Implications of Mainland Processing Trade Policy on Hong Kong

Research Report

June 2007

Study Led by "Task Group on the Impact of Mainland Processing Trade Policy to Hong Kong",
The Greater Pearl River Delta Business Council

Compiled by HKTDC Research Department

Foreword

Processing trade plays an important role in China's economic development, accounting for 47% of the country's total foreign trade and creating an accumulated 30 million jobs. However, in recent years in view of the changing environment, China decided to make adjustments to its processing trade policy. For the 45,000 Hong Kong-invested processing trade enterprises operating in the Pearl River Delta (PRD) region, the implications brought about by the policy change are far reaching. In this connection, the Greater Pearl River Delta Business Council set up the "Task Group on the Impact of Mainland Processing Trade Policy to Hong Kong" in February 2007. The objective is to conduct systematically a first ever comprehensive study on the impact made by the mainland's processing trade policy change on Hong Kong and Hong Kong-invested processing enterprises, as well as to make forward-looking recommendations.

Owing to the fact that processing trade accounts for over half of Hong Kong's re-export trade and that it is a major production mode on which many Hong Kong small- and medium-sized enterprises survive, this study on processing trade carries a strong strategic significance to Hong Kong. For this reason, the Hong Kong Trade Development Council Research Department gladly accepted the request by the Task Group to carry out the study and compile a report on the findings.

During February and March this year, the TDC Research Department sent out questionnaires to over 50,000 manufacturers and traders in Hong Kong. A total of 4,000 valid responses were received, representing a response rate of 7.2%. Based on the responding questionnaires, TDC researchers carried out a second round of in-depth survey on selected companies which are engaged in production activities in the PRD and are seriously affected by the mainland's processing trade policy change and export VAT rebate reduction. The findings were then analysed with other survey data to project the number of Hong Kong companies, their export volume and the number of their mainland and Hong Kong employees, affected by the processing trade policy change.

In addition to the questionnaire survey, TDC researchers also attempted to gain a thorough understanding and make a comprehensive analysis of the processing trade policy change through various channels. These include: (1) desk research on existing literature and statistical data to determine the contribution of processing trade; (2) communication with the relevant central ministries and enforcement authorities to understand the direction of the processing trade policy change; (3) interviews with industry players who are affected by the policy change, and focus group discussions with representatives of trade associations, government departments and academic research institutions in Hong Kong.

This report concludes that despite the mainland government's continued support for processing trade, further adjustments will be made to the processing trade policy in response to changing circumstances. This report also summarises the difficulties facing Hong Kong companies in the transformation and upgrade of processing trade, and in the shift of their operation mode from "processing with supplied materials" to "foreign-invested enterprise". Based on the views gathered from various parties, recommendations on policies are made in this report to the Central Government, Guangdong Provincial Government and HKSAR Government for their reference. At the same time, Hong Kong companies are advised to prepare themselves for transformation and upgrade so that they can have a smooth transition in keeping with state policy to reach a higher level.

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Executive Summary

At the end of 2006, China reduced and removed the export VAT rebates for certain products, expanded the prohibited category under processing trade, and announced that the prohibited category will be adjusted from time to time. In April 2007, the Ministry of Commerce (MOFCOM) announced the latest prohibited category under processing trade, making additions and deletions to the list of products prohibited from import and export in the form of processing trade. In the same month, MOFCOM also issued a circular calling on commerce departments at all levels to take environmental protection, energy consumption, employment conditions, equipment level and other factors into consideration in evaluating the business operation and production capacity of processing trade enterprises applying for approval to engage in processing trade activities, thereby establishing the threshold for participating in processing trade.

Promoting the “transformation and upgrade” of processing trade and restricting industries of “high energy consumption, high pollution and resource consumption” are China’s objectives in adjusting its processing trade policy. To achieve these targets, it is understood that further adjustments will be made to the catalogue of products managed by category under processing trade. Steps will also be taken to include products that are labour-intensive, short in industry chain, low in value-added, susceptible to trade friction, and difficult for customs supervision in the restricted category under processing trade.

Reasons for Processing Trade Policy Change

Processing trade has made a significant contribution to export growth and job creation in the Chinese mainland. Some experts reckon that processing trade is the key driver of China’s trade growth and has brought in new products and new technologies which have helped turn the country into a manufacturing platform that meets the requirements of the international market and lays a solid foundation for furthering China’s industrial structure upgrade. Studies have also found that for every 1% growth in processing trade there is a corresponding 0.29% increase in China’s GDP.

According to mainland statistics, more than 90,000 processing trade enterprises are currently operating in China, of which 70,000 are found in Guangdong. Over 16 million people are estimated to be working for processing trade enterprises in Guangdong. In 2006, total imports and exports related to processing trade amounted to US$831.9 billion, accounting for 47.2% of China’s total foreign trade.

The surge in China's trade surplus in recent years has not only exerted great pressure on the Renminbi to appreciate in value but also triggered increasing trade friction. At the same time, the rate of energy and resource consumption by China's industries is excessively high, and environmental pollution caused by manufacturing activities is serious. As processing trade was first introduced as a preferential policy to attract foreign investment in the early days of China's opening-up, no access requirements were set. In view of the strong correlation between processing trade and China's huge trade surplus, adjustments of the processing trade policy are necessary in a bid to cope with changing circumstances.

Impact on Hong Kong-Invested Processing Activities in PRD

Hong Kong companies are extensively involved in processing trade in the Chinese mainland. According to the latest survey conducted by the Hong Kong Federation of Industries, 57,500 Hong Kong-invested factories are operating in the PRD in various forms employing 9.6 million workers. In terms of the export structure of the surveyed companies, 15.5% fall under general trade, 34% are processing with imported materials, 47.4% are processing with supplied materials, and the remaining 3.2% are others.

The impact of processing trade policy change on China's import and export has proven to be immediate. In September 2006, certain commonly used raw materials including leather, paper and certain metal products were added to the prohibited category under processing trade. Although processing activities using the latter two subsequently resumed in November 2006, the disruption already dealt a severe blow to Hong Kong companies concerned. For instance, they were unable to import or transfer from other factories the raw materials/semi-manufactures needed for production, which in turn disrupted their supply chain. In October 2006, the imports and exports of Guangdong fell 11.7% and 4.4% from the previous month respectively. This decrease is believed to be largely attributable to the processing trade policy change.

After long years of development of processing trade activities in the PRD, a long industry chain has been formed in the region characterised by a high degree of inter-dependence among various industry clusters. Hence, any disruption in the processing link along the production chain would have serious repercussions. According to the survey conducted by TDC, an average processing trade enterprise in the PRD generally has one to five different products or production processes in their day-to-day operation that involve other enterprises. These mainly include packaging, moulds, metal parts, metal electroplating, plastic parts, and bleaching/printing/dyeing. About 42.4% of the processing trade enterprises indicate that their products are supplied to other downstream manufacturers

in the mainland in the form of factory transfer. Such transfer-out products account for about 30% of their total output.

Directions of Further Policy Change and Counter-Measures by Hong Kong Companies

Promoting the transformation and upgrade of processing trade and restricting the development of high energy consumption, high pollution and resource consumption industries are China's policy directions and objectives. To this end, the relevant ministries and commissions will continue to make adjustments to processing trade from time to time. The major directions of adjustment include abolishing the preferential bonded import treatment for industries and exports that are restricted or no longer supported by the state (such as those under the prohibited category in processing trade), removing or reducing export VAT rebates, and raising the access threshold for processing trade enterprises. These adjustments are intended to increase the export cost of enterprises and "internalise" the social cost which should have been borne by the enterprises.

Indeed, Hong Kong companies operating in the PRD have been facing immense cost pressures in the past few years due to rising wages and Renminbi appreciation. At the same time, fierce market competition means that there is no room for export price increase. As a result, the profit margin of processing trade has dropped markedly from 18% five years ago to 10% at present.

The TDC survey has found that in order to cut costs, 37.3% of the enterprises in the PRD have plans to relocate all or part of their production activities to other parts of Guangdong province or other Pan-PRD provinces. But most Hong Kong investors agree that in the long run transformation and upgrade are the ultimate direction for development. In the TDC survey, 53.1% of the responding Hong Kong companies indicate they will seek upgrade through developing better quality products, 45.1% through improving product design and engaging in innovation, and 35% through building their own brands. Over 35% of the respondents say they would strengthen internal management, including inventory control and production automation, to achieve corporate upgrade and better cost control.

Transformation and upgrade involve huge amount of long-term investment. To most companies, their major concerns are the market potential of their products, their financial resources, and their professional management/technical expertise. Moreover, clear and consistent mainland policies are vital in enabling them to work out the cost and return of their investments.

Impact of Processing Trade Policy Change on Hong Kong-Invested Enterprises in Greater PRD

The development of processing trade has significant implications for Hong Kong's import-export trade as well as the related transport services sector. In 2006, 80.7% of Hong Kong's re-exports of mainland origin, totalling US$104.5 billion, were related to outward processing. During the same period, 64.5% (or US$98.6 billion) of Hong Kong's imports of mainland origin were related to outward processing.

Although the vast majority of Hong Kong manufacturers have relocated their production activities to the mainland, most of them are still active in Hong Kong and have maintained their presence in the territory in the form of trading company or operation headquarters. Their contribution to Hong Kong's economy and job market is significant. According to rough estimates, the direct and indirect contributions made by the manufacturing industry and import-export trade (including offshore trade in services) to Hong Kong's economy amount to 37% of GDP.

According to the TDC survey on production enterprises in the PRD, 30.9% are the hardest hit by the processing trade policy change and export VAT rebate reduction. Among them, 55.3% indicate that if they are required to make "actual payment" of customs duty and VAT as deposit for the importation of raw materials, it would pose a heavy burden on their cash flow which would in turn affect the operation of their company.

Another 10.5% indicate that if the imported raw and auxiliary materials and products needed for their production are included in the prohibited category under processing trade, they would have to cease or scale down their production as their competitiveness is being eroded by the cost hike. Meanwhile, 73.2% indicate that they may be forced to cease or scale down their operation as they are unable to cope with the change.

Based on the above-mentioned survey findings, it can be envisaged that if China significantly expands the list of products under the prohibited category in processing trade or removes all preferential tax treatments for processing trade, the worst scenario could be as follows:

14,500 Hong Kong enterprises would be seriously affected	
● 1,500 enterprises would cease production ● 375,000 mainland production workers would lose their jobs ● 10,000 Hong Kong employees of the enterprises concerned would lose their jobs	● 10,000 enterprises may cease or scale down production ● 2.5 million mainland production worker jobs would be under threat ● 70,000 Hong Kong employees of the enterprises concerned would be affected

Difficulties Facing Hong Kong Companies

In coping with the mainland's processing trade policy change, the strategies adopted by Hong Kong companies, such as brand development, innovation or relocation, all involve huge capital. For the many Hong Kong companies which lack financial resources, in particular factories engaging in processing with supplied materials which have great difficulties in obtaining bank loans, transformation and upgrade are something beyond their means. Even if the problem of finance can be solved, the current uncertainties of the mainland's processing trade policy would put Hong Kong companies off from making long-term investment. Moreover, since the majority of Hong Kong companies do not have the experience or knowledge in brand management and product and technology R&D, the risks involved in transformation and upgrade are great hurdles for them.

At present, many Hong Kong companies are still engaging in production and export in the PRD in the form of processing with supplied materials. To shift to production in the form of general trade and domestic sales development, they must change their mode of operation from "processing with supplied materials" to "foreign-invested enterprise (FIE)". However, at the moment the mainland does not have a set of clear and unified procedures for examining and approving such processing enterprises applying for conversion into FIEs. Moreover, the fact that it generally takes six to nine months for these processing enterprises to apply for removal of customs supervision also affects their normal production.

Under the current customs duty deposit system whereby enterprises are managed by category, some Category A enterprises are worried that to convert from the operation mode of processing with supplied materials to FIE, they may be downgraded to Category B since they would become newly established enterprises with no export performance track record. And as such, they would have to pay a large sum of import duty deposit which would create considerable cash flow pressure.

Recommendations

Most Hong Kong companies recognise the inevitability of the processing trade policy change and are willing to take the appropriate action to cope. In fact, “transformation and upgrade” of processing trade are the common goal of the mainland and Hong Kong. Statistics also show that processing trade in the mainland has not only expanded in scale but its product structure has also been upgraded and industry chain extended. It is the projection of this report that market forces will continue to drive processing trade forward in terms of structural upgrade, relocation and transformation. It is recommended that during this process the mainland authorities should maintain a clear and consistent policy direction, conduct advance consultation before introducing policy changes, allow for reasonable transition periods, and strengthen communication with the HKSAR Government.

In terms of providing assistance to enterprises in transformation and upgrade, this report recommends that the authorities concerned should, based on actual circumstances, give support and guidance to help enterprises convert from the operation mode of processing with supplied materials to FIE, and encourage them to develop domestic sales. In introducing policy changes from time to time, efforts should be made to avoid forcing enterprises in any link of the industry chain out of business as this will break the continuity and undermine the competitiveness of the industry chain in the Greater PRD region.

The Central Government is recommended to:

— Provide clear guidelines and lenient treatments for enterprises operating in the form of processing with supplied materials to convert into FIEs so that these enterprises can change their business registration and legal person registration and continue their existing production activities and develop domestic sales within a short period of time by keeping their original location, original factory, original workforce and original export records.

— Allow processing enterprises to provide “bank guarantee” or “insurance policy” as customs duty deposit in order to alleviate their cash flow burden caused by the “actual payment” requirement.

— Take factors such as “production technology level”, “proprietary brand” and “proprietary design” etc into consideration when making policy changes in order to encourage processing enterprises to make more investment in “proprietary

innovation" in the course of transformation. This can also serve to compensate the shortcomings caused by policy changes involving the categorisation of products by tariff codes.

The Guangdong Provincial Government is recommended to:

— Provide "one-stop" consulting service, unify the implementation measures of different localities, and expedite the processing of applications by enterprises for conversion from the operation mode of "processing with supplied materials" into "FIE".

— Expedite the construction of eco parks featuring centralised sewage treatment facilities to give enterprises more options for relocation.

The HKSAR Government and related organisations are recommended to:

— Strengthen the ties between the Central Government and the Hong Kong business community and step up communication and consultation work.

— Strengthen the provision of market information to Hong Kong enterprises and assist them in shifting their business focus from export to domestic sales on the mainland market.

— Step up the promotion of "Hong Kong brands" and assist more enterprises to develop their own brands.

— Adjust the existing "SME Loan Guarantee Scheme" to help alleviate the financial difficulties of enterprises in the course of transformation.

