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*Non-institutional Economic  
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The Case of Mainland China, Taiwan  
and Hong Kong*

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Hong Kong Institute of Asia-Pacific Studies

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## Non-institutional Economic Integration Via Cultural Affinity: The Case of Mainland China, Taiwan and Hong Kong

### Abstract

Economic integration among the Mainland, Taiwan and Hong Kong (the trio) has thrived despite the absence of institutional arrangements such as a trade bloc. Geographical and cultural proximity and the efficiency of Hong Kong as a "middleman" have enabled the trio to develop extremely intense trade and investment linkages despite the Mainland's strict controls on trade, investment and foreign exchange, and Taiwan's unwillingness to deal directly with the Mainland.

To document the extent of economic integration among the trio, this paper combs through and compares the trade and investment statistics of the Mainland, Taiwan and Hong Kong, making careful adjustments for the re-export mark-up in Hong Kong's entrepot trade as well as differences in f.o.b. and c.i.f. prices. It is believed that the statistics presented give the most accurate picture so far of Mainland-Hong Kong trade, Mainland-Taiwan trade (including both indirect trade and the substantial but often ignored direct trade), Taiwan-Hong Kong trade and China's trade by country/region.

Since the inauguration of China's open policy in 1979, China has established more and more direct links with the world, but an increasing fraction of China's trade is handled indirectly via Hong Kong. A theory of intermediation is developed to explain this paradox: the decentralization of China's trading system has greatly increased the number of potential trade links and raised the transaction cost of trade. The efficiency of Hong Kong as a "middleman" lowers the transaction cost of trade with China and promotes the integration of the trio. The theory predicts a bright prospect for Hong Kong as a "middleman" because a big trading centre tends to get bigger and even more efficient due to the economies of scale and economies of agglomeration in trade. Even if Taiwan should deal directly with the Mainland, Hong Kong's "middleman" activities would continue to thrive.

Economic integration among the trio will thrive despite the absence of institutional arrangements. Proposals for institutional integration among the trio such as the formation of a trade bloc, or a "greater Hong

Kong" arrangement involving Hong Kong and Shenzhen are utopian and counter-productive. Hong Kong must maintain border controls against Shenzhen and China. Otherwise, Hong Kong's GATT membership and clothing quotas will be jeopardized. The abolition of Shenzhen's border controls against Hong Kong would also pose similar complications for China. The present unilateral favouritism given by the Mainland to Taiwan is unGATTtable and counterproductive.

The best policy framework for integration of the trio is not the institution of discriminatory preferences but trade liberalization in the Mainland and in Taiwan and GATT membership for both. Consultation through the APEC, through semi-official or private forums can lower transaction costs through improved information flow and policy coordination.

ECONOMIC integration means the lowering of barriers to economic interactions across countries or regions, facilitating trade and investment. Economic integration can occur through institutional channels such as the establishment of a free trade area, granting mutual discriminatory preferences to the parties involved. It can also occur naturally without the establishment of a formal institution, as in the case of a fall in transportation costs as a result of technological advancement.

Institutional integration has played a role in the intensified trade relations among the ASEAN countries while economic integration in the North Pacific (including Mainland China, Taiwan, Hong Kong, South Korea, Japan and the US) has been driven by market forces and unilateral policy changes such as the opening up of Mainland China and trade liberalisation in Japan, Korea, and Taiwan (Amelung, 1990). In the North Pacific region, the trade and investment links among Mainland China, Taiwan and Hong Kong (the trio) are particularly intense. Economic integration among the trio is largely non-institutional and market driven. In fact, intense trade and investment links have developed between Mainland China and Taiwan despite the absence official ties.

This paper argues that economic integration among the trio will thrive despite the absence of institutional arrangements. Moreover, proposals for institutional integration among the trio

such as the formation of a free trade area are utopian and counterproductive. Proposals of a "greater Hong Kong" arrangement involving Hong Kong and parts of Guangdong are also likely to backfire. The best policy framework for integration of the trio as well as for North Pacific is the continuation of the unilateral policies that the trio have been pursuing, namely, continuation and deepening of the open-door policy in China, further trade liberalization in Taiwan and preservation of the complete freedom of movement in goods and capital in Hong Kong. Present trade restrictions in Mainland China and in Taiwan are not GATTtable, and further liberalization are necessary for their GATT memberships. The entry of Mainland China and Taiwan into the GATT will be a great boost to economic integration among the trio as well as among economies of the North Pacific region. This paper also argues that the present unilateral discriminatory preferences of Mainland China for Taiwanese goods and investment are, in the long run, harmful to both economic integration and the national reunification of China. Moreover, such discriminatory preferences are unGATTtable and economically inefficient. Contrary to conventional wisdom, which calls for the institution of discriminatory preferences as a vehicle of economic integration among the trio, this paper argues that their abolition would provide the best environment for economic integration.

Hong Kong is the pivot of economic integration among the trio because its efficiency as a "middleman" lowers the transaction costs of economic interactions of Mainland China with the rest of the world, especially with Taiwan. This paper argues that Hong Kong's "middleman" activities will continue to thrive even if the Mainland were to establish direct trade and transportation links with Taiwan.

The rest of the paper is organized as follows. Section two discusses the nature and characteristics of economic integration among the trio. Section three covers trade and investment among the trio. Section four evaluates the prospect of Hong Kong as a "middleman" for the integration of the trio. Section five concludes

the study.

### The Characteristics of Economic Integration Among the Trio

There is no doubt that the economies of the Mainland and Hong Kong are highly integrated. The Mainland and Hong Kong are each other's foremost trading partner. Hong Kong is the foremost investor in the Mainland while the Mainland is the second largest investor in Hong Kong after Japan.

Despite the absence of official ties, economic integration has proceeded extremely rapidly between the Mainland and Taiwan, largely utilizing the efficient intermediary services of Hong Kong. In the first half of 1991, Taiwan has surpassed Hong Kong and the US to become the second largest supplier of goods to the Mainland after Japan, and Taiwan has also surpassed the US and Japan to become the third largest investor on the Mainland after Hong Kong and Germany. In 1990, the Mainland has surpassed Hong Kong to become the third largest market for Taiwan's exports after the US and Japan.

Despite the intensive trade and investment flows among the trio, there are still many barriers to the economic integration of the trio. The foremost barrier is the command economy in the Mainland. It is inherently difficult for a command economy to benefit from international trade and investment because a command economy is designed to insulate itself from the world market. A command economy tends to have an overvalued and inconvertible currency which is a big obstacle to international economic integration. Moreover, it is extremely difficult for the planner of a command economy to know what goods should be exported or imported because the economy tends to have a highly distorted and arbitrary price system. East-West trade is characterized as "asymmetric integration" as it involves the interaction of two economic systems that are functionally very different.

In the era before the open-door, the economic ties linking the Mainland and Hong Kong were quite strong, but the relationship was asymmetric and one-sided. Hong Kong was open to China's export and investment, but China was closed to Hong Kong's export and investment. Large numbers of Hong Kong people were able to visit their relatives on the Mainland, and remittances from Hong Kong residents to their Mainland relatives were quite large, but Mainland Chinese could not visit Hong Kong. In the 1960s, Hong Kong was the foremost market for the Mainland. China's trade surplus with Hong Kong was around one-fifth of China's total exports, and China used the hard currency thus earned to finance its imports of grain, industrial raw materials and capital goods from DCs (developed countries). With the inauguration of economic reforms and the open policy in the Mainland in 1978, the economic relationship between the Mainland and Hong Kong has become much more balanced and multi-faceted.

Before 1987, the economic ties between Hong Kong and Taiwan was also one-sided due to Taiwan's trade protectionism and foreign exchange controls. Hong Kong was open to Taiwan's exports. In the mid 1970s, Hong Kong became Taiwan's third largest market after the US and Japan, accounting for roughly 7 per cent of Taiwan's exports. However, the barriers against Hong Kong goods in Taiwan were quite high. Hong Kong was the third largest investor in Taiwan after the US and Japan, but Taiwanese investment in Hong Kong was insignificant due to Taiwan's then stringent foreign exchange controls. By the end of 1989, Hong Kong investment in Taiwan totalled US\$1.2 billion, or 11 per cent of total inward investment in Taiwan, while the US's and Japan's investments were US\$3 billion and US\$2.9 billion respectively. Taiwan was an important destination for Hong Kong tourists, but few Taiwanese tourists visited Hong Kong as a result of Taiwan's foreign exchange controls.

However, economic ties between Hong Kong and Taiwan developed extremely rapidly in the late 1980s with the liberalization of Taiwan's imports and foreign exchange controls, the sharp

appreciation of the Taiwanese currency, and Taiwan's use of Hong Kong as an intermediary in its interactions with the Mainland. Many Taiwanese toured Hong Kong on their way to the Mainland and Taiwan became the foremost source of tourists for Hong Kong. Taiwan also became a significant investor in Hong Kong. The share of the Taiwan market in Hong Kong's domestic exports jumped from one per cent in 1985 to 2.6 per cent in 1991, amounting to US\$781 million. Since 1986, Taiwan was the seventh largest market for Hong Kong after the US, China, Germany, the UK, Japan and Singapore.

