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Whither Hong Kong in an Open-Door, Reforming Chinese Economy?

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Introduction

With scarcely four years to go for the sovereignty to be reverted to China, the British enclave of Hong Kong on the South China coast, has been greatly benefiting from the open-door policy of China and her celebrated move from a centrally planned Soviet-style system to a market-type economy. Trade, investment, and financial flows across the 18-mile land border have taken on enormous magnitude over the past decade or so. Especially spectacular is the massive relocation of the Colony's manufacturing activities to the Pearl River delta in neighbouring Guangdong province to take advantage of cheap labour and land costs. The allocative resource realignment has brought about an intricate process of "deindustrialization" in Hong Kong in favour of the tertiary sector. But it has nonetheless hardly helped to mitigate the acute labour scarcity problem which the Colony has been facing since the mid 1980s.

Hong Kong has indeed continued in the past several years to thrive on the unceasing opportunities offered by the hinterland, with a robust annual Gross Domestic Product (GDP) growth of 5 to 6 per cent (amidst worldwide recession), against the backdrop of a mere one per cent growth of labour force per year. If anything, the GDP measure only helps to conceal the real magnitude of economic gains, because profit repatriation and similar net capital inflow from investment in the mainland or elsewhere cannot be adequately captured by the Government's statistical department for a Gross National Product (GNP) measure for the territory, being an entirely free port in the most classical notion[1].

The present Hong Kong-China symbiosis as having emerged in the past decade has certainly bewildered the wildest possible imagination of any dependency theorists or development structurists. For "economic integration" theorists or proponents, the late Professor Bela Balassa in particular, however, the bewilderment must have been compounded by the high import barriers imposed by China being presently not a contracting party to the General Agreement on Tariffs and Trade (GATT)), and the glaring lack of southward labour mobility across the border. Free capital flow is also basically a one-way traffic, notwithstanding increased illicit or semi-licit transfers from the mainland as witnessed in the recent past. The economic symbiosis represents, therefore, a truly rare phenomenon which defies any textbook elaboration, in either theoretical construct or empirical terms, of regional economic integration under the free trade regime.

The question of course is whether the observed Hong Kong phenomenon can be sustained beyond 1997 with its conversion to a Special Administrative Region (SAR) under the People's Republic of China (PRC). Note that presently the capitalist enclave enjoys a per capita GDP of USD16,380 for its 5.8 million residents who are crammed into a tiny total land area of 1,076 square kilometres with virtually no natural resources[2]. By contrast, GNP per head stands at a mere USD550 for Guangdong province, or no more than USD2500 in the Special Economic Zone (SEZ) of Shenzhen (highest in China), just across the border river, which is more a satellite town of Hong Kong rather than any Chinese economic entity[3]. No gainsaying, therefore, that the sharp contrast appears awfully odd in the wake of the imminent reversion of Hong Kong's sovereignty.

The question raised about the real crux of Hong Kong's post-1997 future appears therefore more political rather than economic in nature. There is, however, no point to question the integrity of the Dengist design for the "one-country two-systems" scheme under which Hong Kong as a SAR should be allowed to retain the status quo for 50 years. There is also no doubt that the border check points would remain strictly guarded to prevent any massive influx of intruders to disintegrate the system. Nonetheless, the fundamental economic question remains whether given the present trend and pattern of economic integration with the Motherland without a political reunification, the highly industrialized and commercialized Hong Kong economy would be eventually reduced to a Chinese outpost for trading, banking, shipping, telecommunication and tourist business in the years to come; and how the transformation may bear on the long-term economic vitality and economic welfare of the Hong Kongites.

This paper attempts to shed some light on these intriguing questions by examining the various aspects of the economic interaction between the two sides of the Shenzhen river. We shall focus essentially on import and export relationships, with a particular reference to the unique phenomenon of trade-bound "outward processing" investment undertaken by Hong Kong manufacturers in South China. The analysis will be preceded by a description, in broad contour, of the changing overall economic structure in Hong Kong in terms of GDP and employment structure in the past decade. This helps to provide a frame of reference for assessing the implications of the trade and financial flows across the border. We shall, however, begin the discussion by highlighting the changing basic economic and institutional parameters in China itself in order to place the economic involvement of Hong Kong in a proper broader historical context. The latter part of the paper evaluates the relative degree of Hong Kong's economic dependence on the Chinese Mainland and points to possible course of development in the future.

The Changing Environment

Hong Kong's contemporary history of economic development has been one of continual change. Reportedly, since its inception as a British trading post in 1843, the island economy of Hong Kong whose original acquisition bewildered young Queen Victoria and annoyed Lord Palmerston (then Foreign Secretary of Great Britain), shattered during the Second World War when the Japanese occupied the territory from 1941 to 1945, deluged since then by successive waves of immigrants from across the border, has survived beyond expectations. Yet, as a dependent enclave, Hong Kong's economic development since 1945 has been accompanied by solicitude and uncertainty about its political future. It is no gainsaying that the postwar development of Hong Kong's political economy revolves around the interplay of Britain and China's shared interest in the prosperity and stability of Hong Kong and Sino-British struggles over the object and management of the city economy.

Although history is not pre-determined, Hong Kong's tiny terrain is historically a part of China that has happened, for the past 150 odd years, to be overseen by someone else. As scarcely needs saying, Hong Kong is facing a time of unprecedented economic and political changes as the territory has entered its period of adjustment to the end of British colonial rule. As is well known, under the terms of the Sino-British Joint Declaration on the Question of Hong Kong, formally signed by the British and Chinese govrnments on 19 December 1984, the United Kingdom (UK) will relinquish its authority over Hong Kong on 1 July 1997, which will then become a Special

Administrative Region (SAR) of the PRC. The Joint Declaration provides that for fifty years after 1997, Hong Kong's life style will remain unchanged, and China's socialist system and policies will not be practised in the SAR. The so-called "one country, two systems" principles underlying the Joint Declaration were reconfirmed in the Basic Law, which will form the constitution of the Hong Kong SAR after the date of sovereignty reversion, enacted by the Seventh National People's Congress of the PRC on 4 April 1990. Conceivably, in the run up to 1997 a lot of changes will take place. All such changes, to be sure, will eventually have an impact on public policy and "the ordinary business of life".

On top of how successfully the British government of Hong Kong and Hong Kong's populace particularly prepare the capitalist economy for the new political regime, Hong Kong's trade-dependent economy is today faced with the challenges of changing international division of labour and of growing capacity constraints domestically. Without question, the external orientation of Hong Kong's economy and its very exposure to changing international circumstances have made flexibility necessary. Indeed, Hong Kong has succeeded in the postwar decades because its export-oriented enterprises, large and small alike, have been quick to exploit changing market conditions and to capture speciality niches. Over the long haul, however, the very success of Hong Kong's export industrialism has, on balance, become a double-edged sword. For one thing, export success has engendered stringent quantitative restrictions and other various forms of harsh trade barriers in overseas markets. At the same time, rising costs of labour and land mean that Hong Kong's export-led economy has reached a point where growth can no longer be dependent on sheer domestic factor inputs alone. Willy-nilly, life is like that: in a world of continual change and international competition - Hong Kong is, of course, fully in that world - the international division of labour keeps changing.

So far as the global economic transition is concerned, world development during the last decades of the twentieth century should have made us aware that virtually nothing in development economics is predictable with certainly, particularly not the miraculous economic development of China in the 1980s and its engaging gradualist reform about transforming a basically Soviet-type planned economy to a market-oriented system[4]. As has been well reported, ever since the open-door policy and economic reforms began in late 1978 in China, rapid economic growth has followed in the ensuing years. By contrast, all the former Soviet republics and all the East European economies, without exception, have experienced substantial declines in aggregate output. Over the past couple of years the contrast between China's economic performance and that of the former planned economies of the Soviet bloc has become so large that it is now widely argued that the Chinese gradualist reform has been a success, whereas the shock therapy, otherwise known as the "big bang", is in big trouble[5].

