of Chinese investment. However, China's outward investment has been grossly understated in official statistics due to avoidance of China's foreign exchange controls. This paper tries to appraise those investment flows both quantitatively and qualitatively.

It examines the many estimates of Chinese investment in Hong Kong, tracing their sources and bases of estimation. Most of these estimates are found to be crude guesses with very little empirical support. However, from the data on asset value and market capitalisation of listed Chinese companies in Hong Kong, and also from interviews with knowledgeable sources, it is possible to gauge the rough size of Chinese investment in Hong Kong. The paper also examines China's economic presence in major sectors of the Hong Kong economy. It discusses the composition of Chinese investment by industry and by ownership (central ministries, provincial and local governments, and military-backed). The economic and political determinants of China's investment in Hong Kong are analysed, and the policy implications for Hong Kong and China are examined.

PREFACE

While China has attracted much public attention as a host of foreign direct investment, less attention has been given to the fact that China has been the leading foreign investor among developing countries. There are few studies available on this topic and this paper is intended to fill the gap by focusing on an analysis of recent trends in China's outward investment in Hong Kong, by far the most important destination of Chinese investment abroad. The author shows that several earlier estimates of the size of Chinese investment in Hong Kong are grossly underestimated. The main thrust of his argument is that direct investment in Hong Kong has been an important component of China's open-economy reforms, and at the same time it has made a significant contribution to the prosperity and stability of Hong Kong.

This paper by Professor Yun-Wing Sung provides a detailed analysis of China's outward investment in Hong Kong and presents an insight into the growing interdependence of what is soon to be "two economic systems in one country". Professor Sung is Chairman of the Economics Department, and Co-Director of the Hong Kong and Asia-Pacific Economies Research Programme, at the Chinese University of Hong Kong. Prepared under the theme of "Reform and Growth of Large Developing Countries", the paper makes an important contribution to the Centre's ongoing research on China.

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I. INTRODUCTION

In recent years, China has been the largest investor among LDCs and Hong Kong has been the number one destination of Chinese outward investment. As Hong Kong is China's window to the outside world, the concentration of China's outward investment in Hong Kong is to be expected. While Hong Kong has been the number one investor in China since the inauguration of China's open policy in 1979, consistently accounting for roughly 60 per cent of the foreign investment in China, Chinese investment in Hong Kong had been less notable, as China was short of capital. However, rapid economic development in China changed the picture. Though exact figures are not available, it is commonly reckoned that China surpassed the United States and Japan to become the largest investor in Hong Kong in the early 1990s. Presently, Chinese investment in Hong Kong is well over US$20 billion. The intense investment between China and Hong Kong ties the two economies together and also links the Chinese economy to the world economy. While there have been many studies of inward foreign investment in China, especially that from Hong Kong, there have been few studies of Chinese outward investment in Hong Kong. This paper represents an effort to fill the gap.

Chinese investment in Hong Kong was significant even before the establishment of the People's Republic in 1949, as Hong Kong had historically been the port of South China. The Maoist era of 1949 to 1976 largely coincided with that of the cold war. During this period, China was isolated, and the value of Hong Kong as China's 'window to the world' was thereby enhanced. In the Maoist era, the economic ties linking China and Hong Kong were strong, but the relationship was asymmetric. Hong Kong was open to China's export and investment, and Hong Kong residents were able to visit their relatives on the Mainland, but reverse flows were barred. From the mid 1960s until 1977, Hong Kong consumed around one-sixth of China's exports and re-exported another 4 per cent of China's exports to third countries. In total, Hong Kong accounted for over one-fifth of China's exports (Sung 1991: 19). Hong Kong exports to China (including re-exports of third country goods to China) were negligible during the period. China thus ran a huge trade surplus with Hong Kong, amounting to one-fifth of China's total exports, and China used the hard currency thus earned to finance its imports of grain, industrial raw materials and capital goods from developed countries. China also earned substantial amounts of foreign exchange from remittances and tourist expenditure of Hong Kong residents, and investment earnings from Hong Kong (Jao 1983: 41 - 49). Jao (1983:58) estimated that China's net foreign exchange earnings from Hong Kong ranged between US$2.7 billion and US$6.9 billion from 1977 to 1980, or around 30 per cent of China's total current account foreign exchange earnings.

During the Maoist era, though China's investment in Hong Kong was substantial, Chinese investment strategy was conservative. China's business interests in Hong Kong were traditionally represented by four large conglomerates, namely the Bank of China and its 12 sister banks (BOC Group), China Resources Company, China

Merchants Company and China Travel Service. The BOC Group confined themselves to China-related banking business such as trade financing and handling remittances. The BOC Group largely refrained from lending to local businesses, including in the lucrative and dynamic real estate sector. The China Resources Company controlled by China's Ministry of Foreign Trade served as the sole agent of China's exports to Hong Kong. The China Merchants Company controlled by the Ministry of Communications was mainly engaged in shipping China-related trade. China Travel Service under the control of the Overseas Chinese Affairs Office was China's largest travel agency operating outside China. It handled overseas visitors as well as shipping, warehousing, and handling of cargo. In a nutshell, China's investments in Hong Kong were designed to handle, transport, and finance China's exports to Hong Kong, and also to handle remittances and visitors. As a result of the bureaucratic control from Beijing, they were ill-equipped to take advantage of local business opportunities, and they rarely did. Given the pattern of China's economic relationship with Hong Kong, that is hardly surprising.

In the open-door era since 1979, China's economic relations with Hong Kong became more multi-faceted and balanced. China welcomed foreign loans and investment, and Hong Kong manufacturers of labour-intensive, export-oriented products relocated to China in droves. This boosted Hong Kong-China trade, especially Hong Kong's re-exports. Hong Kong's traditional role as China's entrepot also re-emerged as a result of the decentralisation of China's foreign trade. Decentralisation vastly increased the number of trading partners and raised the cost of searching for a suiTable trade partner. Intermediation emerged to economise on the cost of search, and this demand for intermediation was channelled to Hong Kong due to its efficiency in trading (Sung 1991: 28-43). Though China has established many more direct links with the outside world in the open-door era, the share of China's foreign trade handled via Hong Kong rose sharply, and Hong Kong's importance as China's gateway increased. The impact of decentralising China's foreign trade system has overwhelmed the effect of the increase in China's direct external links (Sung 1991: 28-43). From 1979 to 1994, the share in China's total exports of Hong Kong's re-exports of Chinese goods to third countries rose from 6.6 per cent to 45 per cent, and the share in China's total imports of Hong Kong's re-exports of third country goods to China rose from 1.7 per cent to 36 per cent.

In the open-door era, the previously one-sided flows of foreign exchange earnings from Hong Kong to China in the form of Chinese exports to Hong Kong, investment earnings from Hong Kong, and expenditure of Hong Kong visitors were increasingly balanced by the reverse flows of Hong Kong exports to China, Hong Kong's investment earnings from China, and expenditure of Chinese visitors in Hong Kong. The reverse flows again strengthened Hong Kong's role as China's gateway. With decentralisation and marketization of China's economy, provincial and local authorities swarmed to Hong Kong. China's investment in Hong Kong thus soared in the open-door era.

II. CHINESE INVESTMENT IN HONG KONG: AN APPRAISAL

Estimates of Chinese Investment

There are no accurate estimates of Chinese investment in Hong Kong. The Hong Kong government does not keep records of capital movements and such movements are entirely free. The government has surveyed external investment in manufacturing annually since 1984, but the first survey of external investment in non-manufacturing sectors was not held until 1994, and the results had not been published by the end of 1995. Due to the very rapid decline of manufacturing in Hong Kong and the rapid expansion of the service sectors, external investment in manufacturing would constitute only a small part of the total.

Figures on external investment in Hong Kong can be obtained from source countries, and Japan and the United States respectively were the first and second most important investors in Hong Kong in the 1980s. China does not have accurate statistics on its investment in Hong Kong because a large number of enterprises and provincial and local authorities have established unofficial companies in Hong Kong through evading foreign exchange and investment controls. To take advantage of Hong Kong's position as China's gateway, Chinese trading corporations representing various ministries, provinces, cities, counties, and villages swarmed to Hong Kong in the open-door era. While the number of Chinese companies that have received official approval to operate in Hong Kong was slightly over one thousand (Liu, 1994:39), and the number was quite sTable from 1989 onwards, the total number of Chinese companies in Hong Kong was estimated to be around 14,000 by the end of 1993 (Ni, 1994:4). A popular form of unofficial representation is joint-venture with Hong Kong traders. Since such firms are nominally operated by Hong Kong traders, Beijing has no formal control over them. Counties and villages in Guangdong have been encouraging people who have relatives in Hong Kong to emigrate and to promote exports, and some of them operate as one-person operations after their arrival in Hong Kong. One Hong Kong trader reported to the author in 1984 that, within a few days, he had come across seven 'one-person operators' claiming to represent various local governments.

It should be stressed that some unofficial Chinese companies in Hong Kong can be quite large. For instance, Wing Shan International had a market capitalisation of HK $51 million at the end of 1994 (Ni 1994: 20). This company has widely been reported to belong to Foshan City, a prosperous City in the Pearl River Delta, though the company has consistently denied that it is linked formally to the Foshan Government. However the mayor of Foshan inadvertently admitted to the author in an interview in 1992 that Wing Shan was a company of the Foshan Government.