### *Integration Via Cultural Affinity*

Despite the intense trade and investment flows among the trio, there is an obvious lack of institutional integration among them. China and Taiwan are institutionally more closely integrated with most economies than with each other. Taiwan still prohibits investment from the Mainland and Mainland-Taiwan trade is mostly carried out indirectly through Hong Kong due to the absence of direct official and commercial relationships.

Besides the lack of diplomatic and commercial ties, the three important institutional barriers to economic integration often listed in textbooks are tariffs, controls on factor movements, and exchange risks. On these three counts, the barriers to economic integration among the trio are very high. Take, for instance, the case of the Mainland and Hong Kong. Even though China will resume sovereignty over Hong Kong in 1997, it is specified in the Sino-British Agreement on Hong Kong that Hong Kong will remain a separate customs territory and will continue to have its own currency. Migration from China to Hong Kong will be strictly controlled. It can be argued, therefore, that, even after 1997, Hong Kong and the Mainland will be less institutionally integrated than Italy and Ireland, which are both members of the European Economic Community (EEC) and there is complete freedom of movement of goods and factors between the two

countries. Moreover, both countries are members of the European Monetary System and they have pegged exchange rates. As China is not a member of the GATT and the Chinese currency is not convertible, Hong Kong is institutionally more closely integrated with most of the economies of the free world than with China.

Though economic theory concentrates on tariffs, controls on migration and exchange integration, the effect of geographical and cultural distances may be even more important. Hong Kong is only half-an-hour's train ride from China, and Taiwan is quite close to China in terms of geography. The importance of cultural affinity is quite evident. People in Hong Kong had their ancestral roots in Guangdong, and Guangdong has received the bulk of Hong Kong's investment in China. Taiwan's investment is similarly concentrated in Fujian.

It should be noted that geographic and cultural proximity can enable businessmen to evade the formal barriers to trade and investment. Tariffs can be evaded through smuggling, and there is rampant smuggling from Hong Kong and Taiwan to China. The movement of people from Hong Kong and Taiwan to China is relatively free though movements in the other direction is highly controlled. However, illegal immigrants from the Mainland are quite common in Hong Kong and Taiwan, as the labour markets in the two economies are extremely tight. Though the Chinese Yuan is not convertible, the Hong Kong currency has circulated widely (and unofficially) in Guangdong, especially in the Shenzhen Special Economic Zone (SEZ). It has been estimated that the amount of Hong Kong dollars circulating in China amounts to HK\$6,300 million (US\$808 million) or 16 per cent of the total supply of the Hong Kong currency (*Hong Kong Economic Times*, March 21, 1991).

### *Unilateral Policy Changes*

Unilateral policy changes are also important in the integration of

the trio. China has tailored its open-door policy to build closer links with Hong Kong and Taiwan. In 1979, Guangdong and Fujian were given authority to operate SEZs that have special autonomy in trade and investment. Guangdong operates three SEZs: the Shenzhen and Zhuhai SEZs which are adjacent to Hong Kong and Macau respectively, and the Shantou SEZ which has close links to overseas Chinese populations, including a community in Hong Kong that originated in Shantou. Fujian operates the Xiamen SEZ which is opposite Taiwan and only a few miles from the two coastal islands controlled by Taiwan.

Taiwanese businesses enjoy special concessions in China over all other overseas businesses. In June 1980, China abolished all tariffs on the import of goods with a Taiwanese certificate of origin on the grounds that such trade constituted internal rather than international trade. The concession was short-lived as Taiwanese goods and Hong Kong goods with fake Taiwanese certificates of origin flooded the Mainland market. China levied "adjustment taxes" on Taiwanese goods in May 1981 to stem the flood, though the adjustment taxes were slightly lower than tariffs. Besides lower taxes, Taiwanese exporters enjoy other advantages in the Mainland market as the import controls on Taiwanese goods were less stringent. A 1988 State Council decree also gave Taiwanese investors favourable treatment over other foreign investors. Such concessions include the permission to develop land and a longer duration (or even unlimited duration) of the cooperative period for equity joint ventures or cooperative ventures.<sup>1</sup> Local authorities also tend to give Taiwanese investors more favourable treatment in terms of faster approval process or better supporting services.

Though the Mainland is more open to Taiwan than to any other economy, Taiwan is less open to the Mainland than to other economies. All trade and investment with the Mainland have to be conducted indirectly via third parties, usually via Hong Kong. Though import controls on Mainland products were gradually liberalized since 1987, indirect imports of only 92 items were

allowed by the end of 1990. The import of semi-manufactures from Taiwanese ventures on the Mainland for further processing or finishing in Taiwan was still prohibited. Such controls were partly responsible for the huge trade surplus Taiwan had with the Mainland. The controls also led to rampant smuggling from the Mainland to Taiwan through Taiwanese fishing vessels and also evasion through fake country-of-origin certificates. A Thai certificate of origin could be obtained at a mere US\$100.<sup>2</sup> Taiwan still prohibits investment from the Mainland, though it is reported that the Mainland has invested in Taiwan through its overseas subsidiaries.

The very rapid growth in trade and investment between Taiwan and the Mainland shows that the lack of direct official and commercial relations has not been an insurmountable barrier to business. Hong Kong has been able to offer very efficient intermediary services that have helped to overcome the lack of direct official and commercial ties. The efficiency of Hong Kong as a "middleman" will be detailed later.

On paper, Hong Kong businesses receive no favourable concessions in China over other overseas businesses. In reality, due to geographical proximity and kinship links, Hong Kong businesses have a significant advantage. Hong Kong investors have been able to obtain favourable concessions from local authorities in Guangdong as a result of the kinship network. It is also easier for Hong Kong Chinese to visit the Mainland than foreigners as visas are not required. China is thus more open to Hong Kong than to other economies. Hong Kong, as a free economy, is open to the whole world including China. However, it should be noted that Hong Kong's controls on visitors from the Mainland are stricter than the controls on visitors from other places as a result of the fear of illegal immigrants from the Mainland. In cooperation with Hong Kong, Beijing also imposes strict controls on visits to Hong Kong. Mainlanders often complain that it is easier for them to visit foreign countries than to visit Hong Kong. However, there are few restrictions against Mainlanders entering Hong Kong on official

passports, and it is estimated that over 60,000 Mainland cadres are working in Mainland companies in Hong Kong. Due to kinship links, a substantial number of Mainlanders have been able to settle in Hong Kong and some of them function as business representatives of local authorities or enterprises.

### Trade and Investment Among the Trio

As a large fraction of China's trade is conducted via Hong Kong in the form of entrepot trade, the statistics on China's trade by country is very misleading. In trade statistics, exports are classified by country of destination whereas imports are classified by country of origin. For example, in US-China trade, both countries regard their exports to each other through Hong Kong as exports to Hong Kong. Both countries thus understate their exports to each other. Imports are not understated as they are traced to the country of origin. Both countries thus overstate (understate) their bilateral trade deficits (surpluses). In 1990, according to US statistics, the US has a deficit of US\$11.5 billion in its trade with China, whereas China claimed a deficit of US\$1.4 billion in its trade with the US!

As Taiwan trades with China largely through Hong Kong, Taiwanese researchers and officials often regard Hong Kong's re-exports of Taiwanese (Chinese) goods to China (Taiwan) as the indirect exports (imports) of Taiwan to (from) China. Such a procedure is, however, unsatisfactory because it ignores the re-export mark-up, which is very substantial and is earned by Hong Kong. The re-export mark-up includes profits and the cost of transportation, storage, insurance, packaging and minor processing that is not substantial enough to confer country of origin. The re-export mark-up for Chinese goods is estimated to be 25 per cent whereas that for non-Chinese goods is 15 per cent. The re-export mark-up for Chinese goods is much higher because a lot of Chinese goods are packaged or processed in Hong Kong before exportation

(Sung, 1991a:480-482).

In this study, all statistics on China's trade by region include the direct trade as well as the indirect trade via Hong Kong. The re-export margin is netted out of indirect exports because exports should be reported on a f.o.b. (free on board) basis. For instance, the data on Taiwan's indirect exports to China given in this study is lower than Taiwan's estimates by the amount of the re-export margin. However, the re-export margin is not netted out of indirect imports because imports should be reported on a c.i.f. (cost, insurance, freight) basis. The procedure used in this study should give the best estimates of trade with China.

It is well known that statistics on bilateral trade flows obtained from the import side usually exceed those obtained from the export side because of the cost of transportation and insurance. In the case of China, the discrepancy is especially large because statistics obtained from the import side include the re-export margin whereas the data on the export side exclude the re-export margin.

Using the above procedure, the true US-China trade balance can be easily calculated. In 1990, 62 per cent of China's exports to the US were re-exported through Hong Kong whereas the corresponding percentage for the US was 20 per cent. The US deficit should be US\$10.3 billion whereas China's surplus was US\$7 billion. The difference between the two figures largely represented Hong Kong's re-export mark-up.

