

A New Free Trade Relationship Between Hong Kong and The People's Republic of China

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The Closer Economic Partnership Arrangement (CEPA) was signed by the People's Republic of China and the Hong Kong Special Administrative Region of the People's Republic of China on June 29, 2003. CEPA is a regional free trade agreement (FTA) between Hong Kong and the Mainland that reflects the unique "one country, two systems" arrangement between the two jurisdictions. The effective date of CEPA is January 1, 2004.

The creative idea of a FTA type arrangement between China and Hong Kong was first raised by the Hong Kong General Chamber of Commerce in early 2000 in light of the impact of China's anticipated entry into the World Trade Organization (WTO) in November, 2001. It was recognized that Hong Kong could lose its competitive advantage in dealing with China to other WTO members. Moreover, Hong Kong was enduring an economic slump and a growing unemployment problem at the time. It became clear that something needed to be done, and the Hong Kong Chamber of Commerce determined that a free trade arrangement between the Mainland and Hong Kong could prove a useful tool to help the Hong Kong economy. Ultimately, Hong Kong achieved what it was looking for in the form of the CEPA: a favourable arrangement, with liberalization concessions from the Mainland that go beyond its WTO commitments. Moreover, the CEPA will permit Hong Kong to maintain its role as a gateway for access to China.

CEPA Structure

The CEPA covers three broad areas: trade in goods, trade in services and trade/investment facilitation.

Trade in Goods

Starting in January 2004, China has committed to eliminate tariffs on 273 categories of goods exported from Hong Kong to China. In total, these categories make up 90% of the goods exported to China. However, the goods must be of "Hong Kong Origin", meaning they must meet the CEPA Rules of Origin.

There are three ways to determine origin, depending on the product category:

- **Substantial Transformation:** The "principal process" has to have taken place in Hong Kong. This principal process test already applies to most products and includes such things as the transformation of yarn to woven or knitted fabrics. The majority of the categories under CEPA (187 of 273) will apply this Rule of Origin.
- **Content Requirement:** Under this requirement, at least 30% of the value-added must take place in Hong Kong. This test applies to 46 of the 273 categories of goods,

which include, for the most part, electronic products such as electric motors, clocks and watches.

- **Change in Tariff Heading:** This test applies when a good is altered in Hong Kong so that after its transformation, it falls into a different tariff heading, as when parts are assembled into a finished product. A total of 40 of the 273 categories of goods will apply this Rule of Origin.

For other products not on the initial list of 273, China will apply zero-tariffs by January, 2006, upon applications by local manufacturers and upon CEPA Rules of Origin being agreed to and met.

In order to take advantage of CEPA's zero-tariff on eligible products, manufacturers must obtain a Certificate of Hong Kong Origin (CO) from the Trade and Industry Department in Hong Kong, or one of the government approved certification organizations. The approved CO is then passed to the Mainland importer who will produce it to the PRC customs authorities when the goods are imported.

Trade In Services

China has agreed to liberalize Hong Kong access to its market in 18 service sectors, including banking, insurance, logistics, real estate, telecommunications and legal services.

The liberalization commitments under this part of the agreement fall under four categories. The first, early liberalization of committed market openings, allows Hong Kong firms to take advantage of China's WTO commitments starting from January 1, 2004, thereby giving Hong Kong firms an advantage of between one and four years over other WTO members. Secondly, the CEPA will lower investment thresholds, making it easier for smaller Hong Kong firms to enter the Mainland market. Thirdly, there are regulatory changes to facilitate trade in services, such as mutual recognition of qualifications and relaxation of regulations for professional service suppliers. Lastly, new liberalization measures have been introduced, beyond those agreed to under current WTO commitments, including the opening of the exhibition services sector.

CEPA stipulates that "juridical persons" including companies, partnerships, sole proprietorships, and "natural persons" of Hong Kong will be able to enjoy preferential treatment granted by the Mainland under the arrangement as long as they meet the definition of a Hong Kong Service Supplier under CEPA. Generally speaking, a "natural person" is a Hong Kong permanent resident, while a "juridical person" is a legal entity organized under the applicable laws of Hong Kong that has engaged in substantive business operations in Hong Kong for three to five years. Registered overseas companies in Hong Kong will not qualify for CEPA treatment.

To demonstrate that a business has been incorporated under Hong Kong law, certain documents should be provided such as a Certificate of Incorporation. To determine what "substantive business operations" means, CEPA establishes five criteria relating to the nature and scope of the business, including years of operation, tax, business premises and employment. Qualified companies must obtain a certificate from the Trade and Industry Department in Hong Kong in order to obtain the preferential treatment under CEPA.

Trade and Investment Facilitation

In this section of CEPA, the parties have committed to facilitating trade and investment in various areas such as trade and investment promotion, customs clearance, quarantine and commodities inspection, quality assurance, food safety and transparency of laws. There are seven areas in total in which China and Hong Kong have agreed to co-operate, although new areas may be added in the future. The ultimate aim of these provisions is to simplify procedures, increase transparency and eliminate problems such as the irregular collection of fees by local governments.