1. The Role of Processing Trade in China's Foreign Trade and Economic Development[1]

1.1 Processing Trade Accounts for Half of Mainland's Import-Export Trade

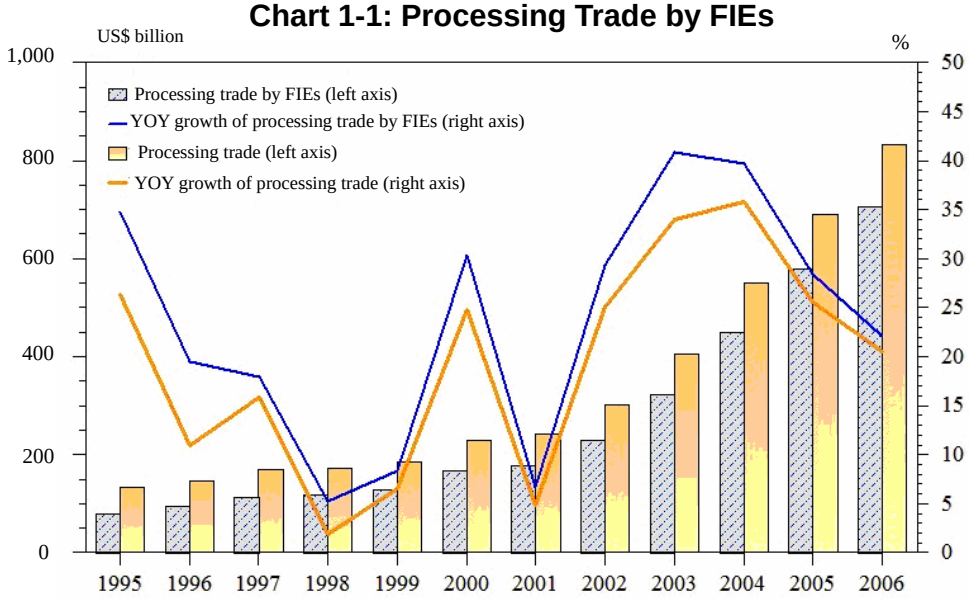
Processing trade refers to a preferential export mode whereby all or part of the raw and auxiliary materials, parts and components, accessories, and packaging materials needed for production are imported in bond, and the finished products after processing or assembly by enterprises on the mainland are re-exported. This form of trade includes "processing with supplied materials" and "processing with imported materials". Under processing with supplied materials, the foreign party is responsible for supplying the imported materials and parts as well as for selling the finished products, while the business enterprise does not have to make foreign exchange payment for the imports but only carries out processing or assembly according to the requirements of the foreign party and at a processing fee. Under processing with imported materials, the business enterprise makes foreign exchange payment for the imported materials and parts and exports the finished products after processing for sales abroad.

During the early days of opening up to the outside world, plagued by the lack of foreign exchange, capital, technology and overseas market connections, China opted for the development of processing trade. By leveraging on its advantages of abundant labour and land resources, China attracted Hong Kong, Taiwan and overseas companies to shift their production facilities to the mainland. As a result, labour-intensive industries were developed, employment was created, and foreign exchange earnings increased. As China's investment environment gradually matured, its processing trade also evolved from the state of domination by "outward processing and compensation trade"[2] enterprises in the early days to domination by foreign-invested enterprises (FIEs) in the 1990s. **As processing trade successfully attracted substantial foreign investment, by 2006, FIEs accounted for 85% of China's total processing trade imports and exports,** with processing with imported materials being the main form of processing trade accounting for 81% and 77% of China's total processing trade exports and imports respectively.

[1] This chapter is compiled jointly by the Economic Analysis Division of the HKSAR Economic Analysis and Business Facilitation Unit and HKTDC

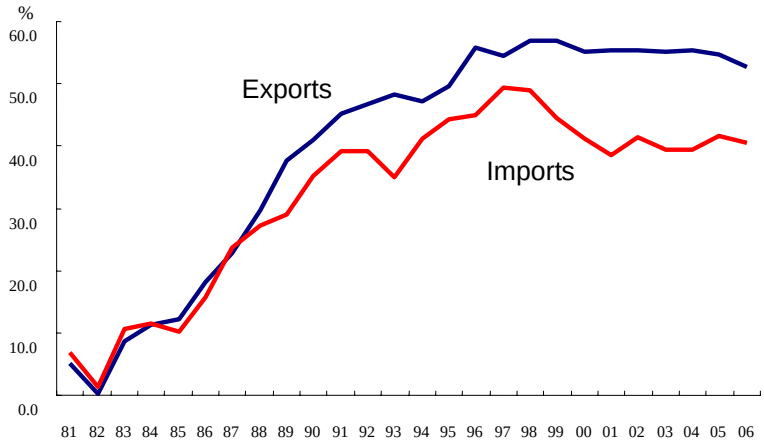
[2] "Outward processing and compensation trade" refer to processing with supplied materials, processing with supplied patterns and samples, assembly with supplied components, and compensation trade

Chart 1-1: Processing Trade by FIEs



Processing trade has expanded by leaps and bounds over the years. The total value of imports and exports posted a staggering 315 times increase from US$2.64 billion in 1981 to US$831.86 billion in 2006, or an average annual growth of 26%. The share of processing trade in China's total foreign trade value went up from 6% to 47.2% during the period.

Chart 1-2: Share of Processing Trade in China's Total Imports and Exports (%)



Source: *China Statistical Yearbook 2006*, p. 735; Ministry of Commerce statistics

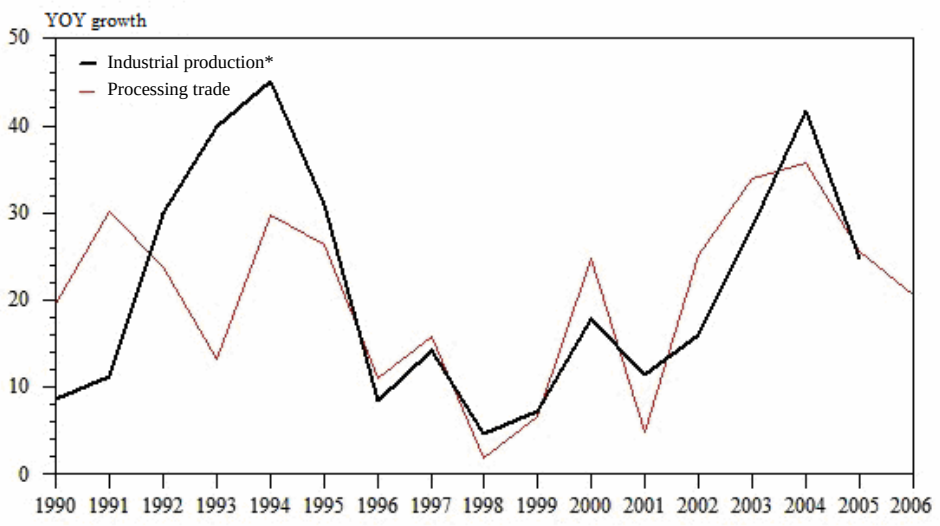
Despite the fact that the mainland government introduced various measures in the mid-1990s to strengthen the management of processing trade and clamp down on illegal activities such as smuggling and tax evasion under the guise of processing trade, processing trade continued to make up about half of China's total export value after the mid-1990s. Between 1996 and 2006, processing trade exports still registered an average

annual growth of 20%, underlining the growth momentum of this form of trade. It does not only give full play to China's comparative advantages in international division of labour but also **plays an active role in China's foreign trade growth**.

1.2 Contribution of Processing Trade to the Mainland Economy

Many studies have found that **processing trade** has played an active role in promoting the economic development of the Chinese mainland, including **propelling the national economy to successfully move towards industrialisation**. For instance, **Long Guoqiang** of the **State Council Development Research Center** reckons processing trade is the key driver of China's trade growth. Processing trade has brought new products and new technologies, promoted industrial upgrade, and helped boost China's technological development capability. **It has also turned the country into a manufacturing platform that meets the requirements of the international market, and lays a solid foundation for furthering China's industrial structure upgrade.**[3] Moreover, a number of studies using quantitative analysis have established the positive correlation between processing trade and economic growth. For instance, the study conducted by **Wang Yong and Zhao Bo** of **South Western University of Finance and Economics** concluded that **for every 1% growth in processing trade there will be a corresponding 0.29% increase in China's GDP.**[4]

Chart 1-3: Growth Rates of Processing Trade and Industrial Production



Note: (*) Figures as from 1999 are growth rates of large-scale enterprises

[3] Long Guoqiang, *An Evaluation on Processing Trade, References for Economic Studies,* 2003 (11)

[4] Wang Yong and Zhao Bo, *Processing Trade and China's Economic Growth, Practice in Foreign Economic Relations and Trade,* May 2006

China's pace of industrialisation is closely related to the development of processing trade, and the rapid growth of processing trade has played a vital role in **creating employment, improving international balance of payments, and promoting industrial structure upgrade and technological advancement. The number of processing trade enterprises has skyrocketed from a handful at the beginning of opening-up to 92,000 at present.[5] Over the years, processing trade has generated more than 30 million direct employment opportunities.[6]** If processing trade-related supporting industries such as transport and logistics services are also taken into account, the magnitude of economic activities and employment attributable to processing trade would be much higher.

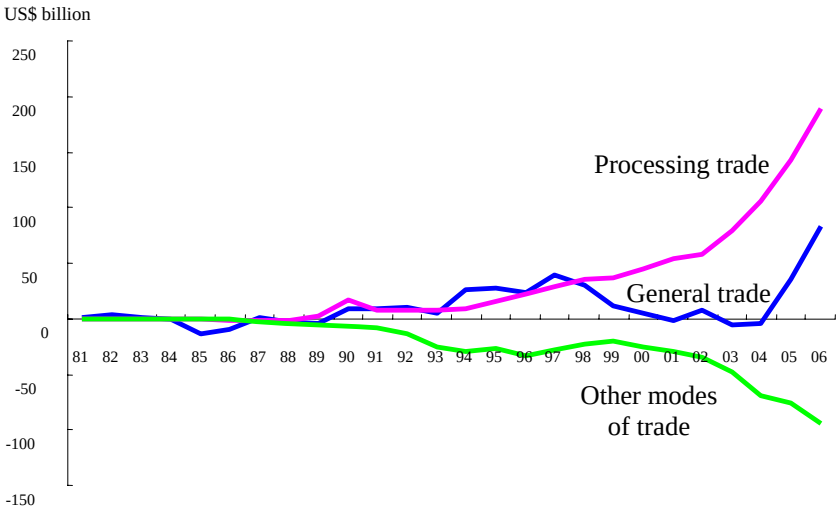
Processing trade does not only create employment opportunities which generate monetary income for the workers, but it also serves as the engine driving the economic development of the coastal regions first and then the inland regions. Take Dongguan as an example. Reportedly, migrant workers (including blue-collar workers and technical personnel from other provinces) in the city had remitted over RMB 30 billion to their hometowns through the post office and other channels between 1996 and 2005.[7] Such funds have provided vital support for the development of the rural economy. Processing trade has also upgraded the quality of the mainland labour force. After working at processing trade enterprises for several years, many workers would return to their hometowns to take up key positions in township enterprises or set up their own business and make a fortune.

5 Wang Lianhai and Wang Xuekun, *A Closer Look at Processing Trade*, Ministry of Commerce, November 2006

6 Zhang Yansheng, *Future Directors for Transformation and Upgrade of Processing Trade in China*, August 2006

7 *Research Report on Processing Trade in Guangdong, International Business*, August 2006

Chart 1-4：Trade Balance of the Chinese Mainland, by Trading Mode



Source: China Statistical Yearbook 2006, p. 735; Ministry of Commerce statistics

Since the 1990s, processing trade has consistently posted surpluses, making a significant contribution to the balance of China's international payments. In 2006, China's foreign trade surplus was US$75.5 billion more than that of 2005, of which US$46.4 billion was attributable to processing trade. Moreover, the foreign exchange generation coefficient[8] of processing trade rose from 1.36 in 1990 to 1.59 in 2006, a reflection of the continued expansion of the foreign exchange generation capability of processing trade.

It is noteworthy that **the rapid surge in China's processing trade surplus and foreign exchange generation capability in recent years is not only attributable to the growth in export volume but also to the fact that the value and value-added along the processing trade industry chain are increasing**. In fact, apart from the continued expansion in scale, the product mix of processing trade has also been upgraded and the industry chain extended. (For detailed analysis, see Chapter 2 on Structure and Value-added of Processing Trade.)

[8] Foreign exchange generation coefficient of processing trade = export value of processing trade/import value of processing trade. The coefficient is a quantitative index used to measure the foreign exchange generation capability of processing trade.

1.3 Processing Trade Drives Guangdong's Outward-Oriented Economic Development

Lying adjacent to Hong Kong, Guangdong was the first to open up to processing trade on the Chinese mainland. This is one of the reasons why the correlation between industrialisation and foreign trade development is closer in Guangdong than the rest of the mainland. In 2005, the share of exports in Guangdong's GDP stood at 87.3%, which was considerably higher than the 65.6% in 2001. And in Guangdong's exports, processing trade accounts for 73.5%, although this figure already represents a gradual decline from 80.2% in 2001. In 2005, Guangdong's processing trade exports still accounted for 42% of the national total, underlining the significance of this mode of trade to Guangdong. Processing trade has become a characteristic and advantage of Guangdong's outward-oriented economy, and is also the province's major channel for attracting foreign investment and leading force in driving export. **Currently, over 70,000 enterprises are engaged in processing trade in Guangdong. An estimated 16 million people are working for processing trade enterprises in the province, of which 13 million are migrant workers from outside Guangdong**.

In 2005, **the foreign-related tax income derived from FIEs that are primarily engaged in processing trade in Guangdong amounted to over RMB 130 billion, accounting for one-third of the province's total tax revenue**. The development of processing trade has brought in large quantities of advanced technology, modern management know-how and professional talent. It has also helped propel the growth of supporting industries and development of own brands by private enterprises. In 2005, the output value of processing trade related supporting industries amounted to over RMB 300 billion. **The industrial value-added of FIEs that are primarily engaged in processing trade made up nearly two-thirds of the provincial total**.[9]

1.4 Contribution of Processing Trade to the Hong Kong Economy

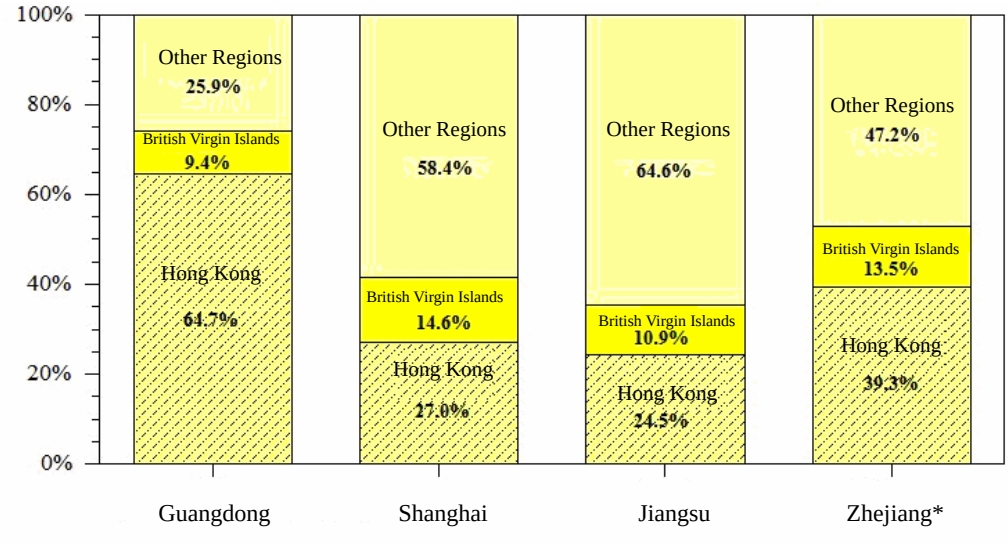
Hong Kong has developed strong manufacturing and foreign trade ties with the mainland, especially with the neighbouring Pearl River Delta (PRD) region in Guangdong province. Thanks to China's reform and opening-up, Hong Kong manufacturers and traders can leverage on the mainland as a production and sourcing base to boost their

[9] Speech by Zhao Yufang, Director of Guangdong Department of Foreign Trade and Economic Relations, at the seminar on the upgrade of processing trade held during the Central China Investment and Trade Expo (28 September 2006)

competitiveness, which has in turn propelled the Hong Kong economy to transform into a service-led economy with higher value-added.

