

# ECONOMIC INTEGRATION BETWEEN HONG KONG, TAIWAN AND THE COASTAL PROVINCES OF CHINA

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## INTRODUCTION

During the past decade, a number of regional trading arrangements have been created or extended.<sup>1</sup> Many governments have reduced barriers to trade and factor mobility within regions with the aim of promoting closer economic links. The creation of the single market in the European Community and the North American Free Trade Agreement are important examples of such arrangements. While there have been numerous efforts to promote regional integration outside the OECD area, the importance and effectiveness of these arrangements has been limited.<sup>2</sup>

A notable exception to this general pattern in the non-OECD area is the rapid integration occurring between Hong Kong, Taiwan and several provinces in southern China, in what one may call the Chinese Economic Area (CEA). This integration process has not been driven by government action to promote closer links, but has developed spontaneously in the wake of economic reforms in China. The opening of China and the economic boom in its southern provinces have allowed Hong Kong to

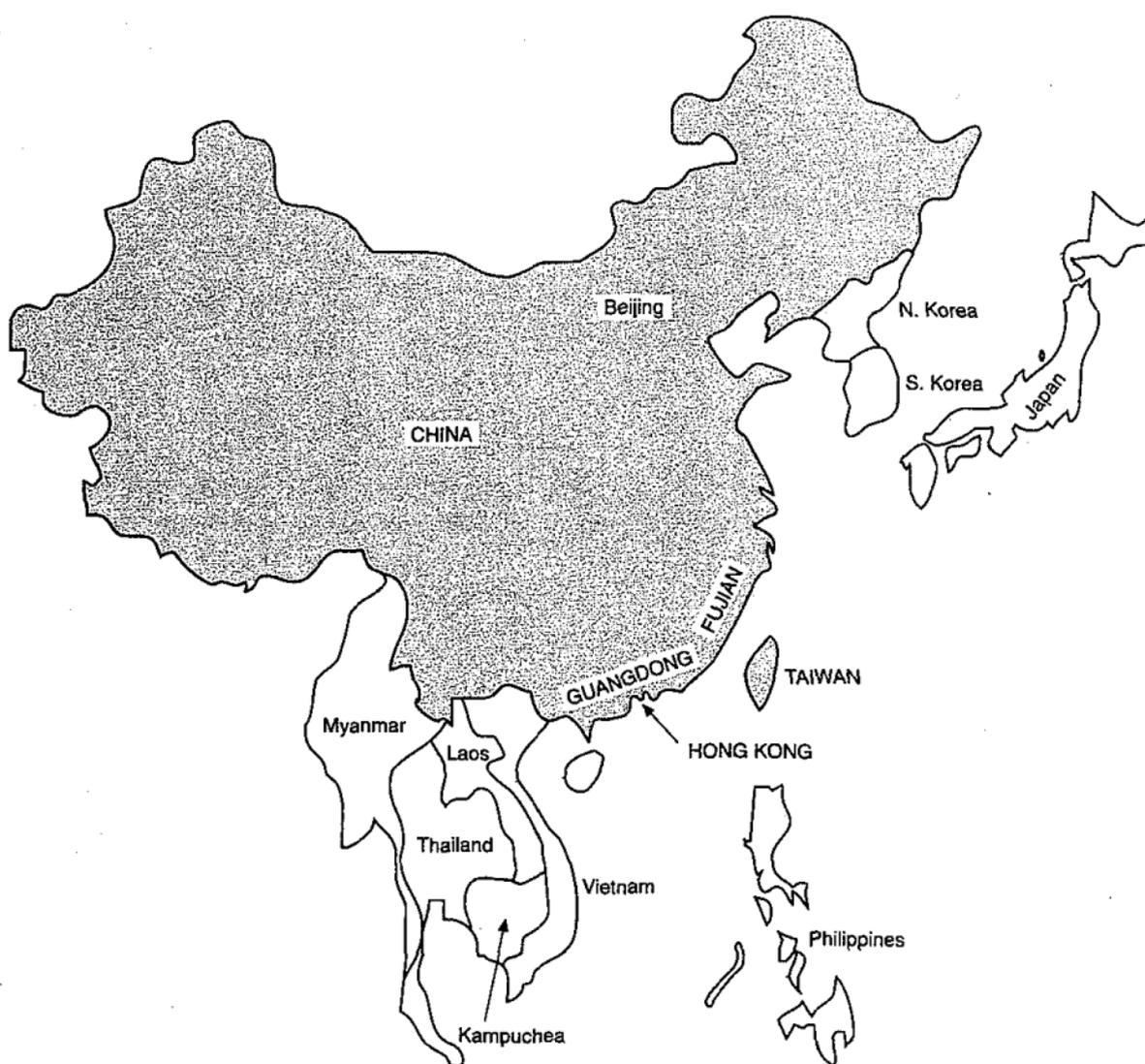
**Table 1. Structural indicators**  
1990 unless otherwise indicated

|                                       | Hong Kong | Taiwan          | PRC     |
|---------------------------------------|-----------|-----------------|---------|
| GDP (\$ billion)                      | 67        | 163             | 420     |
| Population (million)                  | 5.8       | 20.4            | 1 133.7 |
| Area (1 000 km <sup>2</sup> )         | 1.1       | 36.0            | 9 651.0 |
| Density (population/km <sup>2</sup> ) | 5 572     | 574             | 119     |
| Arable land/1 000 persons (square km) | 0.01      | 0.44            | 0.88    |
| GDP per capita (\$)                   | 11 490    | 7 997           | 370     |
| PPP-adjusted GDP per capita' (\$)     | 13 906    | n.a.            | 2 124   |
| Investment/GDP (%)                    | 28        | 22              | 39      |
| Saving/GDP (%)                        | 33        | 30              | 43      |
| GDP growth (1980-90) (%)              | 7.1       | 7.4             | 9.5     |
| GDP per capita growth (1980-90) (%)   | 5.7       | 6.0             | 8.1     |
| Population growth (1980-90) (%)       | 1.4       | 1.4             | 1.4     |
| Exports/GDP (%)                       | 137       | 47              | 18      |
| Agricultural output/GDP (%)           | 0         | 4               | 27      |
| Annual inflation rate (1980-90) (%)   | 7.2       | 3.0             | 5.8     |
| Life expectancy (years)               | 78        | 74 <sup>2</sup> | 70      |

1. Per capita GDP in 1987 dollars, adjusted for differences in price levels.

2. 1987.

Sources: World Bank (1992); Republic of China (1990); United Nations Development Programme (1990).



resume its role as an *entrepôt* for trade between China and the world. Economic ties between China and Taiwan strengthened as Taiwan gradually relaxed its ban on contact with the mainland since 1987. On the strength of rapid economic growth in all its constituent parts (Table 1), the CEA has grown to be a major player in world trade during the past decade (Table 2).<sup>3</sup>

This paper examines the emergence of the CEA as an important player in the world economy and the factors that allowed or encouraged economic integration to occur. The first section reviews the shape integration has taken within the CEA. Section II examines the forces that have driven the integration of Hong Kong, Taiwan and southern China, which has proceeded in the face of policy-induced distortions and barriers to trade and investment. The final section discusses the outlook for the CEA.

**Table 2. World export rankings of selected countries**

Percentage of world exports

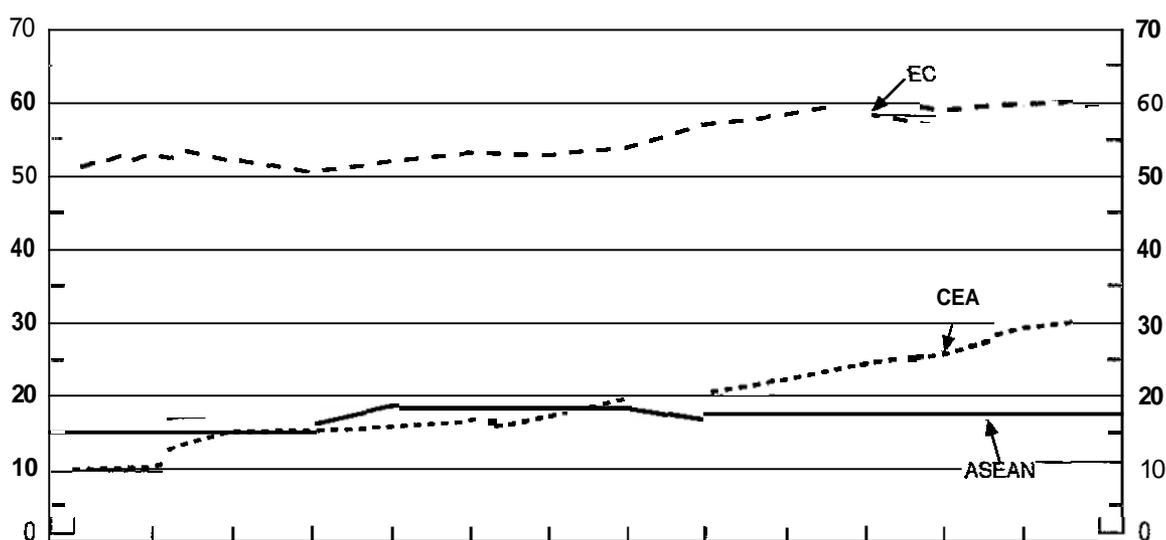
| 1973             |           |            | 1990             |      |       |
|------------------|-----------|------------|------------------|------|-------|
| Country          | Rank      | Share      | Country          | Rank | Share |
| United States    | 1         | 12.2       | Germany*         | 1    | 11.4  |
| Germany'         | 2         | 11.7       | United States    | 2    | 11.3  |
| Japan            | 3         | 6.4        | Japan            | 3    | 8.3   |
| France           | 4         | 6.3        | France           | 4    | 6.2   |
| United Kingdom   | 5         | 5.3        | CEA              | 5    | 6.0   |
| <b>USSR</b>      | <b>10</b> | <b>3.7</b> | United Kingdom   | 6    | 5.3   |
| CEA              | 11        | 2.7        | USSR             | 11   | 3.0   |
| Sweden           | 12        | 2.1        | <b>Hong Kong</b> | 12   | 2.4   |
| Czechoslovakia   | 22        | 1.1        | <b>Taiwan</b>    | 13   | 1.9   |
| <b>China</b>     | 23        | 1.0        | Korea            | 14   | 1.9   |
| Austria          | 24        | 1.0        | Switzerland      | 15   | 1.8   |
| <b>Hong Kong</b> | 26        | 0.9        | <b>China</b>     | 16   | 1.7   |
| Norway           | 27        | 0.9        | Sweden           | 17   | 1.7   |
| <b>Taiwan</b>    | 29        | <b>0.8</b> | Mexico           | 22   | 1.2   |
| Korea            | 39        | 0.6        | Brazil           | 26   | 0.9   |

## I. ECONOMIC INTEGRATION WITHIN THE CEA

### A. Trade

Trade within the CEA has risen sharply in recent years despite remaining trade barriers and the absence of agreements to promote trade. Trade between Hong Kong, Taiwan and China rose from 10 per cent of total CEA trade in 1978 to 30 per cent in 1991 (Figure 1). The intra-CEA increase contrasts sharply with the experience of the Association of Southeast Asian Nations (ASEAN), where the share of intra-regional trade has fallen slightly since 1983 despite an agreement to promote intra-ASEAN trade. None of the 12 regional trade arrangements examined in a recent OECD study achieved increases in intra-regional trade that are comparable to that in the CEA (Table 3).