The high re-export mark-up for Chinese goods implies that Hong Kong earns a lot from re-exporting Chinese goods, and Hong Kong is going to lose heavily if the USA is to revoke China's Most-Favoured-Nation (MFN) status. In 1990, 62 per cent of China's exports to the USA went through Hong Kong in the form of re-exports. If China loses its MFN status, China's exports to the USA will decline substantially, and Hong Kong will lose considerably in the re-export margin as well as in the profits of its investment in China. Though China's loss of exports would be substantial, most of these exports would be from processing/as-



sembling operations which have a low value-added margin and a high import content. The wages (processing fees) that China earns from such operations are usually no more than 20 per cent of the value of exports. This implies that Hong Kong's loss is likely to be as large as that of China in absolute terms if China loses its MFN status (Sung, 1991b:15.6-9).

### *China's Commodity Trade with Hong Kong*

In the case of China's exports to Hong Kong, we have to exclude Chinese goods re-exported via Hong Kong. We subtract the value of Hong Kong's imports of Chinese goods for re-exports from the value of Hong Kong's total imports from China to arrive at the value of Hong Kong's retained imports (i.e. imports retained for internal use) from China. Then we form the ratio of Hong Kong's retained imports from China to Hong Kong's total imports from China. In 1990, the ratio was 16 per cent, showing that the bulk of China's exports to Hong Kong was re-exported. To estimate China's exports to Hong Kong for internal use in Hong Kong, we multiply China's exports to Hong Kong (obtained from China Customs Statistics) by this ratio.

China's statistics of imports from Hong Kong are highly misleading. China's imports from Hong Kong in 1990 amounted to US\$14 billion according to China Customs Statistics, while from Hong Kong's trade statistics, Hong Kong's domestic exports (i.e. exports of Hong Kong goods) to China only amounted to US\$6 billion, though there was another US\$14 billion worth of re-exports of third-country goods. It appears that China includes some but not all of Hong Kong's re-exports as imports from Hong Kong. Over-invoicing of imports on the Chinese side would explain part of the discrepancy. We would expect significant over-invoicing of imports in China as it is a classic means of evading foreign exchange control. Since China's statistics on its imports from Hong Kong are hopelessly inaccurate, we take China's imports from Hong Kong to be Hong Kong's domestic exports to

China. Time lags and differences between f.o.b. and c.i.f. prices are ignored. Due to the geographical proximity of the Mainland and Hong Kong, such differences should be quite minor.

Table 1 shows China's trade with Hong Kong. As mentioned previously, in the pre-1979 era, China had a large trade surplus with Hong Kong and most of China's exports were consumed in Hong Kong. China's imports from Hong Kong were negligible. China-Hong Kong trade was transformed in the reform era. Of China's exports to Hong Kong, the re-exported portion grew rapidly and exceeded the retained portion by 1986. The share in total Chinese exports of Chinese goods re-exported via Hong Kong rose from 6 per cent in 1977 to 40 per cent in 1991. China's imports from Hong Kong also grew rapidly. From 1977-91, China imports via Hong Kong and imports of Hong Kong origin grew 517 times and 996 times respectively. The share of indirect imports in China's total imports rose from 0.5 per cent in 1977 to 31 per cent in 1991. Hong Kong re-emerged as a major entrepot for China, and China also becomes a major market for Hong Kong products. In 1984, the share of the Chinese market in Hong Kong's domestic exports rose to 8.2 per cent, surpassing that of the UK (7.6 per cent), and was second only to that of the US (44 per cent). In 1991, China's share rose further to 24 per cent while the US share dropped to 27 per cent. If present trends were to continue, China would soon surpass the US to become the largest market for Hong Kong products.

Hong Kong was the largest final market (i.e. excluding Chinese exports via Hong Kong) for Chinese exports in the late 1960s and early 1970s, but the Hong Kong market was overtaken by the Japanese market and the US market in 1973 and 1987 respectively. However, the Hong Kong market still accounted for 5 per cent of China's exports in 1991. Domestic exports of Hong Kong to China has grown from negligible amounts to US\$6,975 million in 1991. In 1984 Hong Kong became the third largest supplier of goods to China after Japan and the USA. Part of the reason for the rapid growth of Hong Kong's domestic export is

**Table 1** China-Hong Kong Trade (US\$m)

	China's exports to Hong Kong			China's imports from Hong Kong		
	Total	Retained in Hong Kong	Re-exported elsewhere	Total	Hong Kong goods	Hong Kong re-exports
1931-38 average	87 (31.5)	16 (6.3)	70 (25.2)	87 (21.3)	9 (2.1)	79 (19.2)
1950	137 (24.8)	-	-	221 (37.8)	-	-
1951	151 (20.0)	-	-	281 (23.4)	-	-
1952	145 (17.6)	-	-	91 (8.1)	-	-
1955	157 (11.1)	-	-	32 (1.8)	-	-
1960	207 (11.2)	-	-	21 (1.1)	2 (0.1)	19 (1.0)
1965*	487 (20.5)	399 (16.8)	88 (3.7)	13 (0.6)	3 (0.2)	10 (0.5)
1970	467 (20.7)	376 (16.6)	91 (4.0)	11 (0.5)	5 (0.21)	6 (0.2)
1975	1378 (19.0)	1096 (15.1)	282 (3.9)	33 (0.5)	6 (0.08)	28 (0.4)
1977	1734 (22.8)	1306 (17.2)	428 (5.6)	44 (0.6)	7 (0.09)	38 (0.5)
1979	3044 (22.3)	2139 (15.7)	905 (6.6)	383 (2.5)	121 (0.8)	263 (1.7)
1981	5293 (24.1)	3465 (15.7)	1828 (8.3)	1961 (8.9)	523 (2.4)	1438 (6.5)
1983	5818 (26.2)	3680 (16.6)	2139 (9.6)	2531 (11.8)	856 (4.0)	1675 (7.8)
1984	6689 (25.6)	3979 (15.3)	2709 (10.4)	5033 (18.4)	1443 (5.3)	3590 (13.1)
1985	7168 (26.2)	3746 (13.7)	3422 (12.5)	7857 (18.6)	1950 (4.6)	5907 (14.0)
1986	9778 (31.6)	4734 (15.3)	5045 (16.3)	7550 (17.6)	2310 (5.4)	5241 (12.2)
1987	13762 (34.8)	5710 (14.4)	8052 (20.4)	11290 (26.1)	3574 (8.3)	7716 (17.9)
1988	18269 (38.4)	5579 (11.8)	12690 (26.7)	17030 (30.8)	4874 (8.8)	12157 (22.4)

**Table 1** China-Hong Kong Trade (US\$m) (Continued)

	China's exports to Hong Kong			China's imports from Hong Kong		
	Total	Retained in Hong Kong	Re-exported elsewhere	Total	Hong Kong goods	Hong Kong re-exports
1989	21916 (41.7)	4599 (8.8)	17323 (32.9)	18816 (31.8)	5548 (9.4)	13268 (22.4)
1990	26650 (42.9)	4361 (7.1)	22287 (35.9)	20305 (38.1)	6086 (11.4)	14219 (26.6)
1991	32137 (44.7)	3687 (5.1)	28450 (39.6)	26631 (41.7)	6975 (10.9)	19656 (30.8)

Figures in brackets represent percentage share of China's total exports (imports).

\* Export figures are for the year 1966.

Sources: Hong Kong data – 1931-38, Tom C.F., 1957, *Entrepot Trade and the Monetary Standards of Hong Kong*, Chicago, University of Chicago Press, 1948, & after; *Hong Kong Trade Statistics*, 1966 & after; *Review of Overseas Trade*, Census and Statistics Department, Hong Kong.  
Chinese data – 1931-48, UN Statistical Office, *Yearbook of International Trade Statistics, 1950-79*; *China Statistical Yearbook*, 1981 & after; *China Customs Statistics*.

due to Hong Kong investment in processing/assembling operations in China. Hong Kong firms supply such operations with the required raw materials and components, part of which are made in Hong Kong.

China's exports retained in Hong Kong have been stagnating since 1987 and their share of China's total exports has declined sharply. China has been unable to capture the higher end of Hong Kong's market, which is dominated by Japan. Given the increasing affluence of Hong Kong and the Japanese dominance in vehicles, capital goods, and quality consumer durables and consumer goods, the future of Chinese products in Hong Kong is not very bright (Sung, 1991c:119-122). The exports of Hong Kong goods to China has exceeded China's exports retained in Hong Kong since 1989 and Hong Kong has a surplus in its direct trade

with China from 1989 onwards.

### *China's Indirect Trade Through Hong Kong*

Since the inauguration of the open-door policy, China has established numerous direct links with the rest of the world, including diplomatic, commercial and transportation links. Paradoxically, the "middleman" role of Hong Kong is becoming more prominent, and an increasing share of China's commodity trade is handled through Hong Kong. To explain this paradox, it is worthwhile to construct a theory of intermediation. The theory has strong prediction value for entrepot trade and services trade.

In explaining entrepot trade, it is important to distinguish trans-shipment from entrepot trade. Trans-shipment means that goods are consigned directly from the exporting country to a buyer in the importing country, though the goods are transported via an entrepot and may be stored there for onward shipment. Trans-shipped goods are not regarded as part of the trade of the entrepot and they do not clear customs because they only represent goods in transit.

Unlike trans-shipment, entrepot trade is part of the trade of the entrepot. Imports for re-exports are consigned to a buyer in the entrepot and the buyer takes legal possession of the goods after clearing customs. These imports may then be processed before being re-exported as long as the processing is not substantial enough to confer country of origin.