It is evident that there can be no accurate estimate of the number of Chinese companies in Hong Kong, let alone their investment. Though the Hong Kong Chinese Enterprises Association was formed on March 1991 with official encouragement to co-ordinate the activities of Chinese companies in Hong Kong, its corporate membership was slightly less than a thousand, which implied that unofficial Chinese companies did not join the Association. As will be detailed later, even the New China News Agency (NCNA), China's de facto embassy in Hong Kong, does not know the number of Chinese companies in Hong Kong. However, various estimates of China's investment in Hong Kong have been widely quoted in the press of Hong Kong and China. The most often quoted figures were US$10 billion of Chinese investment in Hong Kong at the end of 1989, and US$20 billion at the end of 1992. The bases of such estimates are very flimsy. Unfortunately, Hong Kong government officials have strengthened the credibility of such estimates by using them in public speeches.

Tales of Guestimation

Due to the popularity of such estimates, tracing their source and basis of estimation often ends with amusing results. The typical pattern is that a 'guestimate' of a Hong Kong researcher first gets reported in the Hong Kong press and later in the Chinese press. Hong Kong newspapers, researchers, government officials then quoted from the Chinese press, tending to emphasise the reliability of the estimate since it appeared in the Chinese press!

The first guestimate of US$10 billion was given by Mr. Yang Zhenhan, head of the Southeast Economic Information Centre, an economic research and information agency established by the NCNA in Hong Kong. The estimate allegedly was derived from figures of the value of assets owned by Chinese companies in Hong Kong. To derive an estimate of cumulative investment from asset values, a certain time path of investment and rate of return must be assumed. The details of the assumptions used and the value of assets owned were not revealed. The fact that the foremost economic research centre established by the NCNA has to guestimate the value of Chinese investment in Hong Kong by such a crude procedure was an indication that China did not know the amount of Chinese investment in Hong Kong. The guestimate was widely reported in the Hong Kong press and later reported in China's Economic Daily in August 1990.

The second guestimate of US$20 billion appeared to originate from the Hong Kong Bank, according to Mr. Chan Kwok-kei, former Chief Economist of the Bank. While the first guestimate referred to the value of cumulative investment, the second guestimate referred to assets owned by Chinese companies in Hong Kong. Assets owned usually exceed cumulative investment by a substantial margin because of appreciation. The two guestimates thus did not imply a doubling of Chinese investment since 1989. The second guestimate was reported in the Hong Kong press, and also used by Mr. Xiangnan, former Party Secretary of the Fujian Province, in a speech given in a seminar in Hong Kong on February 8, 1993. The news was carried by the NCNA and was reported in *The China Daily* and *The Hebei Economic Daily* in China on February 10, 1993. While Mr. Xiangnan was explicit that the estimate referred to value of assets owned by Chinese companies in Hong Kong[1], *The Hebei Economic Daily* reported misleadingly that "Mainland investment in Hong Kong and Macau in 1992 was over US$20 billion". On February 12 1993, the *Hong Kong Standard* quoted the Chinese press, asserting that "China has nearly doubled its investment in the Hong Kong-Macau region, according to two mainland reports"! Few people were aware that both "mainland reports" (reports by the *Economic Daily* in 1990, and by *The China Daily* in 1993) first originated in Hong Kong.

Hong Kong government officials also used the US$20 billion estimate. The latest guestimation was that of Ms. Denise Yue, Director General of Industry of the Hong Kong government. She said in a speech that "Our recent estimate puts the size of China's investment in Hong Kong at around US$25 billion" (*The Hong Kong Standard*, February 11, 1995). The author called the Economic Services Branch to check the basis of the estimate, and was informed that the Branch gave Ms. Yue the usual estimate of US$20 billion. Ms. Yue apparently added another US$5 billion to allow for additional investment since the end of 1992. The Branch admitted that it did not know if the US$20 billion figure referred to cumulative investment or value of assets. However, the figure was accepted because it was reported in the Chinese press!

Mr. Xu Jiatun, the former head of the NCNA, took refuge in the United States after the Tiananmen incident and he was the highest ranking Chinese official to defect since the 1950s. His memoirs contain some revealing guestimates of Chinese investment in Hong Kong. He argued that, contrary to Hong Kong estimates, Chinese investment in Hong Kong could not amount to US$10 billion (Xu 1993: 356-357). He knew the amounts of grants given to the few large companies such as CITIC (Hong Kong) and China Everbright, and those were in the region of US$300 to 500 million. The grant given to the NCNA (Hong Kong) was US$100 million. He added that grants given by provinces/municipalities "could not amount to over US$100 million". While grants from central ministries might be more sizeable, they "could not have amounted to over US$100 million too". "The total is thus estimated to be around US$1 billion". He estimated that the re-investment of profits earned in Hong Kong exceeded US$1 billion, and the maximum estimate of China's investment in Hong Kong was US$3 billion. However, he added later that numerous cities, counties and villages in Guangdong set up offices in Hong Kong through private relationships, and "it is impossible to estimate the numbers" (Xu 1993: 258). Mr. Xu thus admitted that he did not know the number of unofficial Chinese companies in Hong Kong. More surprisingly, Mr. Xu's guestimations revealed that the Chinese government did not keep an accurate tally of the total amount of grants given to official Chinese companies in Hong Kong by the various levels of government in China.

Efforts in Estimation

Among the many unreliable articles on Chinese investment in Hong Kong, there are three exceptional studies that pass the standard of scholarship. The first is an article by Y.C. Jao (Jao: 1983), giving estimates of Chinese investment in Hong Kong in the late 1970s; the second is an article by George Shen (Shen: 1993) giving a painstaking tally of the market capitalisation of the listed Chinese companies in Hong Kong; the third is a report of the Nomura Institute (Ni: 1994), estimating Chinese investment in Hong Kong from the balance sheets and market capitalisation of list companies as well as inside information. Besides these three studies, this article also makes use of a good monograph on the BOC Group by Taiwan's Chung-Hua Institution for Economic Research (Chen, 1993), publications of the Hong Kong Chinese Enterprise Association, the surveys on external investment in manufacturing conducted by the Hong Kong government, and information obtained from knowledgeable interviewees.

Jao's article estimated Chinese investment in Hong Kong at the beginning of the open-door era. Jao mentioned that Mr. David Newbigging, Chairman of the Hong Kong General Chamber of Commerce, gave a figure of US$3-5 billion as the value of Chinese investment in Hong Kong for 1981 (Jao 1983: 45). However, no further breakdown or explanation was given. Jao estimated the net worth of the BOC Group as US$1,556 million at the end of 1980.[2] The net worth of non-financial Chinese companies was difficult to estimate because they were not listed then. Their net worth was conservatively estimated at US$400 million from fragmentary sources, giving a total net worth of around US$2 billion at the end of 1980. Jao indicated that net equity investment of US$2 billion can support assets totalling US$6.6 billion (Jao 1993: 46).

As the major Chinese companies in Hong Kong changed to listed companies in the late 1980s, information on their assets and value of their shares became available. However, the tally of investment in shares in listed companies is painstaking because of complicated cross-holdings. Moreover, the rapid influx of unlisted Chinese companies to Hong Kong (both official and unofficial) implies that a substantial chunk of Chinese investment in Hong Kong cannot be reliably estimated.

Table 1 summarises the assets and China's investment in the shares of 17 major listed Chinese companies in Hong Kong, estimated respectively by Nick Ni of the Nomura Research Institute and George Shen of the *Hong Kong Economic Journal*. The first fourteen companies are controlled directly by the State Council or its ministries, while the last 3 are local companies of Guangdong or Fujian. Their assets (end of 1993) totalled HK$751 billion or US$96.3 billion, including assets of the BOC group of HK$606 billion or US$77.7 billion. The figure is somewhat misleading as it is dominated by the financial assets of the BOC group. Even if we exclude the BOC group, the total assets of the remaining listed companies stood at an impressive US$18.6 billion. China's investment in their shares stood at HK$57 billion or US$7.3 billion. If we include the net worth of the BOC group of US$3.8 billion as equivalent to value of shares, China's investment in these companies would total US$11 billion. On top of this, we have to add a substantial amount for the large number of unlisted companies. A conservative estimate of China's investment in Hong Kong in 1993 would be US$15 billion. This is substantially higher than the official figure on China's total overseas investment of US$5.16 billion by the end of 1992 (*Hong Kong Economic Journal*, February 16, 1995).

It should be noted that Chinese investment has grown very rapidly since 1993. China's investment in the shares of listed companies in Hong Kong rose to US$11.5 billion at the end of 1994 compared with the figure of US$7.3 billion (Ni 1994: 20). The assets of the China Merchants Group rose from HK$25 billion at the end of 1993 to HK$40 billion at the end of 1994. By the end of 1994, a conservative estimate of Chinese investment in Hong Kong would be US$20 billion.

