

Closer Economic Partnership Agreement between China and Hong Kong

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Towards a CEPA

WITH CHINA'S RESUMPTION of sovereignty over Hong Kong, considerable consideration has been given to means of forging closer economic relations between the two sides. When there was economic prosperity, the idea was not particularly attractive to Hong Kongers who feared a blurring of identity upon further integration with China. Now, however, faced with a very worrying economic downturn, many Hong Kongers are much less hesitant to embrace the idea.

In 2001 when the Hong Kong Special Administrative Region (HKSAR) economy was in one of the worst depressions in its history, some small- and middle-sized enterprises put pressure on the HKSAR Government to persuade the mainland government to grant them preferential treatment. The expectation was fuelled by a speech in Oct. 2001 by the mayor of Beijing, who was addressing a HKSAR "business opportunity-finding" delegation led by the pro-China Hong Kong General Chamber of Commerce. He had announced the "granting of special preferential treatment to HKSAR companies."¹ The Ministry of Foreign Trade and Economic Cooperation (MOFTEC) later clarified that the report was incorrect because such preferential treatment is not allowed under the WTO framework. Nevertheless, the Chamber later put forward the idea of a Hong Kong-Macau-Mainland China Free Trade Agreement. It was hoped such an agreement would accelerate the recovery of HKSAR's economy.

In Dec. 2001, the Chief Executive of the HKSAR Government, Tung Chee Hwa, formally submitted proposals to the Central People's Government concerning closer economic and trade relations. His proposal seemed to be immediately acted upon, because consultations concerning the establishment of closer economic and trade relations began in Beijing on 25 Jan. 2002, and a second round took place in Hong Kong on 27 Mar. 2002.² It was reported that the two sides aimed to conclude the Closer Economic Partnership Agreement (CEPA) by the end of 2003.³

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Reluctance to Use Term ‘Agreement’

According to the Basic Law of the HKSAR (hereinafter “the Basic Law”), the HKSAR is part of China. It differs from the mainland in that it enjoys full autonomy in all affairs other than diplomatic relations and defence. Economic affairs are completely within the ambit of the HKSAR. Even in the field of external economic relations, the HKSAR is fully autonomous.⁴ Article 116 of the Basic Law further confirms the HKSAR’s status as a separate customs territory. Pursuant to this, the HKSAR is deemed free to enter trade agreements with any country or region, including mainland China.

However, it is not difficult to see that China is very cautious, if not reluctant, to enter into any bilateral arrangements with the HKSAR, simply because an “agreement” is customarily referred to as a bilateral legal instrument between two or more states, and hence suggests the equality of the parties to the agreement. As a matter of practice, the existing bilateral arrangements between China and HKSAR have often generally resulted from initiatives on the part of the HKSAR. Moreover, it would be extremely inappropriate, at least from the Chinese perspective, for any bilateral arrangement to take the form of an “agreement,” which could misleadingly infer the equality of the parties concerned.

This is why there have been few bilateral arrangements since the 1997 handover. Existing bilateral arrangements are often concluded in the name of various departments, all deliberately taking the form of informal arrangements. Among these arrangements are those concerning recognition and enforcement of arbitral awards reached by the Vice-President of the Supreme People’s Court of China and

¹ The Beijing Municipal People’s Government offered a package of incentives and business opportunities to help boost Hong Kong business and ease economic hardship. Beijing Mayor Liu Qi discussed the details in an interview with *Ta Kung Pao* (IT). For instance, HKSAR companies that form joint ventures with Beijing companies could be treated as local enterprises. Preferential treatment in terms of discount interest and financial assistance for technological transformation and hi-tech projects would be offered to these joint ventures.

² Interestingly, MOFTEC vice minister Long Yongtu disclosed at the 14th General Meeting of the Pacific Economic Cooperation Council (PECC) in Hong Kong on 28 Nov. 2001 that Tung had submitted a proposal to the central government. In view of this, the HKSAR Government must have informally solicited the response from the central government even before the formal submission of the proposal.

³ *Homeway Financial News*, 11 Mar. 2002. <www.homeway.com.cn> [20 May 2002].

