The Evolving Role of Hong Kong as China's Middleman

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Abstract

While Hong Kong's historic role as China's middleman rose to new prominence in the first 15 years of China's open-door era, Hong Kong's shares of China's foreign investment and trade have declined in recent years. It is alleged that, with China's full opening and integration into the world economy, there is no future for Hong Kong as China's middleman.

This paper argues that the above prognosis on the future of Hong Kong as China's middleman is misconstrued theoretically as well as empirically. In theory, the demand for middleman services rises as a command economy decentralizes. Empirically, the decline in Hong Kong shares of China's trade and investment has been overstated as part of Hong Kong's investment in China has been channeled via the tax haven economies (mostly Carribean islands), and Hong Kong's China's-related entrepot trade has been increasingly diverted to offshore trade that does not touch Hong Kong but is still handled by Hong Kong trading companies. The paper corrects for such statistical biases.

Based on newly released statistics on Hong Kong's offshore trade and trade in services by country, the paper examines the evolution of Hong Kong's role as China's middleman: from entrepot trade to offshore trade and services not directly related to physical handling of goods, namely, trading, financing, and professional services. The paper also examines the competitiveness of Hong Kong as a service hub vis-a-vis Shanghai, and concludes with an assessment of Hong Kong's future as China's middleman.

The Evolving Role of Hong Kong as China's Middleman

1. **Introduction**

While Hong Kong's historic role as a middleman for the Chinese Mainland rose to new prominence in the first 15 years of China's open door era inaugurated in 1979, Hong Kong's share of China's foreign investment and trade have declined since the mid 1990s. With China's full integration in the world economy signaled by China's WTO entry in 2002, and the rapid development of rival hubs such as Shanghai and Shenzhen, it has often been alleged that there will be no future for Hong Kong as Mainland's middleman.

In the early years of China's reform era, Hong Kong had a semi-monopoly position as a service hub for China due to the underdevelopment of China's service sector. China had neglected the development of its services sector in the pre-reform era because services were regarded as "unproductive" in Marxist ideology. China did not allow significant foreign investment in services till Deng Xiaoping's 1992 southern tour in support of economic reforms. With the rapid development of China's service sector since the mid 1990's, Hong Kong lost its semi-monopoly position, and Hong Kong's share of Mainland's foreign trade and investment declined.

This paper argues that the prognosis that Hong Kong has no future as China's middleman is misconstrued theoretically as well as empirically. In theory, the demand for middleman services rises as a command economy decentralizes. While the development of rival hubs such as Shanghai and Shenzhen have cut into Hong Kong's share of the China market, China's demand for middleman services has increased tremendously with economic reforms. Moreover, the size of the Mainland economy has increased rapidly with economic development, again raising the demand for intermediation. In a nutshell, Hong Kong is having a smaller share of a bigger pie. It is still possible for Hong Kong's slice of the cake to grow.

Empirically, the decline in Hong Kong shares of China's investment and trade has been overstated as part of Hong Kong's investment in China has been channeled via the tax haven economies (mostly Caribbean islands), and Hong Kong's China's-related entrepot trade has been increasingly diverted to offshore trade that does not touch Hong Kong but is still handled by Hong Kong trading companies. The paper corrects for such statistical biases.

This paper is organized as follows. Besides the introductory section, section two will discuss the theory of intermediation and its implication for the role of Hong Kong as China's middleman. Sections three and four analyse Hong Kong's role in China's trade and foreign investment. Section five discusses the role of Hong Kong as a service hub. Section six concludes.

2. **The theory of intermediation**

A naïve view attributes Hong Kong's role as China's middleman to China's isolation in the Cold War era. The view is untenable. In theory as well as in reality, an economy that is fully integrated with the world economy still demands intermediary services. Empirically, Hong Kong's Mainland-related trade and investment have increased by leaps and bounds since the inauguration of the open-door era in 1979.

Due to the transaction costs of establishing trade links, an exchange structure in which everyone is directly linked to everyone else (the Walrasian model) is generally inefficient; efficient structures minimize the number of trade links and necessarily involve intermediation (Townsend 1978). Increasing the number of participants in a trading coalition decreases risks, but increases the number of links and transaction costs. A trade-off is involved, and Townsend used a core equilibrium concept to show how an equilibrium is generated.

2.1. **Intermediation and decentralization**

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. Part of the demand for intermediation was channelled to Hong Kong due to its comparative advantage in trading.

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 1991: 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.

2.2. **Efficiency of large trading centres**

In trading and transportation, there are significant economies of scale or scope, and also economies of agglomeration. Large trading and transportation hubs such as Hong Kong can provide trading and shipping services efficiently. Hong Kong has been the world's busiest container port for many years, boosting a record container throughput of nearly 22 million T.E.U. in 2004. Hong Kong is also the world's busiest hub for international air cargo.

In transportation, a successful shipping hub must have sufficient freight to attract shipping companies to make frequent calls. A large and busy port tends to be efficient because of economies of agglomeration: an increase in freight will imply more frequent shipping which will in turn attract more freight as the cargo can be shipped out speedily. This gives rise to the hub-and-spoke pattern in transportation: It is often more economical for feeder ports to tranship through a major hub rather than relying on direct shipment.

In trade, Yamamura (1976: pp. 184-5) argues that significant economies of scale exist in the production of trading services, as the production of these services usually involves large fixed costs and small or declining marginal costs. In the production of market information, which is part and parcel of intermediation, he argues that considerable costs are involved, and the same market information is useful in many transactions. Moreover, trading firms can also consolidate small orders to efficiently use warehouse and shipping capacities to achieve economy of scale.