Besides, both Chinese investment in Hong Kong and Hong Kong investment in China are inflated by Chinese capital that flows to Hong Kong and then back to China to be recorded as foreign investment, thereby capturing the benefits given to foreign investors. Hong Kong's utilised direct investment in China amounted to US$60 billion at the end of 1994, exceeding Chinese investment in Hong Kong by a considerable margin.

Evasion of foreign exchange controls

Unofficial Chinese companies have to evade foreign exchange controls to invest in Hong Kong. The classic means of evading foreign exchange control is through under-invoicing exports and over-invoicing imports. A lot of evasion occurs through Hong Kong due to geographic and cultural proximity. The easiest way to misinvoice is for a Chinese company to trade with its Hong Kong subsidiary. The Chinese company exports to (imports from) its subsidiary at an artificially low (high) price, and the resulting profit of the subsidiary is deposited overseas.

False invoicing can be detected by comparing the trade statistics of China and Hong Kong. Table 2 compares Chinese exports to Hong Kong with Hong Kong imports from 1981 to 1992. China Customs Statistics are available only from 1981 onwards. Starting from 1993, China tried to trace the final destination of its exports via Hong Kong, and a substantial portion of its exports to Hong Kong was re-classified as exports to the final destinations. As a result of this reclassification, China's exports to Hong Kong dropped by 41 per cent in 1993 and comparisons of Chinese and Hong Kong statistics from 1993 onwards are not meaningful.

As Chinese exports are valued f.o.b. while Hong Kong imports are valued c.i.f., we have to deflate Hong Kong imports by the ratio of c.i.f. value to f.o.b. value. From international data, this ratio is 1.05 to 1.06[3.] We use a ratio of 1.05 as China is close to Hong Kong and transport cost should be quite low. Even after adjusting for the cost of insurance and freight, China's exports to Hong Kong can be different from Hong Kong's imports from China due to time lags in transportation or reporting, and also exchange rate fluctuations. Table 2 shows that under-invoicing is negligible from 1981 to 1988, but it became very substantial from 1989 onwards, amounting to nearly US$4.6 billion in 1992. It is clear that the amount of foreign exchange obtained from under-invoicing exports alone is sufficient to support a huge volume of investment.

Comparison of China's imports from Hong Kong and Hong Kong's exports to China is not very useful because, in Chinese statistics, part of Hong Kong's re-exports to China are classified as imports from Hong Kong instead of from the country of origin. This is unfortunate as over-invoicing of China's imports appears to be very substantial. China gives high priority to imports of technology and equipment, and over-invoicing of such imports is particularly difficult to detect.

Besides misinvoicing, there are other ways of evading foreign exchange control. The flow of visitors between Hong Kong and China is very large, facilitating the flow of currencies between the two. The Hong Kong government estimated that the amount of Hong Kong dollars circulating in China amounted to 22 per cent to 25 per cent of the total supply of the Hong Kong currency, or roughly HK$17 billion (US$2.2 billion) (*Hong Kong Economic Journal*, May 5, 1994). A grey market for Yuan had also existed in Hong Kong for some time. The grey market was turned into an open market in 1993 when China officially permitted visitors to bring 6 000 Yuan outside or into China.

China's Investment by Industry

The 1991 annual report of the Hong Kong Chinese Enterprises Association listed the distribution by industry of its 922 corporate members (Table 3). The information is of limited value as it pertains to the number of firms rather than the value of investment. Moreover, only a small portion of Chinese companies in Hong Kong are members of the Association. The information was released only for 1991 but not for subsequent years.

According to this limited information, import and export activities were by far the leading recipients of Chinese investment, with nearly 39 per cent of Chinese companies. In 1994, Hong Kong imports from (exports to) China accounted for 49 (43) per cent of China's exports (imports). The concentration of Chinese companies in the import/export business is expected. Manufacturing was a distant second with 11.5 per cent of Chinese companies. Finance and insurance, and transportation and storage were close in the third and fourth places, with respectively 10.4 per cent and 8.5 per cent of Chinese companies. Transportation and storage is obviously trade-related. In the case of Hong Kong, manufacturing is trade-related too as the majority of Hong Kong manufacturing firms have moved their manufacturing operations to China, with the Hong Kong firms specialising on industrial support services, sourcing of materials and marketing of output. The importance of finance and insurance in Chinese investment in Hong Kong is expected given the long history of the BOC Group and the importance of Hong Kong as an international financial centre.

China's Economic Presence in Major Sectors of Hong Kong's Economy

Table 4 summarises China's economic presence in major sectors of the Hong Kong economy. Chinese companies are important in import/export, banking, insurance, manufacturing, shipping, real estate, and tourism.

Chinese companies, led by the China Resources group, handled around 20 per cent of Hong Kong's trade. As China accounted for 35 per cent of Hong Kong's trade in 1994, the prominence of Chinese companies is expected.

The BOC Group is the second largest banking group in Hong Kong after the Hong Kong Bank Group. Its has a 25 per cent share of Hong Kong dollar deposits and a 10 per cent share of total banking assets. In terms of banking assets, it was in fourth place after Japanese banks, the Hong Kong Bank Group, and European banks. However, Japanese Banks and European Banks operate as individual companies rather than as a group. Though Japanese Banks have 53 per cent of all banking assets, they only have 5 per cent of all Hong Kong dollar deposits. Their loans were mainly used outside Hong Kong. Japanese banks are mainly involved in the international financial market rather than the local market. The Hong Kong Bank Group and the BOC Group dominated the local market. The BOC Group will be analysed in detail later as it is the most important group of Chinese companies in Hong Kong.

The China Insurance Holdings Company, a subsidiary of the People's Insurance Company of China, claimed a 20 per cent share of Hong Kong's market for general insurance (Wang 1994: 50). Though the Company has been quite successful in general insurance, its share of the market for life insurance is small. Provincial and local authorities also run subsidiary insurance companies in Hong Kong (Shen 1993: 436). The Insurance Committee of the Hong Kong Chinese Enterprises Association has a membership of 15 companies.

China has an 11 per cent share of external investment in manufacturing, the third after Japan and the United States. Chinese investment in manufacturing is quite modest, and is no more than four per cent of total Chinese investment in Hong Kong. Chinese investment in manufacturing will be analysed in detail later as the Hong Kong government have conducted regular surveys of external investment in manufacturing since 1984.

As mentioned before, many Chinese companies have invested in shipping, transportation, and tourism. The figure on shipping in Table 4 pertains only to the China Merchants Group, accounting for around 10 per cent of the total throughput since 1992. China Merchants had a fleet totalling over six million tons dead-weight and assets over HK$40 billion in 1994.[5] The China Resource Group had a fleet of more than 60 cargo ships (Ni 1994: 14). Besides their investments in shipping and transportation, the China Merchants Group, China Resources, China Travel Service and Guangdong Enterprise also have extensive interests in tourism and hotels. There were 36 mainland tourism companies in Hong Kong in 1992 and Chinese companies owned 8.3 per cent of the total 33,297 hotel rooms in Hong Kong (Ni 1994: 14).

Chinese companies started to invest in Hong Kong property in the 1980s, starting with the 50-storey headquarters of the Chinese Resource Company. In the late 1980s, the unofficial Chinese companies cashed in on the real estate boom in Hong Kong through speculation, though such practices were prohibited by Beijing. George Shen made detailed counts of Chinese investment in Hong Kong property from newspaper reports. The total between 1988 and 1991 was US$941 million; that for 1992 was US$109 million, and the total for the first five months of 1993 was US$643 million (Shen 1993: 437). Ni's estimate for 1993 was US$1.3 to 1.9 billion, or 20 to 30 per cent of the property transactions in Hong Kong (Ni 1994: 12). In the real estate sector, China has undoubtedly become the first among external investors.

The BOC Group

The Hong Kong Branch of the BOC was the largest overseas branch of the BOC and was taken over from the nationalist government in 1949. The BOC has long been the cornerstone of Chinese investment in Hong Kong and has also been the symbol of Chinese influence in Hong Kong. The old BOC building was the tallest building in Hong Kong in the 1950s, towering above the old Hong Kong Bank building, which had been the previous tallest building. The 80-storey new Bank of China Tower designed by the famous American architect I.M. Pei was completed in 1988, and is presently the tallest building in Hong Kong. The BOC and its 12 sister banks formed the BOC Group in the 1950s. Business was initially confined to financing China's trade and handling remittances. Starting with the thaw in Sino-American relationship in 1970, the BOC Group adopted a more outward-looking strategy. In 1977, Beijing prodded the BOC to expand and compete in the Hong Kong market (Jao 1983: 34). Expansion took the form of aggressive branching and the BOC Group overtook the Chartered bank as the second largest banking group in Hong Kong in the late 1970s (Jao 1993: 31). Starting 1979, the BOC Group rushed to form finance companies and joint-venture merchant banks. Computerisation was achieved in June 1980 and a saving-deposit holder can obtain service from any of the Group's 193 branches (1981 figure) in Hong Kong, leading to a large jump in saving deposits (Jao 1983: 34). The BOC first participated in syndicated loans in 1979, and inaugurated a modern staff-training programme in 1980.