⁴ Article 151 of the Basic Law reads: “The Hong Kong Special Administrative Region may on its own, using the name ‘Hong Kong, China,’ maintain and develop relations and conclude and implement agreements with foreign states and regions and relevant international organisations in the appropriate fields, including the economic, trade, financial and monetary, shipping, communications, tourism, cultural and sports fields.”

HKSAR Secretary of Justice in Oct. 1999. Interestingly, after the conclusion of these arrangements, both parties converted them into domestic legal instruments.⁵ It was not merely a measure for the purpose of implementing a “quasi-international” agreement. It was actually the parties intending to avoid linking the arrangement with an international agreement.

With regard to the establishment of closer economic relations between Hong Kong and China, it was originally proposed that the common form of Regional Trade Arrangement (RTA) be employed. However, the above explains why China insisted on the use of “CEPA” instead. While an RTA by definition is two-way, a CEPA between China and HKSAR may be different.⁶ Hong Kong has pursued a policy of free trade and has secured the status of a free port.⁷ Its status as a free port means it has little more to offer the Mainland. In other words, the on-going CEPA would mean more or less one-way open trade from China, particularly if the arrangement brought additional difficulties to China in terms of its implementation of WTO commitments and relations with other WTO members. China will have to look very carefully before granting preferential treatment to Hong Kong.

The ongoing CEPA is essentially designed to grant the HKSAR a time advantage, which would allow Hong Kong companies to move into China quicker to look for new opportunities in the sectors in which China has committed itself to opening up to WTO members.⁸

⁵ The Supreme People’s Court promulgated the “Arrangement on Mutual Enforcement of Arbitral Awards between the Mainland and HKSAR” in the form of judicial directives. See Fa Shi (2000), no. 33. (Fa Shi is a judicial interpretation in the form of directives.) The HKSAR Legislative Council passed the Arbitration (Amendment) Bill 1999, which incorporated and gave effect to the Arrangement.

⁶ According to a study by Deutsche Bank Global Market Research, a one-way model of FTA-related import liberalisation by China would enhance Hong Kong’s GDP growth by 0.43 percentage points from 2001–10, but have a negligible impact on China’s GDP growth. The research shows a one-way CEPA is not desirable for China.

⁷ Article 115 of the Basic Law requires the HKSAR to pursue the policy of free trade and safeguard the free movement of goods, intangible assets and capital. Article 114 requires the HKSAR to maintain the status of a free port and not impose any tariff unless otherwise prescribed by law.

⁸ For instance, according to China’s WTO schedule for market access, by 2005, all restrictions on distribution auxiliary services — warehousing, advertising, technical testing and analysis, and packing services — will be phased out and wholly foreign-owned subsidiaries of freight forwarding companies will be permitted. By 2007, China will relax ownership limitations on foreign management consulting firms, and foreign retailers and chain store operators will no longer have equity limitations. A CEPA may, upon implementation, enable Hong Kong companies to obtain these same opportunities earlier, say one year after accession.

Institutional Constraints

Any RTA is fixed into a legal framework, which in turn provides the institutional foundation for the arrangement. Noteworthy is that such a legal framework itself is subject to certain constraints; primarily it is kept out of the international trade agreements to which either member is a party.

As far as the CEPA between China and HKSAR is concerned, the institutional obstacles lie in the requirements of the WTO Agreements to which both China and HKSAR are members. The most-favoured-nation treatment (MFN) is the overriding principle embodied in the WTO Agreements, particularly in the General Agreement on Tariffs and Trade (GATT) and the General Agreement on Trade in Services (GATS). It requires a WTO Member to grant non-discriminatory treatment to companies of all the other members. Any trade arrangement between certain WTO members, i.e., RTAs, by their very nature, favour imports from members of the grouping, and discriminate against imports from other countries. Then a question arises in the WTO context: is such a discriminatory arrangement a departure from the MFN principle?

The framers of GATT 1947 and Uruguay Round Agreements in 1994 had anticipated certain types of RTAs.⁹ Article XXIV of GATT 1947, authorised and, of course, circumstanced customs unions and free-trade areas. The GATT contracting parties adopted a decision in 1979, allowing derogations to the most-favoured nation treatment in favour of developing countries.¹⁰ In particular, paragraph 2(c) permits preferential arrangements among developing countries in goods trade. It has continued to apply as part of GATT 1994 under the WTO. In the Uruguay Round of negotiations, the Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994 (hereinafter “Article XXIV Understanding”) was formulated to address difficulties. Moreover, Article V of the GATS provides for economic integration agreements in services.