The usual explanation of entrepot trade in terms of transportation cost is faulty because it ignores the importance of transaction costs. It is useful to classify re-exports into processed re-exports and pure re-exports. Processed re-exports refer to re-exports that have been physically treated (packaged, sorted and so on), whereas pure re-exports have not been changed in any physical way.

Pure re-exports are difficult to account for theoretically because re-exports involve higher costs than trans-shipment (other

things being equal) owing to two factors: one, re-exports have to clear the customs of an entrepot twice, whereas trans-shipped goods do not have to clear the customs of the entrepot at all, so fewer delays and lower storage costs for trans-shipment are involved; and two, trans-shipped goods are insured and financed just once, whereas re-exports have to be insured and financed twice – first when they are imported into the entrepot, and second when they are re-exported. While transportation costs determines trans-shipment, pure re-exports are determined by both transportation costs and transaction costs, and processed re-exports involve processing costs as well.

Since China's adoption of an open-door policy in 1979, it is easier to trade directly with China. The transaction cost of establishing a direct trade link has gone down, and this should lead to a rise in direct trade relative to indirect trade. However, China started to decentralize its foreign trade system in 1979, replacing vertical channels of command by horizontal links. The number of trading partners and trade links multiplied rapidly, creating a huge demand for intermediation. Before 1979, establishing trade links with ten state Trading Corporations would have ensured a complete coverage of China trade. The number of trading corporations increased to over one thousand by 1984, and it is very costly for an individual firm to establish trade links with the mushrooming number of Chinese trading corporations. Intermediation emerged to economize on the cost of establishing trade links, and this demand for intermediation was channelled to Hong Kong due to its comparative advantage in trading. China's foreign trade decentralization came in four waves: 1979, 1984, 1988 and 1991. The share of China's trade through Hong Kong jumped up after each wave of decentralization (Table 1).

The market composition of China's indirect trade via Hong Kong and the change over time of these markets in dependency on Hong Kong's entrepot trade confirm the overwhelming importance of trade decentralization on intermediation (Sung, 1991c: 141-143). Countries that have long histories of trading with China

found it worthwhile to pay for the fixed cost of establishing trade links, and they are less dependent on Hong Kong than new entrants. Political recognition and trade pacts also lower dependency on Hong Kong. However, the decentralization of China's trading system in 1979 and 1984 increase the dependency of both old-China hands and new entrants on Hong Kong's entrepot trade. For instance, the dependence of Canada and the USA on Hong Kong for China's exports decreased in the early 1970s as they established political and commercial links with China, but this trend was reversed in 1979. Starting from 1984, the dependence of all of China's major markets (Japan, USA, Singapore, West Germany, UK, Canada and Australia) on Hong Kong for China's exports increased substantially. Similarly, starting from 1979, all of China's major suppliers (Japan, USA, West Germany, UK, France, Italy and Singapore) became more dependent on Hong Kong for their exports to China.

### *China's Service Trade with Hong Kong*

Services trade between the Mainland and Hong Kong is extremely important. Conceptually, the re-export margin that Hong Kong earns through entrepot trade in fact represents export of services. However, such services are embodied in the goods sold and are usually recorded in trade statistics as export of goods rather than export of services.

For tourist services, Hong Kong visitors accounted for 66 per cent of tourist arrivals as well as tourist expenditure in China in 1990. Hong Kong also exports transportation services, trading services, construction services, financial services and business services to China. However, besides the data on entrepot trade and tourism, only some data are available for shipping, trading and financial services. Reliable data are lacking for the other categories. Hong Kong's export of financial services to China will be discussed in the section below on investment. Though Hong Kong's export of construction services and business services to

China is very important, there are very little data to go by. Hong Kong is the foremost base for China consultant services. According to *Intertrade* (October 1984:2), half of the foreign law firms in Hong Kong provide legal advice on China's trade.

Hong Kong is also the foremost gateway for foreigners touring China. Many foreigners also join package tours of China organized in Hong Kong. Though China has established more and more direct air links with other countries since 1979, the percentage of foreign tourists leaving (visiting) China via Hong Kong has been increasing since 1982, rising to 55 (44) per cent in 1987. This paradox can again be explained by the theory of intermediation as China decentralized part of the authority to organize China tours from the China Travel Service to provincial and local authorities in the early 1980s. Taiwan lifted its ban on travels to the Mainland in 1987, and this of course led to another jump in the number of foreigners visiting China via Hong Kong.

In commodity trade, Hong Kong is an important entrepot as well as centre of trans-shipment for China. The value of trans-shipped goods is not available as they do not go through customs, but their weight is known. In 1990, trans-shipment of goods to (from) China weight as much as 9 (13) per cent of China's imports (exports) from (to) Hong Kong. If we assume that the value of trans-shipment to (from) China per ton is the same as China's imports (exports) from (to) Hong Kong, trans-shipment of goods to (from) China via Hong Kong would amount to 3.6 (6.0) per cent of China's imports (exports) by value in 1990. Hong Kong trading firms also perform an important brokerage role for China's direct trade, amounting to US\$15 billion or 7 per cent of China's total trade in 1988 (Hong Kong Trade Development Council, 1988). As we do not have more updated data after 1988, we make the simple assumption that Hong Kong brokers involved in China's direct trade continued to account for 7 per cent of China's trade after 1988. The shares of China's exports consumed, re-exported, trans-shipped and intermediated by Hong Kong were 7 per cent, 36 per cent, 6 per cent and 7 per cent respectively in 1990. The total of the

four categories was 56 per cent. Though there is likely to be some overlap in the last two categories, we can safely conclude that Hong Kong plays an important role in over half of China's exports. On the import side, the shares of China's imports produced, re-exported, trans-shipped and intermediated by Hong Kong were 11 per cent, 27 per cent, 4 per cent and 7 per cent in 1990. The total of the four categories was 49 per cent. We can thus conclude that Hong Kong plays an important role in close to half of China's imports.

It should be noted that China's export of services to Hong Kong has increased rapidly in recent years. China's construction firms are active in construction projects in Hong Kong. A large number of Mainland Chinese are working in Hong Kong, including manufacturing workers imported to relieve the labour shortage in Hong Kong, and engineers working in Mainland-owned factories in Hong Kong. Hong Kong residents have also travelled to China for medical treatment because the price of health care is lower in the Mainland.

### *China's Commodity and Service Trade with Taiwan*

Besides the indirect trade through Hong Kong, China also trades with Taiwan through Singapore, Japan and other third parties. There is also direct trade, including smuggling and the so-called "minor trade" that takes place in designated coastal Mainland ports managed by customs offices. Taiwanese can use Taiwan vessels of under 100-ton size for the "minor trade." From the viewpoint of Taiwan, "minor trade" also constitutes smuggling. For Taiwan's imports from China, direct imports were estimated to be one-third of the indirect imports via Hong Kong.<sup>3</sup> There are no reliable estimates of Taiwan's direct exports to China. However, besides smuggling, it is known that Taiwan's businessmen have illegally trans-shipped goods to the Mainland via Hong Kong on a large scale since 1988 by exploiting a "known loophole" in Taiwan's policy. In October 1988, Taiwan allowed ships and

airplanes flying the flags of third countries to sail or fly from Taiwan to the Mainland as long as it stopped in a third place in its voyage. However, direct trade between Taiwan and the Mainland is still forbidden. To take advantage of the loophole, Taiwanese exporters claim on the bill of lading that their goods were destined for Hong Kong buyers when the goods left Taiwan. However, the documents were switched in mid voyage, and the goods were trans-shipped via Hong Kong to the Mainland. Such goods did not go through Hong Kong customs since they were reported as destined for Mainland buyers on arrival in Hong Kong and the Taiwan exporters saved on the costs and delays of going through Hong Kong customs. The risk of such trade is that, in the event of an accident on the Hong Kong-Mainland leg of the voyage, the insurance company can refuse compensation on the grounds of illegality. The magnitude of this trade can be detected by comparing Taiwan's and Hong Kong's statistics on bilateral trade flows.

The value of Taiwan's direct exports to the Mainland in the form of trans-shipment via Hong Kong is estimated in Table 2. We first estimate the value of Taiwan's exports imported into Hong Kong, which is taken to be 96 per cent of the value of Hong Kong imports from Taiwan to allow for the cost of insurance of freight (96 per cent was the pre-1988 average figure). Then we subtract such estimates from the value of Taiwan's exports to Hong Kong reported in Taiwan statistics. The value of Taiwan's direct exports to the Mainland trans-shipped via Hong Kong in 1988, 1989, 1990 and 1991 were respectively US\$116 million, US\$671 million, US\$1,400 million and US\$3,189 million. The value of such trans-shipment is approaching the value of Taiwan's goods re-exported from Hong Kong to the Mainland. The share of Taiwan's exports to Hong Kong that was retained for internal use in Hong Kong fell from 60 per cent in 1988 to 40 per cent in the first half of 1991. By 1991, the shares of Taiwan exports to Hong Kong that were re-exported and trans-shipped to China were 33 per cent and 26 per cent respectively, and the total of the two categories were 59 per cent.