In addition to the 13 banks of the BOC Group, the CITIC acquired the Ka Wah Bank and the China Merchants Group acquired the Union Bank in 1986. The shares of Chinese banks in the assets, deposits, and loans of the Hong Kong banking system are shown in Table 5. The shares of Chinese banks in assets and deposits are large and rising. The BOC joined the Hong Kong Bank and the Standard Chartered Bank as the third note-issuing bank in Hong Kong in May 1994.

The BOC Group has been very innovative. In Hong Kong, it pioneered the introduction of deposits in European Currency Units, telephone banking, and the use of a single passbook for 19 foreign currency deposits. The BOC Group have also established branches in China and have pioneered the introduction of mortgage loans. Much useful information and many valuable innovations have been transmitted from the BOC Group to China, thus facilitating the banking and economic reforms in China. On the other hand, the rise of Hong Kong as a financial centre also owes a lot to the modernisation and internationalisation of the BOC Group.

Chinese Investment in Manufacturing

Chinese manufacturing investment started in the pre-Communist era. Tien Chu Ve-Tsin Chemical Industries (HK), presently owned by Shanghai Industrial Investment Company, originated in Shanghai in the 1930s as the largest producer of monosodium glutamate in China. The Nanyang Brothers Tobacco Company is another old manufacturing concern owned by Shanghai Industrial Investment Company (Shen 1993: 429).

The Hong Kong government started to survey external investment in Hong Kong manufacturing in 1984, and data on Chinese investment was provided from 1985 onwards, as China's presence in Hong Kong manufacturing was too big to be ignored with the 1984 acquisition of Conic Investment, the largest electronics company in Hong Kong.

In terms of the number of investments, the Chinese share of total external investment in Hong Kong manufacturing appears to be increasing. However, in value terms, it declined from 18 per cent in 1985 to around 11 per cent from 1988 to 1993 (Table 6). Table 7 shows China's manufacturing investment in Hong Kong in 1993 by year of commencement (excluding the investments that failed before 1993). Before 1970, there were only three investments (Tien Chu Chemicals, Nanyang Tobacco and one other), but these were large and worth a total of US$311 million at original cost. From 1970 to 1979, there were 5 small investments. Since 1979, the cumulative number has risen to 37, giving a total of 29 new investments in the open-door era. However, these were small. The 29 new investments were worth US$207 million (at original cost). Among the top three foreign investing (Japan, the United States and China), China's share was increasing in terms of the number of investments, but decreasing in terms of value (Table 7).

As Hong Kong is primarily a services centre for China, and China's labour costs are much lower than those of Hong Kong, the modest scale of China's involvement in Hong Kong manufacturing is not surprising.

Table 8 shows the distribution by industry of China's investment in Hong Kong manufacturing from 1985 to 1993. As the value shares are often suppressed to preserve confidentiality of individual firms, it is more useful to look at the rank of the industries. The value shares and ranks of external investment in Hong Kong (from all countries) by industry are given for comparison. The distribution by industry of Chinese investment is evidently quite different from that of external investment as a whole. In 1993, the top two taget industries for Chinese investment were tobacco and transport equipment. The rank of tobacco in external investment overall was 15th and that of transport equipment was 8th.

Table 8 also shows the correlation coefficient of the rank of the top eight industries of Chinese investment with the corresponding ranks in external investment by industry. The correlations are very low and are often negative in recent years. This again shows that the distribution by industry of Chinese investment is very different from that of total external investment.

Historically, Japan and the United States invested in Hong Kong to take advantage of the low labour costs in Hong Kong. The top industries for external investment, therefore, were roughly the same as the major industries of Hong Kong, namely, electronics, textiles and clothing, and electrical products. However, China has much lower labour costs than Hong Kong and the motives of Chinese investment in Hong Kong manufacturing were very different from those of developed countries.

Chinese manufacturing investment in Hong Kong serves some very useful purposes, despite its modest scale. Access to technology, industrial services, and market outlets appear to be the prime motives of Chinese manufacturing investment in Hong Kong in the open-door era.

Organisation and Operation of Chinese Companies in Hong Kong

Chinese companies are controlled by the Chinese government through the appointment of mainland cadres to top positions. Some 10,000 PRC citizens worked in these companies in 1993 (Ni 1994: 4). The Hong Kong and Macau Working Committee (HKMWC) of the Communist Party oversees Chinese companies from its office in the NCNA in Hong Kong. However, the Committee has not been able effectively to control companies linked to the military, companies associated with “princelings” (children of top leaders), and unofficial companies financed by local governments (Ni 1994: 4). As mentioned before, some well-known companies affiliated with municipal (city) governments refused to acknowledge their connections and refuse to join the Association of Hong Kong Chinese Enterprises.

Table 9 gives Ni’s count of Chinese companies affiliated with various levels of the Chinese government (Ni 1994: 5). Fifty of the companies are controlled by the State Council or its ministries, including the first 14 companies listed in Table 1, and 72 companies representing provincial/municipal (city) governments have been officially approved, while an estimated 530 companies affiliated with municipal (city) or local authorities operate unofficially in Hong Kong. Though officially approved companies are under the purview of the HKMWC, provincial/municipal companies enjoy a lot more autonomy than state-run companies (Ni 1994: 6). They do not need to remit profits to the central government.

Companies operated by provincial or municipal governments can be very large. Table 1 shows that Guangdong Enterprises operated by the Guangdong provincial government has assets as large as those of CITIC (Hong Kong), amounting to HK$20 billion at the end of 1993. The Yue Xiu Group of the Guangzhou municipal government had assets of HK$5 billion at the end of 1993.

Ni estimated that the number of agents functioning as "windows" of local governments in Hong Kong totalled 13,300 (Table 9). This appears to be just a guestimate. The same author mentioned that, according the official Chinese sources, around 40,000 of the foreign-invested enterprises in China were Hong Kong-owned. He claimed that many of these companies engage in import/export activities for their mainland partners, and "the number of such companies is conservatively estimated at about 13,300" (Ni 1994: 7). Since 13,300 is one-third of 40,000, Ni appears to have assumed that one-third of the Hong Kong-owned foreign-invested enterprises in China functioned as agent "windows" for local governments.

In 1993, according to Ni there were 18 companies with military backing operating in Hong Kong, with assets of around HK$10 billion (Ni 1994: 7). The 17 major PRC companies in Table 1 included two military-related companies, the China Poly Group and the China Aerospace Corporation. The China Poly Group was founded in 1984 by military authorities and was the largest arms trader of the People's Liberation Army (PLA). It has tried to diversify away from the arms trade, and its holdings in Hong Kong included interests in shipping and property investment (Ni 1994: 21). The China Aerospace Corporation specialises in high-tech aerospace products. It manufactures the "Long March" rockets which is used for placing commercial satellites into orbit.

The major "Princeling Companies" in Hong Kong as listed by Ni are shown in Table 10. They include some of the most powerful Chinese companies in Hong Kong such as CITIC (HK), CNNC, Continental Mariner of the China Poly Group, Ong Group of China Venturetech, and Guangdong Investment of Guangdong Enterprises. The business elite of Hong Kong often strengthens its relationships with the Chinese leadership by helping the "princelings" to acquire listed companies in Hong Kong. For instance, Hong Kong magnate Li Ka-shing joined hands with Deng Zifang, the youngest son of Deng Xiaoping, and the Shougang Corporation to acquire Kader investment.

In his memoirs, Xu Jiatun complained about the difficulty of managing Chinese companies in Hong Kong that have the personal support of central leaders, especially the "princeling companies". Xu remarked that he was powerless to investigate the irregularities of CITIC (HK), and the China Everbright Company, then under the chairmanship of Wang Guanying, brother-in-law of former State President Liu Shaoqi (Xu 1993: 259-261). Xu knew of around 200 children of high-ranking cadres doing business in Hong Kong (Xu 1993: 261). He mentioned two cases of rampant corruption. In one case, Beijing wanted to transfer the person involved back to the mainland, but he emigrated to Australia. In another case, the complaints of the HKMWC were ignored and the person involved continued to make big money in Hong Kong (Xu 1993: 262).

III. THE DETERMINANTS OF CHINESE INVESTMENT IN HONG KONG

In the open-door era, economic factors are paramount in Chinese investment in Hong Kong, though political factors are still important, as will be detailed later.

Economic Determinants of Chinese Investment

It should be noted that, even in Mao's era, economic factors were important as China was isolated and Hong Kong was China's gateway to the capitalist world. After China's entry into the Korean War in late 1950, it was isolated by the American-led United Nations trade embargo. However, China continued to export to the capitalist world through Hong Kong and significant quantities of strategic supplies were smuggled into China through Hong Kong.

As mentioned before, Hong Kong was the largest market for China in the late 1960s and early 1970s. China's investment in Hong Kong was designed to enhance China's foreign exchange earnings from Hong Kong through exports and remittances. The China Resources Group has many subsidiaries specialising in retail trade, including China Arts and Crafts and many department stores selling Chinese products. A pro-China 1981 economic yearbook listed some 1 136 sub-agents or wholesalers and 101 department stores specialising in Chinese products (Jao 1983: 45).

Hong Kong as China's gateway in the open-door era

In the open-door era, economic factors became paramount and China used its investment in Hong Kong to further its modernisation programme. As political factors have become less important, standard economic theories on foreign investment can be used broadly to explain Chinese investment in Hong Kong.