⁹ According to the CRTA 2000 Annual Report (WT/REG/9), WTO was informed of the conclusion of 220 RTAs worldwide, among which over 100 since 1995 covering trade in goods or services, or both, were forwarded to the WTO. Of the RTAs forwarded to the GATT/WTO, 121 notified under GATT Article XXIV, 19 agreements under the Enabling Clause and 12 under GATS Article V are still in force today. Notable examples include the EU, NAFTA, ASEAN, South Asian Association for Regional Cooperation, Common Market of the South (Mercosur), and Australia–New Zealand Closer Economic Relations Agreement. In the Asia-Pacific, bilateral RTAs have been signed between Australia and New Zealand, Singapore and New Zealand, Hong Kong and New Zealand, and Singapore and Japan. China and ASEAN have indicated that they hope to form a free trade zone over the next decade.

¹⁰ This includes differential and more favourable treatment, reciprocity and fuller participation of developing countries. (Decision of 28 November 1979, L/4903.)

According to the relevant WTO provisions, members may enter into RTAs among themselves to reduce trade barriers in products and services. However, these agreements must not create greater trade barriers for other Member countries. In other words, they are designed to ensure that the countries which form RTAs move genuinely to free trade among themselves.¹¹

For example, a major principle laid down in Article XXIV Understanding is that the RTA must cover *substantially all trade*, and that others must *not be worse off* as a result of the RTA. The “substantially all trade” requirement ensures that an RTA is not misused as a cover for narrow sectoral discriminatory arrangements. The same condition is laid out in Article V of GATT, which requires a “substantial sectoral coverage” in services. Unfortunately, there is no agreement among members on the meaning of these wordings, and many agreements in fact omit from their coverage large and sensitive areas such as agriculture and textiles.

The “not worse off” requirement is to ensure that non-participating members are not harmed by the RTAs. For this purpose, the relevant WTO provisions provide adequate compensation for any damage done to the trade interests of other WTO members.¹²

In order to monitor whether the RTAs conform to the conditions, the WTO agreements provide for a notification procedure. However, the language of the provision means that once the WTO has been notified about the RTA, the parties to the RTA can go ahead unless the WTO, i.e., the Council for Trade in Goods (CTG), Council for Trade in Services (CTS), and Committee on Regional Trade Agreements (CRTA), can somehow arrive at an agreed set of recommendations.¹³

¹¹ Although free trade is the ultimate aim for many RTAs — in fact, Articles XXIV: 8(a)(i) and 8(b) of the GATT require a detailed plan and schedule to show how the members will move to free trade, the WTO allows for this to happen progressively rather than from the beginning. In practice, therefore, trade restrictions may remain among members of an RTA, as long as the spirit of the RTA is that of non-discrimination and not used to disguise ad hoc or partial discrimination.

¹² In the words of Article XXIV Understanding, the purpose of such agreements is to facilitate trade between the constituent territories and not raise barriers to the trade of other members with such territories; and that in their formation or enlargement, the parties to them should to the greatest extent possible avoid creating adverse effects on the trade of other members.

¹³ The CTG is notified of RTAs falling under Article XXIV. Since the establishment of the CRTA by the General Council on 6 Feb. 1996, the practice has been for the CTG to adopt the terms of reference for the examination of an agreement and transfer the examination itself to the CRTA. Once the CRTA has finished the examination and approved the report, it submits it to the CTG, which has then to take appropriate action, i.e., adopt the report and make any appropriate recommendations. Article V of the GATTs stipulates that the CTS may establish a working committee to examine, enlarge or modify any such economic integration agreement,

Empirical evidence has shown that the possibility of agreeing is very slight. At the conclusion of the Uruguay Round, only one agreement out of some 80 examined was found to be fully GATT-consistent, although the examination of RTAs in the GATT led to numerous problems throughout the years. As a matter of fact, the CRTA admitted that there was an “increasing backlog of examination reports”¹⁴ due to the difficulty of agreeing on the compliance of RTAs examined with WTO rules.