**Table 2** Comparison of Taiwanese, Hong Kong and China's Statistics on Taiwan's Exports to Hong Kong and China

	Taiwan's exports to Hong Kong					Trans-shipped to China	China's imports from Taiwan
	Total	Imported into Hong Kong			Re-exported		
	Subtotal	Retained for internal use	To China	Elsewhere			
1988	5580 (100)	5464 (97.9)	3329 (59.7)	1964 (35.2)	171 (3.1)	116 (2.1)	-
1989	7030 (100)	6359 (90.5)	3498 (49.8)	2540 (36.1)	321 (4.6)	671 (9.5)	1856
1990	8570 (100)	7170 (83.7)	3957 (46.2)	2875 (33.5)	338 (3.9)	1400 (16.3)	2254
1991	12418 (100)	9229 (74.3)	4564 (36.8)	4074 (32.8)	591 (4.8)	3189 (25.7)	3639

Figures in brackets represent the percentage distribution of Taiwan's exports to Hong Kong.

Sources: Taiwan's exports to Hong Kong are obtained from the *Monthly Statistics of the Republic of China*, the amount imported into Hong Kong are taken to be Hong Kong's imports from Taiwan (obtained from *Hong Kong Review of Overseas Trade*) less a 4 per cent margin to allow for the cost of freight and insurance. Taiwan's exports re-exported via Hong Kong to China and elsewhere are taken to be Hong Kong's re-export of Taiwanese goods to China and elsewhere (obtained from *Hong Kong Review of Overseas Trade*) less a 15 per cent re-export mark-up. Taiwan's re-export retained for internal use in Hong Kong is obtained as a residual. The amount trans-shipped to China is also obtained as a residual. China's imports from Taiwan are obtained from *China Customs Statistics*.

China released statistics on its trade with Taiwan starting from 1988, and these statistics on China's imports from Taiwan were included in Table 2 for comparison. In 1991, the figure on China's imports from Taiwan was quite close to our estimate of Taiwan's trans-shipment to the Mainland via Hong Kong. However, in 1989 and 1990, the statistics on China's imports from

Taiwan vastly exceeded our estimates of Taiwan's trans-shipment to the Mainland via Hong Kong. As mentioned before, *China Customs Statistics* do not consistently classify imports by country of origin. It is thus possible that only part of Taiwan's goods re-exported from Hong Kong to the Mainland were regarded in *China Customs Statistics* as imports from Taiwan, and the rest were regarded as imports from Hong Kong. Adding the figures on China's imports from Taiwan and Hong Kong re-exports of Taiwanese goods to the Mainland would thus overstate the Mainland's imports from Taiwan. In this paper, we take Taiwan's direct (indirect) exports to the Mainland to be Taiwan's exports trans-shipped (re-exported) from Hong Kong to the Mainland. Taiwan's total exports to the Mainland are taken to be the sum of Taiwan's exports trans-shipped or re-exported from Hong Kong to the Mainland. This understates Taiwan's exports to the Mainland by the amount of Taiwan's exports trans-shipped or re-exported to the Mainland via other places such as Singapore or Japan, but the amount of understatement is probably small because of the dominant position of Hong Kong as an entrepot and trans-shipment centre.

Tables 3a and 3b show respectively the Mainland's trade with Taiwan and Taiwan's trade with the Mainland. Taiwan's exports (imports) to (from) the Mainland are different from the Mainland's imports (exports) from (to) Taiwan because of the difference in f.o.b. and c.i.f. prices. The difference is taken to be the re-export mark-up in the case of indirect trade and 4 per cent in the case of direct trade. The estimation of Taiwan's direct exports to the Mainland was explained above. Since the *China Customs Statistics* has consistently classified exports by country of destination, we take its figures on exports to Taiwan as the Mainland's direct exports to Taiwan. The figures largely represented "minor trade."

By 1991, Mainland's imports from Taiwan constituted 13 per cent of total Mainland imports. Taiwan has thus surpassed Hong Kong and the US to become Mainland's second largest supplier

**Table 3a** China's Trade with Taiwan (US\$m)

	China's exports			China's imports		
	Indirect export via Hong Kong	Direct exports	Total	Indirect import via Hong Kong	Trans-shipment via Hong Kong	Total
1988	382 (0.8)	--	--	2239 (4.1)	121 (0.22)	2360 (4.3)
1989	470 (0.9)	93 (0.18)	563 (1.1)	2896 (4.9)	697 (1.2)	3593 (6.1)
1990	612 (1.0)	320 (0.52)	932 (1.5)	3278 (6.1)	1456 (2.7)	4734 (8.9)
1991	904 (1.3)	595 (0.83)	1499 (2.1)	4685 (7.3)	3317 (5.2)	8002 (12.5)

Figures in brackets represent the percentage share of China's exports or imports.

Sources: China's indirect exports via Hong Kong are taken to be Hong Kong's re-exports of Chinese goods less a 25 per cent re-export mark-up, and China's indirect imports via Hong Kong are taken to be Hong Kong re-exports to China. Hong Kong re-exports are obtained from *Hong Kong Review of Overseas Trade*. China's direct exports are obtained from *China Customs Statistics*. China's imports trans-shipped via Hong Kong are taken to be Taiwan's export trans-shipped to China (obtained from Table 2) plus a 4 per cent margin to allow for the cost of freight and insurance.

after Japan. If present trends were to continue, Taiwan would soon become the Mainland's largest supplier. China's exports to Taiwan are still small, but they have grown extremely rapidly, and Taiwan will soon rank among the Mainland's top five markets.

By 1991, the Mainland surpassed Hong Kong to become Taiwan's third largest market after the US and Japan, accounting for 10 per cent of Taiwan's exports. Together with Taiwan's exports retained in Hong Kong and those re-exported elsewhere, total Taiwan's exports to Hong Kong amounted to 16.3 per cent of Taiwan's exports, surpassing that to Japan (12.1 per cent) and was second only to that to the US (29.3 per cent). In early 1991, Hong Kong surpassed the US to become the trading partner with which Taiwan has the largest trade surplus.

**Table 3b** Taiwan's Trade with China (US\$m)

	Taiwan's exports			Taiwan's imports		
	Indirect export via Hong Kong	Trans-shipped via Hong Kong	Total	Indirect import via Hong Kong	Direct imports	Total
1988	1964 (3.2)	116 (0.2)	2080 (3.4)	478 (0.96)	--	--
1989	2540 (3.8)	642 (1.0)	3210 (4.8)	587 (1.1)	97 (0.19)	684 (1.3)
1990	2875 (4.3)	1361 (2.1)	4275 (6.4)	765 (1.4)	333 (0.61)	1098 (2.0)
1991	4074 (5.3)	3189 (4.2)	7263 (9.5)	1130 (1.8)	619 (1.0)	1749 (2.8)

Figures in brackets represent the percentage share of Taiwan's exports or imports.

Sources: Taiwan's indirect exports via Hong Kong are taken to be Hong Kong's re-exports of Taiwanese goods less a 15 per cent re-export mark-up, and Taiwan's indirect imports via Hong Kong are taken to be Hong Kong's re-exports to Taiwan. Hong Kong re-exports are obtained from *Hong Kong Review of Overseas Trade*. Taiwan's exports trans-shipped via Hong Kong are taken from Table 2. Taiwan's direct imports from China are taken to be China's direct exports to Taiwan (Table 3a) plus a 4 per cent margin to allow for the cost of insurance and freight.

The Mainland suffers a massive deficit in its trade with Taiwan. However, China has a large surplus with Taiwan in tourism, in gifts and remittances and in investment. The payments balance across the Taiwan straits is thus quite even. Moreover, intra-industry trade is expected to develop rapidly with the surge in Taiwan's investment on the Mainland. In late 1991, in response to possible US trade restrictions on imports from the Mainland in accordance with section 301 of the US trade act, Taiwan is considering allowing the importation of semi-manufactures from the Mainland so that the goods can be further processed in Taiwan and claim Taiwanese origin instead of Chinese origin. If implemented, this action will lead to dramatic increases in Mainland exports to Taiwan and will also facilitate Taiwanese investment in

the Mainland.

Service trade between the Mainland and Taiwan is restricted to Taiwanese tourists visiting China. After Hong Kong and Macau, Taiwan is the third source of tourists for the Mainland, accounting for 3.5 per cent of tourist arrivals in China in 1990. The Taiwan share of tourist expenditure in China is likely to be two to three times higher than its share in tourist arrivals because, on a per capita basis, the Taiwanese visitor spends much more than the short-term visitors from Hong Kong and Macau. Of the 950 thousand Taiwanese visitors travelling to China in 1990, 920 thousand visited China through Hong Kong. The number of Taiwanese visiting China via Hong Kong is projected to rise to 1,020 thousand in 1991 (*Sing Tao Yat Pao*, February 5, 1991).

#### *China's Trade by Country/Region*

Given the estimates of the Mainland's trade with Taiwan and Hong Kong, we can form an accurate picture of China's trade by country/region in Table 4. China's indirect trade via Hong Kong is distributed to its final destination or initial source. China's trading partners, in order of importance, are the US, Japan, Hong Kong, West Germany, Taiwan, USSR and South Korea. In order of importance, China's major markets are the US, Japan, Hong Kong, West Germany, Singapore, USSR and South Korea, and China's major suppliers are Japan, the US, Hong Kong, Taiwan, West Germany, USSR, France and South Korea. China regards Hong Kong as its largest market as well as supplier because China's indirect trade via Hong Kong is regarded as trade with Hong Kong in Chinese statistics. As mentioned before, in 1991, Taiwan surpassed both Hong Kong and the US to become the Mainland's second largest supplier after Japan.