One measure of integration is the intensity of trade, which compares the amount of trade between two economies to their share of world trade (Table 4). The intensity of



EC: For all years, the 12 current members of the European Community; ASEAN: Brunei, Indonesia, Malaysia, Philippines, Singapore, Thailand; CEA: China, Taiwan, Hong Kong.  
Sources: IMF *Direction of Trade Statistics*; OECD Staff Estimates.

trade is highest between Hong Kong and China. As China decentralised its foreign trade regime during the 1980s, Hong Kong regained its importance as an intermediary between Chinese producers and the world market? In 1990, 36 per cent of China's exports were re-exported via Hong Kong compared with only 6 per cent in 1977. The share of China's imports arriving via Hong Kong also increased from less than one per cent to 25 per cent over the same period. In value terms, China's exports to Hong Kong increased by more than ten times between 1979 and 1991. Goods re-exported from Hong Kong accounted for about 90 per cent of the increase. The value of Chinese goods retained in Hong Kong, though, has fallen since 1987, as higher-quality products from Japan and other OECD countries replaced China's exports as Hong Kong became more affluent.

While Chinese statistics show Hong Kong as its largest export market and supplier of imports, it falls to third place behind the United States and Japan when re-exports are attributed to their final destination. Hong Kong is particularly important as an intermediary in trade between China and the United States. In 1990, 62 per cent of China's shipments to the United States passed through Hong Kong, as did one-fifth of US. exports to China.<sup>5</sup>

Hong Kong's growing role as a middleman between China and the world is reflected in the growth of Hong Kong's re-exports, which expanded at a 26 per cent annual rate between 1980 and 1992. Re-exports, which surpassed domestic exports in 1988, were equivalent to 93 per cent of Hong Kong's GDP in 1992 compared with only one-fourth a decade earlier, while domestic exports have become relatively less important. China produced 58 per cent of the goods re-exported by Hong Kong in 1990; a

**Table 3. A comparison of the CEA and selected regional integration arrangements**

| Regional arrangement                   | Percentage share of intra-regional trade<br>(as a share of total trade) |             | Degree of openness'<br>(trade/GNP) |             |             | Change in degree of openness<br>(percentage points) |  |
|--|---|-------------|------------------------------------|-------------|-------------|---|--|
|  | Base period   | End period  | Base period                        | End period  | Total       | Change in intra-regional trade as share of GNP      | Change in extra-regional trade as share of GNP |
| <b>CEA<sup>a</sup></b>                 | <b>10.0</b>   | <b>29.8</b> | <b>6.0</b>                         | <b>32.4</b> | <b>26.4</b> | <b>9.1</b>  | <b>17.3</b>                                    |
| <b>Sub-Saharan Africa</b>              |   |             |                                    |             |             |   |  |
| ECOWAS <sup>b</sup>                    | 1.7   | 5.0         | 72.1                               | 39.4        | -32.7       | 0.8   | -33.5  |
| CEAO <sup>c</sup>                      | 4.3   | 4.8         | 60.8                               | 43.1        | -17.6       | -0.5  | -17.1  |
| MRU <sup>c</sup>                       | 0.2   | 0.3         | 92.3                               | 39.3        | -53.0       | -0.1  | -52.9  |
| CEPGL <sup>b</sup>                     | 0.0   | 0.4         | 214.4                              | 27.3        | -187.1      | 0.0   | -187.1   |
| UDEAC <sup>d</sup>                     | 0.8   | 1.8         | 64.4                               | 32.5        | -31.9       | 0.1   | -32.1  |
| PTA <sup>e</sup>                       | 7.7   | 6.6         | 40.2                               | 38.2        | -2.0        | -0.6  | -1.4   |
| <b>Latin America and the Caribbean</b> |   |             |                                    |             |             |   |  |
| CARICOM <sup>f</sup>                   | 2.9   | 1.6         | 102.0                              | 89.6        | -12.4       | -1.5  | -11.0  |
| CACM <sup>d</sup>                      | 3.5   | 5.5         | 35.5                               | 41.2        | 5.7         | 1.1   | 4.6  |
| LAFTNLAIA <sup>d</sup>                 | 4.0   | 6.0         | 26.0                               | 19.8        | -6.2        | 0.2   | -6.3   |
| of which:<br>ANDEAN <sup>f</sup>       | 1.2   | 2.5         | 39.6                               | 26.6        | -13.0       | 0.2   | -13.2  |
| <b>Asia</b>                            |   |             |                                    |             |             |   |  |
| ASEAN <sup>f</sup>                     | 6.2   | 8.8         | 39.2                               | 84.9        | 45.5        | 5.0   | 40.6   |
| Bangkok Agreement <sup>b</sup>         | 0.5   | 0.7         | 24.5                               | 34.2        | 9.7         | 0.1   | 9.5  |
| <b>Europe</b>                          |   |             |                                    |             |             |   |  |
| EC9 <sup>g</sup>                       | 49.0  | 49.9        | 35.5                               | 48.3        | 12.8        | 6.7   | 6.1  |

1. For Bangkok Agreement, ECOWAS and CEPGL. GDP is reported.

Notes:

a) Calculations based on differences between 1970 and 1990.

b) Calculations based on differences between 1976 and 1986.

c) Calculations based on differences between 1974 and 1988.

d) Calculations based on differences between 1960 and 1988.

e) Calculations based on differences between 1980 and 1988.

f) Calculations based on differences between 1970 and 1988.

g) Calculations based on differences between 1968-72 and 1978-82

Sources: OECD (19936); World Bank, World Development Report; Bank of China, Financial Statistics; Wonacott and Lutz (1989).

**Table 4. Intensity of trade within the CEA\***

|      | Hong Kong and China | Hong Kong and Taiwan | Taiwan and China |
|------|---------------------|----------------------|------------------|
| 1970 | n.a.                | 6.7                  | n.a.             |
| 1980 | n.a.                | 5.1                  | n.a.             |
| 1984 | 15.2                | 3.7                  | 0.0              |
| 1987 | 15.7                | 3.3                  | 0.4              |
| 1988 | 15.4                | 3.3                  | 0.7              |
| 1989 | 16.0                | 3.3                  | 0.9              |
| 1990 | 18.0                | 3.7                  | 1.3              |

\* The index is defined as the share of trade between the two economies divided by their share of world trade. A value of one indicates that the bilateral trade relationship is as important as would be predicted from their share in world trade. A value greater than one indicates a closer bilateral trade relationship.

Note: In 1990, the intensity of trade between China and Japan was 2.0, while that between China and Singapore was 1.4. While the intensity of trade between China and Taiwan remains relatively low, it has risen rapidly in recent years.

Source: United Nations.

little more than one-third were purchased by the United States (Table 5). Almost 80 per cent of Hong Kong's re-exports of Chinese origin to overseas markets were products of outward-processing arrangements commissioned by Hong Kong firms. In addition to its role as the major supplier of Hong Kong's re-exports, China is an important destination for re-exports, accounting for 31 per cent in 1992. As for Hong Kong's domestic