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.

There are in fact external economies on both the demand and supply sides in trade. External economy on the demand side operates through search: an increase in the number of potential trading partners makes trade easier. External economies on the production side are also important in trade. Hicks (1969: 47-9) observed that an increase in the number of merchants in the trading centre will permit specialization and division of labour, not only by lowering costs, but also by lowering risks. The larger the number of traders, the easier it is to acquire information, and the easier it is to arrange multilateral contracts or to develop specialized contracts such as insurance and hedging. Lucas (1985) stressed the importance of agglomeration, especially in service industries, because people in the same trade can interact and learn from one another. He called this 'externality of human capital'.

The theory presented here predicts that a decline in travel and communication costs will lower the fixed cost of transaction, and thus the fraction of world trade handled through intermediation will decline. However, a decline in travel cost will shrink cost differentials between market-places and will lead some buyers to shift from small (local) market-places to larger (most distant) ones. For large trading centres, a decline in travel costs may not imply a fall in business. Despite the secular decline in transportation costs, Sung (1991: 33-39) found that the share of world exported handled by as re-exports by Hong Kong and Singapore have risen since 1962 and 1975 respectively.

3. **Hong Kong's role in China's trade**

Hong Kong's role as a middleman in Mainland's trade takes the following forms:

1. Re-exports (entrepot trade) – Hong Kong companies buy goods outside Hong Kong for resale elsewhere, and the goods are imported into Hong Kong for re-exporting. The goods clear customs twice, the first time during importation and the second time during exportation.

2. Middleman in offshore trade – The goods do not go through Hong Kong customs. Hong Kong firms play a role in *Merchanting* or *Merchandising.*
   a. Merchanting - Hong Kong traders buy goods outside Hong Kong for export elsewhere, and such goods do not go through Hong Kong customs.
   b. Merchandising – Hong Kong traders arrange on behalf of buyers/sellers

outside Hong Kong the purchases/sales of goods without taking ownership of the goods involved, and such goods do not go through Hong Kong customs.

Hong Kong has detail statistics on its entrepot trade since 1966. However, offshore trade does not go through Hong Kong customs, and their value can only be obtained through surveys. The Hong Kong Trade and Development Council conducted such surveys for 1991, 1994, and 1997. Since 2000, the Census and Statistics Department of the Hong Kong Government has conducted more detail surveys every year. While complete statistics on offshore trade are only available for 2002-03, offshore trade in earlier years can be estimated with a reasonable degree of accuracy. The details of estimation are given in the Appendix.

Offshore trade was small before 1991 because Mainland's container ports were underdeveloped. Mainland cargo was carried to Hong Kong by land or barges for containerization and delivery overseas. The Mainland did not allow foreign investment in ports till Deng Xiaoping's historic 1992 southern tour in support of economic reforms. Since then, many container ports were developed with the help of foreign capital, especially the help of Hong Kong's premier conglomerate, Hutchison Whampoa. Since the mid 1990's, Shenzhen's burgeoning containers ports started to compete with Hong Kong. As shipping through Hong Kong involves significantly higher costs, part of the re-exports through Hong Kong was diverted to offshore trade via Shenzhen ports.

It should be noted that Hong Kong faces stiffer competition in shipping than in trading because shipping requires container terminals and cargo areas which are relatively land-intensive. Trading activities (negotiation, arbitration, search, marketing, trade financing and documentation) are less land-intensive because trading firms can be housed in skyscrapers. While agglomeration increases efficiency, it also leads to rising costs, especially the costs of land. Unlike entrepot trade, offshore trade does not require shipping through Hong Kong. Theory predicts that, with a rise in costs in Hong Kong, there will be diversion from entrepot trade to offshore trade. In the same vein, trade supporting services that are related directly to physical movement of cargo (e.g., shipping, trucking, warehousing) will decline relative to services not directly related to physical movement of cargo (for example, search, negotiation, arbitration, trade financing, insurance, and documentation). This trend has been confirmed by a survey of Hong Kong companies (Hong Kong Trade Development Council 1998).

3.1. Hong Kong's Mainland-related entrepot trade and offshore trade

Figure 1 shows Hong Kong's Mainland-related entrepot trade and offshore trade. It should be noted that "Mainland related-trade" includes not only exports to the Mainland, but also Hong Kong's exports of Mainland goods to third economies. Mainland-related entrepot trade grew extremely rapidly from US$ 1,265 million in 1979 to US$ 111,636 million in 1995, growing at an average annual rate of over 32 percent. The average annual rate of growth slowed down to 6.6 percent during 1995-97 due to competition from Shenzhen ports. The Asian Financial Crisis and the terrorist of attack of 11 September aggravated the situation, leading to negative growth or stagnation of Hong Kong's Mainland-related entrepot trade during 1997-2001. However, Mainland-related entrepot trade soared during 2001-04, growing at an average annual rate of 16.5 percent. This is mainly due to the very rapid growth of Mainland's trade (average annual rate of 31.3 percent) after WTO entry. This hyper growth temporarily outstripped the capacity of Shenzhen ports. Due to competition from Shenzhen ports, Hong Kong's Mainland-related entrepot trade would stagnate if Mainland's trade growth is moderate, but would exhibit healthy growth if Mainland's trade growth is spectacular.