In 1992, while the West still struggled with recession, China's real GDP grew by a staggering 12.8 per cent, definitely the fastest rate in the world. That China has now the most dynamically growing economy can hardly be doubted. Indeed, over the lengthy period 1978-92, real GDP in China has grown at an average rate of some 9.5 per cent per annum, stop-go cycles notwithstanding. Per se, this growth record has been high not only by China's own historical standards but also internationally. Rhetorically, China's growth performance during the last reform decade would not look out of place amongst the records of the legendary "hyper-growth" East Asian NIEs of the 1960s and 1970s. The achievement stands out all the more if one takes into account the fact that China has the most populous and diverse economy on earth[6]. All of this has led to predictions by western experts that China's domestic economy could become the world's dominant economy by the turn of the twenty-first century. For instance, Lawrence H. Summers, a former chief economist of World Bank, recently extrapolated that, if the growth differential between China and the United States (US) during the 1980s continues, China could surpass the US to become the world's largest economy in eleven years[7].

Yet, in contrast to the pre-reform and closed-door era, no sector in the Chinese economy has undergone as dramatic a change as foreign trade and international production of tradables via direct inward investment, otherwise known as direct foreign investment (DFI). Since December 1978, when the history-making third plenary session of the Eleventh Central Committee of the Communist Party of China was held, China has made tremendous headway in attracting DFI capital. Between 1979 and 1992, China had approved 84,000 DFI projects with an agreed investment from them amounting to same US$100 billion[8], mostly in industrial processing and export-oriented manufacturing. Correspondingly, in the relatively short span of fourteen years, China has emerged as an important trading nation exporting and importing a wide range of products of substantial volume to cause concerns over problems of industrial adjustment in the world's major industrial countries. By 1992, China's foreign trade volume totalled US$165.6 billion, ranking it eleventh in the world, an impressive surge from thirty-second in 1979. Arguably, foreign trade and DFI have now become twin engines of growth behind China's rapid economic advance, accelerating not only the speed of industrial development but the pace of economic transformation as well[9]. It would seem obvious that the Dengist 1978 open-door policy, while open to some conflicting interpretation, consisting of export promotion, trade liberalisation (albeit still modest in scope), attracting foreign capital and resort to foreign loans, has played a central role in this growth and transformation process.

The implications of such a reforming Chinese economy on the industrial structure of Hong Kong's small, open, city-state economy are far-reaching. In the first place, attracted by the liberalisation of DFI regulations and other economic reforms under way in China since the late 1970s, many an energetic industrialist in Hong Kong has shifted a substantial share of his labour-intensive operations across the border to neighbouring regions in South China, where basic wage and land costs are a fraction of those in Hong Kong. The easiness of shifting Hong Kong's labour-intensive manufacturing industries across the Shenzhen border to the coastal areas in the mainland China has contributed much to the DFI proliferation in China and to the rise of China as a trading power. Reportedly, between 1979 and 1992 some three-fifths of all DFIs in China have been made by Hong Kong entrepreneurs. In particular, as high as 80 per cent of DFIs in Guangdong have come from Hong Kong.

On Hong Kong's part, these developments have no doubt led to significant economic changes involving intersectoral shifts of resources. In fact, many argued that a process of "hollowing out", or "deindustrialisation" in somewhat better known, if not less ambiguous, term, has occurred for rather more than a decade now as Hong Kong firms keep shifting out of manufacturing domestically

Table 1 Percentage Contribution by Major Industrial Sectors to GDP, 1980-91

Sector	1980	1985	1990	1991
Primary sector	1.0	0.7	0.3	0.2
Secondary sector	31.8	29.6	25.1	23.0
Manufacturing	23.8	21.9	17.2	15.5
Construction	6.7	5.0	5.6	5.3
Tertiary sector	67.2	69.7	74.6	76.8
Financial services	22.8	16.3	20.8	23.0
Trading services	20.4	21.8	24.3	25.4
Transport and communication	7.5	8.1	9.4	9.7

Notes: Financial services include banking, finance, real estate and business services; trading services include wholesale, retail, import and export trades, and hotels and restaurants; transport includes storage.

Source: Hong Kong Census and Statistics Department, Estimates of Gross Domestic Product 1966 to 1992 (Hong Kong: Government Printer, March 1993).

Table 2 Percentage Distribution of Working Population by Major Industrial Sectors, 1980-92

Sector	1980	1985	1990	1991	1992
Primary sector	1.4	1.8	1.1	1.0	1.0
Secondary sector	49.8	43.8	36.8	33.7	31.5
Manufacturing	41.7	35.6	28.0	25.3	22.6
Construction	7.6	7.5	8.4	8.2	8.4
Tertiary sector	48.8	54.4	62.1	65.3	67.5
Financial services	4.9	5.8	7.3	8.4	8.6
Trading services	20.0	22.9	26.1	26.8	28.0
Transport and communication	7.0	8.2	9.9	10.0	10.8

Source: Hong Kong Census and Statistics Department, Quarterly Report on Household Survey: Labour Force Characteristics, relevant issues.

and into service industries. That Hong Kong is undergoing rapid structural changes towards a more service-oriented economy is revealed just below.

Structural Changes in the Hong Kong Economy

The development and changing structure of Hong Kong's economy as reflected by the relative shares of major industrial sectors in total GDP for the past ten years or so is outlined in Table 1. As can be expected, given the geographical formation and non-factor resource endowment of the territory, the primary products have never been important in Hong Kong. Even more so, its relative contribution to the total domestic product has dwindled from a meagre one per cent of the GDP in 1980 to only 0.2 per cent of the GDP in 1991.

At the same time the contribution of the manufacturing sector to the GDP declined steadily from about 24 per cent in 1980 to some 15.5 per cent in 1991. This reflects what has been called a deindustrialisation process. As a matter of fact, at its height in 1970, manufacturing had accounted for 31 per cent of Hong Kong's GDP. In terms of employed labour force by industrial sector, such a deindustrialisation process is also clearly reflected in a steady decline in the share of manufacturing employment.

As Table 2 shows, the share of manufacturing employment fell from about 42 per cent of the total workforce in 1980 to some 25 per cent in 1991 and to less than 23 per cent in 1992. In other words, over this period employment in the manufacturing sector saw a relative drop of over 19 percentage points, which is even more pronounced than the decline in its relative contribution to GDP. In fact, since the early 1980s manufacturing employment in Hong Kong has not only continued to edge downward in relative terms but also in absolute numbers. Specifically, in September 1992, there were 41,937 manufacturing concerns in Hong Kong employing 571,181 persons. This level of employment was some 37 per cent below the peak of 904,646 recorded in September 1981. On the other hand, the share of the tertiary sector as a whole in total workforce increased from about 49 per cent in 1980 to over 65 per cent in 1991, and further to nearly 68 per cent in 1992. This development signified a growing structural orientation of the economy towards services, in line with Hong Kong's continued expansion as a financial and trading centre and its increasing economic integration with South China.

So far as Hong Kong's status as a financial centre in Asia-Pacific region is concerned, there are now 515 banks (including representative offices of foreign banks) and deposit-taking companies in the territory. Of the world's top 100 banks, 83 have established a presence in Hong Kong, 79 of which operate with a full banking licence. Thanks to the favourable geographical and time-zone location, strong links with China and other economies in the East and Southeast Asia, and, above all, the absence of any restrictions on capital flows in and out the territory, a substantial proportion of the banking transactions in Hong Kong are international in nature: in 1992, more than 60 per cent of aggregate assets and liabilities of the banking sector were, in fact, external, spreading over more than 100 countries. With an average daily turnover of around US$61 billion, according to a global foreign exchange market survey conducted in April 1992, Hong Kong's foreign exchange market, which forms an integral part of the global market, is among the largest trading centre in the region. Moreover, through particularly the syndication of loans and fund management, Hong Kong serves an important centre for the financial intermediation of international flows of savings and investment. It is reported that as large as 70 to 80 per cent of syndicated loans for China as well as Southeast Asia are arranged in the territory[10]. Authentic evidence of Hong Kong's significance as the region's financial centre is also provided by its gold market, which is the largest in Asia and the third largest in the world, and its bustling stock market. The local stock market, with a total market capitalisation of HK$1,332 billion (US$171 billion) at the end of 1992, ranked second in Asia after Japan.