**Table 5. Hong Kong's re-export trade**

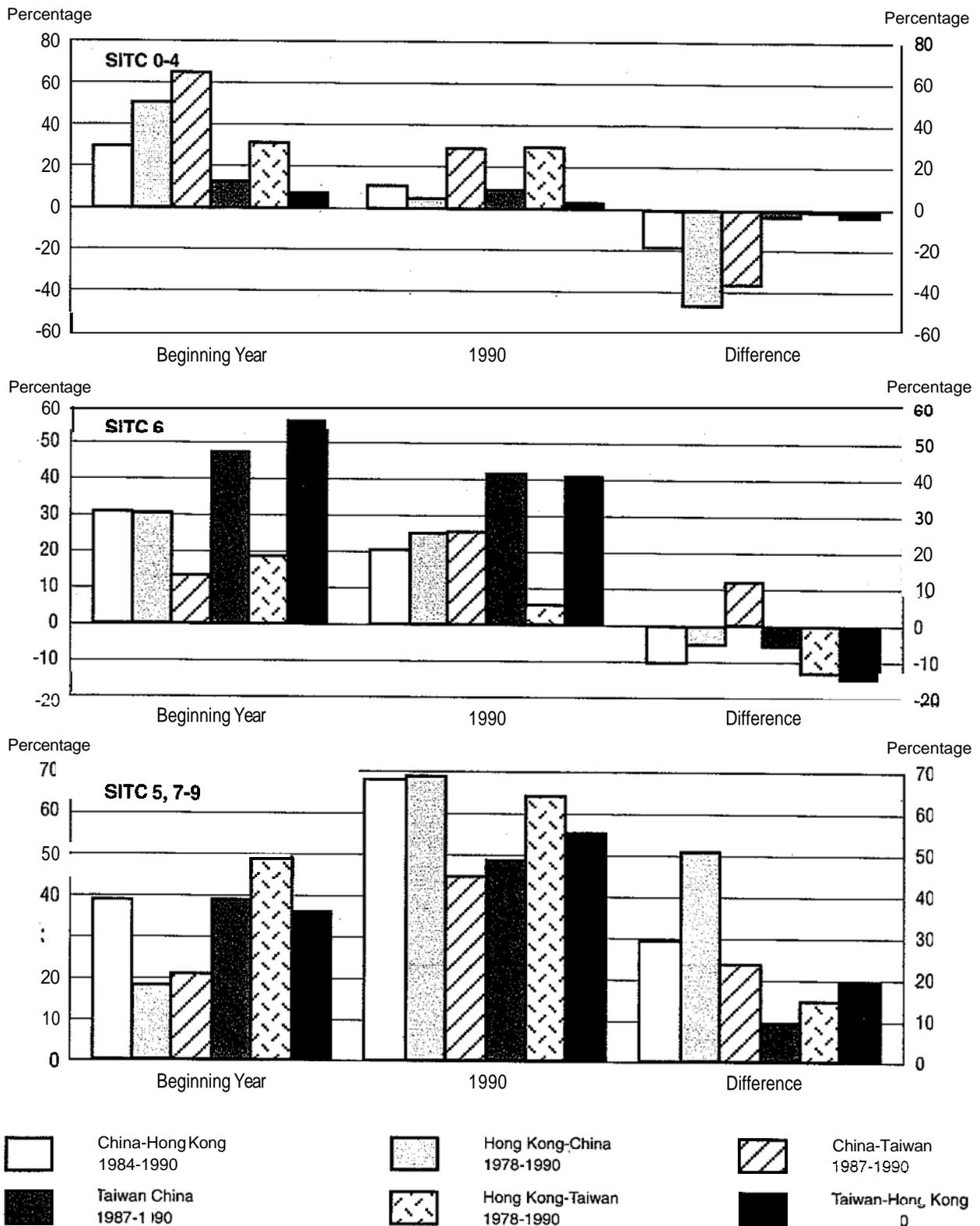
Per cent of total reexports

| Source   | Destination  | Per cent share |             | Annual growth rate in value (per cent) |
|--|--------------|----------------|-------------|--|
|  |              | 1990           | 1992        |  |
| <b>A. Re-exports for which China is the destination:</b> |              |                |             |  |
| China  | China        | 3.4            | 2.9         | 18.3                                   |
| Taiwan   | China        | 6.2            | 7.1         | 40.2                                   |
| Japan  | China        | 6.0            | 8.0         | 32.5                                   |
| U.S.   | China        | 2.5            | 2.6         | 28.5                                   |
| Other  | China        | 8.7            | 10.0        | 32.4                                   |
| World  | <b>China</b> | <b>26.8</b>    | <b>30.7</b> | <b>32.4</b>                            |
| <b>B. Re-exports for which China is the source:</b>      |              |                |             |  |
| China  | China        | 3.4            | 2.9         | 18.3                                   |
| China  | Taiwan       | 1.4            | 1.3         | 18.6                                   |
| China  | Japan        | 3.9            | 4.1         | 28.9                                   |
| China  | U.S.         | 19.7           | 20.3        | 27.0                                   |
| China  | Other        | 29.7           | 29.9        | 26.0                                   |
| <b>China</b>   | <b>World</b> | <b>58.1</b>    | <b>58.4</b> | <b>25.9</b>                            |
| <b>C. Re-exports not involving China:</b>                |              | <b>18.5</b>    | <b>13.8</b> | <b>10.9</b>                            |
| Hong Kong's total re-exports                             |              | 100.0          | 100.0       | 25.6                                   |

Note: Fifty-five per cent of the Chinese goods re-exported by Hong Kong in 1990 were related to outward processing by Hong Kong firms in China.

Source: Hong Kong Government Secretariat (1993).

Figure 2. Composition of intra-CEA trade Exports



Source : UN. Comtrade.

exports, the mainland is the second largest market after the United States, accounting for 26 per cent in 1992. About three-fourths of Hong Kong's domestic exports to the mainland were products shipped for further processing in China.<sup>6</sup> Taiwan, which purchased 3 per cent of Hong Kong's domestic exports in 1992, was the seventh-largest market.

The intensity of trade between Taiwan and China is much lower, but has risen sharply since 1984. Taiwan's two-way trade with China increased from less than \$50 million in 1978 to \$7.4 billion in 1992, with a substantial surplus in favour of Taiwan.<sup>7</sup> Exports to China accounted for 7.7 per cent of Taiwan's exports in 1992, while imports from the mainland, which were mainly restricted to raw materials, were only 1.6 per cent of Taiwan's total imports. Direct trade, which consists of smuggling and "minor trade" in ships of less than 100 tons, is also thought to have increased, although it is difficult to measure.

Hong Kong's intensity of trade with Taiwan is much less than with the mainland. Until the mid-1980s, the relationship was one-sided since Taiwan's market was relatively closed. The intensity of trade, though, increased in 1990, reflecting progress in opening Taiwan's market, the appreciation of Taiwan's currency and its use of Hong Kong as an intermediary in its relations with the mainland.

The sharp rise in the volume of intra-regional trade was accompanied by a shift in its composition away from raw materials towards manufactured products (Figure 2). While the time periods differ according to the availability of data, manufacturing (defined as SITC 5, 7-9) increased in each case. In Hong Kong's exports to China, for example, the share of manufactures increased from 18 per cent in 1978 to 69 per cent in 1990, while the shares of raw materials (SITC 0-4) and material-based manufactures (SITC 6) declined. China's exports to Hong Kong showed a similar pattern between 1984 and 1990. Despite Taiwan's restrictions on the types of products that may be imported from the mainland, total manufactures' (SITC 5-9) share of China's exports to Taiwan doubled from 35 per cent in 1987 to 71 per cent in 1990. Trade is increasingly intra-industry in nature, with textiles accounting for a significant share of both imports from and exports to the mainland. The change in the structure of Hong Kong and Taiwanese exports shows a significant shift away from material-based manufactures (SITC 6) to other manufactures between 1978 and 1990.

## **B. Foreign direct investment**

Taiwan and Hong Kong accumulated a substantial stock of direct investment in the mainland during the 1980s, helping to make China the largest recipient of FDI outside the OECD area (Table 6). According to Chinese statistics, Hong Kong invested an average of more than \$2 billion a year between 1979 and 1990 (Table 7), accounting for 62 per cent of total direct investment in China (Figure 3). This figure is probably biased upwards, since it includes investment by foreign subsidiaries located in Hong Kong, including some from Taiwan.

Taiwanese investment in China between 1979 and 1990 totaled \$2 billion according to Chinese statistics, making it the fourth-largest investor following Hong Kong, the United States and Japan, with 5 per cent of the total. Since 1987, though, Taiwan's

**Table 6. World foreign direct investment inflows**  
Annual averages

|   | 1980-84 | 1985-89 | 1988-89 |
|---|---------|---------|---------|
| World<br>(in billion US\$)                | 49.7    | 119.0   | 173.0   |
| (in per cent of world total)              |         |         |         |
| <b>of which:</b>                          |         |         |         |
| Developing countries                      | 52      | 18.7    | 16.9    |
| Asia                                      | 9.5     | 9.0     | 8.8     |
| China                                     | 1.1     | 2.1     | 1.9     |
| Latin America & Caribbean                 | 12.3    | 7.0     | 5.8     |
| (in per cent of developing country total) |         |         |         |
| Asia                                      | 37.6    | 48.2    | 52.1    |
| China'                                    | 4.2     | 11.2    | 11.3    |
| Latin America & Caribbean                 | 48.8    | 37.4    | 34.2    |

\* China was the largest recipient of direct investment outside of the OECD area between 1985 and 1989 with 2.1 per cent of the world total. Mexico ranked second with 1.7 per cent.  
Source: United Nations, World Investment Report, 1997.

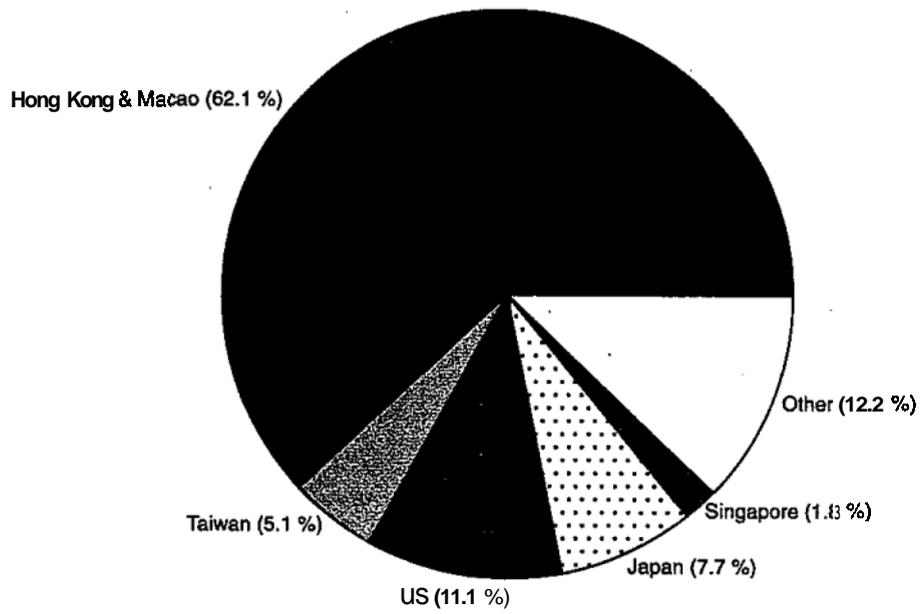
**Table 7. Net approved\* foreign investment in the Chinese Economic Area**  
Annual average in US\$ million

|                        | Inward Investment      |                        |                     |                     |
|------------------------|------------------------|------------------------|---------------------|---------------------|
|                        | Hong Kong<br>(1985-90) | Taiwan<br>(1985-91)    | China<br>(1979-90)  | China<br>(1990)     |
| Total                  | 250                    | 1510                   | 3 363               | 6 596               |
| <b>of which, from:</b> |                        |                        |                     |                     |
| Hong Kong              | —                      | 151                    | 2 088               | 3 943               |
| Taiwan                 | -2                     | —                      | 170                 | 890                 |
| China                  | 52                     | n.a.                   | —                   | —                   |
|                        | Outward investment     |                        |                     |                     |
|                        | Hong Kong<br>(1984-87) | Hong Kong<br>(1985-91) | Taiwan<br>(1981-86) | Taiwan<br>(1987-91) |
| Total                  | 669                    | 650                    | 36                  | 891                 |
| <b>of which to:</b>    |                        |                        |                     |                     |
| Hong Kong and Macao    | —                      | —                      | n.a.                | n.a.                |
| Taiwan                 | 88                     | 36                     | —                   | —                   |
| China                  | n.a.                   | n.a.                   | n.a.                | n.a.                |

\* In the case of China, actual FDI between 1979 and 1990 was about half of the approved value. Hong Kong does not report capital flows.