Economic theories suggest that foreign direct investment involves the reaping of economic rents on firm-specific attributes. Moreover, locational characteristics dictate that efficient exploitation of these attributes entails production overseas rather than exporting products. Finally, it must be cheaper to internalise the transfer of these attributes through establishing subsidiaries overseas than to do so through service contracts in the market.

In the case of Chinese investment in Hong Kong, the most important firm-specific attribute is familiarity and connections with the Chinese business environment. Personal connections are important in any business environment, and especially important in the Chinese business environment because of its lack of transparency, lack of legal framework, the prevalence of bureaucratic regulations, as well as the Chinese cultural preference for personal links. Needless to say, such attributes cannot be transferred in the market, though they can be used to reap economic rent through establishing overseas operations.

In the case of Chinese investment in Hong Kong, the paramount locational factor is the uniqueness of Hong Kong as the gateway of China. Hong Kong's role as China's gateway can be analysed under four main functions (Sung 1991: 17): financier, trading partner, middleman, and facilitator (Table 11). China's investment in Hong Kong can be analysed under these functions.

Hong Kong as financier

Hong Kong's share of foreign direct investment in China has been around 60 per cent throughout the open-door era. Many Chinese provincial and local authorities have set up offices in Hong Kong to attract foreign investors. As we have seen, such "window" companies include 72 official companies, 530 unofficial companies, and thousands of "agent windows".

China has also made increasing use of Hong Kong's stock market to tap funds for Chinese enterprises. As new companies do not have the track record to meet the listing criteria of the Hong Kong stock exchange, Chinese companies acquire control of small Hong Kong listed companies and get *de facto* listing under the shell of the listed companies. From 1984 to 1986, Chinese companies acquired control of three Hong Kong listed companies in rescue operations, namely, Conic Investment in 1984, the troubled Ka Wah and Union Banks in 1986. The Chinese strategy was then passive, rather than active, in tapping funds from the Hong Kong stock market.

From 1987 onwards, the strategy changed. Guangdong Enterprise acquired Union Globe Development and assumed its listing (Ni 1994: 9). Many "Princeling Companies" also acquired control of small Hong Kong listed companies, and the prices of their shares usually rose greatly after acquisition as connection with the Chinese leadership was perceived to be an important asset. For instance, after Deng Zifang, acquired Kadar Investment, the price of its shares rose 30 per cent in one day (*United Daily News*, May 20, 1993).

In 1992, the three traditional giants among Chinese companies in Hong Kong, namely, China Merchants, China Travel Service, and China Resources reorganised themselves into holding companies and became listed on Hong Kong's stock exchange. The listings were very successful and the shares of China Merchants were oversubscribed 373 times while those of the China Travel Service were oversubscribed 412 times, setting new records of oversubscription in the Hong Kong stock market. By the end of 1994, China controlled over 40 listed companies in Hong Kong, with shares worth US$11.5 billion.

In late 1992, Beijing gave permission for selected state enterprises in China to seek listing overseas, particularly in Hong Kong. On 19 June 1993, a Memorandum of Regulatory Cooperation was signed between the relevant securities authorities in China and Hong Kong. Chinese firms listed in Hong Kong would follow international accounting standards and the rules and regulations of Hong Kong would apply. By the end of 1994, 15 such stocks (commonly called H-shares) were listed in Hong Kong

(Ni, 1994: 20). The equivalent market capitalisation was US$1.8 billion. Together with listed Hong Kong companies controlled by China, the aggregate capitalisation was about 4 per cent of the Hong Kong stock market (Ni 1994: 10).[4] Besides tapping external capital, listing in Hong Kong also speeds up China's enterprise reforms, since listed firms have to follow international accounting standards.

Hong Kong's share in China's foreign loans is quite substantial. According to Chinese statistics, China's 1993 utilised foreign loans from Hong Kong amounted to US$1.4 billion or 13 per cent of the total. Chinese statistics only include loans guaranteed by state agencies, excluding the bulk of loans extended to foreign-invested enterprises in China. Hong Kong's financial institutions, including the BOC Group, were important sources for the latter type of loans. The amount of such loans can be obtained from Hong Kong banking statistics. In 1993, Hong Kong loans to non-bank customers in China amounted to US$6.4 billion. The share of the BOC Group in such loans is not known, though it is probably substantial.

Hong Kong plays a leading role in syndicating loans to China. Among China's commercial loans, 70 per cent were syndicated loans and over 60 per cent were syndicated in Hong Kong (*Hong Kong Economic Journal Monthly* August, 1992) The BOC first participated in Hong Kong's international syndicated loan market in 1979 and has since regularly joined hands with multinational banks in syndicating loans to China.

Hong Kong as trading partner

This only refers to the trade involving China and Hong Kong as final markets (i.e. Chinese goods consumed in Hong Kong and Hong Kong goods consumed in China). The much larger entrepot trade is covered under the middleman function. Hong Kong was the largest final market for Chinese exports in the late 1960s and the early 1970s, but the Hong Kong market was overtaken by Japan and the United States in 1973 and 1987 respectively (Sung 1991: 22). China has been unable to capture the higher end of Hong Kong's market, which was dominated by Japan. Given the increasing affluence of Hong Kong and the Japanese dominance in vehicles, capital goods, and quality consumer durables and consumer goods, the future for Chinese products in Hong Kong is not very bright.

However, Hong Kong still consumed substantial amounts of Chinese goods, around US$4.4 billion in 1994 or 4 per cent of China's exports. The China Resource Company still has dominant market shares in live and fresh food, toilet tissue, polyester cotton cloth, and cotton grey cloth. Its market shares in yarn, petroleum, cement, steel, and toy circuits are substantial (China Resources Group 1994: 47). Moreover, China has a vast trading and retail network in Hong Kong that was developed in the 1960s and 1970s. Given the change in taste in Hong Kong, the Chinese department stores survived by diversifying their source of consumer products, offering Japanese and European consumer products in addition to Chinese products. The China Resource Company also diversified its operations. Besides its 12 large department stores, it has established a chain of petrol stations and 37 supermarkets. It has also diversified into banking, financing, energy, transportation, communications, building and construction, manufacturing, real estate, and tourism.

Contrary to the stagnation of Chinese products in the Hong Kong market, China imported increasing quantities of Hong Kong goods, mostly components and semi-manufactures, as a result of the relocation of Hong Kong's manufacturing operations to China. However, the trading of such products is handled mostly by Hong Kong firms instead of Chinese companies in Hong Kong.

Trade in services between China and Hong Kong has increased substantially in the open-door era. In 1994, over 27 million Hong Kong residents visited China, accounting for around 70 per cent of China's tourist arrivals as well as tourist expenditure. Chinese tourists visiting Hong Kong have increased in number rapidly, totalling 1.9 million in 1994. China surpassed Chinese Taipei as the foremost source of tourist arrivals in Hong Kong in that year. Given the rapid development of tourism, it is not surprising that China Travel Service has expanded its operations tremendously, and other Chinese companies including China Resources, China Merchants, and Guangdong Enterprises have also diversified into tourism.

Hong Kong as Middleman

Hong Kong plays the role of middleman both in commodity and services trade, including tourism, financial services, and business consultancy. A middleman creates opportunities for trade and investment by lowering transaction costs. In commodity trade, China's indirect trade via Hong Kong with third countries vastly exceeded its direct trade with Hong Kong in recent years.

Hong Kong is also an important centre for transhipment for China. In transhipment (unlike entrepot trade), the goods are sold directly to the final customer (instead of a middleman), though the goods pass through a third port in the course of shipment, and usually change vessels in the third port. Transhipped goods passing through Hong Kong do not go through customs and are not regarded as part of the trade of Hong Kong because they are not sold to a Hong Kong buyer. Hong Kong's transhipment of Chinese (third-country) goods to third countries (China) has grown very rapidly in the open-door era (Sung 1991: 25-26). Hong Kong trading firms also appear to perform an important brokerage role for China's trade with third countries not passing through Hong Kong. It is estimated that 7 per cent of China's trade were intermediated by Hong Kong brokers even though the goods involved did not pass through Hong Kong.

The decentralisation of the Chinese system of foreign trade has enhanced the position of Hong Kong as China's middleman because decentralisation increases the cost of finding a suiTable trading partner, and intermediation economises on search costs. The vast increase in the number of "window" companies in Hong Kong involved mainly in the import/export trade has been noted above. The impact of decentralisation was decisive not only for commodity trade, but also for the tourist trade and loan syndication. Sung noted that the decentralisation of the authority to borrow external loans had led to a jump in loans syndicated in Hong Kong, and the decentralisation of tourism had led to a jump in foreign tourists visiting China via Hong Kong (Sung 1991: 41).

Sung pointed out that traders tend to agglomerate in big trading centres because it is easier to find a suiTable partner there. This implies that once a location acquires a comparative advantage in trade, the advantage feeds upon itself, and more trading firms will come making it even more efficient in trade (Sung 1991: 28-42). The vast number of trading firms that China has established in Hong Kong demonstrate China's recognition of the established efficiency of Hong Kong in trading. Some Hong Kong traders fear competition from Chinese trading companies in Hong Kong. However, the situation is not a zero-sum game because of economies of agglomeration; the arrival of Chinese trading companies further enhances the position of Hong Kong as a trading centre. Given the dominance of Hong Kong in China's external trade and investment, it is very difficult for other cities such as Shanghai, Singapore, or Taipei to compete with Hong Kong. More and more Chinese trading firms will establish themselves in Hong Kong with the continuing reform and decentralisation of China's trading system.