Nevertheless, where the WTO deems an RTA to be inconsistent with WTO provisions, the members concerned shall modify it with a recommendation. If they are not prepared to modify it they “shall not maintain or put into force” such an agreement.

The WTO Agreements do not set down what to do in the event that members concerned fail to implement the recommendation. Nevertheless, any provisions in an RTA are likely to be subject to WTO dispute settlement procedures. Article XXIV Understanding states that the provisions regarding dispute settlement “may be invoked with respect to any matters arising from the application of these provisions of Article XXIV relating to customs union, free-trade areas or interim agreements.” As a matter of fact, the WTO Dispute Settlement Body once faulted Turkey’s move to impose quotas on non-EU textile imports as part of a customs union agreement with the European Union following the challenge by India.¹⁵ If the Dispute Settlement Body or the Appellate Body finds the provision of an RTA to be inconsistent with WTO provisions, the members concerned are under obligation to modify the RTA, or not maintain or put into force the RTA. Failure to do that would result in compensation or retaliation.

In sum, it is reasonably safe for two or more WTO members to formulate an RTA under Article XXIV of GATT and other relevant provisions. Nevertheless, the requirements

in order to review its consistency with the provisions of Article V. The current practice is that the CTS decides whether a notified agreement need be examined and, if so, passes the task of examination to the CRTA. Following examination, the CRTA makes recommendations to the CTS. In addition to examining individual regional agreements, another important duty of the committee is to consider the systemic implications of the RTAs for the multilateral trading system and the relationship between them.

¹⁴ According to the Report (2000) of the Committee on Regional Trade Agreements to the General Council (WT/REG/9), the CRTA has currently more than 100 RTAs under examination.

¹⁵ WTO/DS34. The WTO ruled that while Turkey may be allowed to adopt a customs union measure that is inconsistent with certain WTO provisions — provided it shows that the customs union is otherwise consistent with the WTO — it could have adopted less restrictive alternatives to the import quotas without jeopardising its customs union with the EU.

of the MFN create a dilemma. On one hand, any RTA is supposed to have a higher degree of liberalisation than is required by the WTO, otherwise it would be meaningless if it merely reiterated the terms and conditions in the WTO Agreement. On the other, the MFN naturally levels the degree of liberalisation *vis-à-vis* WTO members.

The proposed CEPA is expected to comply fully with the relevant rules of the WTO. When concluded, the text of the arrangement will be submitted to the WTO CRTA for examination. As long as the terms of the proposed CEPA do not undermine the interests of any third party, it will not contravene the spirit of the WTO provisions. Given that it is rare for the CTG, CTS, and CRTA to make an agreed set of recommendations to notifiers of RTAs, the CEPA between China and HKSAR is not likely to be seen as inconsistent with WTO requirements. However, any other WTO member can call upon the settlement procedures if it finds inconsistencies.

What is at Stake?

With talks just getting under way, neither China nor the HKSAR has had much to say about the final arrangements. However, it has been made clear that the proposed closer economic relations would take the form of a “CEPA.” The content of the agreement can be guessed, given the concerns of both sides.

HKSAR businesses expect to be given a time-advantage; in other words, they want China to give the territory’s service providers a head start in the mainland as it further opens up to foreign firms. For China, the bottom line is to ensure that the arrangements do not bring additional difficulties to China in its implementation of WTO commitments and its relations with other WTO members. In addition, it is expecting to receive some specific benefits.

Reconciling Competing Objectives

It is quite clear that Hong Kong’s interests lie in strengthening its role as the gateway to China and becoming the first among equals. China, for its part can indeed benefit from having this “experimental” opening and by partnering with Hong Kong companies to get ready for the onslaught of companies from other WTO members at a later date. Apart from this, the HKSAR must be prepared to offer some specific benefits to China. Such interests must be real and directly related to enhancing market access.¹⁶ A prominent issue in this regard is to ensure that China’s businesses and professionals are able to access Hong Kong’s market more freely. For this purpose,

¹⁶ It is true that many poorly performing state-owned enterprises in China would have easier access to Hong Kong capital and personnel with managerial expertise or skills. However, this is not all that a party to an RTA can be expected to obtain from the other party.

both parties need to consider having a framework under which the competent bodies of the HKSAR and China can look into issues relating to the recognition of qualifications and accreditation.