Hong Kong's Mainland-related offshore trade grew much faster than its Mainland-related entrepot trade. From 1997 to 2003, the average annual rate of the growth of the former was 16 percent, compared to the latter's 6.5 percent. Despite competition from Shenzhen ports, Hong Kong's Mainland-related offshore trade continued to exhibit healthy growth. By the early 2000's, Hong Kong's Mainland-related offshore trade is nearly as large as its Mainland-related entrepot trade.

Figure two shows the share of Mainland's trade handled by Hong Kong in the forms of entrepot trade and offshore trade. The share handled as Hong Kong's entrepot trade rose rapidly in the first 15 years of the reform era; peaked in the mid 1990's at 41 percent, and then declined to 22 percent in 2003. The share handled as Hong Kong's offshore trade rose from 9 percent in 1991 to a peak of 25 percent in 2002, but declined to 19 percent in 2003. The two shares combined peaked at 60 percent in 1997, and declined to 41 percent in 2003. Though the absolute value of Mainland's trade handled by Hong Kong has continued to grow quite rapidly, the share to Mainland's trade has fallen quite sharply due to the much more rapid growth of Mainland's trade.

3.2. Gross Margin of Hong Kong's Mainland-Related Trade

There are two factors in the rapid growth of Hong Kong's Mainland-related offshore trade, namely, the expansion of Hong Kong's production base in South China, and the diversion to offshore trade from entrepot trade. In terms of income and employment creation for Hong Kong, the first factor is beneficial but the second factor is harmful because offshore trade bypasses the Hong Kong port.

Figure 3 shows the gross margin of Hong Kong's Mainland-related trade since 2000, the first year that such data is available. Gross margin overstates total value-added slightly because the leakages due to imported inputs used in the production of trading services are not deducted. However, such leakages are not large because services do not use a lot of imported inputs.[1]

While the value of Hong Kong's Mainland-related offshore trade is nearly as large as its Mainland-related entrepot trade, the gross margin of offshore trade is much lower as it bypasses the Hong Kong port. In 2003, the rates of gross margin for Hong Kong's Mainland-related entrepot trade and offshore trade were 20.4 percent and 8.6 percent respectively.

The rate of gross margin for Hong Kong's Mainland-related trade is quite high because such trade mainly involves trade between Hong Kong firms with their

[1] In the early 2000's, the leakage of Hong Kong's import/export trade sector is no more than 5 percent (Sung 2004: Table 3.5).

subsidiaries in South China. Hong Kong firms supply their factories in South China with raw materials imported from third countries, and the output is often re-exported through Hong Kong to third countries. Hong Kong is usually involved in many high value-adding activities in the production chain, e.g., order-taking, product design, sourcing of inputs, production management, financing, exporting, and marketing, while the labour-intensive and low value-adding processing is done in the Mainland (Sung 2001: 220-3).

From 2000-03, while the growth of Mainland's trade handled by Hong Kong is rapid (average annual rate of 11.4 percent), the growth of the gross margin generated by such trade is slow (average annual rate of 2.5 percent). This is partly due to the diversion from entrepot trade to offshore trade. Moreover, from 2000-03, the rate of gross margin of Hong Kong's Mainland-related entrepot trade has fallen from 26.3 percent to 20.4 percent, while that of Hong Kong's offshore trade also fell from 9.9 percent to 8.6 percent. This indicates that the Mainland has been able to perform more steps in the production chain, leaving less value-adding activities for Hong Kong.

International trade is the most important sector of the Hong Kong economy. In 2003, the gross margin of Hong Kong's Mainland-related trade is nearly a third of Hong Kong's GDP. The slow growth of the gross margin is a matter of serious concern for Hong Kong.

4. Hong Kong's Role in Foreign Investment in China

It is well known that China is among the world's largest host of FDI, and Hong Kong is by far the foremost source of FDI destined for the Mainland. Hong Kong accounted for 43 percent of Mainland's cumulative FDI from 1979 to 2004, while the shares of USA and Japan were only 8.5 percent and 8.3 percent respectively. The very large share of Hong Kong conceals an important intermediary role of Hong Kong as many multinationals invest in China through their Hong Kong subsidiaries because Hong Kong has the required expertise. Besides direct investment, Hong Kong has also played a very important role in portfolio investment. Hong Kong is the major offshore funding centre for Mainland enterprises.

4.1. Hong Kong's Role in Direct Foreign Investment

Figure 4 shows Mainland's contracted inward FDI from Hong Kong since 1979, in absolute amount and as a share of Mainland's total inward FDI. For brevity, the figure for utilized FDI, which closely follows contracted FDI, is not shown. As expected, contracted FDI depends on expectations. It leads utilized FDI and is also more volatile.

Hong Kong investors are very sensitive to Mainland's investment environment, and they were the first to rush into the China market after Deng Xiaoping's tour in support of economic reforms in early 1992. Hong Kong's investment in China soared, and Hong Kong's share of contracted and utilized FDI in China reached highs of 69 percent and 68 percent respectively in 1992. As other investors jumped on the China bandwagon, Hong Kong's shares declined after 1992.

Hong Kong's contracted FDI in China soared from US$3.8 in 1990 to a record of US$74 billion in 1993, but declined afterwards as the rise was too sharp to be sustainable. The Asian Financial Crisis aggravated the fall, and contracted FDI from Hong Kong fell to a low of US$ 13 billion in 1999. The Sino-US agreement signed in late 1999 on China's WTO entry led to a sharp rebound in contracted FDI from Hong Kong since 2000, reaching a high of US$ 50 billion in 2004. The trend in utilized FDI was similar, but the fluctuations were less pronounced.