According to statistics, since the mainland implemented its reform and opening-up policy, Hong Kong has always been the largest foreign investor in Guangdong, Shanghai, Jiangsu and Zhejiang. As at the end of 2005, Hong Kong's cumulative foreign direct investment in Guangdong amounted to US$105 billion, accounting for 65% of the province's foreign direct investment. Of the foreign investment in processing trade in Guangdong, about 70% comes from Hong Kong

Chart 1-5: Total Foreign Investments in Guangdong, Shanghai, Jiangsu and Zhejiang as of 2005

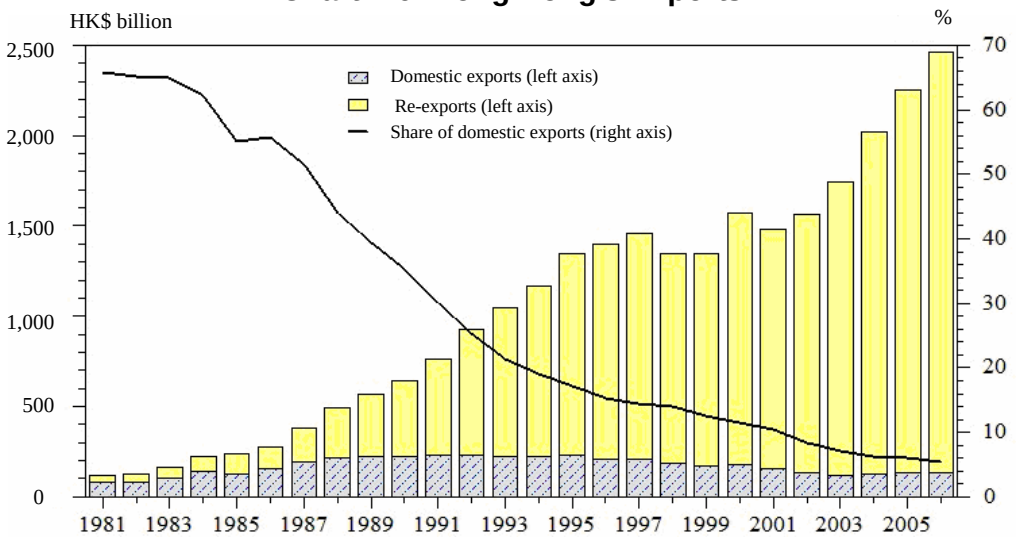


Note: (*) Investment amount of current year

Processing trade brings opportunities for Hong Kong's economic transformation

As the production chain continues to move north, Hong Kong-invested enterprises take advantage of the coastal special economic zones and neighbouring PRD cities to carry out production in the form of processing trade and re-export the manufactured goods to overseas markets via Hong Kong. Against this backdrop, **Hong Kong has developed into an important distribution centre for trade in goods**. The weight of Hong Kong's export trade has also shifted gradually from domestic exports to re-exports. **In 1988, the share of re-exports in Hong Kong's total exports surpassed that of domestic exports for the first time.**

Chart 1-6: Hong Kong's Exports



Despite the northward shift of Hong Kong's manufacturing industry to the PRD region in Guangdong, **Hong Kong's total foreign trade expanded by 23 times in the past 26 years**. Of this, domestic exports increased from HK$68.2 billion in 1980 to HK$134.5 billion in 2006. During the same period, re-exports surged from HK$30.1 billion to HK$2,326.5 billion, representing an accumulative growth of 76 times. Meanwhile, the imports, exports and re-exports between Hong Kong and the mainland also jumped substantially from HK$28.2 billion to HK$2,349.2 billion, with its share in Hong Kong total foreign trade rising from 13.4% to 46.4%. The value of goods related to processing trade carried out in the mainland spiralled from HK$237 billion in 1990 to HK$1,179.3 billion in 2006, at an average annual growth rate of 10.5%.

Table 1-1: Processing Trade Related Hong Kong Imports

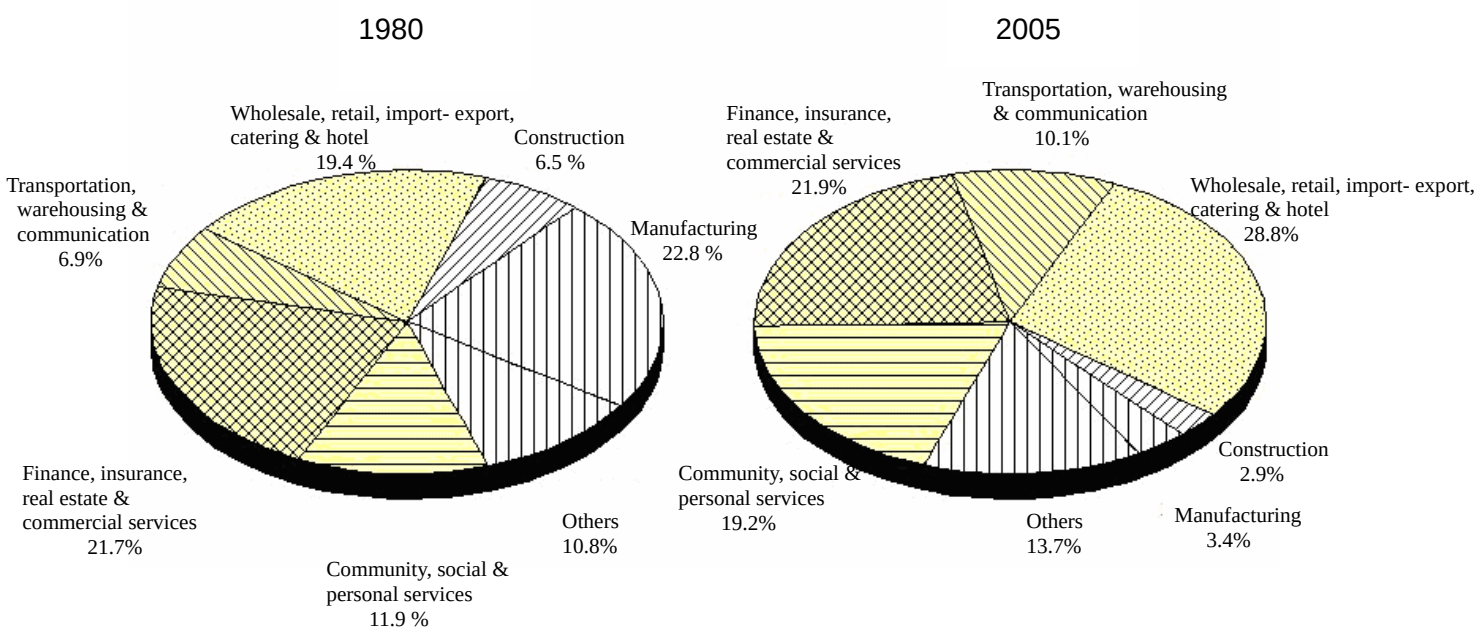
	Of which, outward processing trade related (US$ billion)		Share of outward processing trade (%)	
	1995	2006	1995	2006
Goods imported from the mainland	51.65	99.04	74.4	64.5
Goods of mainland origin re-exported via Hong Kong to overseas markets	63.66	104.89	82.2	80.7

Source: Hong Kong External Trade, March 1997, Census and Statistics Department, HKSAR

Statistics show that development of the processing trade on the mainland has brought about changes in Hong Kong's trade mode. **Following the northward shift of Hong Kong's manufacturing activities, its production resources have been freed up from the manufacturing industry for the benefit of the services industry, driving the**

local economy to move towards high value-added services. At the same time, the vast production base on the mainland has provided Hong Kong manufacturers with greater room for development, business expansion and productivity upgrade. **Currently, Hong Kong-funded processing trade enterprises operating on the mainland employ more than 10 million workers, equivalent to 11 times the number of workers in Hong Kong's manufacturing industry in 1980.** In the last 20 years, Hong Kong's total trade increased instead of declined. Its demand for trade services as well as other services such as commerce, production management, market development, banking and insurance has also continued to grow, promoting the rapid expansion and in-depth development of Hong Kong's service sector. Today, services have already become Hong Kong's leading industry, contributing to 91% of the SAR's total production output, an increase of 22 percentage points from 68% in 1980.

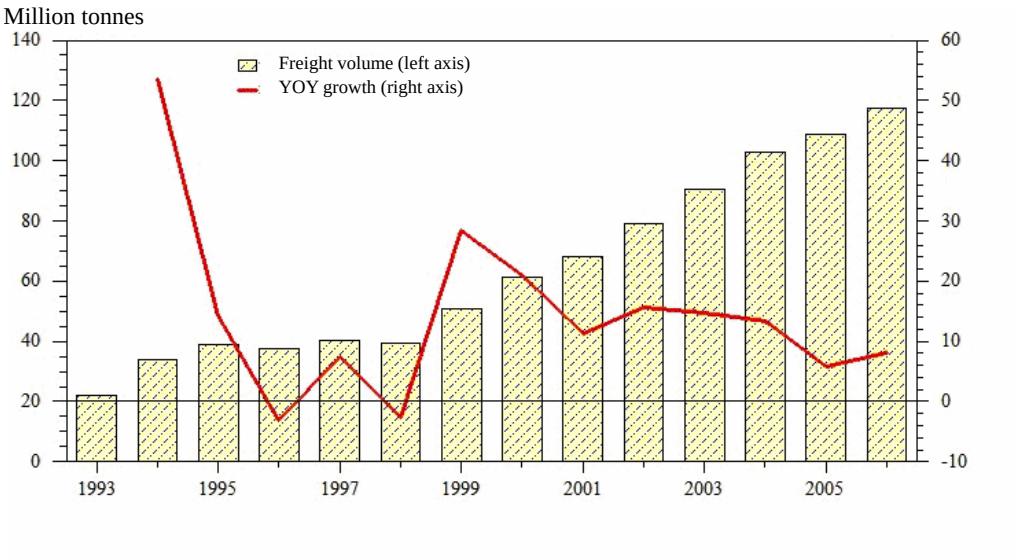
Chart 1-7: Hong Kong's Economic Structure Continues to Shift to Services



Processing trade promotes Hong Kong's transshipment and offshore trade

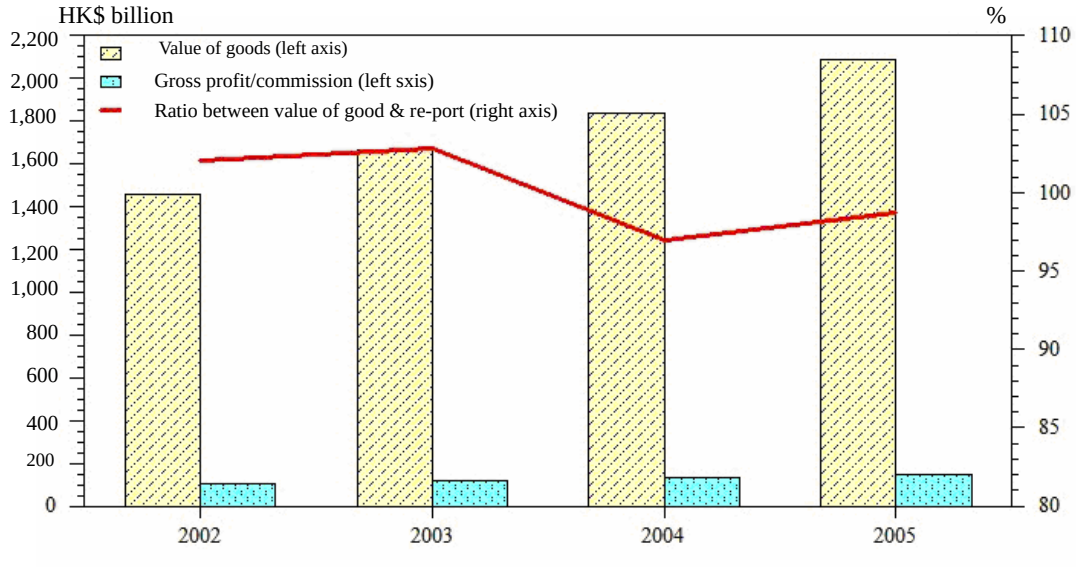
Processing trade has also contributed to Hong Kong's development into a leading trade services centre in the region, with cargo transshipment and offshore trade growing in leaps and bounds. In the past few years, the freight volume of goods transshipped via Hong Kong surged rapidly. In 2006, the transshipment freight volume handled via the port of Hong Kong reached 117.6 million tonnes, more than four times that of the 22.2 million tonnes in 1993.

Chart 1-8: Transshipment Freight Volume of Hong Kong Port



Leveraging on its rich experience in information, transportation, finance, marketing and business management and its excellent international network, Hong Kong has become an **important regional offshore trade centre** providing quality offshore trade services to the region. According to Hong Kong's trade in services statistics in 2005, **the gross profit and commissions generated by services exports related to offshore trade amounted to HK$149 billion, while the value of cargoes involved was even higher at HK$2,087.2 billion, representing 99% of re-exports in goods or 93% of total exports in goods.**

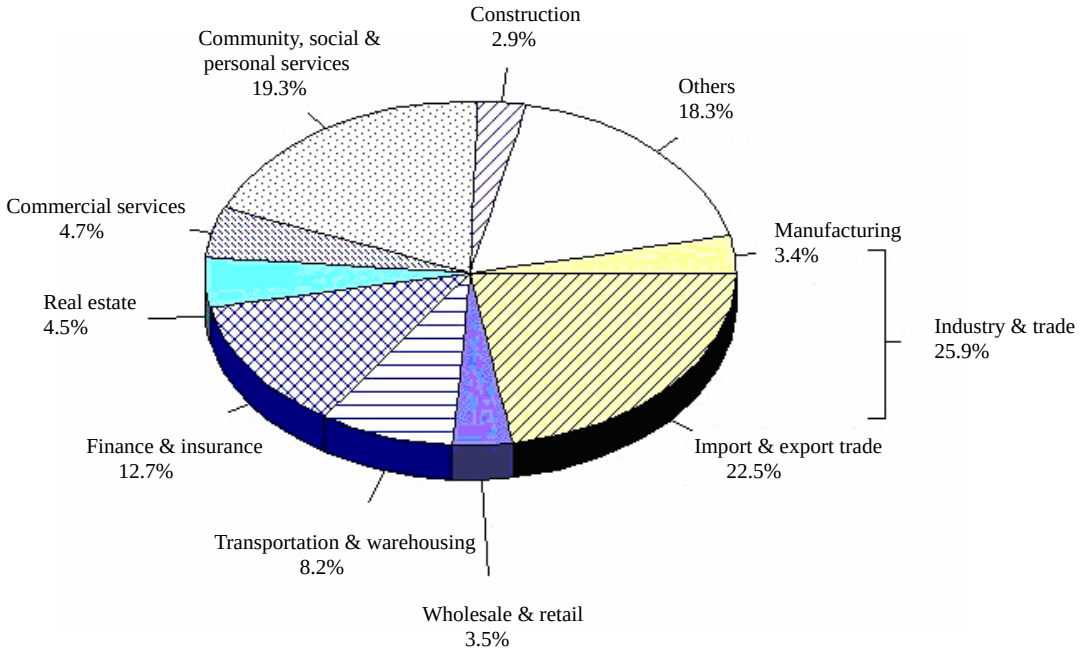
Chart 1-9: Services Exports Related to Offshore Trade



Contribution of processing trade to Hong Kong's total production output

The manufacturing industry and import-export trade are directly related to processing trade. In 2005, manufacturing and import-export trade accounted for about 25% of the value-added of Hong Kong's GDP that year, taking up the largest share. In the past years, as Hong Kong enterprises chose to relocate production processes to the mainland where costs are relatively lower, production activities in the SAR have subsided. However, **manufacturers are still active in Hong Kong, providing high value-added services and laying a solid foundation for Hong Kong as a hub in the global production chain.** Their offices in Hong Kong operate in the form of trading companies or operating headquarters using the territory as an operation base responsible for planning and managing the whole production process. Such arrangement does not only allow Hong Kong companies to fully capitalise on its geographical advantages in achieving the benefit of division of labour, but also brings about a huge demand for intermediary services.