Alongside the continued expansion as a major financial centre in Asia-Pacific region, another robust development that occurred in the 1980s was the reemergence of Hong Kong as a centre for China trade. In genuinely large measure, this upsurge has been activated by the opening of China since the late 1970s, which has not only led to a dramatic revival of Hong Kong's traditional role as an entrepot for China, but also generated an inlet for outward-processing trade which we shall consider later. And, unlike the early postwar period, Hong Kong's new entrepot function has added significant value to trade with banking, transportation, insurance and other business services.

Resulting largely from dynamic outward-processing and re-export trade, Hong Kong has witnessed a steady proliferation of trading entities in its industrial structure. In the mid-1991, according to Hong Kong Trade Development Council (TDC) data[11], there were 68,659 trading firms in Hong Kong, almost five times the number of 1978, the year China started to open up its economy. During the same period, gainful employment in these trading firms rose by four times to some 367,800. In analysing contributions of the trading sector to the local economy, however, one has to consider that the kind of trading activity currently undertaken by Hong Kong companies has far exceeded the traditional entrepot trade, as the TDC rightly argues. It actually embraces a lot of production-related services such as product design, sample-making, quality control, packaging, transportation and warehousing. More important still, many companies declared as trading entities in Hong Kong have industrial undertaking, in one form or another, outside the territory. The most common and easiest form is outward processing venture in South China. As a result, the real distinction between manufacturing and trading activities in Hong Kong as well as their respective value-added contributions to the economy have been blurred over the years.

Indeed, with the continual transfer of an increasingly large part of Hong Kong's manufacturing capacity across the border, not only is the nature of business difficult to define, the geographical boundary of production activity performed by many Hong Kong companies has likewise dissolved. This trend of outward processing development has given rise to an oft-heard question about the appropriateness of GDP as a measure of Hong Kong's aggregate income. As yet Hong Kong has no national income or gross national product (GNP) statistics. Beyond question, with the increasing importance of outward processing trade, net factor income earnings from across the border loom large, and more importantly so with the passage of time, in the determination of the total value added and factor income of Hong Kong residents.

After all, given its comparative advantage, arising from both physical and man-made conditions, in entrepot trade, financial and shipping services, Hong Kong's city-state economy has traditionally had a large service sector when compared with other economies at a similar stage of development. Today, with its booming tertiary sector accounting for almost 77 per cent of total GDP, Hong Kong has perhaps the most service-oriented economy in the world. Conceivably, as

Table 3 Changes in Merchandise Trade Structure and Foreign Trade Proportions, 1980-92

Year	1980	1985	1990	1991	1992
<u>Value (at Hong Kong dollar billion)</u>					
Total exports (X)	98.2	235.1	639.9	765.9	925.0
Domestic exports (DX)	68.2	129.9	225.9	231.0	234.1
Re-exports (RX)	30.1	105.3	414.0	534.8	690.8
Total imports (M)	111.6	231.4	642.5	779.0	955.3
Total trade (X + M)	209.9	466.6	1,282.4	1,544.9	1,880.3
Total GDP (at market prices)	136.8	261.1	558.9	641.1	742.6
<u>Proportion (in percentages)</u>					
DX / X	69.4	55.2	35.3	30.2	25.3
RX / X	30.6	44.8	64.7	69.8	74.7
RX / DX	44.1	81.1	183.3	231.5	295.1
X / GDP	71.8	90.0	114.5	119.5	124.6
M/ GDP	81.6	88.6	115.0	121.5	128.6
(X + M) / GDP	153.5	178.6	229.5	241.0	253.2

Sources: Hong Kong Census and Statistics Department, <u>Hong Kong Review of Overseas Trade</u> (Hong Kong: Government Printer, relevant issues); <u>Annual Review of Hong Kong External Trade</u> (Hong Kong: Government Printer, relevant issues); <u>Estimates of Gross Domestic Product 1966 to 1992</u>.

China's principal trading partner, middleman, financier and facilitator[12], the output and employment of Hong Kong's tertiary sector as a whole are likely to see further surges in the years to come.

Yet, despite its relative decline over the past decade-long years, manufacturing industry has remained one of the most important economic sectors in the territory. To be sure, the significance of export manufacturing in Hong Kong goes far beyond the relative GDP contribution and employment statistics. Amongst other valuable characteristics, there are direct and indirect linkage effects, such as the demand for intermediate and secondary supporting services including banking, insurance, legal services and the like. It is in this light that we should watch Hong Kong's trade-dependent, service-oriented economy going into the last decade of the twentieth century.

Changes in Trade Structure

Hong Kong has always had a highly trade-dependent economy, and increasingly so since the launch of economic reforms and the adoption of open-door policy by China in the late 1970s. The changing degree of Hong Kong's reliance on imports and its export propulsion during the 1980-92 can be seen from the increased import and export ratios in relation to Hong Kong's GDP. As shown in Table 3, import-GDP ratio reached a record high of nearly 129 per cent in 1992, compared to about 122 per cent in 1991 and 82 per cent in 1980. On the other hand, export ratios rose even more markedly from about 72 per cent in 1980 to nearly 120 per cent in 1991 and further to approximately 125 per cent in 1992, indicating an increasing degree of export propulsion over the years. This robust export growth was mainly attributable to the structural shift from domestic exports to re-exports made possible by the availability of outward processing facilities in South China along with the rapid increase in China's exports through Hong Kong. Taken together, the volume of Hong Kong's two-way external trade in merchandise rose from about 1.5 times GDP in 1980 to well over 2.5 times GDP in 1992. Perhaps except in Singapore's city-state economy, such a high and increasing foreign trade proportion is rarely seen, even among the family of small, open economic entities.

By any measure, the growth of Hong Kong's foreign trade volume has been little short of phenomenal. The money value of Hong Kong's merchandise exports in 1992 of HK$925 billion were about 9.4 times those of HK$98 billion in 1980, representing a compound growth rate of 20.5 per cent per year; while imports in 1992 of HK$955 billion were about 8.6 times the HK$112 billion in 1980, at a compound growth rate of 19.6 per cent per year. Altogether, the combined volume of Hong Kong's merchandise trade grew from HK$210 billion in 1980 to HK$1,880 billion in 1992, at an average growth rate of 20 per cent a year, more than three times as fast as world trade. Despite its minuscule size, in value terms Hong Kong is now among the top ten traders in the world.

In respect of trade balance, Hong Kong has had a chronic deficit in trade in merchandise, at least up to the mid-1980s. Deficits in merchandise trade, however, have not been a matter of grave concern in Hong Kong, as in most individual years these deficits have been amply compensated for by net income from invisible trade in services. In 1992, Hong Kong had a trade deficit on merchandise of HK$30.3 billion, or HK$33.5 billion when adjusted for imports of gold for industrial and commercial use. Combined together with an invisible trade surplus of HK$46.3 billion, there was an overall trade account surplus for the year of HK$12.8 billion[13], however. The continued expansion in trade in services in recent years was in line with the growing importance of Hong Kong as a regional trading, financial, business services and tourist centre.

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Meanwhile, capitalising on increasing economic integration with South China through outward direct investment and production, the structure of Hong Kong's merchandise tradables has continued to evolve, with more tilting towards those re-exports involving China in both directions. Enlarged production capacity aside, the lower production cost in South China helped to maintain the external competitiveness of Hong Kong's exportables in the world market. By relocating the more labour-intensive production processes across the border, Hong Kong manufacturers have been able to concentrate on the higher value-added and more human capital-intensive production processes, thereby contributing to the upgrading of the manufacturing sector. Concurrently, it has also facilitated the release of a good portion of the local manufacturing workforce to the service sector, thereby underpinning its continued growth.