In shipping, aviation, telecommunications, finance, and business services, there are also strong economies of agglomeration. For instance, in shipping, big ports with frequent shipping schedules have a tremendous advantage over small ports with infrequent schedules because goods transported to a big port can be shipped to their destination rapidly. Once a port acquires a comparative advantage in shipping, the advantage feeds upon itself, and more ships will use the port, making the port even more attractive. Hong Kong has the world's busiest container port, the fourth busiest airport in passenger traffic, and the third busiest in air cargo traffic. China thus relies heavily on Hong Kong for its exports and imports. Though the China Merchants Group had built a port in Shekou, Shenzhen, the port does not have enough throughput to be viable and it operates as a feeder port for Hong Kong. Container charges in Hong Kong are 20 per cent higher than those in Singapore and Kaoshiung, and nearly double those in Chinese ports, but Hong Kong remains the dominant port for China's trade. It is hardly surprising that Chinese companies have invested heavily in the transportation sector in Hong Kong. For instance, the China Resources Group, the China Merchants Group, the China Travel Service, and Guangdong Enterprises have invested heavily in container terminals, shipping, air freight, aviation, and warehouses. Ni observed that "almost every mainland window company has diversified into transportation since 1985" (Ni 1994: 14).

Hong Kong as Service Centre and Facilitator

China values Hong Kong as a contact point with the world. Hong Kong is the major centre for China's trade and also the centre of consultancy services for businessmen aiming at the Chinese market. Most Chinese companies in Hong Kong, including the "window" companies, offer consultancy services.

The Chinese also value Hong Kong as a conduit of market information and technology transfer. China has established companies specialising in market information in Hong Kong, including the Southeast Economic Information Centre. China's investment in Hong Kong manufacturing is often related to technology transfer. In 1985, China became the third largest investor in Hong Kong manufacturing after the United States and Japan. For instance, China has established two relatively high-technology electronics firms in Hong Kong producing integrated circuits. The engineers in these firms come mostly from China, and these firms have attracted public attention because of an initial ban, later lifted, on supplying training and equipment to them (Sung 1985: 63). China also uses Hong Kong as a market testing ground to gauge consumer acceptance of its new products through its vast distribution network.

Given the economies of agglomeration in most services and Hong Kong's position as the services centre of China, it is hardly surprising that Chinese companies have invested so heavily in the service sector in Hong Kong.

Political Determinants of Chinese Investment

Before the open-door era, political considerations were important in Chinese investment in Hong Kong. The Chinese Communist Party initially established businesses in Hong Kong act to as a cover and to generate revenue for underground activities (Xu 1993: 244). Chinese companies run five newspapers in Hong Kong as part of China's propaganda effort and they account for one-tenth of the newspaper circulation in Hong Kong. China had invested in publishing, book stores, magazines, news agencies, and motion picture production and distribution.

Maintaining Hong Kong's prosperity during the transition

Though economic factors became paramount in the open-door era, political factors are still important. The prospect of the 1997 handover has led to an exodus of British and Hong Kong Chinese capital. To maintain the prosperity of Hong Kong during its transition to Chinese sovereignty, Xu Jiatun's proposed strategy was "To lure British capital to stay, to stabilise Hong Kong Chinese capital, to promote foreign capital, to foster unity with overseas Chinese capital and Taiwanese capital, and to strengthen Chinese capital" (Xu 1993: 229). China has actively used its investment in Hong Kong as a vehicle to pursue these goals.

"To stabilise Hong Kong Chinese capital", the NCNA has on several occasions asked the BOC to extend loans to friendly Hong Kong magnates in financial crises. The more well-known cases include the Hong Kong magnate Fung King Hey (Xu 1993: 131-2) and the Bank of East Asia (Xu 1993: 238). In another case, both the NCNA and China's Office of Hong Kong and Macau Affairs agreed to help a friendly Hong Kong businessman in a financial crisis, but the BOC refused. Xu Jiatun had to pledge special funds of the HKMWC as collateral before the BOC agreed to release the loan (Xu 1993: 131). The episode illustrated both the power and the limitation of the NCNA.

The 1984 rescue of Conic, the largest electronics firm in Hong Kong, was very expensive. Conic employed over ten thousand workers and the NCNA mounted the rescue out of a concern for social stability. The BOC, the China Resources Company, and China Merchants Holdings Company injected around HK$473 million into Conic, after which the Hong Kong businessman absconded with the capital (Xu 1993: 238). The company sustained losses until 1991, when it became profiTable and was acquired by the China Aerospace Industry Corporation (Shen 1993: 443).

The BOC and the NCNA have repeatedly intervened to stabilise financial crises. In 1985, CITIC Hong Kong acquired the Ka Wah Bank to avert a crisis. The decision process involved not only the NCNA and the Hong Kong government but also the State Council of China (Xu 1993: 202-204). In 1986, the China Merchants Group acquired the insolvent Union Bank. In October 1987, after the world-wide stock market crash, the Hang Seng Futures Exchange was insolvent. The Hong Kong government, the Hong Kong Bank and the BOC mounted a joint rescue operation, and the BOC pledged a loan of HK$100 million. The decision process involved Zhao Ziyang, then premier of China (Xu 1993: 198-200). In 1991, there was a run on the Chartered Bank due to rumours, and the crisis was averted after the Hong Kong Bank and the BOC jointly pledged their support.

Interpenetration of economics and politics

There was a subtle interpenetration of economics and politics involving Chinese companies in Hong Kong. As an insurance against the uncertainties of 1997, Hong Kong capital has sought allies overseas as well as allies in China. The courtship of Hong Kong magnates and "princelings" in joint-ventures has been noted above.

British capital has traditionally dominated the highly regulated sectors of the Hong Kong economy due to favouritism of the colonial government. These sectors include public utilities, aviation, telecommunication, and banking. While banking has been progressively liberalised since the 1970s, the liberalisation of the other sectors was only beginning in the mid-1990s. To protect their monopoly rents after 1997, these British companies have forged alliances with powerful Chinese companies. For instance, CITIC has purchased 20 per cent of the shares of Hong Kong Telecommunications, the largest company in Hong Kong, and 12.5 per cent of the shares of Cathay Pacific. Table 12 shows the extensive participation of influential

Chinese companies in the regulated infrastructure sectors of Hong Kong. The rapid influx of Chinese capital into such sectors is likely to retard their liberalisation as Chinese firms are politically influential.

IV. PROBLEMS AND PROSPECTS

China's investment in Hong Kong has been an important component of China's open-door policy. The efficient middleman services of Hong Kong have contributed greatly to China's stunning success in exporting and attracting foreign investment. China's investment in Hong Kong is primarily designed to utilise the middleman services of Hong Kong.

Chinese investment has also contributed greatly to the stability and prosperity of Hong Kong. Foreign investors are bullish over the future of Hong Kong largely because Hong Kong is the gateway to a prosperous and rapidly developing Chinese economy, and Chinese investment in Hong Kong has enhanced the role of Hong Kong as the gateway of China. Moreover, the BOC Group has helped repeatedly to stabilise financial crises in Hong Kong.

Though Chinese investment in Hong Kong benefits China and Hong Kong tremendously, there are also costs. For China, the main cost is the loss of control, especially as a result of evasion of foreign exchange and trade controls. In the long run, the loss of control may be a blessing in disguise as planners are forced to abandon unworkable regulations and push on with reforms. In this sense, Chinese investment in Hong Kong plays a crucial role in China's economic reforms, especially reform of the external sector. China's myriad links with Hong Kong, cultivated partly as a result of Chinese investment in Hong Kong, led to a thriving black market in foreign exchange in China that forced planners to devalue and unify the exchange rate. Such links also exert pressure on China to decentralise its trade, as many localities and enterprises are able to trade with the world covertly through their Hong Kong connections.

Some of the costs to Hong Kong have already been mentioned. The subtle interpenetration of politics and economics in regulated sectors may slow down the pace of liberalisation. Corruption is another obvious danger. The influx of Chinese capital sometimes fuelled speculation unsustainable by fundamentals, as was the case in the real estate boom of 1993 and 1994. The problems are real and may get worse after 1997. The only solution is the continual reform, opening, and modernisation of the Chinese economy.

In the early years of the open-door era, Hong Kong investment in China far outweighed China's investment in Hong Kong. As China develops, the balance is being redressed. At the end of 1994, Hong Kong's utilised direct investment in China amounted to US$60 billion, which far exceeded China's estimated investment in Hong Kong of around US$20 billion. However, the figure of Hong Kong's investment in China is grossly exaggerated as it includes the investment from the subsidiaries of multinationals incorporated in Hong Kong. Moreover, officials in planned economies tend to exaggerate economic performance (the 'success indicators' problem). From anecdotal evidence, it is known that Hong Kong investors often overstate the value of their investments in China with the connivance of local officials. For example, Hong

Kong manufacturers tend to put a high value on the outdated machinery that they move to China. The true figure of Hong Kong's investment in China is perhaps no more than half of the official figure.