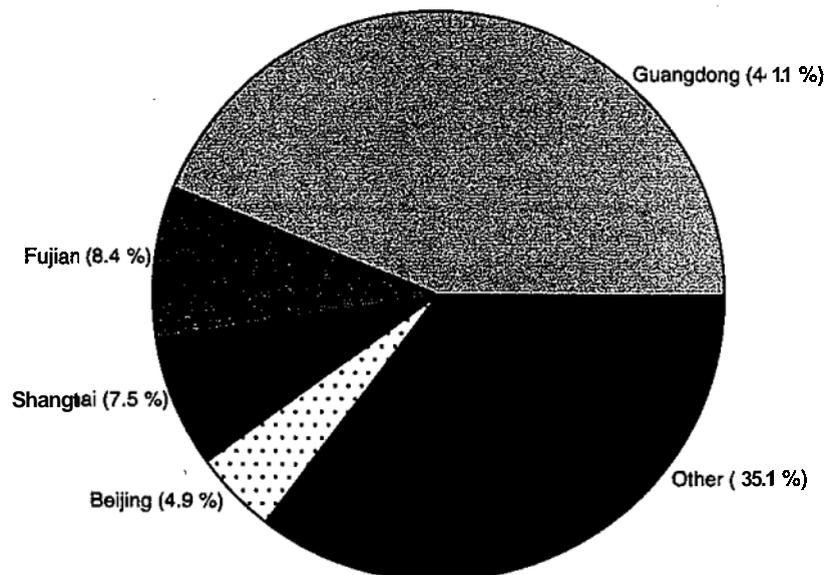
Sources: China Statistical Yearbook, 1991; OECD.

Figure 3. Foreign direct investment in China by source, 1979-90



Source: Huang Fanzhang, 1992.

Figure 4. Foreign direct investment in China by province, 1979-90



Source: Huang Fanzhang, 1992.

importance as a source of investment in China has increased dramatically. In 1990, the latest year for which Chinese statistics are available, Taiwan accounted for 14 per cent of direct investment in China, making it the second-largest investor after Hong Kong. Taiwan's statistics on capital flows seriously underestimate foreign investment outflows, particularly in the case of China. Total outflows, though, show a marked rise since 1987, which may reflect investment on the mainland. In early 1993, the government estimated that 6 000 to 7 000 Taiwanese companies had invested in China, although only about 2 700 had officially registered their investments. Recent estimates of the value of Taiwanese investment on the mainland range between \$5 billion and \$10 billion.<sup>8</sup>

The difficult financial situation of state-owned enterprises in China has accentuated the need for additional capital to make them efficient and profitable. It has been estimated that between one-third and two-thirds are operating at a loss.<sup>9</sup> With an estimated 20 per cent of public expenditures and 80 per cent of bank loans being used to support the money-losing state sector, local levels of government are anxious to sell state firms to foreign investors. Hong Kong and Taiwan, as major exporters of capital, are a prominent source of investment. In August 1992, for example, the city of Quanzhou in Fujian province sold a controlling 60 per cent interest in 40 of the city's 41 state firms to a Hong Kong enterprise.<sup>10</sup>

Hong Kong investment is concentrated in neighbouring Guangdong, where an estimated 2 to 3 million Chinese work for Hong Kong firms. In the Shenzhen Special Economic Zone (**SEZ**) which borders Hong Kong, 80 per cent of the 4 000 foreign-owned factories at the end of 1991 were owned by Hong Kong firms.<sup>11</sup> Much of the Taiwanese investment is located in Fujian province, which shares a common dialect with Taiwan. The establishment of Hong Kong and Taiwanese factories has made the provinces of Guangdong and Fujian the largest recipients of foreign investment in China (Figure 4) and contributed to the development of an industrial structure which is markedly different from the rest of the country. Small enterprises account for a larger share of output and light industrial products are relatively more important (Table 8). In Guangdong, the ratio of light industrial to heavy industrial output is more than double the ratio for China as a whole. In addition, the pattern of ownership differs. The share of state-owned enterprises, which account for more than half of industrial output nationwide, produce less than half in Guangdong and Fujian. Ownership by collectives, individuals and, above all, foreigners (included in the other category) is relatively more important.

The industrial characteristics of Guangdong and Fujian support the observation that Hong Kong and Taiwanese investment in China is concentrated in small factories producing light industrial products.<sup>12</sup> Unlike investment from the United States and Japan, which tends to supply the growing consumer demand in China, Taiwanese-owned plants produce primarily for export to Taiwan or to third countries. Similarly, much of the output from foreign-owned firms in Guangdong is shipped back to Hong Kong for further value-added, often in the form of services, and re-exported. Foreign-owned factories in Shenzhen, which are primarily Hong Kong-owned, account for more than half of the SEZ's exports.<sup>13</sup> China's policy of gradually depreciating its currency has encouraged export-oriented investments in the mainland.

While Chinese investment is not permitted in Taiwan, it has become significant in Hong Kong, estimated at \$12 billion to \$15 billion in 1992.<sup>14</sup> In Hong Kong's manufacturing sector, the mainland ranked third in foreign investment in 1990 behind Japan and

**Table 8. Industrial statistics in selected provinces**

Per cent of industrial output in 1990

|  | Beijing | Shanghai | Fujian  | Guangdong | National total |
|--|---------|----------|---------|-----------|----------------|
| <b>A. Ownership</b>                        |         |          |         |           |                |
| State                                      | 63      | 68       | 45 (26) | 40 (28)   | 55             |
| Collective                                 | 29      | 20       | 31 (10) | 35 (4)    | 36             |
| Individual                                 | 1       | 0        | 6 (13)  | 5 (16)    | 5              |
| Other <sup>1</sup>                         | 7       | 12       | 17 (2)  | 20 (1)    | 4              |
| <b>B. Size of enterprises<sup>2</sup></b>  |         |          |         |           |                |
| Large                                      | 52      | 46       | 17 (28) | 28 (24)   | 35             |
| Medium                                     | 19      | 20       | 27 (7)  | 21 (11)   | 20             |
| Small                                      | 29      | 33       | 61 (3)  | 51 (5)    | 45             |
| <b>C. Ratio of light to heavy industry</b> |         |          |         |           |                |
|  | 79      | 108      | 163 (4) | 207 (2)   | 98             |

1. This category includes foreign ownership.

2. Based on production capacity.

Note: The number in parenthesis shows the ranking of Guangdong and Fujian among China's 30 provinces.

Source: *China Statistical Yearbook, 1991*.

the United States.<sup>15</sup> This may underestimate Chinese investment since there is an incentive for the Chinese to establish unofficial subsidiaries in Hong Kong to evade controls on foreign trade and foreign exchange. Investment in Hong Kong by the Chinese government may partially reflect an effort to improve the credibility of its promise to maintain Hong Kong's economic system after 1997.

Investment between Hong Kong and Taiwan has been more modest. Investment in Hong Kong accounted for less than 6 per cent of Taiwan's total outflows between 1985 and 1991. Meanwhile, Hong Kong invested \$350 million in Taiwan between 1984 and 1987, the latest years for which figures are available.

### C. Other linkages

In addition to direct investment, there are growing financial flows between Hong Kong, Taiwan and China. It is estimated that 30 per cent of Hong Kong's currency is circulating in China.<sup>16</sup> The Bank of China, a state-controlled Chinese bank that has built a large presence in Hong Kong, has been designated as an issuer of Hong Kong bank notes beginning in 1994. It will join two British-based banks in this role. Hong Kong's share of China's external loans rose from less than 1 per cent in 1983 to almost 10 per cent in 1989. Another aspect of Hong Kong's middleman role is syndicated loans for China, 90 per cent of which are raised in Hong Kong. Chinese-owned firms began raising capital on the Hong Kong stock market in 1987. Investments in equity are beginning to cross the border in two directions following the introduction of special

shares for foreigners by China's stock exchanges in Shanghai and Shenzhen in February 1992. Another channel of financial flows was opened in May 1990 when Taiwan lifted a 40-year ban on remittances to the mainland. Residents of Taiwan have since sent more than **\$120 million** to relatives on the mainland.<sup>17</sup>

The economic integration of China and Hong Kong has improved the transportation links between them. An estimated 50 000 Hong Kong residents cross the border each day and Hong Kong firms are constructing highways in Guangdong. In addition, the provincial government in Guangdong plans to invest \$35 billion in infrastructure that will help link more remote areas of the province with the prosperous Pearl River delta region.<sup>18</sup> In 1992, more than one million Taiwanese visited China, while 10 000 mainlanders travelled in the opposite direction. Links between Taiwan and China have expanded with the easing of the ban on contact with the mainland. At least 50 million letters have been exchanged across the straits of Taiwan during the past four years and 15 million phone calls were made over the past three years.<sup>19</sup>

#### D. Impact of integration within the CEA

The growing integration of Hong Kong, Taiwan and China has changed the macroeconomic links within the CEA and between the CEA and the OECD. Prior to 1980, China's isolationist policies resulted in a business cycle that was unaffected by developments in the OECD countries (Table 9). The more open economies of Hong Kong and Taiwan, though, were influenced by developments in the OECD area. While China had little influence on Taiwan's economy, there was a greater link with Hong Kong. For example, the Chinese cultural revolution from 1966 to 1976 had a serious impact on confidence in Hong Kong.