Chart 1-10: Hong Kong's GDP in 2005



The development of the heavy and high-tech industries in the Greater PRD region requires a range of supporting services such as finance, legal, accounting, product sales and marketing. As enterprises have high requirements for the protection of their own designs and technological knowledge, they recognise the advantages of Hong Kong

and would opt for establishing their offices in Hong Kong to serve Guangdong province and even the whole country. These supporting services contribute significantly to Hong Kong's economy. According to a study report by the Federation of Hong Kong Industries (FHKI) in 2007[10] , among the Hong Kong-invested enterprises in the PRD, 58.2% use the import-export trade services provided by Hong Kong, 31.5% use logistics services, 28.4% use customer management services, 22.5% use retail and wholesale services, and 15.3% use finance and insurance services.

According to some rough estimates and related multiplier coefficient information, the **direct and indirect contributions by the manufacturing industry and import-export trade (including offshore trade services) to Hong Kong's economy amounts to 37% of its GDP, or HK$504 billion. In 2006, outward processing trade accounted for 47% of Hong Kong's total foreign trade.**

Contribution of processing trade to Hong Kong's industrial profits

In 2005, the profits generated by manufacturing and import-export trade reached HK$205.1 billion, ranking first among all industries. The average annual growth rate of the profits generated by manufacturing and import-export trade has maintained at over 20% in the last 20 years.

Table 1- 2: Profits Generated by Hong Kong Enterprises in 2005, by Economic Activity

	Profits		
	HK$ billion	Share (%)	Average Annual Growth (1980-2005) (%)
Manufacturing & import-export trade	205.1	31.5	10.4
Import-export trade	186.5	28.6	13.0
Manufacturing	18.6	2.9	3.2
Finance	67.5	10.4	10.5
Transportation service	59.4	9.1	12.2
Real estate	42.7	6.5	3.9
Community, social & personal services	29.6	4.5	8.8
Commercial services	14.4	2.2	10.1
Retail	15.4	2.4	6.7
Wholesale	4.8	0.7	6.5
Insurance	2.4	0.4	6.2
Warehousing	0.7	0.1	5.4
Others	209.9	32.2	10.2
All services	651.8	100.0	9.3

[10] *Made in PRD Study: Challenges and Opportunities for HK Industry*, Federation of Hong Kong Industries, 2007

Processing trade creates substantial job opportunities for Hong Kong

In 2006, the manufacturing and import-export trade sector provided 739,700 jobs in Hong Kong, making it the second largest employer in the territory. This employment figure reflects the job opportunities created directly by cross-boundary production and outsourcing activities. Furthermore, the demand by these companies for related supporting services has also created more job opportunities. According to rough estimates based on existing statistics, **the number of direct and indirect jobs created reached 1.15 million in 2005**.

Although Hong Kong's industrial production activities are dwindling as a result of factory relocation and high production costs, the expansion of Hong Kong companies' trading business (including processing trade) can more than offset the losses sustained in this aspect. As an operation and control centre for such activities, Hong Kong has maintained the high value-added segments, such as sales and marketing, information technology and financial management, in the production chain. According to the survey conducted by the Hong Kong Trade Development Council (TDC) in 2006, owing to the fact that there is complementarity between Hong Kong and the mainland in the area of trading business (e.g. processing trade), it is estimated that 90,000 new jobs can be created by the end of 2008.[11]

[11] *Development and Contribution of Hong Kong's Manufacturing and Trading Sector*, HKTDC, November 2006

2. Structure and Value-added of Processing Trade[12]

2.1 Structural Upgrade of Exports

China's overall exports have undergone significant structural changes in the past decade. Its major product categories have noticeably shifted from light consumer goods such as toys and garments to mechanical and electrical products and high-tech products. For instance, the share of mechanical and electrical products (HS 84 and 85) in China's exports rose from 20.9% in 1997 to 42.7% in 2006, while that of garments (HS 61 and 62) dropped from 15.7% to 9.1%.

Table 2-1: Share of Major Product Categories in China's Exports (%)

HS Code	Product Category	1997	2006	
85	Electrical machinery and equipment and parts thereof	13.4	23.5	↑
84	Machinery and mechanical appliances	7.5	19.3	↑
61	Articles of apparel, knitted or crocheted	6.4	4.6	↓
62	Articles of apparel, not knitted or crocheted	9.3	4.5	↓
90	Optical, photographic, precision instruments and apparatus	2.2	3.4	↑
64	Footwear	4.7	2.3	↓
95	Toys, games and sports requisites	4.1	2.3	↓

Source: China Customs

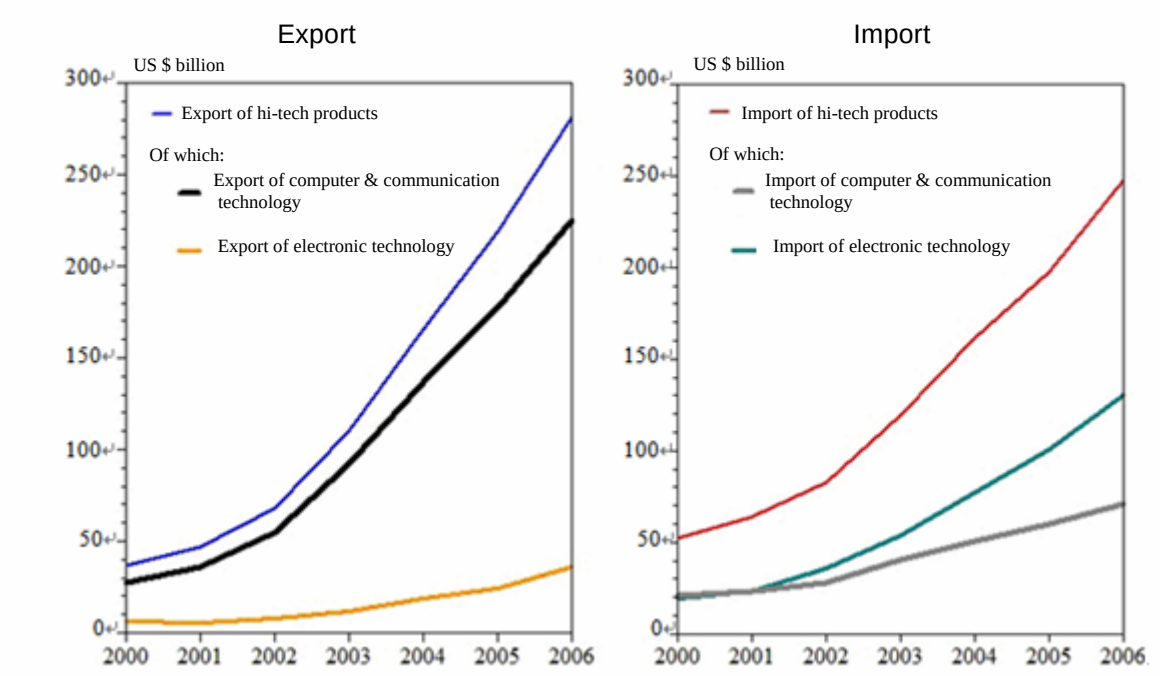
As the pace of transformation and upgrade of the processing trade in the mainland accelerates, foreign-invested enterprises are attracted to shift processing activities of higher technology level and higher value-added content to the mainland. Processing trade in the mainland started off with labour-intensive industries such as textiles, garments and light industry, and has gradually evolved into mechanical and electrical products and high-tech products. In 2005, total processing trade exports of traditional labour-intensive products such as garments, textiles, footwear and toys amounted to US$57.15 billion, still representing a 40% growth from 2001. However, their share in China's total processing trade exports dropped by 14 percentage points to 13.7%. Meanwhile, exports of mechanical and electrical products amounted to US$312.98 billion, accounting for 75.1% of China's total processing trade exports and representing an increase of 39.4 percentage points from 1993. Exports of high-tech products were

[12] This chapter is compiled jointly by the Economic Analysis Division of the HKSAR Economic Analysis and Business Facilitation Unit and HKTDC

worth US$194.77 billion, making up 46.8% of total processing trade exports and up 32.8 percentage points from 1997.[13]

During the 10th Five-year Plan period, exports of mechanical and electrical products attributable to processing trade amounted to US$928.2 billion, accounting for 70.7% of China's total processing trade exports and 74% of all mechanical and electrical products exports. The figure represents a 2.4 times increase over that of the 9th Five-year Plan period at an average annual growth of 29%, or 1.2 times higher than that of processing trade exports nationwide during the same period. Meanwhile, **exports of high-tech products were valued at US$543.8 billion during the 10th Five-year Plan period, accounting for 41.4% of China's total processing trade exports and 87% of all high-tech products exports. The figure represents a 4.5 times increase over that of the 9th Five-year Plan period** at an average annual growth of 41%, or 1.7 times higher than that of processing trade exports nationwide during the period. In 2006, exports of mechanical and electrical products and high-tech products attributable to processing trade were valued at US$391.32 billion and US$245.84 billion respectively. The figures represent 76.7% and 48.2% of China's total processing trade exports, and are 1.6 and 1.4 percentage points higher than those of the previous year respectively.[14]

Chart 2-1: Import and Export of Hi-tech Products



[13] Wang Lianhai and Wang Xuekun, *A Closer Look at Processing Trade*, Ministry of Commerce, November 2006

[14] *Development of Processing Trade in China*, Press Office, Ministry of Commerce, February 2007

China is now the world's largest producer and exporter of mechanical and electrical products such as mobile phones, home electrical appliances and lap top computers. In 2005, 99.9% of notebook computers, 99% of colour video projectors and micro-computers, 98% of plasma colour TVs and 97% of DVD players were exported under processing trade.[15] All in all, **the characteristics of processing trade on the mainland have undergone changes, with the level of technology and level of division of labour gradually moving upward and the industries involved shifting from low value-added and labour-intensive to technology-intensive.**

2.2 Extension of Processing Trade Industry Chain

Following the steady and healthy development of processing trade on the mainland, the technology level, quality of human resources and quality of raw materials have been upgraded, and related supporting industries have also flourished. Through deep processing transfer, upstream and downstream processing activities have developed into a more comprehensive industry chain and a cluster of supporting industries has also taken shape. Meanwhile, deep processing transfer has also grown rapidly in scale and volume. In 2005, deep processing transfer activities nationwide were worth US$139.2 billion, up 24.2%, accounting for 20% of all processing trade imports and exports with the number of transfers averaging at 2-3. This has in turn stimulated the development of the supporting industries on the mainland.[16] More than 2,000 tariff codes of products are involved in deep processing transfer, accounting for 50% of the total number of tariff codes involving processing trade products. The expansion of deep processing transfer and extension of the processing trade industry chain are driving the growth and upgrade of the supporting industries in China.

The value-added rate [17] of processing trade on the mainland has increased progressively from 15.3% in 1989 to 50% on average in recent years. This shows that processing trade in China has outgrown the development stage when only low processing fees were collected. As its industry chain of processing trade is gradually extending, China's position in the global industry chain is also moving upward.

[15] Ditto

[16] Ditto

[17] Processing trade value-added rate = (processing trade export value – processing trade import value) / processing trade import value x 100%

Table 2-2: Average Value-Added Rate of Processing Trade (%)

1986-1990	3.2
1991-1995	24.6
1996-2000	45.8
2001-2005	50.5
2006	58.8

Source: *China Statistical Yearbook 2006*, p. 735; Ministry of Commerce statistics

With the extension of the processing trade industry chain into the area of proprietary R&D, the number of R&D centres has increased steadily. As at the end of 2005, there were over 750 R&D centres established by foreign companies and some 40 regional headquarters set up by multinational companies on the mainland.[18]

As the leading base for processing trade, Guangdong province has seen the steady upgrade of its processing trade industrial structure in recent years. For instance, the share of mechanical and electrical products exports attributable to processing trade in the provincial total had increased from 49.7% in 1999 to 67.7% in 2004.

Table 2-3: Composition of Guangdong's Processing Trade Exports

	Value of mechanical and electrical products exports (US$ billion)	Share of provincial total (%)	Value of high-tech products exports (US$ billion)	Share of provincial total (%)
1999	38.87	49.7	12.03	15.5
2000	49.98	54.4	17.02	18.5
2001	55.38	58.0	22.29	23.4
2004	129.75	67.7	66.48	34.7

Source: Wang Jingbo, *Practical Analysis on the Development of Foreign Trade in Guangdong Province*, Zhongshan University Press, 2006

[18] *Development of Processing Trade in China*, Press Office, Ministry of Commerce, February 2007

3. Processing Trade Policy and Its Future Development Directions

3.1 Processing Trade Policy in Retrospect

A core feature of the processing trade policy is to reduce cost caused by customs duty and value-added tax (VAT) through implementation of “bonded supervision” of imported intermediate inputs and “export VAT rebate” for domestic intermediate inputs. In other words, the processing trade policy is intended to encourage export while ensuring the price competitiveness of mainland processing and assembly enterprises in their participation in international division of labour.

The policy on processing trade was first introduced in 1979. Subsequent to the State Council’s promulgation of the *Trial Measures for the Promotion of Exports by Importation* in March 1979, the *Measures for the Development of Outward Processing, Assembly, and Small and Medium-Scale Compensation Trade* were promulgated in September of the same year. Under these measures, processing with supplied materials became a form of foreign trade utilising foreign investment and promoting export. At the same time, processing trade began to develop on the mainland in full scale.

The policy framework for processing trade gradually took shape in the 1980s. In 1982, the General Administration of Customs (GAC) announced a set of detailed implementing rules for the supervision, taxation and tax exemption of imported and exported goods for outward processing, assembly, and small and medium-scale compensation trade. Under these rules, the registration handbook system was introduced to manage the business of processing with supplied materials, while bonded supervision was implemented on the import and export of materials, parts and equipment for and finished products of processing and assembly. In 1988, as the share of processing with imported materials in processing trade increased as a result of growing numbers of wholly foreign-owned and joint venture enterprises, GAC announced the *Measures for the Administration of Imports and Exports Concerning Processing with Imported Materials*. In 1989, the then Ministry of Foreign Trade and Economic Cooperation (now Ministry of Commerce) issued a circular on strengthening the administration of processing with imported materials for re-export, officially giving processing with imported materials the same preferential treatment as processing with supplied materials, such as exemption of customs duty, VAT concession, and management by registration handbook.

Since the 1990s, in response to the changes in international and domestic economic developments and the irregular practices found in processing trade, the mainland authorities have continued to make improvements in the supervision of processing trade and a more complete policy system has thus emerged. The system consists of four key elements: first, bonded factory management system; second, processing trade customs duty deposit system; third, processing trade enterprise deep processing transfer and cross customs area processing system; and fourth, bonded area and export processing zone system. As for the record filing, import-export customs declaration, processing, supervision, and verification and cancellation procedures in connection with processing trade goods, the stipulations contained in the *Measures for Customs Supervision of Processing Trade Goods* announced and implemented by GAC in 2004 serve as an operation manual for processing trade enterprises.