In terms of the share of Mainland contracted FDI, Hong Kong's share fell rapidly from 69 percent in 1992 to a low of 27 percent in 2000 during the aftermath of the Asian Financial Crisis, but recovered to 33 percent in 2004. While the trend in utilized FDI lagged behind contracted FDI, the sharp decline in Hong Kong's share after 1992 appears to be stabilizing at slightly over 30 percent by 2003.

As mentioned above, many multinationals invest in the Mainland through Hong Kong subsidiaries, including Mainland enterprises that plan to take advantage of preferences given to foreign investors. This implies that Hong Kong's direct investment in the Mainland is overstated. However, the fact that many multinationals invest in China via Hong Kong implies that Hong Kong is an important intermediary in China's inward FDI.

While Mainland's inward FDI from Hong Kong is overstated by the amount of non-Hong-Kong capital channeled via Hong Kong, it is understated by the amount of Hong Kong capital channeled to the Mainland via the tax haven economies in the Caribbean. When, in 1982, China announced its intention to take Hong Kong back in 1997, Hong Kong's large firms tried to insure possible nationalization by registering in the tax haven economies. By mid-1993, 60 percent of all listed companies in Hong Kong moved their registration overseas (Sung 2005: 26). As a result, the tax haven economies accounted for 60 percent of Hong Kong's outward FDI in 2000. A substantial amount of Hong Kong's investment in the Mainland is likely to be channeled via the Caribbean. Many Taiwanese and Mainland companies that had channeled their investment to the Mainland via Hong Kong subsidiaries likewise shifted their registration from Hong Kong to the offshore financial centres as insurance against possible intervention from the Mainland after the 1997 handover (Sung 2005: 29). As a result, the tax haven economies have become the second largest investor in the Mainland in the late 1990s.

The decline of Hong Kong's share in Mainland's inward FDI in recent years is overstated because Hong Kong firms (and also Hong Kong subsidiaries of Taiwanese and Mainland firms) are increasingly investing in the Mainland via the Caribbean. To correct for this bias, we assume in Figure 5 that half of the FDI from the Caribbean in the Mainland came from Hong Kong. While this guestimate is rough, it is not unreasonable as Hong Kong has consistently been the largest investor in the Mainland. Under this assumption, the decline of Hong Kong's share in Mainland's FDI is less pronounced, and Hong Kong's share in contracted and utilized FDI stabilized at around 40 percent in recent years. In a nutshell, Hong Kong's share of China's inward FDI is still very substantial.

4.2. Hong Kong's Role in Portfolio Investment

Hong Kong has become the premier offshore centre for the funding of Chinese enterprises. In 1992, China approved the public listing of selective state enterprises in the Hong Kong stock market and their shares are popularly called H-shares. Besides tapping external funds, listing in Hong Kong also speeds up China's enterprise reforms, since listed firms have to follow international accounting standards.

Listed Hong Kong companies controlled by Mainland Chinese shareholders have been active in Hong Kong's stock market since the 1980s. A China-Affiliated Corporations Index or Red Chips Index was introduced by the Hang Seng Bank in 16 June 1997 due to investor interests in Red Chips. By May 1997, H-shares and Red Chips have a market capitalization of US$ 56 billion or 11 percent of Hong Kong's stock market (Sung 2005:115).

By the end of 2004, 301 Mainland companies (H-shares, red-chips, and other Mainland companies) were listed in Hong Kong with a total market capitalization of US$ 256 billion, which was 30 percent of Hong Kong's total. Total funds raised by these companies in the past 11 years amounted to US$ 102 billion (Hong Kong Trade and Development Council, 2005).

The role of Hong Kong in Mainland's capital market goes far beyond an important channel for raising capital. As Mainland's capital markets are immature and highly distorted, the Hong Kong provides the best market for pricing the risks of investment in Mainland's listed enterprises. It is no accident that the vast majority of Mainland enterprises listed overseas are listed in Hong Kong. While a few are also listed in other overseas markets, more than 70 percent of their trading is conducted in Hong Kong (Ma 2005: 3).

5. Hong Kong as a service hub

Besides trade, transportation, and financing, Hong Kong is also a hub for professional services and regional headquarters of multinational companies. Hong Kong has a strong pool of professional service providers such as accountants, lawyers, and bankers who are familiar with the business environment of the Mainland.

While some prominent multinational companies have moved their regional headquarters from Hong Kong to Shanghai or other Mainland cities, the number of regional headquarters and representative offices of multinational companies in Hong Kong have grown from 3,001 in mid 2000 to 3,609 in mid 2004. There was also a substantial growth in the number of persons engaged in these companies, from 135,000 in mid 2000 to 193,000 in mid 2004.[2]

The Mainland-Hong Kong CEPA (Closer Economic Partnership Arrangement), which is a Free Trade Area agreement between the Mainland and Hong Kong, gives Hong Kong services providers preferential access to the Mainland

[2] Census and Statistics Department, Hong Kong, 2000 & 2004. *Report on Annual Survey of Regional Offices Representing Overseas Companies in Hong Kong*, Hong Kong.

market. The agreement has strengthened the status of Hong Kong as China's premier service hub.