The estimate of Chinese investment in Hong Kong is likely to be biased downwards as there is an incentive for China's local authorities and enterprises to establish unofficial subsidiaries in Hong Kong to evade controls on foreign trade and foreign exchange. Chinese investment in Hong Kong is probably thus of the same order of magnitude as Hong Kong investment in China.

As China continues to liberalise its foreign exchange controls, it is expected that more and more Chinese capital will flow to Hong Kong through official as well as unofficial channels. It is natural for Chinese enterprises and investors to move their capital to Hong Kong, as Hong Kong has stricter protection of property rights than China and the funds can also be used much more flexibly in Hong Kong. As long as property rights and freedom of capital movement in Hong Kong remain protected, the influx of Chinese capital will continue even after 1997.

NOTES

1 The author was also a speaker at that seminar, and has kept a copy of Mr. Xiangnan's speech.

2 The balance sheet of the BOC covered its global operations, though its Hong Kong Branch is certainly the most important. The estimate thus involves guesswork.

3 1.066 in 1980 and 1.053 in 1989. Table 36 from *Review of Maritime Transport 1990*, UNCTAD, U.N.: New York, 1991.

4 Some articles give the higher figure of 8 per cent which is exaggerated as they forgot to allow for the fact that China often owns a fraction of the shares.

5 Information obtained from interview.

APPENDIX TABLES

Table 1 : **Major RPC companies: Value of Assets/Shares Held**

	Assets (HK$bn) (end of 1993)	Market Capitalisation (HK$million, 31.3.1993)
1. Bank of China Group	606	(29 400[a])
2. China Resources	45	1 630
3. China Merchants	25	880
4. China Travel	10	2 850
5. CITIC(HK)[1]	20	34 338
6. China Everbright	4	229
7. China Overseas Land	1.4	3 173
8. Shongang Corporation	5	1 498
9. China Poly Group	2	523
10. CNNC[2]	4	1 263
11. Petroleum-related Companies[3]	1.5	698
12. Top Glory (Ceroil Food)	1.2	4 455
13. China Aerospace	0.5	229
14. China Venturetech	0.8	654
15. Guangdong Enterprises	20	1659
16. Yue Xiu Group	5	2 070
17. Fujian Investment	-	847
Total	751[b]	56 997[c]

1. China International Trust and Investment Corporation (CITIC)
2. China National Non-ferrous Metal Industry Corporation (CNNC)
3. Includes China Petroleum and Natural Gas Corporation, China National Petroleum Petrochemicals Corporation, and China Offshore Oil Corporation. The asses figure pertain to just the first company while the market capitalisation figure is the total for all 3 companies.

a. Net Worth (at end of 1993) instead of market capitalisation. The net worth is estimated to be 5 per cent of assets. See text for basis of estimation.
b. Total excludes assets of Fujian Investment & Enterprise Corporation, which is not available.
c. Total excludes figure for Bank of China Group, Which is net worth rather than market capitalisation.

Sources: Assets figures are taken from Nick Ni, "China's Expanding Economic Interests in Hong Kong", *Asian Perspectives*, Nomura Research Institute, Hong Kong Ltd., Vol. 11, No. 6, December 1994. Market capitalisation figures are taken from George Shen, "China's Investment in Hong Kong", in Choi Po-hing & Ho Lok-sang ed., *The Other Hong Kong Report 1993*, pp. 425-454, The Chinese University Press, Hong Kong, 1993.

Table 2: **Under-invoicing of Chinese exports to Hong Kong (US$million)**

	China exports to Hong Kong (f.o.b.) (1)	Hong Kong imports from China (c.i.f.) (2)	adjusted (f.o.b.) (3)	Export Under- invoicing (3) - (1)
1981	5 293	5 315	5 062	-231
1982	5 186	5 453	5 193	7
1983	5 818	5 890	5 609	-209
1984	6 689	7 100	6 762	73
1985	7 168	7 449	7 094	-74
1986	9 778	10 252	9 764	-14
1987	13 762	14 776	14 072	310
1988	18 267	19 406	18 482	215
1989	21 916	24 431	23 268	1 352
1990	26 650	29 528	28 122	1 472
1991	32 137	36 710	34 963	2 826
1992	37 512	44 186	42 082	4 570
1993	22 063	50 165	47 776	- (1)

Source: Chinese data: *China Customs Statistics*, various issues; Hong Kong data: *Review of Overseas Trade*, Hong Kong Census and Statistics Department, various issues.

Note: In 1993, a substantial portion of China's exports to Hong Kong was re-classified as exports to their final destinations. Therefore the figure dropped by 41 per cent that year and comparisons of Chinese and Hong Kong statistics from 1993 onwards are not meaningful.

Table 3: **Distribution of number of Chinese companies in Hong Kong by industry, 1991**

Manufacturing and related investment	11.5%
Construction and real estate management	6.9%
Import and export	38.8%
Tourism	3.5%
Transportation and storage	8.5%
Finance and insurance	10.4%
Others (Holding companies or non-business administrative organisations)	20.4%
Total	100%

Source: 1991 *Report of the Association of Hong Kong Chinese Enterprises*

Table 4: **China's Economic Presence in Major Sectors of Hong Kong's Economy**

Sector	Value/Volume	Share of Hong Kong's Total	Rank
1. Imports/ Exports[a]	'93 Trade value of US$54bn	20%	First among external investors
2. Banking[b]	'93 Assets of US$77.7 bn 93'HK dollar deposite of US$27.5bn	10% 25%	Fourth after Japanese banks, the Hong Kong Bank Group, & European banks Second after the Hong Kong Bank Group
3. Insurance[c]		20% of market for general insurance	
4. Manufacturing[d]	'93 cumulative investment of US$565mn	11% of external investment	Third after Japan and the US
5. Shipping[e]		10% of throughput from '92-'94	-
6. Real Estate[f]	'93 transactions worth HK$10bn to HK$15bn (US$1.3bn to US$1.9bn)	20%-30% of property transactions	-
7. Hotels[f]		8.3% of 33,297 hotel rooms in April 1992	-

Sources:

a. Liu Qingwen, "Hong Kong PRC-Invested Enterprises: Before and After 1997", *The Hong Kong Chinese Enterprise*, Autumn 1994, pp. 39-44.

b. Hong Kong Monetary Authority, *Annual Report*, 1993

c. Includes only insurance of China Insurance Holdings Company. See Wang Xianzhang, "Expand Insurance Business at an Accelerated Speed", *The Hong Kong Chinese Enterprise*, Autumn 1994, pp. 50-53.

d. Hong Kong Government Industry Department, *1994 Survey of External Investment in Hong Kong's Manufacturing Industries*, December 1994.

e. Includes only shipping of China Merchants Holdings Group. Information obtained from interview.

f. Ni, Nick, China's Expanding Economic Interests in Hong Kong, *Asian Perspectives*, Nomura Research Institute (Hong Kong), 11:6, December 1994.

Table 5: **Bank of China Group - Assets, Deposits and Loans**
(HK$billion)

	Assets	Deposits	Loans
1988			
HK$	150(21.25)	88(22.50)	79(19.51)
Foreign currency	149(5.98)	90(19.78)	24(4.30)
Total	299(8.09)	178(21.04)	103(10.71)
1989			
HK$	169(18.25)	96(21.28)	83(15.81)
Foreign currency	160(4.74)	100(17.95)	25(3.35)
Total	329(7.74)	196(19.44)	108(8.57)
1990			
HK$	202(20.2)	115(22.11)	96(15.82)
Foreign currency	195(4.61)	139(19.55)	27(2.28)
Total	397(7.59)	254(20.63)	123(6.88)
1991			
HK$	261(22.23)	139(23.61)	126(17.40)
Foreign currency	208(4.68)	152(19.74)	33(2.17)
Total	469(8.35)	291(21.16)	159(7.09)
1992			
HK$	289(22.32)	172(25.15)	151(18.60)
Foreign currency	241(5.43)	169(20.63)	44(2.66)
Total	530(9.25)	341(22.69)	195(7.89)
1993			
HK$	331(21.40)	213(24.83)	170(17.76)
Foreign currency	257(5.69)	184(21.30)	50(2.63)
Total	588(9.70)	397(23.04)	221(7.74)

Notes: 1. Loans include advances to customers.
2. Figures in parentheses denote percentage shares in Hong Kong's total.

Source: Hong Kong Monetary Authority

Table 6: **China's Manufacturing Investment in Hong Kong, 1985-1993**

	Value of stock of investment at original cost (US$million)	Percentage Share of Investment from: all countries	top 3 investors (Japan, USA & China)
1985	366	18	24
1986	382	15	20
1987	223	8	12
1988	379	11	16
1989	407	11	15
1990	422	11	15
1991	480	11	15
1992	530	11	15
1993	565	11	15

Source: Hong Kong Government Industry Department, 1994 Survey of External Investment in Hong Kong's Manufacturing Industries, December 1994.