3.1.1 Bonded Factory Management System

Bonded processing trade factories (bonded factories) are enterprises duly approved by customs authorities to carry out bonded processing for producing export goods (that is, all the imported materials and parts are under bond). Customs may post their staff at these factories or send their staff to these factories anytime to carry out supervision, inspection as well as checking of the books.

In 1983, GAC issued the first policy on bonded factories, the *Provisions on the Administration of Bonded Factories Engaged in Processing with Imported Materials*. In 1988, GAC further announced the *Measures for the Administration of Processing Trade Bonded Factories*, clearly setting out the criteria for the establishment of bonded factories, such as large production scale, good credit standing, sound internal management, and proper customs declaration work.

With the growing popularisation of computers and changes in the working modes of supervisory departments, enterprises that are under online customs supervision, i.e. enterprises which implement fully-computerised management of their processing activities and are linked up with the customs' network, have been granted the same status as those factories posted with on-site customs officers. As such, they can enjoy the same customs facilitation policy as bonded factories and can use the electronic registration handbook to carry out the filing, alteration, and verification and cancellation of processing trade contracts.

As at the end of 2006, 3,693 enterprises across the country were subject to various forms of online customs supervision. Processing trade conducted by enterprises under

online supervision accounted for 53.2% of the total import and export value of all processing trade activities in China during the year. In Guangdong, the total imports and exports by processing trade enterprises under online customs supervision were valued at over US$170 billion in 2006, accounting for 69% of the province's total processing trade imports and exports.

3.1.2 Processing Trade Customs Duty Deposit System

In a bid to strengthen processing trade management and stem irregular activities in processing trade such as smuggling and tax evasion, the State Council introduced the customs duty deposit system in 1995. In the same year, GAC and the Bank of China jointly announced the *Interim Administrative Measures for the Trial Implementation of Customs Duty Deposit System by Banks Regarding Imported Materials and Parts in Processing Trade*. Under this system, which required the payment of customs duty deposit, the processing trade bonded system became a "tax first, rebate later" mechanism. However, in order to avoid delay in handling tax rebates, after the customs duty deposit system was introduced, only "nominal payment" was required, which meant the enterprises concerned did not actually pay any customs duty deposit equivalent to the amount of the payable tax into their accounts.

In 1999, in view of the prevailing developments, the State Council issued the *Opinions on Further Improving the Customs Duty Deposit System for Export Processing Trade* (commonly known as Circular No.35), whereby processing trade enterprises and commodities are managed by category.

Under the customs duty deposit system, commodities imported for processing trade are classified into prohibited, restricted and permitted, while processing trade enterprises are classified under four categories, namely A, B, C and D. Different categories of processing trade enterprises producing different kinds of products are subject to different treatments. For instance, categories A and B enterprises importing commodities under the permitted category for processing and category A enterprises importing commodities under the restricted category for processing may continue to practise the "nominal payment" system where no actual payment of customs duty deposit is required. But category B enterprises importing commodities under the restricted category for processing are required to make 50% payment of the deposit, while category C enterprises importing commodities under any category for processing are required to make "actual payment" of the deposit. "Actual payment" refers to the actual payment of deposit made by the processing enterprise at the time of importing materials and parts for processing, with the amount of the deposit equivalent to the import duty required. After the imported materials

and parts have been processed and re-exported, the deposit will be refunded by the designated bank (plus interest accrued) upon verification and cancellation of the processing contract.

3.1.3 Deep Processing Transfer and Cross Customs Area Processing System

The transfer of bonded goods for deep processing refers to the business activity whereby a processing trade enterprise transfers its processed or semi-processed bonded goods to another processing trade enterprise for deep processing and re-export (including transfer to another processing trade enterprise in a different customs area). Since the mid-1980s, supervisory customs authorities have permitted deep processing transfers among processing trade enterprises. Under the *Measures for the Administration of Imports and Exports Concerning Processing with Imported Materials* released by GAC in 1988, goods that are transferred out may continue to enjoy the "tax later" treatment. Moreover, under a circular issued by the State Council General Office on behalf of several ministries including the State Economic and Trade Commission regarding the opinions on further improving the processing trade customs duty deposit system, deep processing transfer is deemed import-export trade by the relevant government authorities and is therefore subject to bonded supervision.

Cross customs area processing refers to the business activity where a processing trade business enterprise commissions the processing of imported materials and parts to another processing trade production enterprise in a different customs area. But this does not include the outsourcing of certain processing procedures in the production of processed goods for export. According to the *Measures for the Administration of Cross Customs Area Processing* issued by GAC in 1999, for cross customs area processing, the business enterprise and the processing enterprise must sign a "commissioned processing trade contract" and submit it to the supervisory customs office of the business enterprise for approval. The business enterprise and processing enterprise involved in cross customs area processing are also managed by category by GAC. When the two parties belong to different categories, the supervision measures for the lower category will apply.

3.1.4 Bonded Area and Export Processing Zone Management System

Bonded areas are designated areas under customs supervision where enterprises are subject to the special policy of "licence waiver, tax exemptions and bonded treatment". Under the *Measures for Customs Supervision of Bonded Areas* approved by the State Council in 1997, customs authorities do not apply the processing trade customs duty

deposit system to enterprises engaged in processing with imported materials and processing with supplied materials in the bonded areas. Goods entering non-bonded areas from bonded areas are subject to the same clearance procedures as imports. Goods entering bonded areas from non-bonded areas are subject to the same clearance procedures as exports, with export VAT rebate handled according to the relevant procedures prescribed by the state.

In an effort to overcome the difficulties in managing processing trade which was extensively distributed all over the country, the relevant government departments decided to construct export processing zones in 2000 with the hope of grouping processing trade enterprises in the same places. Under the *Interim Measures on Customs Supervision of Export Processing Zones* approved by the State Council in 2000, export processing zones are defined as special customs-supervised zones where only activities related to processing trade can be carried out, such as warehousing, transport, and processing of imports for re-export. Processing trade enterprises operating in the zones are not subject to the customs duty deposit system and the processing trade registration handbook system. Processed goods produced in the zones are exempt from VAT. Goods sold by enterprises outside the zones to enterprises within the zones are treated as exports and are eligible for export VAT rebate. To date, customs authorities have approved the establishment of 59 export processing zones, of which 37 have been sealed off and gone into operation. However, owing to the limited number and land area of these zones, even though the unit prices of the export goods are high, the total import-export value of the enterprises in the export processing zones only accounted for less than 10% of China's total processing trade imports and exports in 2006.

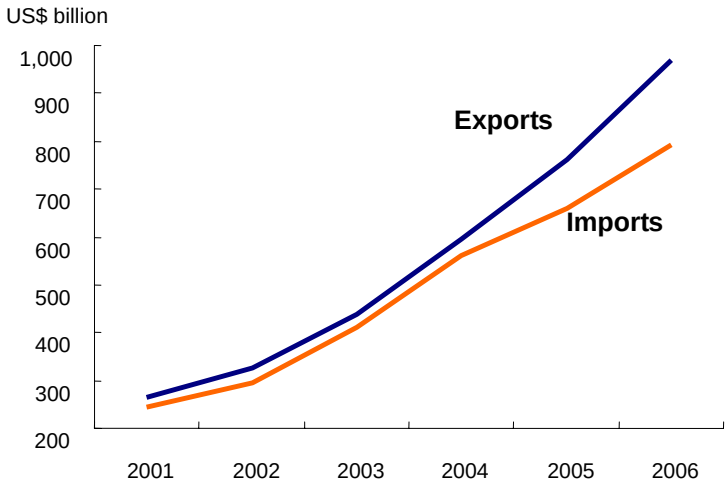
3.2 External and Internal Factors Driving Changes in Processing Trade Policy

Thanks to the rapid development of processing trade, China has grown to become the world's third largest trading economy since 2004. China's status as a large foreign trading nation is beyond dispute. Despite the fact that the export product mix and value-added rate of China's processing trade continue to expand, the mainland authorities still find it necessary to further fine-tune the processing trade policy in the face of the increasingly serious conflicts both externally and internally. Just as Premier Wen Jiabao pointed out in his 2007 government work report, the country must further open up to the outside world, give support to the export of own brand products and high value-added goods, as well as control the export of high energy consumption and high pollution products in order to facilitate the transformation and upgrade of processing trade.

3.2.1 Conflicts and Disputes Arising from Trade Imbalance

China's exports expanded at an average annual rate of 30% during 2002-2006. Although imports also registered an average annual growth of 27% during the same period, China's trade surplus surged from US$22.5 billion in 2001 to US$177.4 billion in 2006.

Chart 3-1: China's Import-Export Trade



Source: Chinese Customs

The surge in trade surplus has not only exerted more pressure on the Renminbi to appreciate in value, but has also triggered increasing trade friction. According to World Trade Organisation (WTO) statistics, China was targeted in 468 anti-dumping investigations during 1995-2005, ranking top among all nations under investigation. Moreover, some countries and regions have resorted to provisions in China's WTO accession protocol, such as "special safeguard measures" and "textiles restriction measures", as well as various kinds of technical barriers to suppress China's export growth. The fact that China is faced with intense trade frictions is due in part to rising protectionism and in part to the low-price competition strategy adopted by mainland enterprises. Hence, China's 11th Five-year Programme calls for a change in the way foreign trade growth should be achieved. China will place emphasis on improving the quality of its exports while maintaining growth in quantity. It will also strive to increase the share of deep processed and high value-added products in exports, thereby boosting its status from a large trading nation to a strong trading nation.

Table 3-1: No. of Newly Initiated Anti-dumping Investigation Cases

	2002	2003	2004	2005	Jan-Jun 2006
World	312	232	213	201	87
China	51	52	49	56	32

Source: World Trade Organisation

3.2.2 Excessive Energy and Resource Consumption

According to the United Nations' *Trade and Development Report 2005*, **the rate of petroleum consumption in China's production activities is more than double that of OECD countries on average, while China's import of resource- and energy-type products has also risen sharply. The degree of import dependency of** various strategic resources such as **crude oil, iron ore and oxidized aluminium exceeds 40%, while that of nickel and natural rubber is even over 55%.** In view of the rapid rise in the import dependency of resource- and energy-type products, the Chinese authorities are worried that once trade frictions, which are currently centred around those mainland products posting fast export growth, shift to these resource- and energy-type products which are imported in mass volume, the extent of damage done to the country will be even greater.

Moreover, **the shares and growth rates of high resource consumption and high energy consumption products are relatively high among China's exports. According to studies, the amount of energy consumption per US$1 worth of China's exports is 2.4 times that of the international average. In 2006, China only accounted for 5.5% of the world's total GNP, yet its share of the global consumption of energy stood at 15%,** with its consumption rates of steel and concrete at 30% and 54% respectively. China's massive production of high resource consumption and high energy consumption products has drained its domestic resources supply. As a result, its sufficiency ratio is falling steadily and its reliance on imported resources is growing. In view of this, the mainland authorities need to keep tabs on the haphazard development of processing trade which is characterised by high energy consumption, high resource consumption and low value-added. Alternatively, efforts have to be made to guide and accelerate the upgrade of industrial structure, which involves the improvement of production technology and the lowering of energy consumption and resource consumption levels.

3.2.3 Serious Environmental Pollution

The haphazard pattern of economic growth in the past has damaged the ecological environment and created environmental pollution in China resulting in a great loss to the national economy. **The deputy director of the State Environmental Protection Administration (SEPA) has estimated this loss at around 11% of China's GDP. During 1996-2004, great efforts were made by China to protect its environment and more than RMB 952 billion were spent on containing environmental pollution.** In recent years, the pace of environmental pollution and ecological damage has slowed, but China's overall environment is still at stake. For example, environmental pollution and ecological deterioration are still quite serious in some regions where the levels of water, air and soil pollution are high.

The 11th Five-year Programme calls for greater efforts to be devoted to environmental protection. It attaches great importance to prevention and comprehensive containment to control pollution at source. Efforts will be stepped up to prevent and control water, atmospheric and solid waste pollution, and to improve the quality of the environment of major rivers, regions and cities as soon as practicable.

3.2.4 Imbalance of Regional Development

In China, economic development has concentrated in the coastal regions. Although the "Go West" and "Rise of Central Region" policies have expedited the development of the western and central regions, **wide gaps remain among different regions in terms of economic development.**

Table 3-2: Comparison on Regional Development (2005)

	National Total	Eastern Region	Central Region	Western Region
Per capita GDP (RMB)	14,040	10,871-51,474	8,675-12,495	5,052-16,331
GDP	100%	62%	20%	18%
Foreign direct investment	100%	77%	15%	8%
Fixed asset investment	100%	62%	18%	20%
Land area	100%	17%	11%	72%
Population	100%	45%	27%	28%

Source: *China Statistical Yearbook 2006*

The 11th Five-year Programme calls for coordinated development among regions. It also calls for due consideration to be given to the capacity of resources and the environment, the existing development density and development potential of various regions in planning the future population distribution, economic development priorities, land resources utilisation and urbanisation in China. National land resources will be classified into four categories based on their development potential, namely optimised development, key development, restricted development and prohibited development. Development policy will be formulated according to this categorisation.

Optimised development regions refer to regions with a relatively high land development density but declining capacity in environment and resources. Hence, these regions have to move away from the economic growth model of heavy land consumption, heavy resources consumption and heavy pollutants emission. They should give top priority to improving quality and efficiency so that they can raise their level in international division of labour and global competition.

Key development regions are regions with a relatively high capacity in environment and resources, and better conditions for economic development and population clustering. Hence, efforts have to be made to strengthen infrastructure facilities, improve investment and business environment, promote industry cluster development, and expedite industrialisation and urbanisation in these regions in a move to **take up the industries relocated from the optimised development regions**.

The PRD has been designated as an optimised development region. It is estimated that 98% of the processing activities in Guangdong are located in the PRD although the region only accounts for 23% of the province's land area. The land resources and environment of the PRD are coming under increasing constraint. For instance, a Guangdong official pointed out that one of the reasons why contracted foreign investment in Dongguan had not been utilised fully in 2005 was the lack of suitable land. Apart from the shortage of land supply, labour shortage and rising costs are two other major factors restraining the development of the processing trade in the PRD.

3.3 Change in Processing Trade Policy: Directions and Measures

China's huge trade surplus is largely attributable to processing trade. **Boasting the world's largest foreign exchange reserves** (US$1,066 billion as at the end of 2006), **China's economic development priority today is no longer export expansion or foreign exchange generation.** On the contrary, the pressure on the Renminbi to

appreciate in value and trade friction with other countries created by the trade surplus is forcing the **Chinese government to set "trade surplus suppression" and "foreign investment diversion" as its targets**.

In the early days of opening-up, the objective of China's processing trade policy was to attract foreign investment to boost exports. As such, provided that the export volume was high, tax concessions would be offered by the mainland government to the foreign investment projects regardless of their technology level or their impact on the environment and resources. In addition, no market access threshold was set. Today, as China has reached the stage where the development of its foreign trade must undergo transformation and upgrade and its export product mix must be optimised, officials of the National Development and Reform Commission (NDRC) pointed out that **processing trade as a preferential policy to promote exports has to be adjusted and fine-tuned in keeping with the times**. Officials from the Ministry of Commerce (MOFCOM) also remarked that since processing trade is a preferential policy, it is necessary for the mainland authorities to select the beneficiaries. In 2006, three official documents – Circulars No.139 [2006] and No.145 [2006] of the Ministry of Finance (MOF) and Circular No.82 [2006] of MOFCOM – were released, spelling out changes in this direction.