While Hong Kong is China's premier service hub, Shanghai is a serious rival. Shanghai has the advantage of location as it is situated at the mouth of the Yangzi Delta, the largest and most prosperous region in China. Although Shanghai is set to become the domestic financial centre of China, it cannot compete with Hong Kong as a regional or international centre. Shanghai cannot become a serious contender as a regional or international financial centre unless the *Renminbi* can achieve convertibility on the capital account. Although China has achieved convertibility in merchandise trade, capital account convertibility will take much longer.

The development of infrastructure and services skills is a time-consuming and capital-intensive process. Moreover, the development of services is highly dependent on a clean, transparent, and even-handed regulatory environment. Though Shanghai is developing its financial institutions, a reputable legal framework and regulatory system takes time to evolve and mature. Given the corrupt, inefficient, and immense bureaucracy in China, the development of an efficient international service and financial centre may prove difficult. In the context of China, a reputable legal and regulatory system needs political reforms, which are more time-consuming and risky and economic reforms.

6. Conclusion

The rapid development of services in the Mainland does not imply the demise of Hong Kong as China's premier service hub. While the shares of China's foreign trade and investment handled by Hong Kong have declined, the absolute volumes of Mainland-related trade and investment handled by Hong Kong are still growing. The demand for intermediation of the Mainland has increased tremendously, partly due to rapid economic growth, and partly due to the continuing decentralization of the Chinese economy, which creates tremendous need for intermediation. Moreover, Hong Kong is very efficient in providing intermediary services due to economies of scale and agglomeration in such activities. Despite competition from rival hubs such as Shenzhen and Shanghai, Hong Kong still handles some 40 percent of Mainland's foreign trade and inward foreign direct investment.

However, Hong Kong does face serious challenges from rival hubs. With rapid development of the service sector, the Mainland is able to undertake more steps in the production chain, leaving less value-adding services for Hong Kong. As Hong Kong's costs are much higher than that of the Mainland, Hong Kong has to concentrate on higher value activities that are least affected by high factor costs, for example, trading, business services and financial services. Such services are least affected by high land prices and wages because they are neither land-intensive nor labour-intensive. New York and London long ago lost their comparative advantage in manufacturing, but their positions in trading, business, and finance remain formidable.

As Hong Kong is Mainland's premier services hub, Hong Kong's exports of Mainland-related services are extremely large. Table 1 shows that Hong Kong's exports of Mainland-related services in 2003 were US$ 61.1 billion, or 37 percent of Hong Kong's GDP. The gross margin of Hong Kong's Mainland-related entrepot trade, which is not usually classified under export of services, is regarded as services exports in the Table because the gross margin of entrepot trade conceptually represents services embodied in re-exports. The 2003 gross margin was US$37.8 billion, or 62 percent of Hong Kong's exports of Mainland-related services. Services related to Mainland's trade (entrepot trade and offshore trade) were US$52.7 billion, or 86 percent of Hong Kong's exports of Mainland-related services.

The Table shows that Hong Kong's exports of Mainland-related services are largely associated with flows of goods and people, for example, services related to Mainland's trade (86.3 percent), transportation (3.9 percent), and tourism (7.2 percent). These three items added up to 97.4 percent of the total. Other services (exports of pure services not related to flows of goods and people, e.g. finance, insurance, professional, business, and social services) were only US$1.6 billion or 2.6 percent of the total. This shows that Mainland's markets for pure services are not yet very open. While Hong Kong's exports of services (including financing and business services) embodied in Mainland-related trade are large, exports of pure services, especially pure services not related to flows of goods and people, are small.

With entry to the WTO, China is committed to opening its services sectors in 2005-06. With preferential access for Hong Kong's service providers under the Mainland-Hong Kong CEPA, and Hong Kong's comparative advantage in services, Mainland's services liberalization would be highly advantageous for Hong Kong.

Appendix: Estimating Hong Kong's Offshore Trade

Offshore trade includes *merchanting* and *merchandising*. Government surveys give data on the value of goods and gross margin in merchanting for 2000-03, but comparable data on merchandising is only available for 2002-03. For 2000-01, only the gross margin of the merchandising of Mainland's imports is available. Table A.1 shows the estimation of the value of goods and gross margin of merchandising. The estimation assumes that the commission rate of merchandising for 2001-02 is the same as the average for 2002-03. The estimation should be fairly robust as the commission rate does not appear to change a lot. Moreover, merchandising is small relative to merchanting. For instance, in 2003, a year for which hard data is available, the gross margin of merchandising was less than 9 percent of that of merchanting. Adding the estimated data of merchandising to that of merchanting gives the data of offshore trade from 2000-01.

Table A.2 shows Mainland's trade handled by Hong Kong as re-exports (entrepot trade) and as offshore trade. The estimation of offshore trade from 2000-03 is described above. For the years 1991, 1994, and 1997, *Hong Kong's offshore exports of Mainland goods* are available from surveys of the Hong Kong Trade and Development Council. However, data on *Hong Kong's offshore imports for the Mainland* are not available. They are estimated on the assumption that the ratio of offshore trade to entrepot trade on the import side is the same as that on the export side. In other words, the ratio of *offshore imports* to *Hong Kong's re-exports to the Mainland* is the same as the ratio of *offshore exports* to *Hong Kong's re-exports of Mainland goods*.