**Table 4** China's Trade by Region in 1990 (US\$m)

	Total Trade		Exports		Imports	
	Value	Rank	Value	Rank	Value	Rank
US	20142 (17.5)	1	13554 (21.8)	1	6588 (12.3)	2
Japan	18230 (15.8)	2	10642 (17.1)	2	7588 (14.2)	1
Hong Kong	10447 (9.1)	3	4361 (7.1)	3	6086 (11.4)	3
West Germany	6732 (5.8)	4	4048 (6.5)	4	2684 (5.0)	5
Taiwan	5666 (4.9)	5	932 (1.5)	—	4734 (8.9)	4
USSR	4379 (3.8)	6	2239 (3.6)	6	2140 (4.0)	6
South Korea	3652 (3.2)	7	2099 (3.4)	7	1553 (2.9)	8
Singapore	3231 (2.8)	8	2373 (3.8)	5	858 (1.6)	—
France	2897 (2.5)	—	1234 (2.0)	—	1663 (3.1)	7

China's indirect trade with other countries via Hong Kong are excluded from the Hong Kong figures and included in the figures of other countries. Data for Taiwan include only the indirect trade via Hong Kong.

Figures in brackets represent percentage share of China's total trade/exports/imports. Sources: Data on China's direct trade are obtained from *China's Customs Statistics*, and data on China's indirect trade via Hong Kong are obtained from the Census and Statistics Department of Hong Kong.

#### *Investment Among the Trio*

Table 5 shows China's inward foreign investment by source. The large share of Hong Kong in China's direct foreign investment conceals an important "middleman" role of Hong Kong. In



**Table 5** Foreign Investment in China by Source, 1979-90  
(contracted investment US\$mn)

	1979-84	1985	1986	1987	1988	1989	1990	Cumulative total	Percentage share
National total	10328	6333	3330	4319	6191	6294	6986	43781	100
Hong Kong	6495	4134	1449	2466	4033	3645	4258	26480	60.5
US	1025	1152	541	361	384	646	366	4476	10.2
Japan	1158	471	283	386	371	515	478	3662	8.4
Taiwan	-	-	-	100 <sup>1</sup>	420	480	1000	2000	4.6
Singapore	117	77	141	80	137	148	107	805	1.8
Canada	66	9	91	34	40	49	21	309	0.7
Australia	91	14	32	47	17	84	18	303	0.7
South Korea <sub>2</sub>	-	0.1	1.8	6.0	5.4	14.5	57	81	0.2

1. Cumulative total up till 1987.

2. Direct investment in China approved by the South Korean Government. Data are obtained from the Korean Overseas Trade Association.

Sources: Data for Taiwan are obtained from press releases of the Xinhua News Agency. Data for South Korea are obtained from the Korean Overseas Trade Association. Data for other economies are obtained from the *Almanac of China's Foreign Relations and Trade*, various issues.

China's statistics, investment from Hong Kong includes the investment of the subsidiaries of foreign companies incorporated in Hong Kong. Many multinational companies like to test the Chinese investment environment through investments from their Hong Kong subsidiaries because Hong Kong has the required expertise. If such investment is successful, then the parent company will also invest in China.

The US and Japan have been significant investors in China.

However, the investments of both countries have decreased appreciably after the Tiananmen incident. Moreover, the investment of the two countries in China is minuscule in comparison with their total overseas investment. For instance, Japan's cumulative investment in China was only 29 per cent of its investment in Hong Kong and only 0.9 per cent of its total overseas investment by June 1990. China had openly complained about the lack of Japanese investment in China and Japanese stinginess in technology transfer. Japan's strategy is to invest in Hong Kong since Japanese business regards Hong Kong as the future capital of an industrialized Southern China. Similarly, the US's cumulative investment in China was only 37 per cent of its investment in Hong Kong and only 0.57 per cent of its total overseas investment by the end of 1990.

### The Investment of Taiwan in China

Despite the explosive growth of Taiwanese investment in the Mainland in recent years, the total stock of contracted Taiwanese investment at the end of 1990 was less than 8 per cent of that of Hong Kong. This indicates that there is a considerable potential for further expansion of the Taiwanese share. Taiwan's investment was largely in small-scale labour intensive operations producing light manufactures for export. The industries involved include textiles, shoes, umbrellas, travel accessories and electronics. The projects were concentrated in Fujian and Guangdong, particularly in the Xiamen region of Fujian. However, Taiwanese investment was increasing in size and sophistication, with an increasing number of more technology-intensive projects such as chemicals, building materials, automobiles and electronic products and components. The fields of investment diversified from manufacturing into real estate, finance, tourism and agriculture. The location of investment spreads inland from the coast.

The surge of Taiwanese investment in the Mainland had raised fears that such investment would lead to the "hollowing

out" of Taiwan industry and also posed security threats. In July 1990, the Taiwan government tried to cool down the Mainland investment boom by improving the investment environment in Taiwan and steering investment away from the Mainland to the ASEAN. Both carrot and stick were used to prevent Formosa Plastics from implementing its gigantic project to build a naphtha cracking plant in Xiamen. To control the Mainland investment boom, Taiwan authorized 3,319 products for indirect investment in September 1990. These were mostly labour-intensive products with low degrees of processing. Authorization was not granted for investment in industries that were still competitive in Taiwan, including naphtha, catalysts, knitwear, synthetic leather, sheet glass and glass fibres.

The Taiwan government is trying to guide the Mainland investment boom rather than to reverse it. Taiwan's indirect trade and investment with the Mainland continued to grow rapidly in 1991.

### Hong Kong's Investment in China

Hong Kong investment in China is very diversified, ranging from small-scale labour intensive operations to large-scale infrastructural projects. Though Hong Kong manufacturing is not as sophisticated as that in South Korea and Taiwan, Hong Kong has considerable expertise in service industries including construction, hotels and financial services.

The share of Hong Kong in China's external loans was small in the early 1980s, but the share rose from 0.6 per cent in 1983 to 9.4 per cent in 1989. Hong Kong's share was low partly because Hong Kong does not extend official loans to China. However, China-back companies began to raise funds in Hong Kong's stock market through share placements in 1987 (*South China Morning Post*, 18 June 1987), and there are signs that China may make more use of Hong Kong's stock market in the long run.

Hong Kong is the centre for raising 80 per cent of China's syndicated loans. Loan syndication is an important "middleman"

function performed by Hong Kong. The share of China's external loans (syndicated loans and other loans) syndicated in Hong Kong rose from 6 per cent in the 1979-82 period to 31 per cent in 1987 and then declined to 14 per cent in 1989. Such changes can be explained by the theory of intermediation. The rapid jump of the share of China's loans syndicated in Hong Kong in 1987 was related to the 1986 decentralization of the power to raise foreign loans to selected provincial governments and enterprises. The rapid decline of the share of China's loans syndicated in Hong Kong since 1988 was related to the 1988 recentralization of the power to borrow foreign funds as part of the retrenchment program. In commodity trade, tourist trade as well as financial services, decentralization had a decisive impact on intermediation.

Hong Kong's industrial investment in Guangdong has transformed Hong Kong manufacturing as well as the entire Hong Kong economy. Presently, Hong Kong manufacturing firms employ up to 3 million workers in Guangdong, while the manufacturing labour force in Hong Kong is only around 700,000. By moving the labour-intensive processes to Guangdong, Hong Kong can concentrate on the more skill-intensive processes such as product design, sourcing, production management, quality control and marketing. Hong Kong manufacturing has thus been able to achieve a very high rate of labour productivity growth. The expansion of exports from processing operations in Guangdong also increased the demand for Hong Kong's service industries, including entrepot trade, shipping, insurance, business services and financial services. Both the Hong Kong manufacturing sector and the Hong Kong economy have become increasingly service oriented. In short, Hong Kong has become the economic capital of an industrialized Guangdong. The region has a population of 66 million, exceeding that of South Korea.

### China's Investment in Hong Kong

China's investment in Hong Kong is likely to exceed Hong Kong's investment in China. According to Chinese statistics, Hong

Kong's contracted investment in China from 1978 to 1990 amounted to US\$26.5 billion. However, Hong Kong's utilized investment in China was only around 52 per cent of contracted investment. Hong Kong's utilized investment in China from 1978 to 1990 is thus estimated to be around US\$14 billion. However, this is likely to be a gross overestimate as it includes the investment of the subsidiaries of Taiwanese companies and multinational companies in Hong Kong. In fact, Mainland companies have also invested in China through their Hong Kong subsidiaries in order to qualify for the concessions granted to overseas investors. From anecdotal evidence, it is known that Hong Kong investors often overstate the value of their investment in China with the connivance of local officials. For example, Hong Kong manufacturers tend to put a high value on the outdated machinery that they move to China. It is well known that government officials in command economies tend to exaggerate economic achievement reflected in the phenomenon called the "success indicator problem."

China's cumulative investment in Hong Kong was estimated to be around US\$10 billion, but this is likely to be an underestimate as there is an incentive for China's local authorities and enterprises to establish unofficial subsidiaries in Hong Kong to evade controls on foreign trade as well as foreign exchange controls. China's investment in Hong Kong is thus likely to exceed Hong Kong's investment in China.