During the 1980s, Chinese economic growth has become more closely correlated with the OECD, while the reverse is true for Hong Kong and Taiwan. The increasing influence of China is one reason for the reduced macroeconomic correlation between Hong Kong and Taiwan and the OECD. While the correlation of growth between Hong

Table 9. **Links between business cycles in the CEA and the OECD**

Correlation coefficient

| Correlation between | 1967-80 | 1980-92 |
|---------------------|---------|---------|
| OECD - China        | -0.01   | 0.48    |
| OECD - Taiwan       | 0.77    | 0.48    |
| OECD - Hong Kong    | 0.53    | 0.23    |
| China - Taiwan      | 0.07    | 0.24    |
| China - Hong Kong   | 0.30    | 0.10    |
| Taiwan - Hong Kong  | 0.59    | 0.79    |

**Sources:** OECD, *OECD Economic Outlook*; IMF, *IFS*; Hong Kong, *Estimates of Gross Domestic Product 1966 to 1992*; Republic of China, *National Income in Taiwan Area, The Republic of China*.

Kong and the mainland was lower in the 1980s, the process of negotiating China's post-1997 relationship with Hong Kong had a significant impact on its growth during the past ten years. The influence of China is illustrated by developments between 1989 and 1991. While growth in the OECD area decelerated, that in the CEA accelerated, boosted by growing trade and investment flows in the region.

Economic integration has also had a profound effect on the structure of the three economies. The greatest impact is evident in Hong Kong, which has benefited greatly from the re-export business. The mark-up on re-exports of Chinese goods from Hong Kong was estimated at 13.4 per cent in 1990.<sup>20</sup> In addition to profit, the mark-up reflects the cost of transportation, storage, insurance, packaging and minor processing that is not substantial enough to change country-of-origin status. Structural change in Hong Kong is reflected primarily in the sectorial composition of GDP and the labour force rather than in the composition of manufactures exports. The shift of factories to Guangdong and the expansion of service industries related to re-exports has helped reduce the share of manufacturing from 24 per cent of GDP in 1980 to 17 per cent a decade later. Meanwhile, manufacturing's share of the labour force fell from almost half to one-fourth.

China has also experienced rapid structural change during the past decade. Industrial production increased at a 12.5 per cent annual rate between 1980 and 1990, while exports rose at an 11 per cent rate. Exports accounted for more than one-fifth of GDP in 1990 compared with less than 6 per cent in 1978. The composition of exports has changed as well. The value of exports of telecommunications equipment, electrical appliances, camera equipment and electronic machinery each increased at more than a 40 per cent annual rate between 1985 and 1990 (Table 10).

The coastal provinces of Guangdong and Fujian have played a leading role in the industrialisation of China.<sup>21</sup> Guangdong accounted for more than 8 per cent of GDP in 1990, the largest of any province. In 1992, Guangdong's GDP grew almost 19 per cent, compared to 13 per cent for the country as a whole. Guangdong's rapid growth has boosted its per capita income, which was below the national average in 1978, to 60 per cent above the average in 1990. The growth of Guangdong has, in turn, been led by the Shenzhen **SEZ**, which experienced a 32 per cent rise in GDP in 1992. Shenzhen, a town of 50 000 people in 1978, has grown into a city of more than 2 million. In 1992, China announced plans to expand Shenzhen by more than six times from its current size.

Integration in the CEA has had less impact on the economic structure of Taiwan since its trade and investment links to Hong Kong and China are at present relatively less important. The movement, though, of labour-intensive manufacturing industries to the mainland is beginning to change the structure of Taiwan's economy. While Taiwan's exports of apparel have fallen by 27 per cent in volume terms since 1987, exports of textile products have risen 68 per cent. This suggests that Taiwan's exports of textile materials have increased to supply overseas apparel factories in China and elsewhere. Exports of other basic manufactures, such as rubber and plastic products and non-metallic mineral products, have also fallen since 1987. The decline of light industries, which had led Taiwan's industrial development since the 1960s, has resulted in a shift in industrial structure toward higher value-added goods, for which the labour-intensive components are increasingly produced on the mainland. Taiwan's exports of electronics nearly doubled between 1988 and 1990, partly as a result of the growth of its computer industry, which is the world's fifth-largest.

Table 10. The changing structure of Chinese exports

Per cent

| A. Share of 10 major product groups             |                        |      |                 |
|---|------------------------|------|-----------------|
|   | Total value of exports |      | Change in share |
|   | 1985                   | 1990 |                 |
| 1. Yarn, fabrics                                | 11.9                   | 11.3 | -5.0            |
| 2. Clothing/garments                            | 7.5                    | 11.0 | 46.7            |
| 3. Petroleum and derivatives                    | 24.8                   | 7.2  | -71.0           |
| 4. Vegetables/fruits                            | 3.0                    | 2.8  | -6.7            |
| 5. Telecommunication equipment/electronic goods | 0.3                    | 2.8  | 833.3           |
| 6. Footwear                                     | 0.9                    | 2.6  | 188.9           |
| 7. Metal products                               | 1.6                    | 2.3  | 43.8            |
| 8. Fish   | 1.0                    | 2.2  | 120.0           |
| 9. Non-metallic mineral products                | 0.8                    | 2.1  | 162.5           |
| 10. Electrical machinery appliances             | 0.4                    | 2.0  | 400.0           |

| B. Annual growth of the 10 fastest growing export product groups |                      |                             |
|--|----------------------|-----------------------------|
|  | Annual growth        | 1990 share of total exports |
|  | 1. Telecommunication | 79.6                        |
| 2. Electrical appliances   | 59.5                 | 2.0                         |
| 3. Camera/optical  | 54.2                 | 0.9                         |
| 4. Footwear  | 44.3                 | 2.6                         |
| 5. Non-metallic minerals   | 42.1                 | 2.1                         |
| 6. Electrical machinery  | 40.8                 | 0.4                         |
| 7. Fish  | 37.1                 | 2.2                         |
| 8. Special machinery   | 28.5                 | 0.9                         |
| 9. Metal products  | 27.5                 | 2.3                         |
| 10. Clothing/garments  | 27.3                 | 11.0                        |

*Source: China Statistical Yearbook, 1991.*

## II. FORCES DRIVING INTEGRATION

### A. Resource endowments

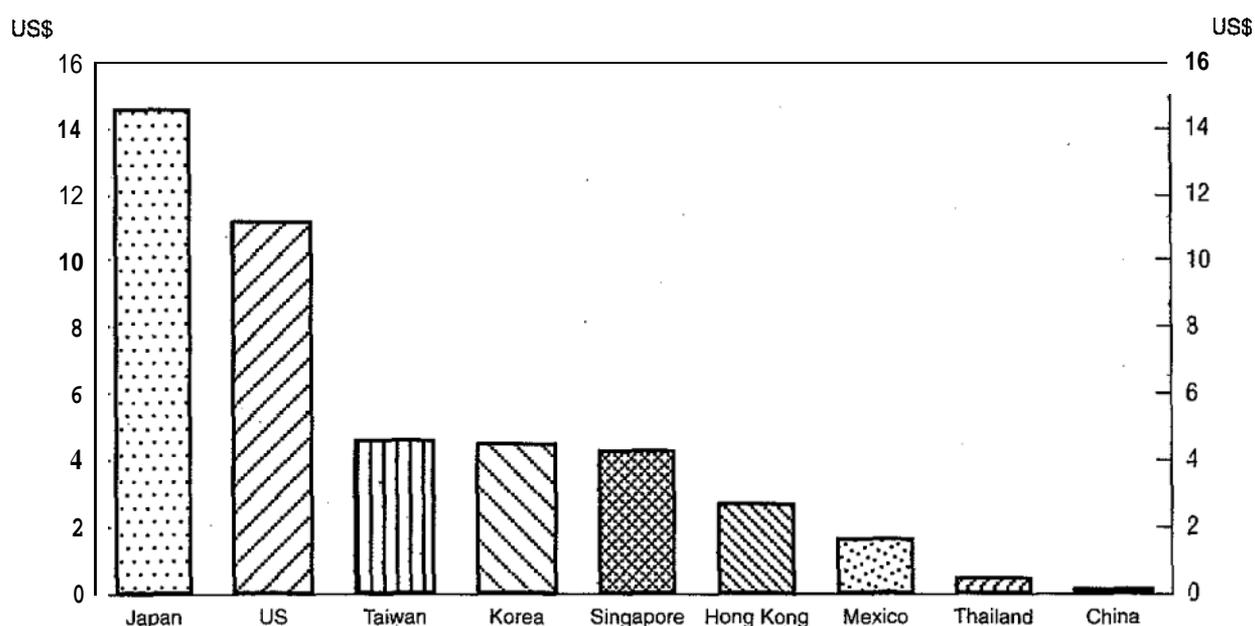
The differences in China's resource endowments relative to Hong Kong and Taiwan have resulted in significant complementarities among the three economies that have promoted the rapid increase in intra-CEA trade and investment. Although China has large reserves of some natural resources, it cannot be categorised as a natural resource-rich country. It has about half of the Western Pacific area's stocks of oil and 15 to 20 per cent of its stock of natural gas. In addition, China has large reserves of

coal, bauxite and iron ore. In per capita terms, though, China's reserves of petroleum and minerals are small and the resource-rich areas of central and western China tend to be isolated from the coastal provinces by transportation problems. Agricultural land is also relatively scarce in China, which has almost one-fourth of the world's population but only 7 per cent of its arable land.