3.3.1 Adjustment of Export VAT Rebate

On 14 September 2006, five ministries[19] jointly issued a circular on adjustments made to the export VAT rebate rates for certain products and the expansion of the prohibited category under processing trade (Circular No.139 [2006]). Then on 29 September, a supplementary circular (No.145 [2006]) on adjustments made to the export VAT rebate rates for certain products was issued. Under Circular No.139 [2006], the export VAT rebates for certain products with **high energy consumption, high pollution and resource consumption, as well as low value-added and can easily trigger international trade friction, were removed or lowered. At the same time, the export VAT rebates for high-tech and high value-added products were raised.**

According to MOF officials, the adjustments were intended to reduce the export VAT rebate concession offered to those industries and products that are restricted or no longer supported by the state. By so doing, the social cost which should have been borne by the enterprises concerned will be "internalised". At the same time, the export VAT rebates for those industries and products encouraged by the state were raised in

[19] The Ministry of Finance, National Development and Reform Commission, Ministry of Commerce, General Administration of Customs, and State Administration of Taxation.

order to boost their export competitiveness. The principles underlying these adjustments are:

- Conserve non-renewable resources of the country
- Protect the ecological environment of the country
- Improve the trade environment
- Encourage the export of high-tech, high value-added products
- Encourage the export of proprietary innovation and own brand products

The removal or reduction of export VAT rebates has a direct impact on the cost of export enterprises. For both enterprises processing with imported materials and enterprises processing with supplied materials, the import duty and VAT of their imported materials and parts are subject to the customs duty deposit system. However, for enterprises processing with imported materials, the locally-produced materials and parts used by them as well as the value-added portion carried out within the mainland are subject to VAT "exemption, deduction and rebate". In other words, tax payable = output VAT on goods for domestic sale - (input VAT - amount of tax on export goods not eligible for exemption, deduction or rebate). Also, amount of tax on export goods not eligible for exemption, deduction or rebate = FOB price of exports x (VAT rate - export rebate rate). For instance, in garment processing, as the export VAT rebate rate of textiles has been reduced from 13% to 11%, the amount of export tax not eligible for exemption, deduction or rebate would go up from 4% (i.e. 17% - 13%) to 6% (i.e. 17% - 11%). This difference would translate into a higher amount of tax payable by the enterprises.

3.3.2 Expansion of Prohibited Category

Under MOF Circulars No.139 [2006] and No.145 [2006], all the products for which export VAT rebates were abolished this time and the products for which export VAT rebates have been removed earlier now come under the prohibited category. According to MOF and NDRC officials, this is to avoid exports originally conducted in the form of general trade to shift to exports under processing trade. As the state no longer supports the production of products under the prohibited category in processing trade, such exports are now not granted VAT rebate and such imports now cannot enjoy bonded treatment.

For processing enterprises having to import materials and parts which have been put under the prohibited category with export VAT rebates removed, the impact is much greater and the increase in their costs is much higher. Before the policy change, such processing enterprises could import the necessary raw materials under bond in the form of processing trade contract. But **with the implementation of the new policy, now raw**

materials put under the prohibited category in processing trade can only be imported in the form of general trade and as such they are subject to customs duty and VAT. Also, when the finished products are exported, they are not entitled to any tax rebate. Hence, their production costs go up significantly. Compared with other countries, although most of them implement the policy of bonded imports only in export processing zones, the policy of export tax rebate is adopted in some countries such as France, the UK and Korea, where exported goods can enjoy zero export tariff. Hence, for the production of products listed under the prohibited category in processing trade in China, the tax costs in the mainland are higher than those in these foreign countries.

As for foreign investors engaged in processing with supplied materials, since they do not have legal person status in the mainland, they are not allowed to handle import and export in the form of general trade. Even if they are willing to pay import duties under general trade terms for the importation of the necessary raw materials, customs would not grant approval. In other words, under the current policy, for enterprises engaged in processing with supplied materials whose production involves products under the prohibited category, they have practically lost their qualification to continue operation.

The release of Circulars No.139 and No.145 aroused much concern and worry from Hong Kong companies. Representatives of Hong Kong's business community and trade associations reflected their concerns and difficulties to the relevant authorities under the State Council and the Guangdong provincial government, and officials from MOFCOM and several other ministries also visited Guangdong to conduct studies and gather feedback and suggestions on this policy. Based on their findings, MOFCOM, GAC and SEPA jointly issued Circular No.82 [2006] on 3 November 2006, clarifying the prohibition details and implementation date of the products put under the prohibited category in processing trade.

Circular No.82 further classifies products under the prohibited category into three sub-categories, namely "prohibited from import", "prohibited from export" and "prohibited from import and export". Each prohibited product item is identified by a 10-digit customs tariff code. Among these, the 77 items prohibited from import are mainly products barred from import under international conventions and products causing serious pollution in the course of processing. Examples include tiger bones, mineral ores, slag, and fibre waste. The 503 items prohibited from export are mainly primary raw materials used in deep processing, such as boards, sulphur, earth, stone and metal raw materials. Processing trade enterprises importing these raw materials are still entitled to bonded treatment. As for the 224 items prohibited from import and export, they are mainly low value-added,

high energy consumption and high pollution products, such as mineral water, coal, asphalt, combustible gases and pesticides.

In terms of implementation date, processing trade contracts approved by the commerce departments before 22 November 2006 are allowed to be filed with customs according to relevant regulations and completed within the contract validity period. Meanwhile, enterprises under customs online supervision are allowed to complete their processing trade contracts before 22 November 2007. But for all processing trade activities, by 22 November 2007, even if the products are still not exported, no imports or exports in the form of processing trade will be allowed.

3.4 Direction of Further Adjustments

According to Circular No.82, the relevant departments will exercise **dynamic management** over **processing trade**. It is understood that in keeping with the objectives and policies of controlling high energy consumption, high pollution and resource consumption products, as well as expediting the **transformation and upgrade of processing trade**[20], the five ministries under the Central Government have reached consensus on further revising the list of products under processing trade which are subject to management by category, and formulating a processing trade market access mechanism.

3.4.1 Prohibited Category under Processing Trade

MOFCOM, GAC and SEPA jointly issued Circular No.17 [2007] in April 2007 announcing that the new catalogue of products under the prohibited category in processing trade would come into force on 26 April. This new round of adjustments is mainly technical in nature. Adjustments made include synchronising the tariff codes with China's latest customs import and export nomenclature; making minor changes to the content of the catalogue with regard to high energy consumption, high pollution and resource consumption products; as well as integrating the three catalogues which were in force concurrently, including the catalogues contained in Circulars No.105 [2005], No.63 [2006] and No.82 [2006]. In the latest catalogue, certain products have been removed while 184 products have been added. The newly added products are mainly products

[20] Transformation and upgrade of processing trade include: 1. upgrade of processing technology; 2. extension of processing activities both upwards and downwards along the value chain to encompass product design, R&D and marketing; 3. extension of processing products both upwards and downwards along the production chain to include parts and components, equipment etc.; 4. low energy consumption, low resource consumption and low pollution

that are prohibited from export. The revised prohibited catalogue contains 1,140 items under 10-digit tariff codes.

3.4.2 Restricted Category under Processing Trade

MOFCOM and GAC have both indicated that they are now working on a new catalogue of products under the restricted category in processing trade. The scope of restricted products will be more extensive than that of prohibited products. They will mainly cover products that are labour-intensive, short in industry chain, low in value-added, frequent in arousing trade friction, and difficult for customs authorities to monitor. Using Circulars No.139 [2006] and No.145 [2006] as the base, the relevant government departments will study each and every one of the items listed in the two circulars for which export VAT rebate has been reduced. The finalised new catalogue of restricted products to be released will also be using the 10-digit tariff codes to identify the affected products.

According to preliminary estimates, certain products of traditional industries such as garments, baggage, furniture and plastic articles are more likely to be listed under the restricted category. But what is more noteworthy is that there may be changes in the management method for the restricted products. Reportedly, some supervisory departments had earlier suggested that, in the course of expanding the list of products under the restricted category in processing trade, the applicability of the processing trade policy should also be adjusted in a bid to encourage the relocation of processing trade enterprises to the central and western regions and the export processing zones. For instance, apart from the central and western regions, the processing trade policy will not be applied to all newly established labour-intensive enterprises. However, discussion on this issue has yet to be held and the final decision will be made by the State Council.

3.4.3 Encouraged Category under Processing Trade

In order to guide and encourage the introduction of advanced technology and equipment, development of own brands and products featuring core technologies, and optimisation and upgrade of industrial structure, China is likely to introduce the list of products under the encouraged category in processing trade. Items to be included in the encouraged category will cover products using high technology and advanced application technology, products that can help upgrade product range, products that are energy and raw materials efficient, products made from integrated resources and renewable resources, and products with proprietary IPR or own brand.

3.4.4 Access Mechanism for Processing Trade

The relevant ministries will continue to adjust the catalogues of products under the encouraged, restricted and prohibited categories in processing trade from time to time based on national economic development needs and state industrial policies. By so doing, an effective market access management mechanism will be developed for processing trade industries while processing activities with high energy consumption, high pollution, resource consumption, low technology and low social benefit will be gradually phased out. At the same time, products featuring proprietary IPR and with high value-added will be encouraged in order to promote industrial transformation and upgrade.

Another core feature of the market access mechanism for processing trade is the management of the qualifications of the processing enterprises. As China's current level of development stands, the practice of promoting trade without taking cost and access threshold into account is outdated. In this connection, MOFCOM issued the *Circular on Issues Concerning the Management of Processing Trade* in April 2007 calling on commerce departments at all levels to step up efforts on improving the management of processing trade enterprises. In future the relevant departments will assess the qualifications and processing capability of the processing trade enterprises based on hard facts. Processing trade enterprises not meeting the requirements for operation conditions and production capability will not be granted approval by the commerce departments to engage in processing trade activities. Under this circular, indicators such as environmental protection, energy consumption, labour employment, and technological level of equipment are to be used to assess the operation conditions and production capability of the processing trade enterprises. For enterprises not meeting the environmental protection and energy consumption requirements, enterprises involved in environmental liability incidents, enterprises not complying with the relevant labour employment procedures or paying employees wages lower than the local minimum standard, and enterprises not observing the local regulations on social insurance payment, no approval will be granted by the commerce departments for them to engage in processing trade business. According to MOFCOM, the assessment results will also be used as the basis for categorising processing trade enterprises under the customs duty deposit system.

According to SEPA, the administration has reached a verbal cooperation agreement with MOFCOM to conduct a study on selected industries involved in processing trade. A market access system will then be implemented in these industries on a trial basis with the objective of integrating environmental protection with trade. The first batch of

industries selected for the study will be those causing serious pollution and accounting for a relatively large share of the total emission of pollutants in the country.

National Targets for Reducing Emission of Major Pollutants under 11th Five-year Programme

The State Council has endorsed the plan for controlling the total emission of major pollutants in the country under the 11th Five-year Programme. The national total emissions of air pollutants such as chemical oxygen demand (COD) and sulphur dioxide and water pollutants such as nitrogen and phosphorus are targeted to decrease by 10% during the 11th Five-year Programme period. In order to ensure that local authorities at all levels take responsibility for reducing pollutant emission, all provinces and cities are required to incorporate the pollutant emission reduction targets into their local 11th five-year programmes and annual plans. As implementation will go down to the grass-root level and key polluting units, implementation plans have to be drawn up, law enforcement and supervision will be strengthened, investigation and punishment of illegal pollutant emissions will be stepped up, and the "three simultaneous system"[21] will be strictly enforced. Efforts will be made to promote industrial structure adjustment and upgrade according to the state industrial policy, and to increase production while maintaining or reducing pollution levels. Meanwhile, clean production, development of the recycling economy, lower consumption and reduced pollution will be promoted in key industrial sectors such as electricity, metallurgy, building materials, chemicals, paper making, textiles, printing and dyeing, and food.

[21] Under the "three simultaneous system", pollution control measures for new construction projects, redevelopment projects, extension projects, technology renovation projects and regional development projects must be simultaneously designed, simultaneously constructed and simultaneously commissioned with the main project.

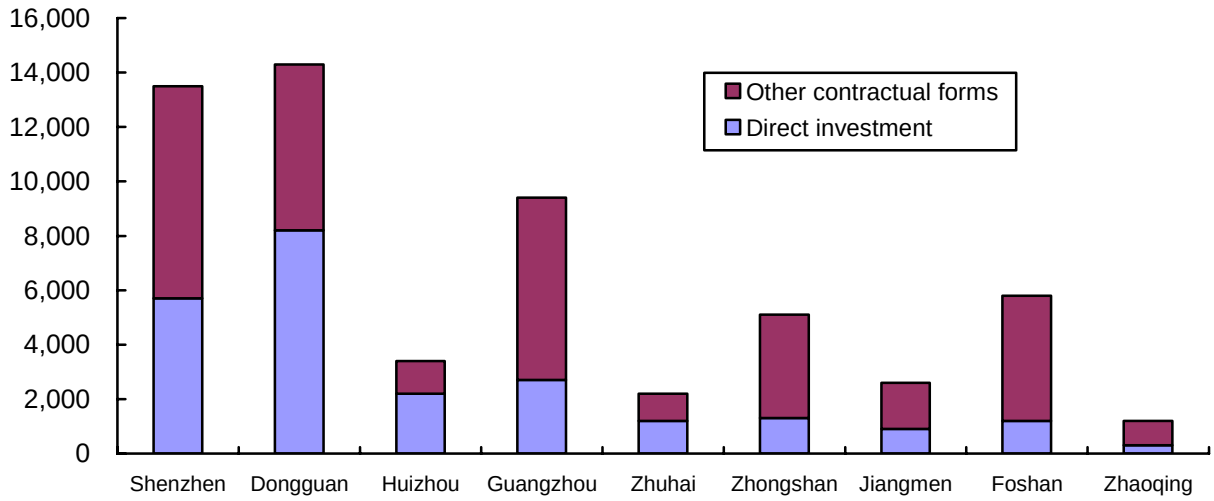
4. Development of Hong Kong-Invested Processing Trade Enterprises in Guangdong

4.1 Overview of Operation of Enterprises

According to the survey conducted by the Hong Kong Centre for Economic Research for the Federation of Hong Kong Industries (FHKI) in 2006 [22], **Hong Kong-based companies have 22,900 direct investment enterprises (i.e. foreign-invested enterprises or FIEs) in the PRD which run 23,7000 factories in the region. Hong Kong companies have investment in another 32,300 enterprises in the PRD in other contractual forms (i.e. other contractual form enterprises) which run 33,800 factories.** The number of factories under these two forms of investment totals **57,500**, hiring **9.6 million workers**.

The majority of these Hong Kong-invested factories in the PRD are found in Dongguan and Shenzhen, accounting for nearly half of the total number. Distribution by sector shows that the 10 sectors with most Hong Kong investment are: electronic and telecoms equipment (17.4%), garments and other textile products (13.6%), hardware (10.5%), plastic products (9.0%), leather, fur, down and related products (7.7%), textiles (6.4%), electrical equipment and machinery (5.4%), printing and print media reproduction (3.6%), chemical raw materials and products (3.4%), and paper and paper products (3.3%).