China's investment in Hong Kong is very diversified, covering nearly all sectors of the Hong Kong economy, namely banking, insurance, entrepot trade, shipping, aviation, real estate, and manufacturing. China's investment strengthens the ties of Hong Kong to China and enhances the position of Hong Kong as the gateway to China.

### The Prospect of Hong Kong as a "Middleman" for the Mainland

The role of Hong Kong as a "middleman" for China is important both in commodity trade and services trade, including tourist services and financial services. A "middleman" creates opportunities for trade and investment by lowering transaction costs. An efficient "middleman" thus enhances the degree of economic integration between different economies. Due to the many rigidities of China's economy and political barriers, the efficiency of Hong Kong as a "middleman" is crucial to its economic interactions with the world, especially to transactions with Taiwan and South Korea.

The Tiananmen incident has paradoxically speeded up the reform and decentralization of China's foreign trade, and such reforms have enhanced the "middleman" role of Hong Kong. After the cutting off of soft loans following the Tiananmen incident, China was under great pressure to expand its exports to pay off its foreign debt. China devalued the *Renminbi* against the US dollar in December 1989 and in November 1990 by 21 per cent and 9.6 per cent respectively. China further decentralized its external sector in early 1991. Provincial governments and export enterprises were allowed to retain 80 per cent of their foreign exchange earnings and subsidies on exports were abolished. The number of commodities that could only be exported with licenses decreased from 185 categories to roughly 90 categories. China's exports continued to grow at double digit rates from 1989 to 1991. As expected, the further decentralization of China's trade enhanced the "middleman" role of Hong Kong. The share of China's exports (imports) re-exported via Hong Kong jumped from 36 (27) per cent in 1990 to 40 (31) per cent in 1991 (Table 1).

As China is likely to further decentralize its foreign trade and investment, the prospect of Hong Kong as a "middleman" is very bright. There are significant economies of scale and economies of

agglomeration in trading activity, and it is very difficult for other cities such as Singapore or Shanghai to compete with Hong Kong because Hong Kong is the established centre for China's trade. The existence of economies of scale in intermediation would enhance the demand for the "middleman" without which small firms will not be able to trade efficiently.

Traders tend to agglomerate in a city, suggesting that there are significant external economies involved. This implies that once a city acquires a comparative advantage in trade, the advantage feeds upon itself, and more trading firms will come to the city, making the city even more efficient in trade (Sung, 1991c: 28-42).

Though the greater part of Hong Kong's entrepot trade is China-related trade, the non-China component of Hong Kong's entrepot trade is also thriving, growing faster than world trade. This implies that an increasing share of the trade among market economies is handled through Hong Kong in the form of entrepot trade, confirming our theory on the efficiency of large trading centres.

In the long run, China is likely to overcome its transportation bottlenecks and acquire modern trading skills. China may even clean up its bureaucracy. However, China will still rely on Hong Kong for trade and financial and business services because of economies of scale and of agglomeration in such activities.

The Chinese themselves are establishing many trading companies in Hong Kong, showing that they recognize the established efficiency of Hong Kong in trading. Some Hong Kong traders fear competition from Chinese trading companies in Hong Kong. However, the situation is not a zero-sum game because of economies of agglomeration; the arrival of Chinese trading companies further enhances the position of Hong Kong as a trading centre.

It is often alleged that if South Korea and Taiwan were to establish direct commercial links with the Mainland, the role of Hong Kong as a "middleman" in China's trade would decline.

This view is mistaken as it is supported by neither theory nor empirical evidence.

The combined indirect trade of Taiwan and South Korea with the Mainland via Hong Kong was only 13 per cent of China's indirect trade via Hong Kong in 1990. As mentioned before, though most countries have direct commercial and diplomatic relations with China, they have become more dependent on Hong Kong for their trade with China since 1979.

Canada, the USA, and Indonesia only established direct commercial or diplomatic relations with China in the 1970s or 1980s, and their experiences again confirm the efficiency of Hong Kong in intermediation. In these four countries, the establishment of direct commercial or diplomatic relations led to a sharp and once-for-all decline in the dependence on Hong Kong, but their dependence on Hong Kong rose again as China decentralized its trading system. For example, in the case of China's exports to the US, the share of indirect exports via Hong Kong fell sharply from 100 per cent in 1970 to 15 per cent in 1975. However, the share rose in 1979 with the decentralization of China's trade, and it increased to over 62 per cent in 1990. In the case of China's exports to Canada, the share of indirect exports via Hong Kong also fell sharply to as low as 7 per cent in 1975, but it also rose in 1979, and it increased to 59 per cent in 1990. In the case of China's exports to Indonesia, the share of indirect exports via Hong Kong fell to a low of 50 per cent in 1988, but rose slowly thereafter.

### The Prospect of Integration of the Trio

As long as the Mainland is committed to the continuation and deepening of economic reforms and the open-door policy, market forces will strengthen the economic integration of the trio. As wages have risen rapidly in Hong Kong and Taiwan, the labour-intensive industries of Hong Kong and Taiwan have moved to the Mainland on a large scale. The synergy of China's cheap labour

with Hong Kong's and Taiwan's know-how and capital was the main factor behind China's spectacular export drive (Sung, 1991d:22-26).

The economic ties of the Mainland with Hong Kong and Taiwan have become especially important after the Tiananmen incident of June 1989. Since the Tiananmen incident, China has become more isolated, but China's economic links with Hong Kong and Taiwan have strengthened. Since June 1989, investment and tourists from developed countries (DCs) have declined, but investment and tourists from Taiwan increased sharply, and investment and tourists from Hong Kong rebounded rapidly in 1990. Thanks to investment from Taiwan and Hong Kong, total contracted foreign investment in China grew from US\$6.2 billion in 1988 to US\$6.3 billion in 1989 and grew further to US\$6.9 billion in 1990. China's tourist earnings decreased from US\$2.2 billion in 1988 to US\$1.9 billion in 1989, but recovered to US\$2.2 billion in 1990 largely due to the continuing surge of tourists from Taiwan, Hong Kong and Southeast Asia. In a nutshell, Hong Kong and Taiwan are essential to the success of China's open-door.

The nature of the economic ties between the Mainland, Hong Kong and Taiwan is qualitatively different from China's ties with DCs. China's commodity trade with the DCs is mostly inter-industry trade, whereas the trade with Hong Kong and Taiwan includes substantial intra-industry trade. This is because China's stage of development is closer to Hong Kong and Taiwan than to the DCs. Moreover, Hong Kong and Taiwan have invested heavily in outward processing operations in China, giving rise to thriving intra-firm trade. Hong Kong and Taiwan have less of the advanced technology of the DCs, but their medium-level technology may be more suited to China's level of development and could enhance China's bargaining power in acquiring technology from the DCs. The investment from Hong Kong and Taiwan tends to be in export-oriented processing/assembling operations whereas Japan and the US tend to invest in import-substitution enterprises. The investment from Hong Kong and Taiwan is the

most significant factor behind China's successful export drive.

There have been a lot of proposals for promoting the integration of the trio through institutional arrangements such as the formation of a free-trade area. Most of these proposals are utopian and counter-productive. The reality is that there are very real political differences dividing the Mainland and Taiwan, and such differences are not going to disappear overnight with economic integration. While the economy of Hong Kong is irrevocably tied up with that of the Mainland, Taiwan will not allow its economy to be too dependent on the Mainland unless the Mainland is willing to give up the use of force in the Taiwan Straits. Since there are no signs that the Mainland is willing to do so, any dramatic breakthrough in Mainland-Taiwan relations is unlikely. Despite the dramatic increase of Taiwanese investment in the Mainland, Taiwan's Mainland investment is still much less than Taiwan's investment in the ASEAN. The transportation cost from Taiwan to the Mainland is not very different from that of Taiwan to the ASEAN countries, as goods have to be loaded from trucks to ships and unloaded again. ASEAN is thus a strong competitor with the Mainland for Taiwanese investment. A survey showed that wages in China were comparable to that in the ASEAN, and the only advantage China had over ASEAN was in consignment processing, the most simple of all production areas (Watanabe, 1990:11).

The economic reality of the trio is that the US is their largest market, and Japan is their largest supplier of capital goods and technology. An inward-looking bloc of the trio excluding the US and Japan would thus not be in the long-term interest of the trio.

Though Hong Kong is irrevocably integrated with the Mainland, it must be remembered that Hong Kong can function as the bridge linking the Mainland and the world only because Hong Kong is also irrevocably integrated with the world economy. An inward-looking bloc involving Hong Kong and the Mainland would be detrimental to both.

Hong Kong is traditionally a free port, and the freedom of movement of goods and capital in Hong Kong is enshrined in the

Sino-British agreement on the future of Hong Kong as well as the Basic Law because all parties involved recognised that such freedom is essential to the future prosperity of Hong Kong. As the free-port status of Hong Kong is guaranteed by constitution and by international agreement, the only way that the Mainland and Hong Kong can form a trade bloc is for the Mainland to abolish all its tariffs. This is obviously ludicrous and utopian.