Instead, China's factor endowment, particularly in its coastal provinces, is typical of the resource-deficient, labour-rich economies of East Asia. In many respects, it resembles Taiwan and Hong Kong at an earlier stage of development. Compared to present-day Taiwan and Hong Kong, land is relatively abundant and inexpensive in China. In Hong Kong, a crowded city of almost 6 million, rents rival those in other major cities of the world. Taiwan, an island of 20 million, has a population density that is 75 per cent higher than Japan and 2½ times higher than the United Kingdom. In Guangdong and Fujian, the provinces closest to Taiwan and Hong Kong, the population density is less than half that in Taiwan. Even in Shenzhen, rents for industrial space are only 10 to 20 per cent of those in Hong Kong.<sup>22</sup>

The availability of labour in China is another major difference with Hong Kong and Taiwan, which face labour shortages. Their unemployment rates have remained below 3 per cent during the past few years and foreign workers have been allowed into both economies. Manufacturing wages in Taiwan and Hong Kong rose at a 12 and 13 per cent annual rate, respectively, between 1987 and 1991. China, in contrast, has abundant supplies of labour and the problem of excess workers at state enterprises has become serious. The Chinese labour force, though, tends to be less skilled than that in Hong Kong and Taiwan. The illiteracy rate in China was 27 per cent in 1990.

**Figure 5. Manufacturing wage per hour, 1991**  
(US\$)



**Source:** International Labour Organisation.

The differences in quantity and quality of labour, as well as different levels of capital per worker, have resulted in large differences in wage levels. Compared to the mainland, the average manufacturing wage was 25 times higher in Taiwan and 15 times higher in Hong Kong in 1991 (Figure 5). Chinese wages are also much lower than in Thailand, another major recipient of direct investment. While wages in the most advanced provinces of Guangdong and Fujian are much higher than the national average, they were still only one-fifth as high as in Hong Kong according to a 1991 estimate. The migration of labour from inland areas of China to coastal regions should help maintain the wage differential. It is estimated that Guangdong alone has 8 million migrant workers, attracted by higher wages. Wages for unskilled workers in Shenzhen, for example, are three to four times higher than in the Pearl River delta. The higher cost of labour and land has helped to push investment inland and reduced the importance of manufacturing in some coastal regions.<sup>23</sup>

Changes in unit labour costs reflect trends in wages in the CEA (Table 11). Unit labour costs measured in U.S. dollars increased 64 and 38 per cent, respectively, in Taiwan and Hong Kong between 1986 and 1990, while that in China fell 21 per cent as a result of the depreciation of its currency. According to a 1990 survey of outward investment by Hong Kong firms, the factors pushing firms to other regions were insufficient labour, rising wages and soaring land prices. The main factors pulling investment to China were thus abundant labour and land and proximity to Hong Kong. The availability of cheaper labour as well as land in neighbouring provinces of China has been essential to maintaining and improving the competitiveness of Hong Kong and Taiwanese firms. There is no indication that first-mover advantages<sup>24</sup> in establishing large-scale factories lie behind investment patterns.

|      | China            |                              | Unit Labour Cost<br>(domestic currency) |           |        | Unit Labour Cost<br>(common currency-US\$) |           |        |
|------|------------------|------------------------------|---|-----------|--------|--|-----------|--------|
|      | Nominal<br>wages | Productivity<br>(per worker) | China                                   | Hong Kong | Taiwan | China                                      | Hong Kong | Taiwan |
| 1978 | 43               | 49                           | 86                                      | 69        | 58     | 191  | 114       | 50     |
| 1980 | 53               | 54                           | 97                                      | 84        | 84     | 242  | 132       | 74     |
| 1982 | 54               | 56                           | 97                                      | 93        | 99     | 190  | 119       | 80     |
| 1986 | 90               | 88                           | 103                                     | 103       | 101    | 111  | 103       | 85     |
| 1990 | 149              | 131                          | 113                                     | 142       | 117    | 88   | 142       | 139    |

Sources: OECD; *China Statistical Yearbook, 1991*.

## B. Revealed comparative advantage

Revealed comparative advantage (RCA) for Hong Kong, Taiwan and China has tended to reflect differences in resource endowments. During the past 30 years, China's economy has shifted away from its heavy reliance on agricultural production and become a net importer of food.<sup>25</sup> Its RCA in foodstuffs and animal and vegetable oils has fallen sharply since 1975 and was less than other Asian countries such as Thailand and the Philippines by 1987 (Table 12). As its RCA in raw materials and agriculture declined, that in labour-intensive products increased. China had its greatest RCA in miscellaneous manufactures, which is composed largely of labour-intensive products, and manufactures classified by material. Even in 1987, China's comparative advantage was more closely correlated with Hong Kong and Taiwan than with the raw material-based economies of Thailand, Malaysia and Brazil (Table 13). Its RCA in machinery and transport equipment, though, was the lowest of the nine East Asian economies examined, suggesting a low level of industrialisation and lack of technology.

Since RCA indices reflect the impact of policy distortions on trade flows, China's RCA in labour-intensive goods might reflect government efforts to promote such industries. However, estimates of domestic resource costs based on the opportunity cost of producing different types of goods in the mid-1980s supports the view that China's comparative advantage lies in the primary goods and labour-intensive manufacturing sectors.<sup>26</sup> The latter category includes food processing, textiles and clothing and paper. China's exports were thus consistent with the pattern of domestic resource costs. Hong Kong and Taiwan, meanwhile, had a much higher RCA than China in machinery and transport equipment. Soaring wages and land prices, though, were especially damag-

Table 12. Revealed comparative advantage indices\* of selected east Asian economies in 1987

| SITC Groups                | China | Hong Kong | Taiwan | Thailand | Malaysia |
|----------------------------|-------|-----------|--------|----------|----------|
| <b>Foods</b>               | 1.27  | 0.13      | 0.59   | 4.62     | 1.05     |
| Beverages & tobacco        | 0.48  | 0.08      | 0.03   | 0.08     | 0.17     |
| Crude materials            | 0.11  | 0.09      | 0.31   | 0.42     | 4.61     |
| Refined fuels              | 0.72  | 0.01      | 0.10   | 0.25     | 0.89     |
| Animal & vegetable oils    | 0.69  | 0.07      | 0.03   | 0.43     | 21.76    |
| Chemicals                  | 0.62  | 0.09      | 0.24   | 0.24     | 0.26     |
| Manufactures by material   | 1.46  | 0.49      | 1.04   | 0.93     | 0.67     |
| Machinery & transport      | 0.23  | 0.58      | 0.80   | 0.51     | 1.04     |
| Miscellaneous manufactures | 2.82  | 4.11      | 2.54   | 1.99     | 0.78     |

\* The revealed comparative advantage (RCA) of country *i* in the trade of product *j* is measured as product share in the country's exports relative to its share in world trade. Thus,  $RCA_{ij} = (x_{ij}/X_{ij}) / (X_{iw}/X_{iw})$  where  $x_{ij}$  is the country *i*'s exports of *j*,  $X_{ij}$  is the country's total exports, and *w* refers to world totals. When  $RCA_{ij}$  is greater than unity, the country has a revealed comparative advantage

Source: Yeats (1991).

Table 13. **Correlation of China's revealed comparative advantage with that of selected economies, 1986/87\***

| Country     | Spearman correlation coefficient |
|-------------|----------------------------------|
| Hong Kong   | 0.538                            |
| India       | 0.492                            |
| Taiwan      | 0.481                            |
| Thailand    | 0.377                            |
| Korea       | 0.363                            |
| Philippines | 0.288                            |
| Indonesia   | 0.201                            |
| Singapore   | 0.086                            |
| Malaysia    | 0.074                            |
| Brazil      | 0.011                            |
| Japan       | -0.174                           |

\* The Spearman correlation coefficient is computed using paired RCA indices (see explanation given in Table 10) for 129 industries.  
*Sources:* Yeats (1991), United Nations, and TARS (World Bank).

ing to the competitiveness of their labour-intensive industries, leading firms to shift production from Hong Kong and Taiwan to the mainland.

### C. The Role of Policies

Hong Kong is the only one of the three economies that has not made significant changes in its economic policies during the past decade. Under its laissez-faire system of government, Hong Kong has always been open to international trade and capital flows from Taiwan and China, as well as other countries. Hong Kong does not impose controls on international trade or capital movements and maintains no anti-dumping system. Its economy has flourished in an environment of low taxation and a minimum of government regulation. The laissez-faire atmosphere has helped make Hong Kong an important centre of international finance, with 44 of the world's 50 largest banks operating in the territory and the fourth-largest stock exchange in Asia.

There have been significant changes, though, in the policies of Taiwan and China during the past 15 years that have made them more open to each other and to the rest of the world. In Taiwan, the nominal tariff rate exceeded 30 per cent in 1980, and half of the items on its tariff schedule required import licenses. Import barriers, though, were reduced during the 1980s as part of its restructuring programme and in response to foreign pressure. Between 1984 and 1989, tariff rates were reduced to an average of 9.7 per cent despite a 24 per cent average tariff on farm products that helped Taiwan to maintain a surplus in food products.<sup>27</sup> In 1989, the government announced a four-year

plan to reduce the average tariff on nonagricultural goods to 3.5 per cent.<sup>28</sup> Taiwan, which hopes to become a member of the General Agreement on Tariffs and Trade (GATT), has announced that it will phase out investment, tax and financing subsidies for exports in order to make its trade regime consistent with GATT rules.