Having said this, we now turn to the significance of the close economic links between Hong Kong and China that have developed in the years following China's adoption of a more open

Table 4 Origin of Re-exports, 1980-92 (at Hong Kong Dollar Billion)

Origin	1980	1985	1990	1991	1992
China	8.4 (27.9)	34.6 (32.9)	240.4 (58.1)	315.7 (59.0)	403.8 (58.4)
Japan	5.9 (19.6)	22.5 (21.4)	42.3 (10.2)	57.2 (10.7)	85.0 (12.3)
Taiwan	2.1 (7.1)	9.6 (9.1)	30.3 (7.3)	41.7 (7.8)	54.4 (7.9)
United States	3.2 (10.5)	9.5 (9.0)	24.5 (5.9)	26.6 (5.0)	32.1 (4.6)
South Korea	0.9 (2.9)	3.7 (3.5)	11.6 (2.8)	15.0 (2.8)	19.4 (2.8)
Germany	0.5 (1.6)	2.0 (1.9)	5.5 (1.3)	6.8 (1.3)	9.1 (1.3)
Singapore	0.3 (0.9)	0.9 (0.9)	4.7 (1.1)	6.2 (1.2)	8.3 (1.2)
United Kingdom	0.5 (1.6)	1.7 (1.6)	4.6 (1.1)	5.8 (1.1)	7.4 (1.1)

Notes: Figures in parentheses are percentage shares of the corresponding total re-export trade. As the Federal Republic of Germany (West Germany) and German Democratic Republic (East Germany) came into unification on 3 October 1990, entries for Germany before that date refer to West Germany and those from 1990 onwards refer to the trade with the unified Germany.

Sources: Hong Kong Review of Overseas Trade and Annual Review of Hong Kong External Trade, relevant issues.

Table 5 Destination of Re-exports, 1980-92 (at Hong Kong Dollar Billion)

Destination	1980	1985	1990	1991	1992
China	4.6 (15.4)	46.0 (43.7)	110.9 (26.8)	153.3 (28.7)	212.1 (30.7)
United States	3.1 (10.3)	14.7 (14.0)	87.7 (21.2)	110.8 (20.7)	148.5 (21.5)
Japan	2.2 (7.3)	5.5 (5.2)	24.4 (5.9)	29.6 (5.5)	37.5 (5.4)
Germany	0.7 (2.2)	1.5 (1.5)	23.4 (5.7)	32.1 (6.0)	33.1 (4.8)
Taiwan	2.2 (7.4)	4.3 (4.1)	21.2 (5.1)	24.8 (4.6)	26.2 (3.8)
United Kingdom	0.8 (2.7)	1.2 (1.2)	12.1 (2.9)	14.7 (2.7)	20.6 (3.0)
Singapore	2.5 (8.4)	4.4 (4.2)	12.6 (3.0)	12.1 (2.3)	13.9 (2.0)
South Korea	0.9 (3.0)	3.9 (3.7)	13.0 (3.1)	14.6 (2.7)	13.6 (2.0)

Note: Figures in parentheses are percentage shares of the corresponding total re-export trade.
Source: As Table 4.

economic policy in relation to Hong Kong's changing merchandise trade flows with China and other major trading partners.

Re-exports. One of the most visible evidences of Hong Kong's increasing economic integration with South China is the upshot of re-export growth in the territory. In 1988, for the first time in over thirty odd years, the volume of Hong Kong re-exports exceeded that of domestic exports. By 1992, around three-quarters of Hong Kong's total exports were re-exports. Spurred by the robust growth in outward processing activities as well as the continued expansion of international trade in China, the distributive shares of Hong Kong's domestic exports and re-exports as a percentage of its total exports have been more than neatly reversed between the late 1970s and early 1990s.

Hong Kong entrepot trade with relation to major places of origin and of consignment are listed in Tables 4 and 5, respectively. As shown, China was, of course, the largest source of, as well as the largest market for, Hong Kong's re-exports. Yet, as regards Hong Kong's re-exports to China, it is of interest to note that as late as early 1970s Hong Kong's re-export to China remained at a very low level, amounting to a few per cent of its total re-exports. This scene changed dramatically when China's open-door policy came into being. Since 1980, China has replaced the US and Japan as the largest market for Hong Kong's re-exports in addition to its more traditional role as the largest source of goods re-exported through Hong Kong. Despite the relative decline since the mid-1980s, China accounted for about 31 per cent of all goods re-exported through Hong Kong in 1992, compared with a meagre share of less than 2 per cent in 1977. Hong Kong has now recovered as a fully-fledged entrepot, with China playing the role of the leading trader, accounting for over 89 per cent of Hong Kong's two-way entrepot trade.

Apart from China, the other major re-exports markets were the US, Japan, Germany, Taiwan, South Korea and Singapore. In general, the relative importance of Japan and that of Singapore have been declining and that of the US, like China, has been increasing very rapidly. The implications of the rapid growth in Hong Kong's entrepot trade involving China on the one hand and the US on the other on Hong Kong's status as an international entrepot are far-reaching. For one thing in particular, its prospect is shadowed by the issue of annual renewal of China's most-favoured-nation (MFN) status in the US. With regard to the origin of the re-exports, the other major suppliers were Japan, Taiwan, the US and South Korea. In 1992, 86 per cent of Hong Kong's re-exports originated from these five leading suppliers, compared to some 68 per cent in 1980. As destinations, however, they accounted for around 63 per cent and 43 per cent in 1992 and 1980, respectively.

At this juncture, it is worth pointing out that because of Taiwan's ban on direct economic ties with China, Hong Kong has played a pivotal role as an intermediary handling much of the trade flow between the two sides of Taiwan Strait. By dint of this, indirect trade between Taiwan and the mainland China has been one of the fastest growing components in Hong Kong's entrepot trade[14]. Between 1978 and 1990, indirect trade across the Strait grew at a torrid average annual rate of 51 per cent. It reached US$5.8 billion and US$7.3 billion in 1991 and 1992, respectively. This entrepot trade now makes up around 45 per cent of Hong Kong's bilateral trade with Taiwan. On top of this, as high as 50 per cent of Hong Kong's imports from Taiwan are destined for China. Conversely, around 30 per cent of Hong Kong's total exports to Taiwan are made up of products of the Mainland origin, and these China-made re-exports now exceed Hong Kong's domestic exports to Taiwan.

Correspondingly, Taiwan became China's seventh largest trading partner in 1991, and the fifth largest in 1992. Meanwhile, Taiwan was China' fifth largest importer in 1990, and the fourth largest in both 1991 and 1992. Much of this increased trading interaction was attributable to the rapid upsurge of Taiwan's outward direct investment and processing activities across the Strait. In 1992, Taiwan stood second in the number of DFI projects in China and third in contract value after Hong Kong and the US[15]. This is noteworthy as an obvious reflection of the deepening economic relations between Taiwan and the Mainland. Apparently, the increasing economic integration and cooperation between the China "giant dragon" and the two "small dragons', namely Hong Kong and Taiwan, have signalled the coming of a Greater China Economic Community that is bidding to become a significant player in the global economy of the coming century. To be sure, if the twenty-first century is the Asia-Pacific era, the continuing economic integration and cooperation of the three Chinese economies must be the cornerstone.

Domestic exports. Apart from the booming entrepot trade, Hong Kong's domestic exports

Table 6 Domestic Exports by Major Importing Economies, 1980-92 (at Hong Kong Dollar Billion)

Destination	1980	1985	1990	1991	1992
United States	22.6 (33.1)	57.7 (44.4)	66.4 (29.4)	62.9 (27.2)	64.6 (27.6)
China	1.6 (2.4)	15.2 (11.7)	47.5 (21.0)	54.4 (23.5)	62.0 (26.5)
Germany	7.4 (10.8)	8.0 (6.2)	18.0 (8.0)	19.3 (8.4)	16.0 (6.8)
United Kingdom	6.8 (10.0)	8.5 (6.6)	13.5 (6.0)	13.7 (5.9)	12.5 (5.4)
Japan	2.3 (3.4)	4.5 (3.4)	12.1 (5.3)	11.7 (5.0)	11.0 (4.7)
Singapore	1.8 (2.6)	2.2 (1.7)	7.8 (3.5)	8.8 (3.8)	10.4 (4.4)
Taiwan	0.8 (1.2)	1.2 (1.0)	5.7 (2.5)	6.1 (2.6)	6.5 (2.8)
Canada	1.8 (2.6)	4.4 (3.4)	5.4 (2.4)	5.0 (2.2)	5.0 (2.1)
Netherlands	1.6 (2.3)	2.1 (1.6)	5.0 (2.2)	5.2 (2.3)	4.9 (2.1)
France	1.4 (2.1)	1.8 (1.4)	3.6 (1.6)	3.7 (1.6)	3.2 (1.4)

Note: Figures in parentheses are percentage shares of the corresponding total domestic exports.
Source: As Table 4.

to China had increased by leaps and bounds over the past decade or so. In 1977, only about 0.1 per cent of Hong Kong's domestic exportables found their ways into China. But this has changed dramatically since China launched its economic reforms and adopted the open-door policy in late 1978. In 1984, for the first time in postwar years, China overtook the UK and Germany to become the second largest market for Hong Kong's domestic exports. As shown in Table 6, which outlines the performance of Hong Kong's domestic exports in major markets, by 1992 China's share had risen to an all-time high of 26.5 per cent, more than the combined total of the UK and Germany's intakes. However, it is important to note that, although an increasing proportion of Hong Kong's domestic exports to China was to meet its local demands for final goods, the bulk of these exports consisted of raw materials, parts and semi-manufactures, and were related outward processing arrangements commissioned by Hong Kong companies, amid the tight labour market situation in Hong Kong.

