

CEPA: Your Shortcut Into China

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As a small place of 400 square miles with little natural resources, Hong Kong has always been an externally-oriented economy. We believe that the best policy is free trade underpinned by the rule of law, a level playing field, free flow of capital and information and a clean and efficient government. We devoted many resources to nurturing a well-educated, cosmopolitan and versatile work force which can capitalize on every opportunity that comes along. Hong Kong's strength rests in its ability to constantly reinvent itself.

Over the years, Hong Kong has transformed from a sleepy fishing village to a manufacturing centre of basic plastic goods, then textile and garments and electronic products, to a nascent service centre and now an international financial, business and logistics centre supported by world-class economic infrastructure and a pool of personnel with professional, managerial and entrepreneurial expertise. But one thing never changed, Hong Kong is a gateway into China and a hub for the Asia region—a role we have excelled in.

The pace of development in Mainland China over the past 28 years has been nothing short of phenomenal. China's trading volume has grown 70 times over the period and it is the third largest trading economy in the world. China is also the third largest Foreign Direct Investment (FDI) recipient in 2005, and the amount is rising every year. For businessmen round the world, it is not a question of whether you should get into the Mainland market, but how best to do it. And the solution: do it through Hong Kong.

You may ask why Hong Kong and not Singapore or Shanghai or some other cities in the region. The answer is simple: we are situated right in the middle of the most dynamic region of China, the Pearl River Delta (PRD). The PRD region, excluding Hong Kong and Macao, accounts for 38% of the total exports of Mainland China and 31% of its GDP. Hong Kong traders have gone into the Mainland market from Day One. Our bilateral trade with the Mainland has grown 190 times in the past 28 years. Hong Kong accounts for over 70% of the total investment in Guangdong Province and over 40% of the Mainland overall. Our physical proximity and our quarter-of-a-century experience of working the Mainland market are advantages that can never be replaced.

But there is a further reason: Hong Kong has concluded the first and only free trade agreement (FTA) by the Mainland to date.

The Mainland and Hong Kong signed the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA) on 29 June 2003 for implementation as from 1 January 2004. Two supplements were subsequently signed in 2004 and 2005 to provide for further trade liberalization.

WHAT IS CEPA?

CEPA covers three broad areas, namely trade in goods, trade in services, and trade and investment facilitation.

For trade in goods, Hong Kong applies zero tariffs to all imported goods of Mainland origin. Starting from 2006, the Mainland has applied zero tariffs to all imported goods of Hong Kong origin, upon application by local manufacturers and upon the CEPA rules of origin being agreed and met.

Broadly speaking, the CEPA rules of origin will mostly be determined in one of three ways: process-based, change in tariff heading, or 30% value-added. The Mainland and Hong Kong have agreed on the CEPA rules of origin for more than 1,400 products, which cover almost all existing imports of Hong Kong origin into the Mainland. For products which are not yet currently produced in Hong Kong, Hong Kong manufacturers may apply and request to include them in biannual discussions of CEPA rules of origin.

For trade in services, Hong Kong has undertaken not to apply any new discriminatory measures on Mainland's services and service suppliers in the covered services areas. Conversely, service suppliers in Hong Kong are now enjoying WTO-plus access to 27 service areas in the Mainland market. Such areas include accounting; advertising; air transport; audiovisual; banking; convention and exhibition; cultural; distribution; freight forwarding agency; individually owned stores; information technology; insurance; job intermediary; job referral agency; legal; logistics; management consulting; medical and dental; patent agency; professional qualification examinations; real estate and construction; securities and futures; stor-

age and warehousing; telecommunications; tourism; trade mark agency; and transport.

CEPA also provides a framework for the facilitation of trade and investment. It spans across a broad range of issues: enhancing cooperation in trade and investment promotion; customs clearance facilitation; commodity inspection and quarantine, food safety and quality and standardization; electronic business; transparency in laws and regulations; co-operation of small and medium enterprises; and co-operation in Chinese traditional medicine and medical products sector. The area of intellectual property protection was added in June 2006 to strengthen co-operation over information exchange.