Rules of Origin

An RTA is by nature exclusive and must therefore ensure that only goods of origin benefit from the removal of tariffs. It would be reasonable for goods produced only in the HKSAR by Hong Kong companies to be entitled to the preferential treatment that China offers under the CEPA.¹⁷ The issue in turn concerns how to define “produced in the HKSAR” and how to identify Hong Kong companies. As for the first, a local content requirement (e.g. 40%) probably needs to be introduced. Fake documentation and under-invoicing of imports also need to be addressed.

Nevertheless, it is even more difficult to identify the origin when the rules of origin are applied to services. Financial services such as banking and insurance often involve capital from various countries. The issue here is to distinguish Hong Kong companies from foreign ones (including many Chinese-invested companies), although such a distinction also applies to the origin of goods produced by “Hong Kong” companies.¹⁸ Since Hong Kong’s economy is already international, the issue must be handled in an appropriate manner.¹⁹ A definition which is too narrow undermines Hong Kong’s international character, while one that is too all-encompassing, may render, by opening the door too wide and too quickly, the time-advantage which Hong Kong seeks for its companies, particularly its SMEs, less material. Nevertheless, these rules must not be allowed to become trade obstacles in themselves.²⁰

In this regard, another prominent issue is related to, *inter alia*, China’s obligations under the WTO. Misuse or even abuse of the rule of origin for Chinese products transshipped via HKSAR has caused problems. On one hand, some Chinese companies abuse the rules (e.g. through the above-mentioned fake documentation and under-invoicing of imports) to circumvent the foreign regulation on Chinese imports (e.g. quota on Chinese textiles). On the other, the statistics of Chinese imports by foreign customs is often over-counted. Given that the bulk of Chinese products are transshipped via the HKSAR, that the circumvention of WTO-consistent regulations through transshipment is a breach of China’s WTO obligations, and that statistics of imports

¹⁷ The Hong Kong SAR Government trade statistics define exports of goods produced in Hong Kong as direct exports.

¹⁸ Roughly one-third of Hong Kong’s foreign investment comes from China.

¹⁹ There are many criteria for defining Hong Kong companies, such as local registration, substantial local business in Hong Kong, operation history, local employment, etc.

²⁰ Article XXIV: 5 (b) of the GATT.

weights are crucial in evaluating the trade surplus on the Chinese side, designing the rules of origin does matter to China.

Pressure to Further Liberalise China's Trade Regime

An RTA basically facilitates trade between its members and aims at achieving a higher level of liberalisation than is required by the WTO. Hong Kong has established a zero-tariff policy for decades, with a few exceptions. In terms of non-tariff barriers, Hong Kong is also among the most open economies. Therefore, although the form of a CEPA may allow some flexibility for China to adapt its trade regime, China is under pressure to adopt a similar policy since it has agreed to establish a CEPA with the HKSAR.

In many sectors, there are barriers to foreign investment or operation which are not covered by the WTO accession instruments. An example is the exhibition services sector, where wholly foreign-owned operations are not allowed. Another example is the asset barrier of \$20 billion for foreign banks setting up branches in the country. There are also some sectors covered by the WTO's plurilateral agreements to which China has not yet become a member (e.g. government procurement). Theoretically, in these sectors, there are potential areas in which the CEPA can play a role. A CEPA with Hong Kong could open up a wide range of opportunities by lowering some of these barriers or removing prohibitions for Hong Kong companies. For example, one could expect China to agree on the modalities for early elimination of tariffs on all goods of HKSAR origin by an agreed date.

Similarly, since the WTO Dispute Settlement Mechanism does not exclude the possibility of resolving disputes through negotiation, both parties presumably are free to agree on a simple mechanism for the timely settlement of disputes related to their rights and obligations under the Agreement.

Closer Economic Relations between the Pearl River Delta and HKSAR?

In recent years the HKSAR and neighbouring Pearl River Delta have become more economically integrated and there is a strong call for building yet closer relations, especially for an earlier implementation of the proposed CEPA framework.²¹ China has reportedly displayed a positive attitude towards the proposal.²²

²¹ For example, according to the Hong Kong General Chamber of Commerce: "Hong Kong should begin to move quickly down the route of Pearl River Delta integration. Anything from border control and transportation facilitation, to environment protection, infrastructure planning, technology development, to labour movement, education and social issues should be discussed with the Guangdong authorities on a continuous basis. Hong Kong's future lies in being the center of a Pearl River Delta commerce area, and that cannot be done in isolation with protectionist policies or with procrastination."