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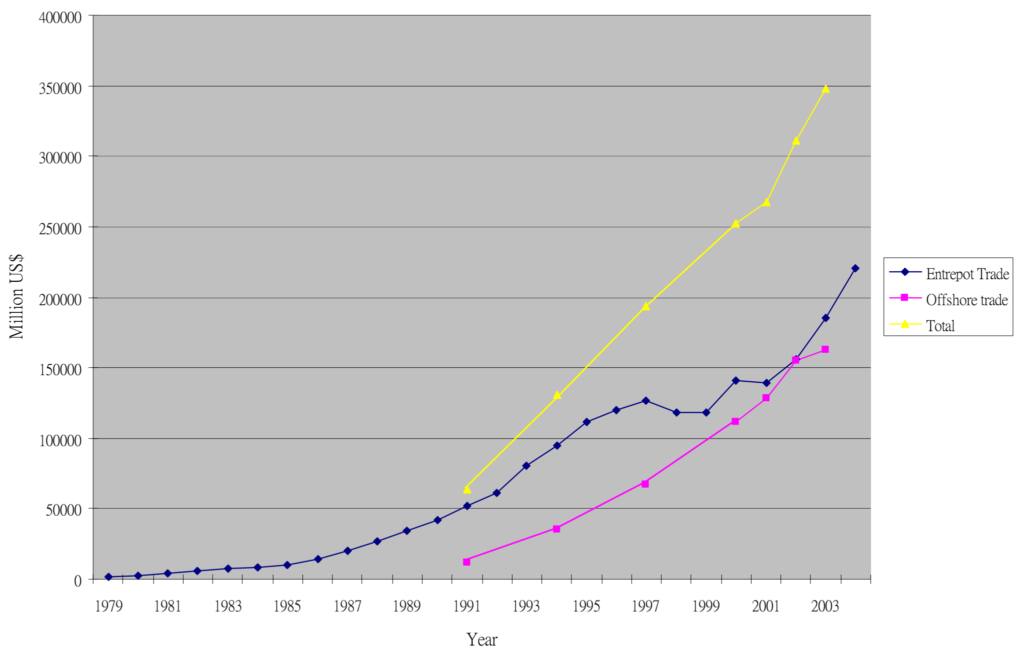
Figure 1 Hong Kong's Mainland-related Entrepot Trade and Offshore Trade



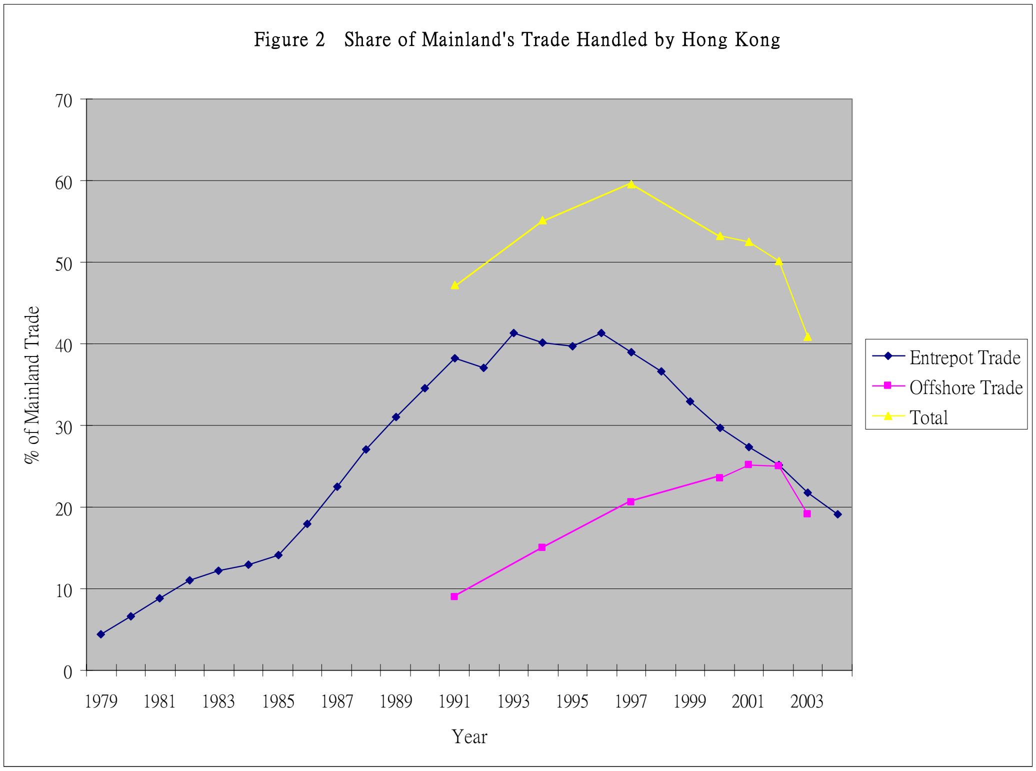


Figure 2 Share of Mainland's Trade Handled by Hong Kong
% of Mainland Trade
70
60
50
40
30
20
10
0
1979
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003
Year
Entrepot Trade
Offshore Trade
Total