Hong Kong can conclude a FTA with the Mainland because we are a separate customs territory and a self-standing member of the WTO, a status guaranteed under the "One Country, Two Systems" principle set out in the Basic Law, our mini-constitution. Under this principle Hong Kong has full autonomy in the area of trade and we can negotiate and enter into FTAs with other economies.

NATIONALITY-BLIND ARRANGEMENT THAT BENEFITS ALL

There are many FTAs and Regional Trade Agreements. All have different thresholds to determine eligibility. In formulating CEPA, we aimed to be as all-embracing as we possibly could. The result is one of the most liberal arrangements where neither ownership nor source of capital has any bearing on qualifying for CEPA benefits.

On the goods side, the only eligibility criterion for goods to claim CEPA zero tariff preference is rules of origin. As long as the goods are produced in Hong Kong in accordance with CEPA rules of origin, they are eligible for CEPA tariff-free treatment when entering into the Mainland market, regardless of by whom they are made.

So investors from all over the world can set up or invest in manufacturing operations in Hong Kong. Their products manufactured in Hong Kong can then meet the CEPA origin rules and enjoy zero tariff in the Mainland market. Apart from the CEPA tariff-free preference that provides Hong Kong with competitive advantage in producing goods subject to high Mainland tariffs, Hong Kong's legal system and strong intellectual property rights regime also make it an ideal place to manufacture brand name goods with recognition in the Mainland, and goods with high intellectual property content.

Similar to trade in goods, the qualifying criteria of "Hong Kong Service Suppliers" bear no relation to nationality. Any foreign service-supplier is treated as a "Hong Kong Service Supplier" provided that it has been incorporated in Hong Kong and has engaged in substantive business operations as defined under CEPA for a specific period of time (i.e. three to five years depending on the particular service area).

The best way for overseas service suppliers to leverage on CEPA to gain access to the Mainland market is to

set up a service company in Hong Kong, or partner with, invest in or even acquire service suppliers in Hong Kong. Overseas service suppliers acquiring an existing Hong Kong service supplier need to operate in Hong Kong for one year to demonstrate they are carrying on substantive business operations after the acquisition. If a foreign services supplier acquires less than 50 percent equity interest in a Hong Kong service supplier, the one year time bar does not apply.

This approach of treating all firms incorporated in Hong Kong on an equal basis, or what we referred to as being "nationality-blind," is an integral part of our economic philosophy. The government's role is to ensure a level playing field for all.

WTO-PLUS BENEFITS

Not only is CEPA "nationality-blind", it also offers WTO-plus preferential treatment to qualified firms and service providers. WTO-plus means better and earlier market access than what Hong Kong and the Mainland have committed to other WTO members. It gives Hong Kong firms the "first mover" advantage, a critical factor in a fast developing market like the Mainland.

Now that the Mainland has implemented its commitments five years after its accession to WTO, why will CEPA continue to provide a useful platform? It is because "WTO-plus" treatment refers not only to earlier market access but wider access. This translates into better access rights, lower entry thresholds, relaxed equity control and accreditation of qualification requirements, etc.

As an economy where over 90% of our GDP comes from services, Hong Kong's strengths lie in services. On the other hand, the Mainland's services sector has been developing at a noticeably slower pace compared to its manufacturing sector. The potential hence for overseas firms under CEPA is enormous.

To illustrate what "WTO-plus" treatment means for service sectors under CEPA, let me highlight several key sectors.

Banking. Because of CEPA, financial institutions incorporated in Hong Kong have the opportunity to enter the Mainland market under preferential terms. For instance, the asset requirement for Hong Kong banks to establish branches in the Mainland has been reduced to US\$6 billion from US\$20 billion. In addition, the requirements for conducting Renminbi (RMB) business by the Mainland branches of Hong Kong banks have been relaxed.

CEPA not only opens the Mainland door for medium-sized banks incorporated in Hong Kong and extend their reach to the fast expanding market on the Mainland, it also strengthens Hong Kong's role as an international financial centre for the Mainland and the region. Hong Kong is now the only place outside of the Mainland where RMB business is conducted. Hong Kong is well placed to be the first economy in the world which

can offer real time settlement for US dollars, Euros and RMB.