Despite its relative decline in recent years, the US was nevertheless still the largest market for Hong Kong's domestic exports, accounting for 27.6 per cent of the total value in 1992, compared with the record high of over 44 per cent in 1985. For historical reasons, the UK was traditionally one of Hong Kong's most important market outlets. But its relative importance has been declining. In the early 1960s, its share still stood at over 20 per cent, second only to the US, whereas Germany's share was less than 4 per cent. By 1992, the UK's intake had declined to only 5.4 per cent, while Germany's share was 6.8 per cent. Although Japan has been Hong Kong's fourth largest export market for most of the postwar years, its relative intake has seen little improvement over time. It accounted for less than 5 per cent of the total value in 1992.

As to other important markets, in the early 1960s, a number of economies in Southeast Asia, including Malaysia, Thailand and Indonesia, were still among the list of Hong Kong's top ten markets. But by 1970s, only Singapore remained on the list. The shares of these Southeast Asian countries were replaced by Canada, the Netherlands, France and more recently, Taiwan. At any rate, the direction and level of Hong Kong's domestic export trade and their changes over time have been much influenced by the changing economic conditions and commercial policies in major importing countries.

Table 7. Imports by Major Source Economies, 1980-92 (at Hong Kong Dollar Billion)

Source	1980	1985	1990	1991	1992
China	21.9 (19.7)	59.0 (25.5)	236.1 (36.8)	293.4 (37.7)	354.3 (37.1)
Japan	25.6 (23.0)	53.3 (23.1)	103.4 (16.1)	127.4 (16.4)	166.2 (17.4)
Taiwan	8.0 (7.1)	20.9 (9.0)	58.1 (9.0)	74.6 (9.6)	87.0 (9.1)
United States	13.2 (11.8)	21.9 (9.5)	51.8 (8.1)	58.8 (7.6)	70.6 (7.4)
South Korea	3.9 (3.5)	8.3 (3.6)	28.2 (4.4)	34.9 (4.5)	44.2 (4.6)
Singapore	7.4 (6.6)	11.3 (4.9)	26.1 (4.1)	31.5 (4.0)	39.1 (4.1)
Germany	2.9 (2.6)	6.7 (2.9)	14.8 (2.3)	16.6 (2.1)	21.9 (2.3)
United Kingdom	5.5 (4.9)	8.4 (3.7)	14.1 (2.2)	16.5 (2.1)	19.2 (2.0)
Italy	1.4 (1.2)	3.6 (1.5)	10.9 (1.7)	11.7 (1.5)	14.8 (1.6)

Note: Figures in parentheses are percentage shares of the corresponding total imports
Source: As Table 4.

Imports. To meet the needs of its teeming populace and the requirements of its diverse industries, Hong Kong is almost entirely dependent on imported resources. Under free trade, these supplies come from many sources in the world. What is imported from different exporting economies largely reflects their competitive supply conditions. Because of geographical proximity, it is only natural that Hong Kong oftentimes turn first to China for competitive supply. Aside from the usual merchandise imports, around 75 to 80 per cent of fresh water now consumed in Hong Kong is imported from China.

As Table 7 shows, China's share of Hong Kong merchandise imports increased from about 20 per cent in 1980 to over 37 per cent in the past two years. As one can surmise, a large part of this rapid import growth in recent years has been derived from the upsurge in Hong Kong's re-export trade, which was, in turn, partly due to the continued migration of Hong Kong's manufacturing base in the form of outward-processing activity across the border, and partly due to the increase in exports from China, a significant proportion of which was channelled through Hong Kong to overseas markets, especially to the US.

In the dawn of the 1980s, Japan was still the largest supplier of merchandise goods to Hong Kong. But with the opening up of China and the subsequent closer economic ties between China and Hong Kong, since 1982 China has regained its traditional number one position. From the mid-1980s onwards, Hong Kong has obtained around 50 per cent of its imports from China and Japan, with the former being the most important source of foodstuffs and latter supplying industrial materials, parts and components. The two are approximately equally important as suppliers of consumers. Despite the relative decline of Japan, the combined share of these two traditional sources reached a record high of nearly 55 per cent in 1992, compared with some 43 per cent in 1980.

The other major sources of Hong Kong's imports were Taiwan, the US, South Korea, Singapore, Germany and the UK. The importance of the US and the UK in particular has been declining. On the other hand, Taiwan and South Korea have emerged as important sources of supply to Hong Kong. In fact, not only has Taiwan surpassed the UK as Hong Kong's major supplier since the mid-1970s, it has also replaced the US since 1987 to run a distant third as an import source. Like the surge of Taiwan, the growth momentum from South Korea in recent years has been supported by a substantial amount of re-exports to China.

At this point, we should not fail to divulge that, due to the large proportions of re-exports, Hong Kong's official import trade statistics per se can be quite misleading at large, especially when analysed by end-use categories. In 1990, for example, industrial raw materials and semi-manufactures accounted for some 39 per cent, consumer goods another 39 per cent, capital goods 15 per cent, foodstuffs 6 per cent, and fuels 2 per cent, respectively, of Hong Kong's gross import payment. But as much as some 51 per cent of these raw materials and semi-manufactures, 89 per cent of the consumer goods, 57 per cent of the capital goods, 31 per cent of the foodstuffs, and 17 per cent of the fuels were later re-exported. With this caveat in mind, one has to look into retained imports (gross imports net of re-exports) for information on Hong Kong's own import requirements.

The surge of "Outward-processing" Trade

For obvious factor-endowment reasons, Hong Kong's industrial development had to concentrate on light industries, as dictated by the comparative advantage doctrine. Yet, comparative advantages are never static assets. Since the late 1970s, as noted earlier, Hong Kong's price competitiveness in light export manufacturing has begun to erode as a result of increases in wages and land costs and the emergence of lower-cost regional competitors. Fortuitously the opening up of the Chinese economy and the subsequent setting up of four special economic zones (SEZs), including in particular the Shenzhen SEZ which is just across the Hong Kong border, in the early 1980s, have provided new and competitive outlets for Hong Kong's hard-pressed manufacturers. As also noted earlier, attracted by the much lower costs of production in the open coastal areas of South China, many Hong Kong industrialists shifted their production facilities or part of their production processes over there. This development gives rise to a large volume of what is called "outward-processing trade" between Hong Kong and China[16].

In this outward-processing trade, there were exports (both domestic exports and re-exports) of raw materials and semi-manufactures, including near-finished goods, from or through Hong Kong to China, normally import duties exempted, for processing with a contractual arrangement for subsequent reshipment of the processed goods to Hong Kong for final packaging and further processing if not yet completed, or else for re-export to third countries; and on the other hand, there were imports from China of which all or part of their raw materials and semi-manufactures, also including near-finished goods, were under contractual arrangement previously exported from or through Hong Kong. To be sure, the development of outward-procession activities has been stimulated by a host of push and pull factors. At the risk of over-simplification, however, the push factors, especially on the question of labour, pertaining to this important facet of Sino-Hong Kong economic relations in Hong Kong mirror closely the pull factors in South China. The decade-long experience has now proved that highly favourable factor-resource conditions exist for complementary development and inter-territory division of labour under the outward processing arrangements, leading to dynamic economies of scale and scope that benefit both places concurrently.