Chart 4-1: Geographical Distribution of Hong Kong-Invested Factories in PRD



Source: FHKI survey

[22] *Made in PRD Study: Challenges and Opportunities for HK Industry*, Federation of Hong Kong Industries, 2007

Although OEM and ODM remain the principal production modes of Hong Kong-invested companies in the PRD, an increasing number of these companies are developing OBM in recent years. What merits attention is that OBM is not the privilege of wholly Hong Kong-owned and joint venture enterprises, Hong Kong-funded enterprises of other contractual forms, including factories processing with supplied materials, have also developed their own brands. In the FHKI survey, 11.3% of enterprises of other contractual forms indicate that they are producing their own branded products, comparable to the 14.1% of FIEs.

Table 4-1: Production Modes of Hong Kong-Invested Processing Enterprises

	Percentage of Enterprises (%)		
	All Enterprises Surveyed	**Direct Investment Enterprises**	**Enterprises of Other Contractual Forms**
OEM	65.1	61.9	68.6
ODM	9.8	13.2	6.0
OBM	6.6	7.0	6.1
OEM & ODM	11.9	10.3	13.8
OEM & OBM	3.0	3.3	2.6
ODM & OBM	1.1	1.4	0.8
OEM, ODM & OBM	2.1	2.4	1.8
Others	0.4	0.5	0.3

Source: FHKI survey

At present, the vast majority of Hong Kong-funded factories in the PRD are engaged in production and export in the form of processing trade. **According to the FHKI survey, the export structure of the surveyed enterprises shows that** 15.5% are engaged in general trade, **34.0% in processing with imported materials, 47.4% in processing with supplied materials**, and the remaining 3.2% in other forms of trade. In the exports of factories in Shenzhen, Dongguan, Zhuhai and Zhongshan, the share of processing trade is even as high as 90%.

Among all enterprises responding to the FHKI survey, 43.5% say they import all materials and components for production while the remaining enterprises say they purchase some of the materials and components or obtain the required materials and components from other processing factories through deep processing transfer in the mainland. The source structure of the materials and components of all surveyed enterprises shows that 56.3% are imported, 40.0% are purchased from the domestic market, and 3.7% are obtained through deep processing transfer.

Among all the surveyed enterprises, 67.0% indicate they export all their products via Hong Kong, while 15.2% say they export part of their products via Hong Kong, with products exporting via Hong Kong accounting for 43.9% of their total exports. For the import of materials and components, 69.8% of the enterprises say they import all materials and components for production via Hong Kong while 15.5% say they import 40.9% of the materials and components for production via Hong Kong. The survey also finds that compared with enterprises in cities like Guangzhou, Foshan and Jiangmen, those in Hong Kong's neighbouring Shenzhen, Dongguan and Zhuhai are more inclined to increase their imports and exports via Hong Kong in the next two to three years.

Table 4-2: Source of Production Materials and Components of Hong Kong-Invested Processing Enterprises

	No. of Enterprises (%)	Source (Average Value %)		
		Import	Factory Transfer	Local Purchase
Single source				
100% import	43.5	100.0	0.0	0.0
100% factory transfer	0.7	0.0	100.0	0.0
100% local purchase	23.3	0.0	0.0	100.0
Two Sources				
Import & factory transfer	0.6	69.6	30.4	0.0
Import & local purchase	20.6	46.9	0.0	53.1
Factory transfer & local purchase	2.8	0.0	33.9	66.1
All the above three sources	8.4	31.9	22.4	45.6
Weighted average	100.0	56.3	3.7	40.0

Source: FHKI survey

4.2 Changes in PRD Investment Environment and Hong Kong Manufacturers' Counter-Measures

In recent years, Hong Kong manufacturers are coming under increasing pressure as the business environment in the PRD changes. This includes the Central Government's policy changes as well as the environmental and policy factors in the PRD itself. In tandem with rapid development, the energy, land, labour and manpower "bottlenecks" in the PRD have pushed up costs. Meanwhile, Guangdong has continued to tighten its grip on processing trade in an effort to expedite the transformation and upgrade of processing trade and promote the gradient transfer of industries. It has also imposed higher environmental protection requirements on new and expanded investment projects.

In the survey conducted by TDC in February and March 2007, 1,749 responding enterprises are engaged in production activities in the PRD. They generally opine that rising labour cost and shortage of skilled workers affect their day-to-day production most and pose the biggest challenge to them.

Table 4-3: Evaluation by Hong Kong Manufacturers of Factors Affecting the Investment Environment in PRD

	Weighted Average Score	Evaluation Percentages (%) *1 - most impact, 5 - least impact, No - no impact*					
		1	2	3	4	5	No
Rising labour cost/shortage of skilled workers	**1.78**	56.2	22.9	11.2	4.4	3.9	1.4
Renminbi appreciation	**1.96**	43.9	26.8	17.3	6.1	4.4	1.5
Rising land cost/land-use restrictions	**2.21**	25.4	19.8	25.5	11.2	6.9	11.2
Tightening of processing trade policy	**2.22**	26.9	21.4	25.5	9.9	7.2	9.1
Tightening of Labour Contract Law[23]	**2.27**	24.6	28.4	29.5	7.9	5.1	4.5
Power/water shortage	**2.33**	25.0	23.2	27.2	11.4	6.8	6.3
Adjustment of export VAT rebate	**2.37**	19.2	21.9	26.7	12.4	8.8	11.0
Higher environmental protection requirements	**2.37**	21.8	26.8	28.3	10.8	6.6	5.6
Expiry of corporate income tax concession	**2.39**	20.2	22.7	29.0	12.3	7.5	8.3

Source: TDC survey

4.2.1 Labour

The PRD suffers from labour shortage in recent years and wage increase is a problem confronting all manufacturers. According to the estimates by Guangdong's labour and social security office, total supply and demand in the labour market in the province totalled 12.12 million person-times in 2006, of which demand reached 7.3 million person-times and supply amounted to 4.82 million person-times, i.e. a shortage of 2.5 million. The demand for labour in the PRD was 6.46 million person-times, accounting for 88.5% of the provincial total. Manufacturing continued to be the major sector in absorbing labour, accounting for 54% of the total, up 5.9 percentage points from 2005. It is estimated that the demand for ordinary workers and technicians in Guangdong will increase by 9.5% and 20.4% respectively in 2007.

[23] After this questionnaire survey, the mainland announced the third draft of its Labour Contract Law setting ceilings for the financial compensation made to staff leaving service. It is believed that the tightening of the Labour Contract Law will alleviate the burden on Hong Kong companies

Take Shenzhen for example. In the first quarter of 2007, the demand in its labour market amounted to about 1 million workers. As migrant workers returned from their home leave after the Spring Festival and with the inflow of new labour, labour supply should increase by 700,000, leaving a shortage of 300,000 workers. According to the latest labour demand situation announced by the Shenzhen authorities, 25% of the enterprises plan to raise their wage level in order to recruit new workers and keep the existing ones. Nearly 60% of the enterprises are offering their workers a monthly wage of RMB 1,000 to RMB 1,600.

Table 4-4: Change in Minimum Wage in Guangdong in Recent Years

	1 Nov 2002	1 Dec 2004	1 Sep 2006
Guangzhou	510	684	780
Zhuhai, Foshan, Dongguan, Zhongshan	450	574	690
Shantou, Huizhou, Jiangmen	400	494	600
Shaoguan, Heyuan, Meizhou, Shanwei, Yangjiang, Zhanjiang, Maoming, Zhaoqing, Qingyuan, Chaozhou, Jieyang, Yunfu	360	446	500
Shenzhen Special Economic Zone	595*	690**	810***

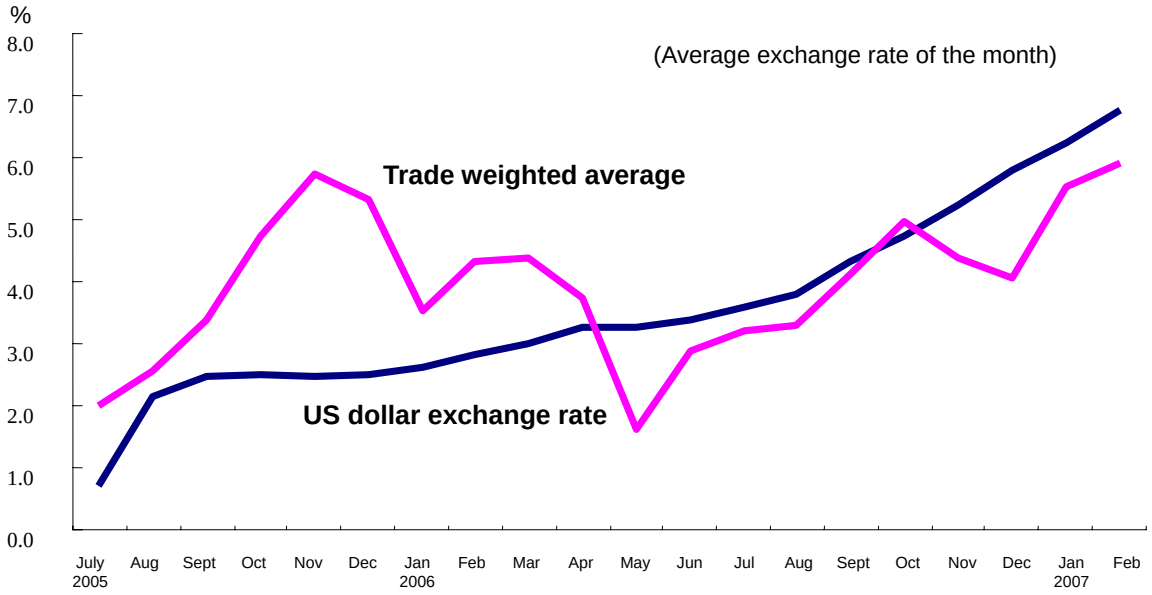
* 1 May 2002 ** 1 July 2005 *** 1 July 2006

Source: Labour and Social Security Office of Guangdong

4.2.2 RMB Appreciation

By February 2007, the RMB exchange rate had crept up 6.8% against the dollar and 18.3% against the yen since June 2005 (before the exchange rate reform). The trade weighted average exchange rate was also up by 5.9%. Preliminary findings of a survey commissioned by TDC and conducted by the Institute of International Economics of the National Development and Reform Commission show that among various types of enterprises in the PRD, 62.7% of the responding enterprises indicate that they could tolerate an appreciation of the RMB of up to 10%. So, it can be said that the magnitude of the appreciation of the RMB recently is approaching the limit of their tolerance.

Chart 4-2: Percentage of RMB Exchange Rate Increase over June 2005



Source: Pacific Exchange Rate Services; inference by TDC

4.2.3 Electricity

There were signs of deterioration in Guangdong's power supply situation in 2006, especially during the summer peak season. The drastic increase in power demand due to continuous hot weather further exacerbated the shortage, resulting in the growing instability of power supply. In Dongguan and certain areas beyond the second line of Shenzhen, sudden blackouts without warning are not uncommon, putting a sudden "brake" on production processes and causing damages to the raw materials and machinery used. In the past, the authorities would issue notices before power stoppages so that factories could switch off their machines in time to prevent the damage done to their raw materials and equipment. Thus, even though there were power disruptions once or twice a week, they would only affect the progress of production at the most but would not result in immediate economic loss. But now, sudden power stoppages keep the nerves of Hong Kong manufacturers constantly on tenterhooks. In order to ensure smooth production in times of blackouts, many Hong Kong manufacturers have invested in their own power generators. However, high oil price is pushing up the cost of electricity consumption.

Apart from unstable power supply, electricity tariff is also on the rise. In Dongguan, for instance, starting from August 2006, the peak hour electricity tariff for large industrial consumers has soared by 27% compared with 2004. Even off-peak tariff has increased by 10%. Although the PRD is not the only place affected by electricity tariff hikes, the

situation in Dongguan shows that electricity tariff for large industrial consumers in the PRD is 25% higher than in places like Heyuan in northern Guangdong.

Table 4-5: Electricity Tariffs for Dongguan and Heyuan in Guangdong

	Jun 2004	Aug 2006	Increase
Dongguan	RMB 0.01/kwh	RMB 0.01/kwh	
Large industrial consumers			
Peak	82.41	104.86	27.2%
Off-peak	61.4	67.46	9.9%
General industrial consumers	72.3	78.36	8.4%
Heyuan			
Large industrial consumers			
Peak	64.99	84.48	29.9%
Off-peak	48.5	54.56	12.5%
General industrial consumers	63.3	69.36	9.6%

Source: Price bureaus of Guangdong and the two cities

4.2.4 Water Consumption Quotas and Sewage Treatment

On water usage, the Guangdong Provincial Development and Reform Commission, Provincial Economic and Trade Commission and Provincial Water Conservancy Department jointly issued a circular on *Water Consumption Quotas for Guangdong (Trial Implementation)* for a trial period of two years with effect from 1 March 2007. In recent years, the problem of water resources in Guangdong has become increasingly acute, with many cities and counties in the province experiencing seasonal water shortages and the situation is worsening.

Water consumption quotas basically cover 41 major industries. Such quotas are unlikely to have too great an impact on the majority of large-scale enterprises in Guangdong because these enterprises have large output, advanced technology and low unit water consumption. The quotas are mainly directed against small enterprises with small output, backward technology and heavy water consumption. Higher production cost brought about by progressive water tariffs will force these enterprises to either upgrade their technology or exit from the market.

On sewage treatment, Guangdong will be gradually raising its sewage treatment charges in the next few years in accordance with the principle of “recovering cost at a small profit”. The province is currently drafting the *Administrative Measures Governing the*

Standards for the Collection of Sewage Treatment Charges and Their Usage. Under these measures, all cities in the PRD and in eastern, western and northern Guangdong will be classified into two major categories, and minimum sewage treatment charges for these two categories of cities will be set and all localities will be required to start collecting sewage treatment charges before a stipulated date. According to analyses made by the Guangdong authorities, while sewage treatment charges in the province have been on the rise in recent years, they are currently still lower than other regions such as the YRD. In Dongguan, for instance, sewage treatment charges were raised from RMB 0.25 per tonne to RMB 0.6 per tonne in 2004 and to RMB 0.8 per tonne in 2006. This upward trend is expected to continue.

4.2.5 Environmental Protection

In April 2006, the Guangdong government announced the launch of its Environmental Protection Initiative across the province. The initiative targets 10 industries causing heavy pollution, including chemical, petrochemical, smelting, electroplating, tanning, printing and dyeing, cement, papermaking, nuclear and radioactive, and hazardous wastes treatment, with efforts directed at rectifying and controlling illegal sewage discharge that affects drinking water sources. It can be expected that the number of enterprises forced to close down, suspend operation or relocate because of the Environmental Protection Initiative will continue to increase.

On market access, Guangdong will implement the Environmental Impact Assessment Law and strictly enforce environmental assessment and the “three simultaneous” system. Environmental protection bureaus at all levels will not approve the environmental impact assessments of projects that do not comply with national or provincial industrial policies, development plans, environmental standards and clean production requirements. Projects that have not submitted the required environmental impact assessment documents, projects built before their environmental impact assessment is approved, construction projects that fail to pass environmental examination and acceptance upon completion, and projects that cause serious pollution will be dealt with according to law.

Guangdong will also formulate unified plans for polluting industries and carry out centralised pollution control. In accordance with the *Decision on Strengthening the Comprehensive Harnessing of the Pearl River*, *Suggestions for Further Strengthening the Environmental Protection and Management of Construction Projects*, *Suggestions for the Implementation of Centralisied Planning and Centralised Distribution for Electroplating Industry in Guangdong* and *Suggestions for the Implementation of Centralised Planning and Centralised Distribution for Chemical and Paper Pulp*

Industries in Guangdong, industries causing heavy pollution such as electroplating, papermaking (except chemical pulp), textile printing and dyeing, tanning, chemical, building materials, smelting, fermenting, and the comprehensive utilisation or disposal of hazardous wastes and general industrial solid wastes will be put under centralised planning and relocated to industrial parks for better control. Ecological industrial parks and industry relocation parks will be built and total emission control targets and corresponding management measures will be set for these parks in order to exercise centralised pollution control.