Business Opportunities under CEPA

Trade in Goods

For certain industries, such as garment manufacturing, the zero-tariff on goods exported to China from Hong Kong will bring substantial savings. There are numerous high tariff products, such as jewellery and cosmetics, which will enjoy expanded production with the zero-tariff rule CEPA has introduced. The zero-tariff will also increase the competitiveness of Hong Kong goods in the Mainland market, compared to goods imported from other places. Moreover, businesses can take advantage of opportunities to manufacture new zero-tariff products after 2006, especially those incorporating high design and intellectual property content.

Many of Hong Kong's manufacturers are currently producing in the Mainland for export to third countries. Increasingly, these companies are interested in China's domestic market. The CEPA zero-tariff will allow these manufacturers to move some of the specialized manufacturing processes back to Hong Kong, where they can upgrade their productions, or design new brands, and then distribute the product in the Mainland. This move back to Hong Kong will also assist in the protection of a company's more sensitive intellectual property, as IP protection is more stringent in Hong Kong in both legal and practical terms. By establishing a manufacturing facility in Hong Kong that, for example, uses a new, proprietary technology, there is less likelihood that the technology will be copied.

These new business opportunities also exist for overseas investors seeking to set up new manufacturing operations in Hong Kong. Indeed, it is not necessary that a company be incorporated in Hong Kong for this purpose, as the trade in goods provisions are concerned only with whether a good complies with CEPA's Rules of Origin.

Trade in Services

Realistically, it is not expected that Hong Kong will return to its manufacturing glory days. Hong Kong thus considers the trade in services provisions in CEPA a very important part of the arrangement. CEPA will result in Hong Kong companies having easier access to the Mainland market and give them a considerable advantage over foreign competitors, since the agreement's concessions go beyond China's WTO commitments. CEPA also provides the opportunity for Hong Kong wholly-owned businesses to locate in the Mainland, allowing greater control over Mainland operations.

Although CEPA only lists 18 service sectors, Hong Kong's service economy will result in more businesses indirectly benefiting from the arrangement. Indeed, as new opportunities open up for Hong Kong service suppliers, there will be a trickle down effect in the economy as a

whole. The agreement will also make Hong Kong more attractive to foreign firms, which may view CEPA as a way to establish a foothold in the Mainland market. This is especially true for sectors left out of the WTO agreement.

Certain services sectors will benefit more than others under CEPA. For example, in the area of financial services, asset requirements for Hong Kong banks and insurance companies to enter the Mainland market prior to CEPA were US\$20 billion, while under the agreement the entry barrier has been dramatically lowered to US\$6 billion. Moreover, Mainland banks will be able to re-locate their international treasury and foreign exchange trading centers to Hong Kong. In the retail sector, there has been a lowering of entry thresholds, so that Hong Kong service suppliers can set up wholly-owned retail commercial enterprises in the Mainland. Smaller retailers will be able to operate single shops in Guangdong. In the telecommunications sector, Hong Kong operators have been given a three-month advantage in market access in value-added services, beginning in October, 2003, affording Hong Kong operators a material head start in preparing to enter the Chinese market.

Legal services is another area in which there has been marked improvement. Under CEPA, Hong Kong law firms that have set up representative offices in the Mainland will be permitted to operate in association with Mainland law firms, although these Hong Kong lawyers cannot handle matters of Mainland law. Mainland law firms will also be permitted to employ Hong Kong lawyers to practise Hong Kong law. Hong Kong lawyers can sit the legal qualifying examination in the Mainland and may practise non-litigation legal work. Additionally, the minimum residency requirement for Hong Kong representatives in the Mainland is either waived or shortened to two months each year.

The business community in Hong Kong will be embarking on a "Phase II" of CEPA, to promote further liberalization in the area of trade in services. It has been suggested by the Hong Kong Chamber of Commerce that since January 1, 2006 has been chosen as the date upon which zero-tariffs will apply to all other products, the same date should prompt the introduction of further improvements in trade in services. It is hoped that new commitments would include the liberalization of sectors that have not yet been opened up, and more concessions in those sectors where there have been only limited commitments to date.

Trade/Investment Facilitation

For many businesses, the problem is not so much market entry in China, but in conducting business after entry. It is for this reason that Hong Kong and China have committed to helping investors deal with a variety of problems encountered in the Mainland. Through greater transparency, for example, it is hoped that businesses will be less burdened by red tape and costly inefficiencies. The commitments made in this section of CEPA are practical, relevant, and vital for businesses to reap the benefits of the other parts of the agreement. Nevertheless, it is apparent that these commitments cannot possibly remove all of the challenges and difficulties of doing business in China.

To implement CEPA, there will be a Joint Steering Committee set up by the two sides to supervise the implementation and interpretation of the agreement, to handle dispute resolution, draft amendments, and direct working groups. Considerable effort will be made to promote and educate the Hong Kong business community, parties in the Mainland, as well as international businesses, about CEPA.

Conclusion

As China has reformed and opened up to the world beyond its borders, Hong Kong's enviable economic position as the sole gateway to China has weakened. With CEPA, Beijing has given Hong Kong the opportunity to maintain a favoured position for trade with the Mainland. CEPA is evidence that Beijing is committed to making "one country, two systems" work.

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