²² *Homeway Financial News*, 11 Mar. 2002. <www.homeway.com.cn> [20 May 2002].

However, the WTO also includes a provision concerning the responsibility of a WTO member to take reasonable measures to ensure that low-level regional or local governments observe the WTO rules.²³ A more preferential treatment arrangement between the Pearl River Delta and HKSAR would not only raise the issue of uniform application of WTO obligations, but also further complicate the issue of whether or not China has complied with the WTO's MFN obligation, with the Pearl River Delta breaching the WTO obligation *vis-à-vis* other WTO members.

Customs Cooperation

A relatively easy issue is customs cooperation. Negotiations would seek to identify ways to simplify customs procedures for bilateral trade and personnel flow, in particular, by streamlining boundary operations through co-location of customs and immigration officials on the mainland and the opening of bordering customs checkpoints 24 hours a day. The difficulty lies in the HKSAR's fears about the negative impact of the measure on housing prices in the border areas.²⁴ Nevertheless, this worry will find no justification in the context of economic integration.

Earlier Implementation

Earlier implementation of market opening measures, of which there are many precedents from other RTAs, could offer more significant benefits to the HKSAR (first of equals), but this could encounter implementation difficulties. Although most privileges would finally be offered to foreign firms through the MFN principle, the preferential treatment for the HKSAR raises concerns about China violating rules under the WTO.

Nevertheless, with over 100 WTO-permitted RTAs in existence for the two parties to consult, a satisfactory solution can presumably be found. In this regard, particularly noteworthy is the experience of either party in dealing with any third party. China and ASEAN have agreed to form a free trade zone over the next decade. However, no institutional framework has been laid out to date, let alone formulated. Therefore, no experience can be taken from therein. Meanwhile Hong Kong has been negotiating a

²³ For instance, paragraphs 13–15 of Article XXIV Understanding say that WTO members are fully responsible for breaches by subordinate levels of government of the GATT, and may ultimately have to provide compensation if they cannot make the subordinate level meet GATT obligations.

²⁴ The cost of housing bordering Shenzhen (just north of the Hong Kong border) is much lower than in Hong Kong. It is likely that after border control service hours are extended, many low- and middle-wage earners of Hong Kong who would otherwise buy housing in Hong Kong will choose to buy in Shenzhen.

CEPA with New Zealand. In fact, a legal framework has been in place for the CEPA and this experience will be useful in the HKSAR-Mainland CEPA.

Prospects: From a CEPA to a Greater China?

Although the constituent members of an RTA have special regard to the individual circumstances of such economies or economic groupings when considering the admission of new entrants, the RTA is generally open to accession by economies or economic groupings which share its underlying objectives. On the part of the HKSAR, the ongoing CEPA is derived from the conception of a free trade area consisting of China, Hong Kong, and Macau. Mainland China is taking a very affirmative approach in the establishment of a CEPA and does not rule out the possibility of building a special trade area comprising the Mainland, Hong Kong, and Macau.²⁵ According to vice minister of MOFTEC Long Yongtu, Macau could join the proposed zone but Taiwan's participation might pose certain difficulties.

However, increased economic integration means the "China factor" looms even larger for Taiwan. Any proposal for further integration is foreseeable.²⁶ A "Greater China" plan, if implemented, will likely be traced back to the on-going CEPA between China and Hong Kong.

²⁵ Long Yongtu said this while attending the 14th General Meeting of the Pacific Economic Co-operation Council (PECC) in Hong Kong. A free trade zone would probably play an active role in bringing Mainland-Hong Kong economic ties closer. Macau, another SAR under the "One country, two systems" principle, should have no problem in joining the free trade zone. It would be difficult, however, to hold any free trade zone talks with Taiwan, which has shunned the issue of resuming the three direct links (trade, transport and postal) across the Taiwan Straits.

²⁶ For instance, Liu Taiying, a key figure in the Guomindang, proposed the inauguration of a unified "Chinese *yuan*" for China, Taiwan, Hong Kong and Macau.