Taiwan has also relaxed controls on capital flows and foreign exchange together with domestic interest rate deregulation. Quantitative ceilings on outward and inward remittances of capital have been raised. The currency was allowed to float in April 1989 and companies and households can now purchase more foreign currency than in the past without prior approval. The number of sectors closed to foreign direct investment in Taiwan has been reduced. While controls on outward direct investment have also been liberalised, much overseas investment leaving Taiwan is unrecorded, to avoid official scrutiny and taxes on profits remitted to Taiwan.<sup>29</sup>

Since 1987, Taiwan has eased its restrictions on contact with the mainland, which were known as the "three no's" (no contact, no communications, no compromise). Indirect trade, investment and travel to China through third countries are now allowed. Taiwan, though, remains less open to China than it is to other countries since it fears that close economic ties with the mainland may make it vulnerable to economic blackmail. Until recently, the list of products that may be imported from the mainland was restricted to about 460 raw material and semi-finished products. The dramatic growth of trade between Taiwan and the mainland since 1987, however, suggests that geographic and cultural proximity has enabled businessmen to evade formal barriers to trade and investment. In early 1993, Taiwan decided to abandon its goal of limiting China's share of Taiwan's total exports to 10 per cent of total exports, a level likely to be achieved soon, on the grounds that it would prevent Taiwanese firms from exploiting major business opportunities. The government also announced that imports of finished industrial products from the mainland would be allowed.<sup>30</sup>

Investment from the mainland in Taiwan remains banned, but Taiwanese firms have been able to invest in China indirectly via third countries since September 1990. Investment in the manufacturing sector, though, is limited to primarily labour-intensive products. Investment in high-technology and heavy industrial projects has been prohibited since it was feared that it would make China a more powerful competitor with Taiwan in world trade. The government of Taiwan took several steps during 1992 to facilitate investment in the mainland. First, it decided to allow companies to invest in China without first establishing subsidiaries in third countries. This will reduce the cost of investment, particularly for small companies. Second, it allowed Taiwanese banks to handle flows of corporate investment capital to the Chinese mainland. Third, Taiwan's government announced that it will consider, on a case-by-case basis, investment by producers of steel, cement, cars, petrochemicals and glass in the mainland. Finally, it decided to allow investment by some service companies, such as wholesalers and retailers. Investment by financial companies will not be permitted until later.

While Hong Kong was always open and Taiwan only reluctantly allowed exchanges with the mainland to expand, it was the liberalisation of trade and foreign exchange policies in China which allowed the comparative advantages of the respective economies to come to the fore. Prior to liberalisation, China's policy of autarkic self-reliance made foreign trade the monopoly of 12 foreign trade corporations (FTCs) organised along product lines. Enterprises were given production targets under the plan to supply goods for exports to the FTCs.<sup>31</sup> This system insulated the tradeable

goods sector from the rest of the world and limited economic contact with other countries.

During the 1980s, the government decentralised control over trade by allowing local branches of FTCs to become independent. At present, there are about 4 000 FTCs managed by provincial or local authorities that trade either as agent or principal. In addition, about 400 manufacturing enterprises have been allowed to trade directly. The scope of trade subject to the central plan has been reduced significantly as government planning has become less important. The number of items allocated through the government's output plan declined from 250 products in the early 1980s to about 20 in 1988 (*e.g.* steel, coal, petroleum and electricity).<sup>32</sup> The decline in the importance of planning has increased the share of trade determined by market forces, thus reducing the gap between international prices and China's domestic prices. As a result, China's foreign trade pattern reflects more closely its comparative advantage. In addition, the decentralisation of trade has forced Chinese producers, which tend to be weak in international marketing, to rely more on Hong Kong intermediaries for their link to world markets. China's underdeveloped financial system also leads them to rely on Hong Kong for financing.

With the decline in direct control over exports and imports, trade restrictions, such as licenses and duties, have become the major instruments of trade policy. In 1991, 55 per cent of exports and 40 per cent of imports were subject to licensing requirements. Tariffs, which range from 3 to 180 per cent, averaged 21 per cent in 1992. The government has announced tariff cuts on more than 3 000 items to help reduce its overall tariff level to 15 per cent in 1993. The move is intended to speed China's re-entry into GATT and to fulfill its bilateral agreement with the United States to reduce tariffs by the end of 1993. In addition, China is reducing the number of imports which require licenses by two-thirds.<sup>34</sup> Despite the reforms since 1978, China's trade policy is still characterised by a high level of government intervention. Studies of China's trade pattern have found that administrative controls still play a major role in determining the composition of exports and imports.<sup>35</sup> Following China's application to re-join the GATT in 1986, the GATT working party examining China's trade policy has repeatedly found it inconsistent with GATT rules. The major demand of the GATT is to unify the nation's trade policies and make them transparent.<sup>36</sup>

China, in contrast to Taiwan's policy toward the mainland, is more open to Taiwan than to other countries. "Adjustment taxes" imposed on Taiwanese goods are slightly lower than import tariffs and import controls on goods from Taiwan are less stringent. Taiwanese investors have also received more favourable treatment than other foreign investors since 1988, reflecting China's hope that closer economic ties with Taiwan will help bring the island back under its control.<sup>37</sup>

The emergence of a non-state sector is another factor that increased China's openness to the world. Reforms at the enterprise level, which began in the agricultural sector, were extended to the industrial and service sectors in 1984. Various forms of non-state enterprise, including township and village enterprises (TVEs), foreign-funded enterprises and private enterprises, have been encouraged. TVEs were given concessional tax treatment, allowed to sell their products at market prices and granted more independence in wage and manpower issues. The various forms of non-state enterprises have proved to be the most dynamic sector of the economy; their share of industrial output has risen from one-fifth in 1978 to half in 1991. The state-owned enterprise sector, though, remains a serious drag on the economy. At least one-third of

the firms are incurring losses, requiring subsidies that steadily increased central government deficits in the second half of the 1980s. Concern about the possible effect on employment has made the government reluctant to close loss-making enterprises.

China also decided to utilise foreign capital by allowing direct investment and borrowing from abroad. Joint ventures with foreigners were promoted under a 1979 law. Five Special Economic Zones<sup>38</sup> featuring tax incentives and improved infrastructure provision were established as the principal areas for direct investment. In 1984, 14 coastal cities and Hainan Island were also permitted to offer tax incentives to attract foreign investment. These zones, which the government initially tried to isolate from the rest of the economy, were used as laboratories for market-oriented reforms.<sup>39</sup> There is increasing FDI, though, outside the SEZs.

The foreign exchange market has been deregulated to some extent. The government now operates a dual exchange rate system comprised of a controlled official market and a less regulated market in foreign exchange retention quotas, which is operated country-wide through about 100 swap centers and fed by foreign exchange retained by exporters. The permitted retention rate gradually increased from 25 per cent to up to 100 per cent for firms operating in export-processing zones. The official exchange rate has in recent times been allowed to move closer to the rate established in swap centers. The adoption of a managed floating exchange rate system and the decision to allow exporting firms to maintain a higher share of foreign exchange has increased the attractiveness of exports relative to local sales. Data on unit labour costs in Hong Kong, Taiwan and China clearly show that the nominal depreciation of the Chinese yuan was a crucial factor in establishing export competitiveness.

#### D. Political ties

Political developments between Hong Kong, Taiwan and China have also influenced economic integration. In the Sino-British Joint Declaration of 1985, Britain declared that it will restore Hong Kong to China on 1 July 1997. China, in return, promised to maintain Hong Kong's capitalist system and way of life for 50 years after 1997 under the principle of "One Country, Two Systems". The Basic Law, which will become the constitutional document for Hong Kong after 1997, contains numerous provisions to maintain Hong Kong's economic system. The right of private ownership, including foreign investment, will continue. Hong Kong will be allowed to supervise its financial markets independently so as to maintain its status as an international financial center and its public expenditure and taxation systems will remain independent of those in the mainland. Hong Kong will also maintain its own currency and an independent monetary policy. The Hong Kong dollar will remain freely convertible and no controls are to be applied to foreign exchange or capital movements. Hong Kong will continue to participate in **GATT**, which it joined in 1986, as a separate customs territory.

Despite the assurances in the Joint Declaration and the Basic Law, the prospect of Chinese control has created considerable uncertainty in Hong Kong. The events of June 1989 in China, the difficulty in obtaining Beijing's approval for the construction of a new airport and controversy over political reform have reduced confidence in Hong Kong's future. Many enterprises, including Hong Kong's de facto central bank, the

Hong Kong & Shanghai Banking Corp., have diversified their activities away from Hong Kong. Still, it seems unlikely that China would intentionally damage the stability and viability of Hong Kong as a center of trade and finance, given China's large investments in Hong Kong.

The "One Country, Two Systems" idea has also been proposed by China as a way to unite Taiwan and the mainland. Taiwan, though, remains at least officially committed to its policy of "three no's". Still, an increasing number of co-ordinating mechanisms exist between Taiwan, Hong Kong and China. All three are members of the Asian Development Bank, where Taiwan participates as "Taipei, China". In November 1991, China, Hong Kong and Taiwan joined the potentially powerful Asia-Pacific Economic Co-operation group (APEC), which includes the United States, Japan, Australia and New Zealand. There are also indications that China and Taiwan may be simultaneously accepted soon as members of GATT. Increased economic ties between Taiwan and China have led to direct bilateral contact as well, including a high-level meeting in April 1993, which led to the signing of four agreements.

## E. Rapid growth despite policy distortions

It appears clear that economic liberalisation in China has unleashed the economic forces driving integration in the CEA. While the reforms have also been accompanied by some degree of macroeconomic stability and control over inflation, policies are still highly distortionary. Many "contractual" details, such as tax treatment and infrastructure provision, remain ill-defined. Extensive opportunities for arbitrage and rent-seeking exist, including price arbitrage under the two-tier system, abuse of tax privileges in special economic zones and arbitrage in the dual foreign exchange market. Factor markets for labour and capital are highly distorted and rigid, due in large part to widespread government interference.

In spite of this, China's areas of fastest growth, the southern provinces, are rapidly integrating with Hong Kong and Taiwan. Development is not restricted to the favoured special economic zones but has spread across the provinces containing the SEZs. Technical, managerial, marketing and financial know-how is provided by entrepreneurs from Hong Kong and Taiwan. Infrastructure is created as production sites are opened further and further inland in the provinces.<sup>40</sup> Rapidly growing capitalism is supported by local officials and is accompanied by a certain amount of corruption.<sup>41</sup> Formal property rights and judicial process appear to be of limited importance. This raises the issue of how binding contracts can be concluded and how markets can function in this atmosphere.