In many ways, especially in terms of GNP measures, the continued migration of the territory's manufacturing base across the border has effectively enlarged Hong Kong's productive capacity. Today, on top of some four-fifths of Hong Kong manufacturers having transferred production to the Mainland, around 25,000 factories in the Pearl River Delta region of Guangdong alone are engaged in outward processing for Hong Kong companies, while between three and four million workers there are directly or indirectly employed by these Hong Kong outward-processing firms[17]. When it is noted that the entire employed labour force of the manufacturing sector in Hong Kong was less than 0.6 million in the end of 1992, the sheer magnitude of the outward-processing counterpart, which was about five to seven times as large as Hong Kong's own manufacturing workforce, becomes quickly apparent. Following the relocation of more labour-intensive processes across the border, many Hong Kong workers previously on the production line have become responsible for much of the training, supervision, quality control, and other jobs of more demanding nature. For those still on the production front, the tasks involved have become more skill and knowledge intensive. Meanwhile, the local manufacturing sector has been able to release a good portion of its labour resources to other sectors which are likewise faced with the problem of labour recruitment in a very tight overall labour market situation. As mentioned earlier, the tertiary service

Table 8 Percentage Share of Trade of Outward-processing Nature to Total Trade with China by Commodity Groups, 1989 and 1992

	Domestic exports		Re-exports		Imports	
Commodity group	1989	1992	1989	1992	1989	1992
Textiles	84.8	87.4	71.5	81.9	12.8	23.0
Clothing	85.1	93.2	87.3	76.0	84.5	84.4
Plastic products	83.9	77.5	58.0	64.5	73.4	89.3
Machinery and electrical appliances	56.7	59.7	24.9	27.3	77.8	81.0
Electronic products	94.6	92.7	43.1	41.4	85.2	92.7
Watches and clocks	98.5	98.6	93.5	97.7	94.6	94.3
Toys, games and sports goods	96.4	91.9	60.1	80.1	94.1	96.9
Metals and metal products	64.2	69.0	37.8	34.8	30.2	43.6
<u>All commodities</u>	76.0	74.3	43.6	46.2	58.1	72.1

Source: Hong Kong Census and Statistics Department, <u>Hong Kong External Trade</u>, relevant issues.

sector in general and those trading, finance and business services particularly have been absorbing these labour resources and their relative contributions to the domestic economy have been rising as a result.

To provide a better understanding of Hong Kong's trade with China, the Hong Kong Census and Statistics Department began to compile statistics on domestic exports and re-exports to China for outward-processing purposes in the third quarter of 1988; and statistics on imports from China related to outward processing in the first quarter of 1989. Apart from providing an indirect indication of the growth in outward-processing activities on a quarterly basis, these statistics serve to confirm the general impression that much of the phenomenal increase in Sino-Hong Kong trade during the past decade are attributed to the expansion in such activities. On this basis, over 72 per cent of Hong Kong's imports from China were related to outward processing in 1992, compared to some 58 per cent in 1989. The corresponding proportions in 1992 were 74 per cent for domestic exports and 46 per cent for re-exports, compared to the respective ratios of 76 per cent and 44 per cent in 1989. Altogether, in 1992, over 52 per cent of Hong Kong's total exports were related to outward-processing arrangements.

Analysed by broad commodity categories, the outward-processing contents of all importables from China, as shown in Table 8, were generally high except for textiles. As regards domestic exports, the percentage of outward-processing trade with respect to most individual commodity groups were no lower than their import equivalents. The ratio for machinery and electrical equipment, however, was somewhat lower than the others. In large measure, this is due to the existence of strong demand for such Hong Kong products in China. The same was true for re-exports as there was a large market in China for foreign machinery, electrical equipment, consumer electronics such as television sets and sound recorders, as well as metals and metal products. In a nutshell, a large volume and variety of commodities in the trade between Hong Kong and China were associated with outward consignment or commissioned processing businesses. As a corollary, Hong Kong's manufacturing mix has been altering. Instead of expanding horizontally as in the past, the city economy has had to respond vertically by raising its own skill-levels and productivity by moving into higher value-added activities.

As to the major locations in China where outward-processing activities were domiciled, in 1992 more than 93 per cent of Hong Kong's import trade of this nature had processing work carried out in Guangdong province, according to the latest Census and Statistics Department's estimates. To be sure, through the aggressive outward-processing activities of Hong Kong industrialists, the city economy of Hong Kong has entered into a process of economic integration with South China centred on the Pearl River Delta region for more than a decade now. With the benefit of hindsight, it would not be too farfetched to describe this process, which has progressed to a point of virtually no return to date, as the "Hongkongisation" of South China. And in point of fact, the growing interdependence of Hong Kong and Guangdong economies has now actually gone beyond the domain of real economic aggregates. Concurrent with the growth of cross-border investment and trade, an increasing pool of Hong Kong dollar notes has been used as a second medium of exchange in Guangdong and elsewhere in China. According to a recent study by the Hongkong and Shanghai Banking Corporation, the amount of Hong Kong dollar notes in circulation in South China increased from HK$0.7 billion in 1980 to as much as HK$15 billion in 1992, representing some 30 per cent of total currency issued in Hong Kong[18]. Against this backdrop, as one can surmise, several key ratios of Hong Kong's monetary aggregates have become less indicative of the state of the local economy and, in some case, even misleading.

Issues and Problems Areas in Sino-Hong Kong Trading Nexus

Since China initiated its economic reforms and opened up its doors to foreign trade and investment some fourteen years ago, Hong Kong's economic fortunes have become increasingly enmeshed with those of China. Today the most dynamically growing component in Hong Kong's overall external trade is the re-exports of products from Guangdong and elsewhere in China. Hong Kong and China are now each other's largest external investment and trading partner. Over the long haul, however, the growing integration of Hong Kong's manufacturing and outward-processing trade flows with South China has become something of a new double-edged sword for Hong Kong's externally oriented economy. On the plus side, China's diverse economy and labour abundance have provided Hong Kong with a vast hinterland of cheap land and low-wage labour just as its own external competitiveness in world tradables was gradually eroding. The economic integration, however, has made Hong Kong inherently vulnerable to the vagaries and vicissitudes of China's external commercial relations with the rest of the world. Most damaging to Hong Kong is, of course, the very prospect of US trade action against China, both in the form of a revocation of China's MFN trade status with the US and Section 301 of US Trade Act of 1974 or the so-called "Super 301" action of the US Omnibus Trade and Competitiveness Act of 1988. For obvious political and economic reasons, trade between China and the US has been conducted over troubled waters over the past years. Amidst this, the importance of MFN status to China and its implications for Hong Kong could hardly be overstressed.

As has been well reported, under the Jackson-Vanik Amendment to the US Trade Act of 1974[19], as a nonmarket economy country China's MFN status must be certified annually by a presidential determination stipulating that China meets the requirements for emigration freedom, or by a presidential waiver of the certification. The decision by the US President to extend MFN is automatically implemented unless both Houses of US Congress pass a resolution of disapproval. The US President can veto such a resolution, and China's MFN status then continues unless the veto is in turn overturned by a two-thirds majority vote in both Housess of Congress. Beyond question, the yearly debate over renewal would create a high level of uncertainty which would be damaging to the long-term business prospects of all parties concerned. For the purpose of seeing the extension of MFN status, over the past two years or so China has made a great deal of efforts towards resolving a good number of trade disputations with the US, leading to the subsequent signing in 1992 of three memoranda of understanding on the protection for US intellectual property rights, on prohibition of the export of forced-labour products, and on US access to the Chinese market. So far as the market-access agreement is concerned, China has pledged to reduce or eliminate a wide range of trade barriers over the next five years, including tariffs, quotas, import licences, import substitutions, and other forms of non-tariff trade restrictions.

The stakes of Sino-US MFN trading nexus are high. For Hong Kong's part, the economic effects of a loss in China's status could be no less enormous than China's lot. The arithmetic is simple: China and US, when taken together, now account for some half of Hong Kong's total foreign trade volume. Take away China's MFN, the US import tariffs on Hong Kong's re-exports from China would go up be as much as ten-fold. Put another way, without the MFN, around two-thirds of China's exports to the US, much of which originated in Hong Kong-owned plants in South China, would be cut off, dealing a heavy blow to Hong Kong's entrepot economy. In addition to the loss of the profits arising from outward investment in China, Hong Kong would lose considerably in the re-export markup, which includes profits and the cost of transportation, insurance, packaging and warehousing, is very substantial and is earned by Hong Kong middleman. While estimates of the re-export markup which Hong Kong companies earn vary, conservative survey findings put the average figure for Chinese goods at no smaller than 16 per cent[20].