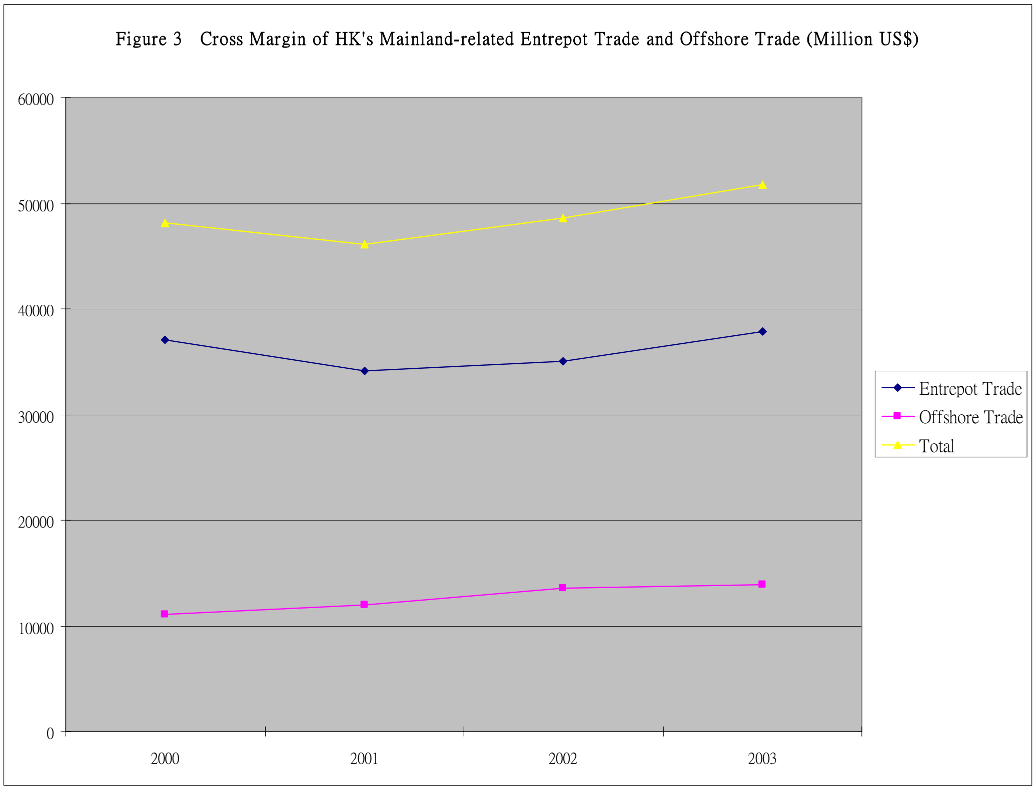
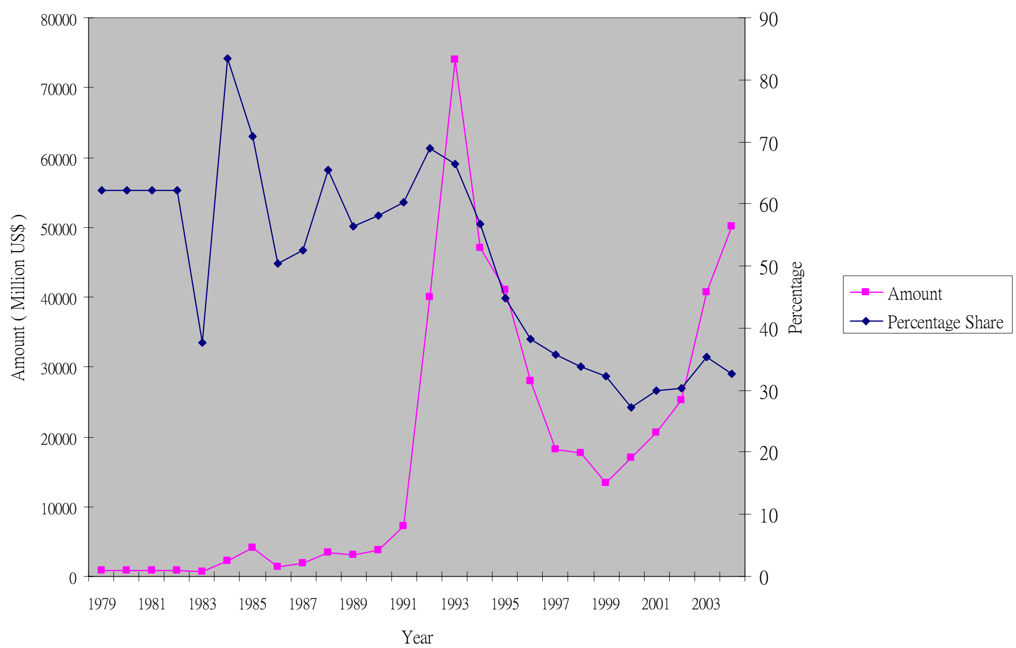


Figure 3 Cross Margin of HK's Mainland-related Entrepot Trade and Offshore Trade (Million US$)
60000
50000
40000
30000
20000
10000
0
2000
2001
2002
2003
Entrepot Trade
Offshore Trade
Total