It appears that the official framework of policies is less binding in the southern provinces that are more distant from the central power of Beijing. Local authorities and entrepreneurs have wider scope to conclude contracts that allow rents generated by official policy to be allocated among interested parties. As a result of this arbitrage process, many firms *de facto* face prices which are relatively undistorted.<sup>42</sup> The allocation of rents appears to broadly follow profit-sharing arrangements with efficiency properties similar to those identified in the literature on share-cropping. Firms would, for example, conclude deals with – often competing – local authorities to receive regular

electricity supply in return for a share of the firm's profit. As many firms are owned by local authorities, such profit-sharing arrangements are compatible with existing ownership rights. One might thus consider southern China as an application of the Coase Theorem,<sup>43</sup> which implies that private parties have an incentive to agree mutually to allocate external costs and benefits<sup>44</sup> so that the overall outcome is efficient, when transaction costs are zero (or small).

Hence, the rather spontaneous development of profit-sharing (or rent-sharing) arrangements requires small transaction costs and, in particular, that contracting parties have incentives to comply with contractual arrangements. Economic theory suggests that repeated interaction in groups with links that facilitate information flows about whether contracting parties honour agreements can produce outcomes resembling that of efficient markets.<sup>45</sup> If contracting parties have some degree of trust in their business partners and expect to deal repeatedly with them in the future, they will have incentives to engage in mutually profitable exchange.

Reduced mobility of factors of production, which generally might be thought to affect economic efficiency negatively, may actually increase the expectations of long-term repeated interaction between business partners. In the case of larger firms and some governmental institutions, repeated interaction can be expected, because they are based on sizeable location-specific investments and cannot easily move. In addition, labour mobility is severely restricted throughout China. Even workers in township and village enterprises tend not to switch jobs frequently.<sup>46</sup>

Extended and overlapping family ties have facilitated the development of southern China. Many overseas Chinese families appear to have strong and far-reaching ties,<sup>47</sup> which help explain strong economic booms in other countries with distorted policies, such as Thailand. Kinship, common dialects and common origins in villages or counties provide a setting of trust for business agreements among the Chinese, who tend to be distrustful of governments and laws.<sup>48</sup> Over one million visitors from Taiwan now visit the mainland every year. Presumably, repeated contacts are thus established with relatives in coastal provinces. Overseas Chinese business people also appear to find operating on the mainland easier than foreigners due to their language capabilities and greater familiarity with and understanding of business practices.

If indeed the above factors facilitating repeated interaction and information flows are important for the economic boom in the coastal provinces, they are, by the same token, likely to limit economic development eventually. Greater product and factor mobility will be required to allow inland provinces to reap benefits from internal and external trade. Family ties can only help to some degree and appear to be most important in the coastal provinces, where many overseas Chinese originate. From this perspective, further policy reform on the mainland is essential to sustain growth momentum.

### III. OUTLOOK

While the formation of formal trade agreements sometimes gives rise to suspicions of increasing protectionism and fears of trade diversion, this is not the case for the

CEA. Hong Kong remains the closest equivalent to an open economy. China is reducing barriers and Taiwan has liberalised trade significantly. The only policy favouring trade diversion over creation is China's preferential treatment of Taiwanese imports. These preferences are counterbalanced, however, by Taiwanese restrictions on exports and appear to be small in any case. A comparison of trade creation and diversion effects in a wide range of formal trade arrangements shows that trade diversion dominates in most such arrangements (Table 3). The CEA differs drastically, even from the more beneficial trade arrangements such as the European Community and ASEAN, as it has raised openness and trade creation far in excess of trade diversion.

The sharp increase in intra-CEA trade may be a once-and-for-all adjustment to the opening of China. If policy reform continues in China, and to a lesser degree in Taiwan, while Hong Kong remains open to the mainland, there appears to be a potential for further expansion of intra-regional trade in the CEA. In addition, deregulation within China and removal of inter-provincial barriers should foster the integration of other coastal and inland areas with Hong Kong and Taiwan.

However, special relationships with Hong Kong and Taiwan based on geographical and cultural proximity will be less important for other provinces of China. Future liberalisation, therefore, may see more rapid integration of China with the rest of the world than in the past, relative to the expansion of intra-regional trade between the three Chinese economies. Trade between China, Hong Kong and Taiwan as a proportion of their total trade is likely to peak sometime in the not too distant future. Meanwhile, however, the integration of southern China is playing a key role in easing the transition of China from a centrally-planned economy to one that is more market-based. This may lead in the long run to the emergence of China as one of the key world economic powers.

The CEA is now on the way to becoming the fourth largest trading entity in the world. By the year 2000, its share of world trade may be almost equal to shares of the United States, Japan and the EC (net of intra-EC trade).<sup>49</sup> Indications from business cycle analysis show that cycles in Hong Kong and Taiwan during the 1980s have become more closely related to those in China. While the opening appears to have made business cycles in China more dependent on OECD patterns, domestic demand growth in China seems to have rendered its economic development more independent of outside developments. There thus exists the possibility that the OECD conjuncture will be significantly affected by Chinese developments by the first decades of the new millennium.

## NOTES

1. See Lloyd (1992).
2. See OECD (1993b).
3. Per capita income levels of Hong Kong and Taiwan are now comparable to those of some OECD countries and they have become the most important OECD trading partners among non-member economies, ranking 12<sup>th</sup> and 13<sup>th</sup>, respectively, in world exports in 1990. Following the economic liberalisation policies adopted in the late 1970s, the Chinese economy grew at an average annual rate of nearly 10 per cent. According to some estimates, China's GDP in purchasing power parity prices may be as large as that of Germany or even approach the size of the Japanese economy.
4. See Jones, King and Klein (1992), for background on the relationship between China and Hong Kong.
5. The statistics in this paragraph and the preceding one are taken from Sung (1991), pp. 10-11.
6. Hong Kong Government Secretariat (1993), pp. 18-19.
7. All dollar figures refer to U.S. dollars.
8. *Reuters*, 8 February 1993 and *The Asian Wall Street Journal*, 24 March 1993. Many Taiwanese firms are believed to under-report foreign investment in order to avoid taxes as well as to escape laws restricting contact with the mainland in the case of investment in China.
9. *Far Eastern Economic Review*, 10 October 1991, p. 77.
10. *The Asian Wall Street Journal*, 8 January 1993, pp. 1 and 3.
11. *Far Eastern Economic Review*, 14 May 1992, p. 29.
12. According to Ohashi (1991), for example, "Guangdong has so far achieved growth primarily through textiles, plastic goods, and other light industries".
13. *Far Eastern Economic Review*, 14 May 1992, pp. 23-32.
14. *The Asian Wall Street Journal*, 11 February 1993. The large difference between this estimate and the level of Chinese FDI in Hong Kong reported in Table 6 illustrates the unreliability of statistics on foreign investment in the CEA.
15. See Tang (1992), p. 114.
16. Hongkong Bank (1993). A rising inflation rate and a depreciating currency have prompted many Chinese workers in foreign-invested enterprises to demand that their wages be paid in Hong Kong or New Taiwan dollars.
17. The data on financial flows is taken from *Reuters*, 12 February and 21 October 1992.
18. *Far Eastern Economic Review*, 16 May 1991, pp. 64-68.
19. *The Economist*, 10 October 1992, p. 15.
20. Hongkong Bank (1992).
21. While international trade has been partially deregulated, trade barriers continue to exist between China's provinces. These result from efforts by provincial governments to prevent arbitrage intended to profit from differing provincial pricing arrangements or to protect

“domestic” producers. As more and more transactions are carried on outside of the central plans, data on inter-provincial trade have become less meaningful. The limited evidence suggests, however, that inter-provincial trade is hampered by barriers and may develop more slowly than exchanges between Hong Kong, Taiwan and selected coastal provinces. See World Bank (1989), pp. 80-85.

22. Ohashi (1991).
23. In Shenzhen, for example, the service sector accounted for 45 per cent of GDP in 1991 compared with 40 per cent the previous year according to the *Far Eastern Economic Review*, 14 May 1992, p. 28.
24. In industries where the optimal scale of a plant represents a significant share of world demand, being the first to establish a plant is an important advantage.
25. Anderson (1990), pp. 12-13.
26. Warr and Guang (1991).
27. OECD (1993a), pp. 45-47.
28. Noland (1990), pp. 35-37.
29. L. Lim and P. E. Fong (1991), pp. 63-68. It is estimated that outward direct investment is about ten times higher than official figures indicate.
30. *The Asian Wall Street Journal*, 4 January 1993, p. 4 and *Reuters*, February 12.
31. Cheng (1992), p. 11.
32. Bell and Kochkar (1992).
33. Export licenses are applied primarily to goods subject to foreign quotas as well as goods for which domestic prices have been artificially repressed.
34. *International Herald Tribune*, 16 December 1992.
35. Brender (1992).
36. *China Market*, No. 10, 1992, p. 9.
37. Sung (1991), p. 7.
38. The framework under which Special Economic Zones operate illustrates the special mix of free-market policies and legacies from the planned system that is characteristic of current policy. The zones provide commercial freedoms to firms. Each zone is nevertheless supposed to serve distinguishable foreign markets. While the zones are officially intended to provide special incentives to exporters, less than five per cent of exports originate there and many firms sell part of their production in the domestic market.
39. Bell and Kochhar (1992), p. 9.
40. Bateman and Mody (1992).
41. See, for example, “The Wild, Wild East“, *Business Week*, 28 December 1992, pp. 18-20.
42. Byrd and Gelb (1990).
43. Coase (1960).
44. Many costs and benefits are in this case “external”, because property rights are partly undefined.
45. See Kurz (1977) and Radner (1980).
46. See Byrd and Gelb (1990).
47. See Redding (1990).
48. *The Economist*, 18 July 1992, pp. 22-24.
49. See Jones, King and Klein (1992).

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