Table 7: **China's Manufacturing Investment in Hong Kong in 1993, by Year of Commencement**

	Cumulative Number of Investments	Value of Stock at Original Cost (US$million)	Percentage share of investment from top 3 investors (Japan, USA, & China) by Cumulative No. of Investments	Value
Pre-1970	3	311	10	25
1970-1979	8	358	8	
1980	8	358	8	19
1981	9	--	8	--
1982	10	--	8	--
1983	11	395	8	--
1984	13	--	9	--
1985	15	453	9	18
1986	20	475	11	16
1987	22	--	11	--
1988	26	479	11	15
1989	32	498	13	--
1990	32	498	13	14
1991	33	--	12	--
1992	34	--	13	--
1993	37	565	14	15

Source: see above table

Table 8: **Distribution by industry of Chinese cumulative investment in manufacturing, at original cost**

	1985		1986		1987		1988		1989		1990		1991		1992		19
	Distribution %	Rank	Distribution %	Rank	Distribution %	Rank	Distribution %	Rank	Distribution %	Rank	Distribution %	Rank	Distribution %	Rank	Distribution %	Rank	Distributic %
Electronics	14.4	2	11.7	3	24.3	1	18.9	2	12.9	4	7.8	5	14.0	3	10.0	4	(6.1)
	(32.3)	(1)	(40.2)	(1)	(40.3)	(1)	(36.4)	(1)	(29.0)	(1)	(29.8)	(1)	(32.3)	(1)	(31.4)	(1)	(30.2)
Textiles & Clothing	2.9	6	2.5	6	6.6	6	10.4	5	9.3	5	8.3	4	8.7	4	7.3	5	n
	(8.5)	(3)	(7.3)	(3)	(9.6)	(2)	(10.5)	(2)	(9.4)	(3)	(10.7)	(3)	(9.3)	(3)	(11.0)	(3)	(9.6)
Electrical products	3.4	5	n	7	n	8	3.9	7	n	7	2.8	7	2.5	8	2.6	7	n
	(6.4)	(5)	(5.5)	(6)	(8.6)	(3)	(8.9)	(3)	(11.6)	(2)	(10.9)	(2)	(13.0)	(2)	(11.1)	(2)	(9.2)
Chemical products	n	3	n	2	23.3	2	24.8	1	18.8	2	18.9	3	2.2	9	1.8	9	(6.8)
	(6.1)	(6)	(6.9)	(4)	(7.7)	(4)	(8.4)	(4)	(7.8)	(4)	(7.9)	(4)	(5.1)	(5)	(5.8)	(5)	(8.5)
Food & beverages	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
	(5.8)	(7)	(4.7)	(7)	(5.0)	(7)	(4.5)	(6)	(4.8)	(7)	(4.8)	(6)	(4.8)	(7)	(6.9)	(4)	(6.9)
Printing & Publishing	2.3	7	3.3	5	7.8	5	4.5	6	n	8	n	n	n	10	n	n	n
	(6.9)	(4)	(3.8)	(9)	(6.0)	(5)	(5.9)	(5)	(7.7)	(5)	(4.7)	(7)	(4.3)	(8)	(3.8)	(7)	(4.8)
Metal products	n	9	-	-	n	7	n	n	n	n	n	6	4.4	7	4.2	6	n
	(47)	(9)	(4.0)	(8)	(3.3)	(9)	(2.9)	(9)	(4.8)	(8)	(3.9)	(9)	(3.1)	(10)	(3.0)	(10)	(4.4)
Transport Equipment	-	-	-	-	-	-	n	3	29.5	1	n	1	n	1	n	2	n
	(5)	(15)	(0.03)	(15)	(0.1)	(15)	(2.4)	(10)	(3.7)	(9)	(3.6)	(10)	(4.0)	(9)	(3.7)	(8)	(3.5)
Watches & clocks	n	12	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
	(4.8)	(8)	(6.3)	(5)	(5.2)	(6)	(4.3)	(7)	(5.0)	(6)	(6.3)	(5)	(3.1)	(11)	(3.9)	(6)	(3.1)
Plastic products	n	8	n	8	7.9	4	n	n	n	n	n	n	n	n	n	3	n
	(1.4)	(11)	(1.4)	(11)	(1.8)	(10)	(0.6)	(14)	(0.8)	(14)	(1.2)	(13)	(1.3)	(12)	(3.7)	(9)	(3.1)
Non-metallic mineral products	n	1	n	1	n	n	n	n	n	n	n	n	n	n	n	n	n
	(12.2)	(2)	(10.0)	(2)	(1.0)	(12)	(1.7)	(11)	(1.4)	(12)	(1.2)	(12)	(4.9)	(6)	(1.4)	(11)	(1.2)
Tobacco	n	4	n	4	n	3	n	4	n	3	n	2	n	2	n	1	n
	(5)	(10)	(3.3)	(10)	(3.3)	(8)	(3.5)	(8)	(3.5)	(10)	(4.4)	(8)	(5.3)	(4)	(n)	(15)	(n)
Non-electrical machinery	-	-	-	-	1.5	10	1.2	8	n	10	n	10	n	6	n	n	n
	(0.8)	(12)	(1.1)	(12)	(1.7)	(11)	(1.4)	(12)	(2.0)	(11)	(2.5)	(11)	(1.1)	(14)	(0.6)	(14)	(1.1)
Paper products	n	10	(0.2)	9	n	n	n	9	2.5	6	n	9	5.9	5	2.2	8	n
	(0.2)	(14)	(0.2)	(14)	(0.5)	(14)	(0.5)	(15)	(0.8)	(15)	(0.8)	(14)	(1.3)	(13)	(1.1)	(12)	(1.1)
Jade & Jewellery	n	11	n	10	n	9	n	10	n	9	n	8	n	n	n	n	n
	(0.7)	(13)	(0.8)	(13)	(0.9)	(13)	(1.0)	(13)	(0.1)	(13)	(0.6)	(15)	(0.8)	(15)	(0.7)	(13)	(0.7)
Correlation coefficient	0.3497		0.3768		0.1006		0.2048		-0.1588		0.0556		0.0815		-0.1292		-0.
t statsic	1.595		1.941		0.370		0.929		-0.683		0.290		0.458		-0.730		-1.

Figures in brackets represent share by industry (%) and rank of external investment (from all countries) in manufacturing at original cost.
The correlation coefficient is computed for (i) the rank of top 8 industries according to Chinese investment, and (ii) the rank of the corresponding industries according to external investment (from all countries)
n denotes not reported, and - denotes no investment
Sources : *Survey of External Investment in Hong Kong's Manufacturing Industries*, Hong Kong Government Industry Department, various issues.

Table 9: **Chinese Companies in Hong Kong, by supervisory level of government**
(end of 1993)

	No. of firms	Supervisory government body
State-controlled	50	State council & ministries
Provincial-controlled	72	Provinces & Municipalities
Local-controlled	530	City government or below
Agent "Window"	13 300	various local governments
Military-backed	18	various military authorities

Source: Ni (1994:5)

Table 10: **Major "Princeling Companies" in HK (known to the public)**

Company	Person-in-charge	Family Links
CITIC (HK)	Larry Yung	Son of Rong Yiren, VP of PRC
Continental Mariner	Wang Jun.	Son of Wang Zhen, VP of PRC
(China Poly Group)	He Ping	Son-in-law of Deng Xiaoping
First Shanghai	Chen Weili	Daughter of Chen Yun, influential leader
Ong Group (China Venturetech)	Chen Weili	Daughter of Chen Yun, influential leader
Guangdong Investment (Guangdong Enterprises)	Ye Weiping	Son of Ye Yuanpoing, VP of CPPCC
Laws Property (CNNC)	Song Kefong	Son of Song Renqun, influential leader
Kader Investment	Deng Zifang	The youngest son of Deng Xiaoping
CNNC	Wu Jiangchang	The eldest son-in-law of Deng Xiaping

Source: Ni (1994:8)

Table 11: **Role of Hong Kong as China's Gateway**

Financier	Direct investment Indirect investment Loan syndication	
Trading partner	Commodity Trade Services trade	
Middleman	Commodity trade	Entrepot trade Trans-shipment Brokerage in direct trade
	Services trade	Tourism Loan syndication Business consultancy
Service Centre & Facilitator	Contact point Conduit of information and technology	
	Training ground	Marketing Production

Table 12: **Chinese Companies' Stake in the HK Infrastructure Sector**

Mainland Co.	Hong Kong Co.	Infrastructure Sector	% Share
CITIC	HK Telecom	Telecom services	20.0
	Cathay Pacific	Aviation Services	12.5
	Eastern Harbour Tunnel	Sea Tunnel Services	25.0
CITIC Pacific	Dragonair	Aviation Services	38.5
	HACTL	Aviation Services	10.0
China Resources	Modern Terminal	Container Harbour Services	10.0
	Tunnel Services		20.0
China Merchants	Modern Terminal	Container Harbour Services	13.0
COSCO	Container Terminal 8	Container Harbour Services	50.0
CAAC	Jardine Air	Aviation Ground Services	40.0
CITIC	Western Harbour Tunnel	Sea Tunnel Services	35.0

Source: Ni 1994:13.

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