Distribution. Effective December 1, 2006, Hong Kong service suppliers are allowed to become the controlling shareholders for chain stores with more than 30 outlets, with shareholding not exceeding 65%. This is WTO-plus. Foreign majority ownership is not allowed for the operation of such chain stores for other foreign investors. Japanese, American and European investors are keen to explore the distribution sector of the Mainland under CEPA for a great variety of products and many have already made a head start.

Transport and Logistics. CEPA allows Hong Kong companies to set up wholly-owned enterprises in the Mainland. It also allows freight forwarding agencies established by Hong Kong companies in the Mainland to open their branches once they have fully injected the registered capital. By comparison, other foreign companies are only permitted to do so one year after they have set up the relevant Mainland enterprises. As from 2007, Hong Kong air transport sales agencies are allowed to set up wholly-owned air transport sales agencies in the Mainland.

With the above WTO-plus benefits, Hong Kong transport/logistics players can more easily set up their operations and expand their businesses in the Mainland and offer a wide range of transportation and supply chain management services to their Mainland customers. Many world leading service suppliers in the field have leveraged on CEPA and set up wholly-owned transport and logistics operations in the Mainland.

Audiovisual. Under CEPA, Hong Kong video/sound recording product distributors are allowed to set up joint ventures with majority shareholding up to 70%, giving them better control in distributing their products in the Mainland. Hong Kong service suppliers are also permitted to construct and renovate cinema theatres for the operation of film screening business on a wholly-owned basis and at more than one location. For other WTO Members, joint venture with foreign ownership up to 49% is allowed. Through CEPA, some of the major film distributors and cinema operators have commenced operations in the Mainland, co-owning or wholly owning cinemas in various cities.

BENEFITS FROM CEPA

In the three short years of its implementation, CEPA is starting to show results.

On the goods side, US\$782 million of goods of Hong Kong origin have been imported into the Mainland tariff-free as at end October 2006. To quote just one example, a franchised bottler in Hong Kong of one of the world's leading brands of soft drinks gained tariff-free access to the Mainland market through CEPA. Such products would otherwise have been subject to a tariff rate of 20%. We expect to see continued growth as the coverage expands.

On the services side, 992 enterprises have been certified as Hong Kong Service Providers as at the end of November 2006. Among them, 461 are known to have predominant foreign investment. Taken as a single group, the European Union ranks as the largest foreign investment source for these CEPA beneficiaries (124 enterprises), followed by Japan (108) and the United States (69). By service classification, the majority of these enterprises engages in transport and logistics services (209 enterprises), distribution (including franchising, trading and retailing; 151), advertising (30) and construction (19). Their most favorite destinations of investment in the Mainland, in order of priority, are Guangdong Province (especially in Shenzhen and Guangzhou), Shanghai, and Beijing.

MAKE CEPA WORK FOR YOU

Hong Kong has long been a major destination for foreign direct investment and a preferred location for regional headquarters. In 2005, Hong Kong came second after Mainland China in Asia in attracting FDI inflows. Hong Kong's FDI inflow in 2005 ranked 6th overall and was greater than the total of the next three FDI recipients in Asia—Singapore, South Korea and India. The number of regional headquarters and regional offices located in Hong Kong also grew over the past ten years from 2,514 to 3,845, a 53% increase, with US firms topping the list. CEPA only adds to our attraction. Twenty percent of the firms who have set up operations in Hong Kong last year cited CEPA as a reason.

Apart from attracting inward investment, CEPA also stimulates outward investment. Between August 2004 and June 2006, a total of 426 Mainland enterprises were granted approval for investment in Hong Kong under CEPA, accounting for US\$2.31 billion of planned investment. CEPA enhances Hong Kong's role as the two-way springboard for investors into and out of the Mainland.

For Mainland firms wanting "to go out," Hong Kong offers the best gateway. The number of record-breaking IPOs floated on the Hong Kong Stock Exchange in the past 18 months bears witness to the fact.

CEPA is not a one-off liberalization measure. Rather, it adopts a building block approach. It is an open and developing platform. Further liberalization of trade and goods and services will be implemented as and when agreed by both parties under this framework. It will be for the businesses to come up with new products and service sectors which may benefit from CEPA. The government's role is to facilitate.

CEPA is the world's shortcut into the Mainland market.

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