In fact, according to the most recent estimates by Hong Kong government, the loss of China's MFN status would cost Hong Kong up to 70,000 jobs and up to three percentage points of Hong Kong's annual GDP growth[21]. There are, in fact, more in these than meet the eye. For one, Hong Kong's loss would significantly enlarge if China were to retaliate against the US. For another, the casualty would not be confined to China and Hong Kong only. Reportedly, withdrawal of China's MFN status would also cost US consumers some US$14 billion because of higher tariffs, while retaliation by China would put at risk over 150,000 US jobs, among others[22].

So far as US external commercial policy is concerned, with the passage of the Omnibus Trade and Competitiveness Act of 1988, as the world trading community knows, the US Congress has given de facto legitimacy to unilateralism in defining US trade rights, in determining their violation and in meeting out punishment to secure satisfaction. As such, even leaving aside political factors such as human rights, missiles sales, and nuclear material and technology proliferation, China is still in the risk of losing the MFN status in the medium term. The sheer fact is that, according to US Department of Commerce statistics, China already has one of the largest trade surpluses with the US of any exporting economy in the world. Closely related to the trade imbalance issue is the problem of discrepancies between the US and Chinese trade data. Official Chinese Customs statistics differ widely from US reckoning. The Chinese figures do not take into account export of goods through Hong Kong. The US Department of Commerce statistics, in contrast, consider Chinese goods re-exported through Hong Kong to be Chinese exports, but count US goods transhipped through Hong Kong as exports to Hong Kong. Correspondingly, China claims to suffer trade deficits with the US but the US trade officials say that the reverse is true. After all, according to the US Department of Commerce, US bilateral deficit with China was US$3.5 billion in 1988. By 1992 it had risen to over US$18 billion, making China's trade imbalance with the US second to Japan's and surpassing Taiwan's surplus with the US. By and large, China's surplus, as recorded by the US Department of Commerce, has become unpalatable to Americans because of its growing magnitude, and, therefore, works against the smooth continuation of its MFN status.

To a considerable extent China's rapid export expansion to the US and the world market at large since the early 1980s has been spurred by the burgeoning outward-processing activity of Hong Kong manufacturers in Guangdong and elsewhere in China. This has enabled Hong Kong to hold down its trade surplus with the US by shifting a substantial part of the surplus onto China's trade ledgers. And, following the footsteps of Hong Kong, since the mid-1980s many manufacturing concerns in Taiwan have also shifted their production bases to the coastal areas in China, reducing Taiwan's controversial trade surplus with the US as well. Taken together, these developments could well threaten to blow out China's surplus with the US to such a magnitude that protectionist lobbying groups in the US would become fiercely enraged. Arguably, then, China's MFN status and ultimately Hong Kong's trade prospects are more likely to be jeopardised by economic developments than by political controversy.

More pertinently, within these on-going trends of outward investment from the two small dragons to the mainland China what is in fact emerging as a new economic entity is the Greater China triangle. As noted earlier, the implications of the advent of the Greater China Economic Community for the global economy are far-reaching. For one thing in particular, because of the massive transfer of manufacturing capacity from Hong Kong and Taiwan to China over the past decade, the Greater China combined trade deficit with the US, perhaps, gives a truer picture. As a matter of fact, while there is increasing attention focused on China's trade imbalance with the US, the US combined trade deficit with the Greater China trio actually declined by some US$3 billion during 1987-91[23]. In the main, the growing US trade imbalance with China must be looked at from a broader regional perspective rather than in isolation.

How Far the Economic Integration?

That the interdependence and economic integration of two economies, be they large or small, relatively poor or rich, are not a one-way street needs little economics to gather. Beyond question, the Hong Kong factor to China's reforming economy is, to a greater or lesser extent, the mirror image of the China factor to Hong Kong's evolving economy, and all our discussion in this article must be seen in that light. Yet, it is a fact of life that while the China factor is beyond the control of Hong Kong, the converse is clearly not true.

Concurrent with the strong growth in money and capital funds from Hong Kong to China, the open-door policy and economic decentralisation have encouraged many provincial and 都市的 municipal entities in China to set up their own companies in Hong Kong. Over the past reformist decade, China's investment in Hong Kong has not only increased rapidly, but also proliferated into practically all major economic sectors. Besides the traditional banking, trade and trade-related activities such as transportation and warehousing, newer areas of investment range from manufacturing, stock market, real estates and property development, construction and infrastructural projects, tourism and tourist-related facilities such as hotels and restaurants, to the operation of taxi and bus fleets and supermarkets. In particular, reflecting the increasing financial links between Hong Kong and China, the Bank of China Group now forms the second largest banking group in Hong Kong, after the Hongkong Bank Group, in terms of deposits and the number of branches.

Today, with more than 3,000 mainland companies operating in the city, the China-related businesses are now involved in virtually everything that makes Hong Kong's bustling economy budge. It is likely that no one, including the highest ranking officials in Beijing, knows just how much China has invested in Hong Kong. Even granting that the large state-run mainland firms are well charted, the puzzling question is how much capital fund is funnelled in by the uncontrolled businesses and

Table 9 Percentage Contribution to the Hong Kong Economy by the China Factor

GDP sectors	Contributive share 1980	Contributive share 1990
Primary sector	0.0	0.0
Secondary sector		
Manufacturing	0.0	10.6
Construction	0.0	5.0
Electricity, gas and water	2.7	7.0
Tertiary sector		
Financial services	0.8	6.5
Trading and entertainment services	8.9	33.7
Import and export trades	17.4	48.4
Wholesale and retail trades	0.0	5.9
Hotels and restaurants	0.0	13.2
Transport, storage and communication	12.0	20.5
Direct contribution	2.7	12.8
Total (direct and indirect) contribution	5.3	25.7

Source: Hang Seng Bank, "The Current State of the Chinese Economy and Its Impact on Hong Kong", Hang Seng Economic Monthly (June 1993).

wealthy Chinese mainlanders. In all, while the total value of China' external investment in Hong Kong is a matter of conjecture, an oft-quoted figure these days is of US$15-20 billion[24], well outpacing that of Japan and the US.

On balance, there is little question that the China factor has emerged as the single most important factor underlying Hong Kong's robust economic growth in the 1980s. In this regard, a recent study by the Hang Seng Bank has the virtue of being informative into an overall quantitative assessment about the contribution of the China factor in relation to Hong Kong's aggregate domestic output, as Table 9 shows. In 1980, at the dawn of the Dengist economic reforms, business with China contributed only about 5 per cent to Hong Kong's economy; by 1990, or just a decade later, that share had risen to nearly 26 per cent. Without doubt, given the extensively growing economic links between the two places, China's direct and indirect contributions should have had increased further in the past two years. The corollary is: without the Dengist reforms about more liberal trade and investment policies, Hong Kong's GDP growth during the 1980s would have averaged only 4.6 per cent in real terms instead of the actual 7.1 per cent[25].

Looking forward, the Hong Kong economy is bound to be even more intimately tied in with the Mainland's in the years to come. And given the anticipated political parameters by way of the promised "one-country two systems" framework, any further economic integration with the hinterland appears likely to be for better rather than worse for the future SAR, which as a separate independent economic entity as prescribed in the Sino-British Joint Declaration of 1984 and the promulgated Basic Law, would not be obliged to share, for example, its budget revenue with Beijing or the Guangdong authority.

Possible disturbance from the MFN-Status wrangle aside, the hinterland will clearly continue to provide a pool of unlimited labour supply for Hong Kong's manufacturers to fall back on. In a way, the expedient recourse may forestall the urge and pressures for a technological upgrading in Hong Kong in the long-run, but the potential losses in this respect will probably be outweighed by the continuous structural shift of the Hong Kong economy towards the modern services sector, such as banking, finance, and telecommunication, with higher value-added contribution.