Figure 4   Mainlans's contracted FDI from Hong Kong



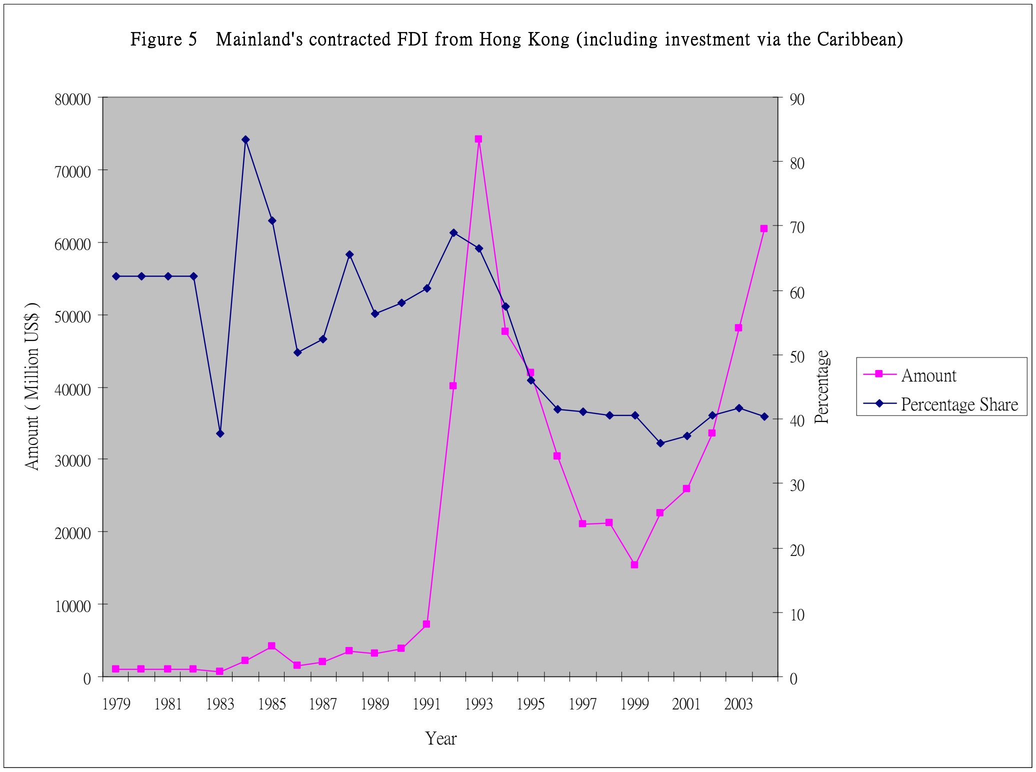


Figure 5 Mainland's contracted FDI from Hong Kong (including investment via the Caribbean)
Amount (Million US$)
Percentage
Year
Amount
Percentage Share
80000
70000
60000
50000
40000
30000
20000
10000
0
90
80
70
60
50
40
30
20
10
0
1979
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003

Table 1: Hong Kong's Mainland-related Services Exports, 2003 (US$bn)

	Services Related to Mainland's Trade					Transportation	Tourism	Other Service	Total
	Gross Magin of Entreport Trade	Offshore Trade			Subtotal				
		Merchanting	Merchandising	Subtotal					
	37.8	12.9	2.0	14.9	52.7	2.4	4.4	1.6	61.1
(i)	(24.1)	(8.2)	(1.2)	(9.4)	(33.5)	(1.5)	(2.7)	(1.0)	(37.2)
(ii)	(61.9)	(21.1)	(3.3)	(24.4)	(86.3)	(3.9)	(7.2)	(2.6)	(100)

(i) Percentage share to Hong Kong's GDP
(ii) Percentage share to total

Source: See text for estimation of services related to Mainland's trade. Other data are taken from Report on Hong Kong Trade in Services for 2003, Census and Statistics Department, Hong Kong.

Table A.1 Hong Kong's Offshore Merchandising of Mainland Related Trade (US$mn)

	Mainland's Exports			Mainland's Imports			Mainland's Trade	
	Gross Margin	Value of Goods*	Commission Rate (%)	Gross Margin	Value of Goods*	Commission Rate (%)	Gross Margin	Value of goods
2000	348[2]	10306	4.25[3]	175[1]	5844	3.0[4]	613	16149
2001	443[2]	10424	4.25[3]	177[1]	5906	3.0[4]	620	16330
2002	694[1]	17119	4.1[1]	288[1]	9282	3.1[1]	982	26401
2003	811[1]	18252	4.4[1]	307[1]	10575	2.9[1]	1118	28827

Source : Report on Hong Kong Trade in Services Statistics for 2003, Census and Statistics Department, Hong Kong

Notes: *Value of goods are obtained by dividing the gross margin by the commission rate.

1. Data taken from Report
2. Taken to be 2.5 times (ratio for 2002-03) of the gross margin of the merchanting of Mainland's imports
3. Average commission rate for 2002-03
4. Average commission rate for 2002-03

Table A.2 Mainland's Trade Handled by Hong Kong (US$mn)

	As HK's Re-exports	As HK's Offshore Trade	Total
1991	51,952[1]	12,122[2]	64,074
	(38.3)	(8.9)	(47.2)
1994	94,819[1]	35,611[2]	130,430
	(40.1)	(15.0)	(55.1)
1997	126,758[1]	67,006[2]	193,764
	(39.0)	(20.6)	(59.6)
2000	140,632[1]	111,422[3]	252,054
	(29.7)	(23.5)	(53.1)
2001	139,318[1]	128,433[3]	267,751
	(27.3)	(25.2)	(52.5)
2002	155,837	154,980[3]	310,817
	(25.1)	(25.0)	(50.1)
2003	185,149[1]	162,941[3]	348,090
	(21.8)	(19.1)	(40.9)
2004	220,177	-	-
	(19.1)	-	-

Figures in brackets represent percentage share to China's trade.

Notes:
1. Taken from Table 4.2 of Sung 2005:78
2. Estimated from ratio of HK's offshore exports of Mainland origin to HK's re-exports of Mainland origin. See text for method of estimation. The ratios are taken from surveys of the Hong Kong Trade Development Council (HKTDC): That for 1991 is from HKTDC 1996:8, and those for 1994 & 1997 are from HKTDC 2002:8.
3. Sum of off-shore merchandising (Table A.1) and merchanting (see source in Table A.1).