Shenzhen has built a "second line" managing the flow of goods and people between its SEZ and the rest of China, and Shenzhen has plans to become a free trade zone. However, even if Shenzhen were to become a free trade zone, Hong Kong and Shenzhen would still be separate entities in trade. Trade between Hong Kong and Shenzhen would be like trade between Hong Kong and any other free trade zone, e.g., Singapore or the Kaoshiung export processing zone. Moreover, Hong Kong still has to maintain its border controls against Shenzhen. To qualify for GATT membership, Hong Kong must be able to effectively distinguish between goods made in Hong Kong and those that are made in Shenzhen and elsewhere. The abolition of Hong Kong border controls against Shenzhen would jeopardize Hong Kong's GATT membership and Hong Kong's textile and clothing quotas. As China is applying for GATT membership, the abolition of Shenzhen's border controls against Hong Kong goods would also pose complications for China's GATT membership and China's textiles and clothing quotas. Theoretically, Hong Kong and Shenzhen can enter GATT as a single customs territory. However, this will be an infringement on Hong Kong's autonomy as Shenzhen will then have a say over Hong Kong's trade policy as well as textile and clothing quotas. It will require amendments to the Sino-British agreement on the future of Hong Kong as well as the Basic Law. A trading bloc involving Hong Kong and Shenzhen is thus also utopian.

The entry of the Mainland and Taiwan into the GATT would promote the integration of the trio in many ways. To qualify for GATT membership, the Mainland must radically reform its trad-

ing system, and Taiwan has to further liberalize its trade. This would allow greater scope for market forces to strengthen the integration of the trio. GATT membership would also give the Mainland and Taiwan some protection against trade protectionism in the US. As mentioned before, the synergy of China's cheap labour with Hong Kong's and Taiwan's know-how and capital was the main factor behind China's spectacular export drive, and revoking China's MFN status in the US would be very detrimental to the further integration of the trio. GATT membership for both the Mainland and Taiwan would also strengthen the reformers in the Mainland as well as strengthen the international position of Taiwan. Taipei can thus afford to allow its ties with the Mainland to grow further.

The Mainland's unilateral tariff and investment preferences for Taiwan are unGATTable, economically inefficient, politically counter-productive, and detrimental to the long-term integration of the trio. Taiwanese businessmen are given special concessions over others on the grounds that they are Chinese and Taiwan is a part of China. However, Hong Kong businessmen are not entitled to the same treatment even though Hong Kong is also a part of China, and the Mainland Chinese themselves receive the worst treatment of all. The logical conclusion is that Taiwanese businessmen receive the best treatment only because Taiwan's reunification with the Mainland is not assured, and there is no need to give special treatment to Hong Kong businessmen because Hong Kong's return to the Mainland is already assured. The Taiwanese businessmen will thus try to maintain Taiwan's political separation from the Mainland in order to keep their concessions. The policy of the Mainland is time-inconsistent and runs contrary to the goal of national reunification.

As mentioned before, Beijing's tariff exemption for Taiwanese goods in 1980 was largely reversed in 1981 to stem the flood in the Mainland market of Taiwanese goods and Hong Kong goods with fake Taiwanese certificates of origin. The episode illustrated the economic and political dangers of favouritism and discrimination.

However, Beijing has yet to learn the lesson in full. Special concessions were given to Taiwanese investors in 1989, and Beijing is starting to have problems with investors putting on a Taiwanese disguise. There were also complaints of unfair competition from domestic producers in the Mainland whose exports have been displaced by the exports of Taiwanese investors in the Mainland.

In 1991, some Hong Kong businessmen have lobbied for tariff preferences from the Mainland. Such preferences, if granted, would be detrimental not only to the Mainland but also to Hong Kong. Free competition has long been the source of strength and dynamism of the Hong Kong economy. Such preferences would entice Hong Kong businessmen to spend their energy on lobbying for favouritism instead of concentrating their resources on improving productivity. Moreover, there is no free lunch, and Hong Kong's seeking favouritism from the Mainland would invite the Mainland to ask for reciprocal favouritism from Hong Kong. Given Chinese sovereignty and Beijing's intervention-prone record, Hong Kong would have a hard time preserving the autonomy promised in the Basic Law. The seeking of favouritism from Beijing would further compromise Hong Kong's ability to manage its own affairs. It should be stressed that the erosion of Hong Kong's autonomy and dynamism would also be detrimental to China's long-term interests.

It should be noted that Hong Kong and Taiwanese businessmen already have a tremendous advantage in the Mainland market due to geographic proximity and cultural affinity. If Hong Kong and Taiwanese businessmen cannot compete against foreigners in the Mainland market, they must be highly inefficient, and they deserve to lose in competition.

It is often not realized that tariff preferences and institutional arrangements may not be important for economic integration. Economic integration means the lowering of transaction costs, and tariffs are often only a small part of transaction costs. Other factors such as transportation costs, cultural affinity, foreign exchange controls and government regulations may be much more

important. According to Ulrich Heimenz of the Kiel Institute of Economics, tariff preferences did not play a significant role in ASEAN's integration, and

In the ASEAN group, transaction costs were lowered through the emergence of Singapore as a regional trading and services center and the software cooperation among member countries. In the North-Pacific it was unilateral policy action such as the partial liberalisation of goods and services trade which served the same purpose of reducing transaction costs and thereby stimulating trade integration. These findings contain the important lesson that trade expansion depends on a wide range of interlinked influences and not just on discriminatory trade preferences. This should be taken into account when designing foreign economic policies in the Asian-Pacific region. (Heimenz, 1991:14)

In the case of the integration of the trio, the pivotal role of Hong Kong as an efficient "middleman" and the importance of the unilateral trade liberalization of the Mainland and Taiwan were clearly important. The integration of the trio will continue to be largely market-driven, though consultation through the APEC, through semi-official organizations such as the Straits Foundation in Taiwan, or through privately sponsored forums to improve information flow and to discuss possible policy coordination will be useful. GATT membership for both the Mainland and Taiwan would give a tremendous boost to the integration of the trio. Institutional discriminatory preferences are utopian and counter-productive, and unilateral discriminatory preferences are unGATTable and detrimental.

In the long run, the best economic and political policy for Beijing is national treatment for all. However, given the many distortions of the Chinese economy, this goal can only be gradually realized in many stages. Needless to say, national treatment for all is the best policy for promotion of economic integration, not just for the trio, but also for the North Pacific region and for the world as a whole.

## Notes

1. For equity joint ventures, the cooperation period is generally 20 years for heavy industry, 10-15 years for light industry, and 5-10 years for service and tourist industry. At the end of the contract, the asset of the company can be sold to the Chinese partner at an agreed price, or the company can apply for an extension of the contract.
2. Information obtained from interview with Dr. Rong-Feng Chang of the Chung Hua Institution for Economic Research, Taiwan.
3. Estimated by Dr. Rong-Feng Chang of the Chung Hua Institution for Economic Research, Taiwan. The estimate was based on his interviews with fisherman in Taiwan.

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# 通過文化淵緣之非制度性經濟整合： 中國大陸、台灣及香港之案例

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(中文摘要)

中國大陸、台灣及香港三地雖然沒有成立制度性之貿易集團，三地間之經濟整合卻有長足的發展。三地之文化、地理淵緣及香港有效率之中介服務克服了種種經濟交往的障礙，包括大陸繁鎖的貿易、投資與外匯管制，及台灣的“三不”政策。

為了準確地描述三地的經濟整合，本文詳盡地比較三地之外貿及投資數據，並對外貿數字作出兩種必需的調整：(一)香港轉口差價，(二)到岸價及離岸價之差價，由此而得到迄今最準確的資料來描述(一)大陸—香港貿易、(二)大陸—台灣貿易(包括經港之間接貿易及經常被忽略的兩岸直接貿易)、(三)台灣—香港貿易及(四)大陸按國家/地區之貿易。

自一九七九年中國開放以來，中國與外界建立之直接聯繫越來越多，可是中國外貿卻有越來越大的部份通過香港間接進行。本文建立了一個中介理論來解釋這個現象：中國外貿權力下放使眾多單位擁有外貿自主權，貿易聯繫的數目和貿易的交易成本因此激增。香港提供中介服務的效率高，減低了外界與中國貿易的交易成本及促進了三地的經濟整合。因為貿易活動具有規模經濟及聚結經濟，大型的貿易中心是以有強大的競爭力。就是台灣與大陸直接通商，香港的中介活動將繼續興旺。

雖然沒有制度性的安排，三地的經濟整合仍將迅速發展。種種企圖將三地經濟整合制度化的建議(如“大中華經濟圈”或包括香港和深圳的“大香港”)都不切實際，並會有反效果。香港必需對大陸及深圳維持邊境及海關控制，否則香港便不能享有其國際關貿協定下作為獨立關稅地區的權利，包括享有獨立的成衣配額。深圳亦同樣需要維持其邊界及海關控制。大陸以往給予台灣的貿易及投資上的優惠並不符合國際關貿協定的規定，兼且有反效果。

促進三地整合的最佳政策，並非建立甚麼經濟圈，而是進一步開放大陸和台灣的外貿，並接納大陸和台灣加入國際關貿協定。通過APEC或其他半官方或私人論壇的洽商，亦能加強訊息交流和政策調協，從而降低交易成本，促進三地整合。