There are other favourable factors at work as well, the foremost being the prospective China's readmission to the GATT family. The expected wide-ranging industrial deregulation, just to make China compatible with GATT's market economy regime, will almost certainly help to open up many hitherto untapped trading opportunities to the outside world, let alone the abolishment of the various non-tariff import barriers and the reductions of import tariffs[26]. Already, amidst the GATT euphoria which strongly unfolded in China since the summer of 1992, many Hong Kong industrial and business conglomerates were strongly poised to move into the vast Chinese service sector, including retail business, real estates, transportation, and the like. Likewise, any early measure taken to make the Chinese currency Renminbi fully-convertible will only help to make China even more attractive as an investment proposition for Hong Kong businessmen.

To conclude, Hong Kong's economic prospects and the solutions to its problems are now intimately tied to both economic performance and political developments in China. Under the Sino-British Agreement of 1984, the direction of Hong Kong's capitalist economy towards one increasingly integrated with China, especially South China, is a fact of ordinary business of Life in Hong Kong, for better or for worse. While the China factor now forms the main impetus of Hong Kong's prosperity and stability, Hong Kong's very usefulness to China's modernisation also goes without any more saying here. Rhetorically, tiny Hong Kong and the China giant have more or less become Siamese twins. It is tempting to argue, therefore, that Hong Kong and China are going to be in the same boat, and for the dependent Hong Kong not to go under in a sea of incessant changes, China must be kept afloat. All said, the growing interdependence and increasing economic integration between Hong Kong and China underlines the need to maintain a concordant relationship in the years to come.

1. Capital movement in and out of Hong Kong is entirely free, and it can take place at any time by simply keying in the figures to computer for outward remittance via fax machine. Import levies are virtually non-existent, except for the "domestic consumption taxes", referred to as duties in Hong Kong, which are currently imposed on three groups of commodities - tobacco, alcohol and fuel, irrespective of whether they are imported or manufactured locally.

2. As an island economy, Hong Kong's terrain is rocky and hilly. Of this tiny land area, however, only rather more than 14 per cent is built up and less than 9 per cent is suitable for crop and fish farming.

3. See Rober Ash and Y. Y. Kueh, "Economic Integration within Greater China", in The China Quarterly, No. 137, December 1993 (forthcoming) for the comparative Chinese GNP figures.

4. For a comprehensive review of the economic situation in China following the introduction of its market-oriented economic reforms in late 1978, see World Bank, Country Operations Division, China and Mongolia Department, and East Asia Pacific Region, China: Country Economic Memorandum - Reform and the Role of the Plan in the 1990s, Report No. 10199-CHA (19 July 1992).

5. The "gradualism" and the "big bang" have now been almost unanimously identified as the two main models of transition from a Soviet-type dirigisme to a market-oriented system. Roughly speaking, China has taken the gradualism, while all the East European countries and the former Soviet Union have followed the big bang. Such a dichotomisation is, of course, not quite correct. Hungary and Poland had practiced the gradualism before the big bang. Even the former Soviet Union had engaged the gradualism before the collapse of its Communist regime.

6. In terms of land surface area, China's is the world's third largest country encompassing and area of about 9.6 million square kilometres. Most telling, its 1.18 billion population represents some 22 per cent of mankind on earth.

7. Lawrence H. Summers, "The Rise of China", International Economic Insights (May-June 1992). The departure growth rates for Summers' extrapolation are: during the 1980s, China's annual GDP growth averaged about 8.7 per cent, while the US equivalent was 2.3 per cent. By Summers' reckoning, even if that growth differential were cut in half, China's total GDP would surpass that of the US by 2014.

8. See Gao Shangquan (former Vice Minister of State Commission for Restructuring the Economy, PRC), "Taking a Market-oriented Direction and Pushing Forward in a Gradual Way - A Basic Experience of China's Economic Reform" (paper delivered at the International Symposium on the Theoretical and Practical Issues of the Transition Towards the Market Economy in China organised by China (Hainan) Institute for Reform and Development, held in Haikou, Hainan, 1-3 July 1993), p. 3.

9. For fuller discussion concerning the role of foreign investment and trade in China's economy, see, for example, Y. Y. Kueh, "Foreign Investment and Economic Change in China", The China Quarterly, No. 131 (September 1992), pp. 637-90; Nicholas R. Lardy, Foreign Trade and Economic Reform in China, 1978-1990 (Cambridge: Cambridge University Press, 1992); and Yin-Ping Ho, "China's Foreign Trade and the Reform of the Foreign Trade System", in Joseph Cheng Yu-shek and Maurice Brosseau (eds), China Review 1993 (Hong Kong: Chinese University Press, 1993), chapter 17.

10. See Zhou Zhenxing (senior deputy general manager of Bank of China's Hong Kong Branch), "Hongkong the Hub of Massive Growth", South China Morning Post (4 May 1992).

11. TDC, Research Department, Survey on Hong Kong Domestic Exports, Re-exports and Triangular Trade (November 1991).

12. A succinct account of these four pivotal roles of Hong Kong can be found in Yun-Wing Sung, The China-Hong Kong Connection: The Key to China's Open-Door Policy (Cambridge: Cambridge University Press, 1991).

13. Hong Kong Government Secretariat, Economic Services Branch, 1992 Economic Background (Hong Kong: Government Printer, March 1993), p. 21.

14. For details, see TDC Research Staff, "Cross-Strait Trade Boom", International Market News (July-August 1992).

15. See Masaniro Hirano, "Recent Trends in Investment and Operations of Foreign Affiliates", JETRO China Newsletter, No. 104 (May-June 1993).

16. A lucid analysis pertaining to this important facet of Sino-Hong Kong connection is given in K. Y. Tang, "Outward Processing in China and Its Implications for the Hong Kong Economy" (paper presented at the Symposium on Asian NIEs: Past Success and Future Challenge organised by Lo Fung Learned Society, held in Hong Kong, 30-31 May 1991).

17. Burton Levin, "The Hong Kong-China Phenomenon", in Hong Kong Government Information Services, Hong Kong 1993 (Hong Kong: Government Printer, 1993), chapter 1; cf. also TDC Research Staff, "Hong Kong's Role in China's Economic Reforms", International Market News (October-November 1992).

18. Hongkong Bank, "Monetary Integration Between Hong Kong and China", Economic Report (February 1993); cf. also, "HK$ Currency in Southern China - An Updated Estimate", Asian Monetary Monitor, Vol. 16, No. 6 (November-December 1992), pp. 34 et seq.

19. At its origin, the Jackson-Vanik Amendment was enacted in 1974 to address concerns about the Soviet Union's restrictions on emigration by its Jewish citizens.

20. TDC (November 1991), supra. In his "Non-institutional Economic Integration Via Cultural Affinity: The Case of Mainland China, Taiwan and Hong Kong", Hong Kong Institute of Asia-Pacific Studies, Occasional Paper No. 13 (July 1992), pp. 10 et sqq., Yun-Wing Sung argues that re-export markups are, in fact, higher for trade flows with China, with 25 per cent a more realistic estimate for such margins, otherwise Hong Kong official trade statistics would imply that retained imports, when conventionally defined as imports net of re-exports, from China were actually negative in both 1990 and 1991.

21. See Hamish Macleod, Building on Success: The 1993-94 Budget (Speech by the Financial Secretary, moving the Second Reading of the Appropriation Bill, 1993) (Hong Kong: Government Printer, 3 March 1993), p. 12.

22. Ibid.; cf. also Barber B. Conable, Jr. and John C. Whitehead (co-chairs), and David M. Lampton and Alfred D. Wilhelm, Jr. (co-rapporteurs), United States and China Relations at a Crossroad, Policy Paper (Washington, D. C./New York: The Atlantic Council of the United States and National Committee on United States-China Relations, February 1993), p. 15.

23. See US Information Service, Economic Policy Backgrounder, "Greater China Trade with the United States, 1987-92: The Trend" (23 March 1993).

24. See Douglas Hurd (Secretary of State for Foreign and Commonwealth Affairs), White Paper on the Annual Report on Hong Kong 1992 to Parliament (Hong Kong: Government Printer, March 1993), p. 4; cf. also Burton Levin, op. cit., p. 9.

25. Hang Seng Bank, "The Current State of the Chinese Economy and Its Impact on Hong Kong", Hang Seng Economic Monthly (July 1993).

26. For a further discussion see Y. Y. Kueh, "Industrial Deregulation and Economic Restructuring in China: A GATT Perspective" paper presented at the 34th International Congress on Asian and North African Studies, held in Hong Kong, 22-28 August 1993.