To strengthen supervision and control over pollution sources, Guangdong will establish a system of declaration and dynamic management of the discharge of pollutants. Enterprises engaged in polluting industries must declare their pollutant discharge every year. Based on the information declared by the enterprises, environmental protection departments will promptly update the registered details and database and establish a dynamic archive and dynamic management system for the dynamic management of the discharge from pollution sources.

4.2.6 Hong Kong Manufacturers' Counter-Measures

Hong Kong manufacturers operating in the PRD have seen their profit margin narrowing significantly in recent years due to mounting pressure from rising production and export costs as well as intense market competition which has made it impossible to raise the selling price of their products. According to the in-depth survey by TDC on enterprises seriously affected by the processing trade policy change and export VAT rebate cut (TDC second round survey)[24], **the median profit margin on products exported in the form of processing trade was 10%, a big drop from 18% five years ago**. In order to stay afloat, these enterprises have no choice but to (i) expand their scale of production to maintain income level, or (ii) relocate to an area with lower land and labour costs to control costs.

Over the past few years, more and more enterprises have moved to the mountainous regions and the eastern and western wings of Guangdong, and even to inland provinces like Hunan and Jiangxi, where production costs are lower. In the TDC survey, Hong Kong manufacturers in the PRD are asked whether they have plans to relocate their operations from the PRD over the next three years. The findings show that **37.3% of the**

[24] In order to gain a better understanding of the effect of Circulars No.139 and No.145 and Circular No.82 on Hong Kong's processing enterprises, TDC carried out a second round of more in-depth survey on enterprises engaged in production activities in the PRD which claimed in the questionnaire survey conducted in February to March that the tightening of the processing trade policy and export VAT rebate adjustment had a big impact on their day-to-day production.

enterprises already have plans to move all or part of their production from the PRD. Most of them hope to relocate to other parts of Guangdong or to the Pan-PRD region outside Guangdong.

Table 4-6: Relocation Plans of Hong Kong Production Enterprises in PRD Over the Next Three Years

	Share of Enterprises (%)
Relocating all production activities elsewhere	5.9%
Relocating some production activities elsewhere	31.4%
No plans/no idea	62.7%

Source: TDC survey

Table 4-7: Areas where Hong Kong Production Enterprises in PRD Plan to Relocate to

	Share of Enterprises (%)
Other parts of Guangdong outside PRD	33.6%
Pan-PRD provinces outside Guangdong	36.6%
YRD	20.8%
Other parts of the mainland	5.7%
Outside the mainland	3.3%

Source: TDC survey

4.3 Impact of Processing Trade Policy Change on Hong Kong Manufacturers in PRD

From Section 4.2 above on the evaluation by Hong Kong manufacturers of the factors affecting the investment environment in the PRD (Table 4-3), it can be seen that the tightening of processing trade policy has made quite a significant impact on the day-to-day operation of these enterprises. Of all the surveyed enterprises, 26.9% point out that the policy change has affected them most. **Among the enterprises engaged in shoemaking, 34.7% indicate that they are most affected. Other sectors most affected by the policy change include watches and clocks, computer/ telecommunications products, printing/packaging materials, machinery and hardware (Table 4-8)**. A common feature among these sectors is that the raw materials or components needed by some of the enterprises for production have been listed in the *Catalogue of Products under the Prohibited Category in Processing Trade* in Circulars No.139 [2006] and No.145 [2006]. For example, **imported leather is needed for shoemaking; imported paper is needed for printing/packaging materials; while**

stainless steel, copper, alloys and other metals are needed for the production of hardware, watches and clocks, and computers. After leather, paper and metals have been included in the prohibited category in Circulars No.139 and No.145, these enterprises can no longer import or transfer-in from other factories the necessary raw materials/semi-manufactures for production and cannot file their new processing trade contracts for the record.

Table 4-8: Percentage of Enterprises Most Affected by Processing Trade Policy Change

Textiles	24.4%	Electrical appliances	25.0%
Garments	25.0%	Machinery	**27.0%**
Shoes	**34.7%**	Hardware	**27.3%**
Toys	24.7%	Chemicals	22.2%
Travel goods/handbags	19.5%	Printing/packaging materials[25]	**29.7%**
Jewellery	16.3%	Houseware (non-electrical)	25.2%
Watches & clocks	**32.6%**	Gifts/premiums	25.4%
Food & beverage	13.9%	Stationery/office supplies	20.5%
Electronic parts & components	22.9%	Decorations & handicrafts	23.6%
Audio-visual equipment	19.1%	Plastic articles	26.4%
Computers/telecoms products	**29.6%**	Raw materials & metals	22.9%
Other electronic products	21.7%	Others	23.7%

Source: TDC survey

The adjustment of export VAT rebate rates mainly affects the locally purchased materials and components of enterprises processing with imported materials and the local value-added part of their business. **Among the Hong Kong-invested production enterprises in the PRD surveyed, 33.7% indicate that all their exports are processed with supplied materials; in other words, 66.3% of the surveyed enterprises are involved in the export of products processed with imported materials. Among all respondents, 85.8% say they do purchase raw materials on the mainland, with 11.0% indicating that all their raw materials are purchased on the mainland.** Since not all respondents are engaged in processing with imported materials or purchase raw materials on the mainland, the impact of the export VAT rebate rates adjustment on these enterprises is relatively small.

[25] After the survey, the mainland announced the *2007 Catalogue of Products under the Prohibited Category in Processing Trade* under which some paper products are added to the list of paper products already placed under the category of prohibited exports. According to the trade, this adjustment has exacerbated the impact on the industry

Table 4-9: Percentage of Enterprises Most Affected by Export VAT Rebate Rates Adjustment

Textiles	18.9%	Electrical appliances	17.5%
Garments	16.0%	Machinery	21.6%
Shoes	20.4%	Hardware	18.2%
Toys	18.7%	Chemicals	18.5%
Travel goods/handbags	15.7%	Printing/packaging materials	**26.1%**
Jewellery	11.6%	Houseware (non-electrical)	23.8%
Watches & clocks	20.0%	Gifts/premiums	19.0%
Food & beverage	13.9%	Stationery/office supplies	18.8%
Electronic parts & components	14.5%	Decorations & handicrafts	16.4%
Audio-visual equipment	17.0%	Plastic articles	19.8%
Computers/telecoms products	18.5%	Raw materials & metals	18.8%
Other electronic products	14.7%	Others	15.5%

Source: TDC survey.

4.3.1 Impact of the Expanded Prohibited Category

Dongguan is a place with the most Hong Kong investment in processing trade. According to the local foreign economic and trade officials, Hong Kong investors have developed a long industry chain after long years of investment in Dongguan, and disruption of any one link in this chain would bring about a great impact. For example, last year when MOF Circulars No.139 [2006] and No.145 [2006] were issued, listing paper, zinc alloy, aluminium alloy and other commonly used products under the prohibited category in processing trade and announcing that the new rule would take effect on the following day, there were chaos in the affected enterprises and in customs offices as there were no implementing rules and the frontline law-enforcement officers were not prepared for the change. At that time, factories engaged in paper products, printing, die casting and electroplating were the hardest hit and some of them were forced to suspend production because they were unable to import the necessary raw materials. Downstream manufacturers, including computer and automobile enterprises, were also affected because supply of carton boxes needed for packaging and alloy die cast components necessary for production was interrupted. **In October 2006, Guangdong's imports and exports were down by 11.7% and 4.4% respectively from the previous month. It is believed that Circulars No.139 and No.145 were largely responsible for the fall**.

Table 4-10: Impact of the Expanded Prohibited Category Based on Circulars No.139 and No.145 on Hong Kong-Invested Processing Enterprises

Cannot file new processing trade contracts for the record	17.4%
Cannot execute/complete orders on hand	7.1%
Cannot import or transfer-in raw materials/semi-manufactures for production	23.9%
Other impacts	5.8%
No impact	56.8%

Source: TDC second round survey.

The second round of the TDC survey finds that for enterprises most seriously affected by the processing trade policy change, their day-to-day production generally involves one to five different supporting/linking products or processes. These mainly include packaging, moulds, metal components, metal electroplating, plastic components, and bleaching/printing/dyeing. Among these enterprises, 42.4% indicate that they would supply their products to other downstream manufacturers in the mainland through factory transfers, which account for 30% of their total output on average. This shows the considerable length of the PRD processing chain and the close inter-dependence among different industry clusters.

Table 4-11: Inter-Dependence of PRC Processing Industries

Number of Processes Involved

No. of Processes	Share of Enterprises (%)
1	24.0
2	18.7
3	17.3
4	17.3
5	12.0
6	6.0
7	4.7

Processes Involved

Processes	Share of Enterprises (%)
Packaging	65.3
Moulds	55.3
Metal components	49.3
Metal electroplating	43.3
Plastic components	36.0
Bleaching/printing/dyeing	22.7
Electronic components	16.0
Plastic electroplating	14.7
Others	8.7

Source: TDC second round survey

As a matter of fact, **the present level of wages in the PRD is higher than that in most Southeast Asian countries. But the PRD can maintain its competitiveness in export mainly because it has a complete range of supporting industries which are lacking in other countries**. According to manufacturers in Dongguan, most operations in the city are SMEs which are not self-sufficient and have to rely on a number of factory transfers

for production. Hence, they cannot survive or maintain their competitive edge in regions without a complete range of supporting industries. **Although the FHKI survey indicates that only 12.5% of the Hong Kong-invested enterprises in the PRD obtain the necessary materials and components for production through deep-processing transfers, the fact is, for various reasons many processing factories, especially those processing with supplied materials, choose to export instead of making deep-processing transfers (factory transfer) to downstream manufacturers.[26] As such, statistics on deep-processing transfers have somewhat under-estimated the degree of inter-dependence among industry clusters in the PRD**. The TDC survey finds that about 24.4% of the production enterprises in the PRD re-exported products made in the mainland via Hong Kong to the mainland market in 2006.

According to Dongguan's foreign economic and trade officials, processing with supplied materials accounts for 30-40% of Dongguan's processing trade exports, while enterprises engaged in such processing account for over 50% of the total number of processing enterprises. **Among the 1,749 PRD production enterprises surveyed by TDC, 33.7% of them are 100% engaged in processing with supplied materials. If the products of these enterprises are listed under the prohibited category in processing trade, they would encounter greater difficulties because they cannot switch to general trade at once**. Even if they can switch to general trade, they have to pay tariffs and VAT on all their raw materials and components imports but are not entitled to VAT rebates for their exports. Thus, the problem facing them is not just rising costs but a matter of survival.

[26] According to the enterprises, one manufacturer usually supplies supporting parts to several clients. But since some clients demand very short delivery time (one day or a few hours) in order to cut inventory cost, some manufacturers choose to export their products to minimise/avoid delays caused by insufficient "handbooks" or time-consuming handling formalities in a bid to save time. As factories processing with supplied materials are not allowed to sell their products on the domestic market or are subject to a limited number of factory transfers, they are inclined to export their products instead of making factory transfers.

Table 4-12: Counter-Measures of Hong Kong-Invested Processing Enterprises if Raw and Auxiliary Materials and Components/Products Are Included in the Prohibited Category under Processing Trade

Switch to production and export in the form of "general trade"	Share of Enterprises
Yes	17.4%
May consider	12.3%
No, because tariffs and other costs will make their products uncompetitive	**14.8%**
No, because they have no tax registration for general trade	6.5%
No, because of other reasons	4.5%
No idea, it depends on the situation	45.8%

Switch to purchasing affected raw and auxiliary materials and components/products on the mainland	Share of Enterprises
Yes	33.8%
May consider	29.9%
No, because there are no substitutes on the mainland	**9.7%**
No, because of other reasons	3.2%
No idea, it depends on the situation	23.4%

Cease/scale down operation of the affected production lines	Share of Enterprises
Yes	10.5%
No	16.3%
Probably, it depends on the situation	**73.2%**

Source: TDC second round survey

Under Circular No.82 [2006], wooden furniture was listed in the catalogue of products under the prohibited category in processing trade. Although the circular makes exception for furniture made of imported timber, according to a representative from the International Furniture and Decoration (Hong Kong) Association, in order to control cost it is very difficult for enterprises to import all the raw materials needed because furniture processing on the mainland is already very mature and the industry chain is long with many materials and parts used in production being purchased locally. Even in the case of high-end furniture, only about 80% of the timber used is imported. For mid-range and low-end furniture, imported timber (mostly surface material) only accounts for 50-60% and 20-30% respectively.

According to an official from Dongguan's foreign economic cooperation bureau, while some locally produced auxiliary materials may be used in the production of wooden furniture under the prohibited category, the use of locally purchased timber is prohibited. Since the registration of new processing trade contracts for products under the prohibited category has now been stopped, Hong Kong-invested furniture enterprises using mainland timber for production would have to carry out import and export in the form of general trade. According to the International Furniture and Decoration (Hong Kong) Association, most Hong Kong furniture companies are producing mid-to-high-end products, with domestic sales accounting for half of their output. Since the majority of Hong Kong factories are FIEs, switching to general trade is not a big problem, although general trade requires more operating funds than processing trade and therefore involves higher costs. Enterprises must enhance their product design, production management and automation in order to stay competitive. Furniture production has in fact gradually become mechanised and automated in recent years due to labour shortage and environmental reasons. It can be expected that this trend will continue.

4.3.2 Impact of the Expanded Catalogue of Products under the Restricted Category in Processing Trade and Reduction of Export VAT Rebate

Under the existing customs duty deposit system, the expanded catalogue of products under the restricted category in processing trade would have little impact on Category A enterprises because they are not required to pay customs duty deposit. However, Category B and Category C enterprises would be affected because Category B enterprises are required to pay 50% of the tariff and VAT payable on the import of restricted commodities as customs duty deposit while Category C enterprises are required to pay the deposit in full. At present, **since the majority of Hong Kong-invested processing enterprises are Category B enterprises, the expansion of the restricted category would affect their operation and hold up their funds**. If all enterprises (including Category A enterprises) are required to make "actual payment" of

customs duty deposit for the import of restricted commodities, the impact would be even greater. In the case of the toy industry, raw materials account for 60-70% of production cost and the proportion is even higher for electronic toys. Since most Hong Kong toy makers are Category B enterprises, if the raw materials needed are listed under the restricted category and actual payment of customs duty deposit is required, the funds held up would be substantial. Take an enterprise with a business turnover of RMB 500 million for example. With the cost of raw materials amounting to 60% of this figure, the 11% tariff and 17% VAT payable in customs duty deposit (i.e. the funds held up) would reach RMB 84 million.

Table 4-13: Percentage of Hong Kong-Invested Processing Enterprises Affected by Change from "Nominal" to "Actual" Payment of Customs Duty Deposit

The change from "nominal" to "actual" payment of customs duty deposit on imported materials and components poses a heavy burden on circulating funds and affects the company's operations	**55.3%**
The change from "nominal" to "actual" payment of customs duty deposit on imported materials and components has a certain impact on circulating funds but the impact is still bearable	22.4%
The change from "nominal" to "actual" payment of customs duty deposit on imported materials and components only has a slight impact on circulating funds	5.3%
Other impacts	2.6%
No impact	15.1%

Source: TDC second round survey

Since the majority of Hong Kong-invested processing enterprises are Category B enterprises, once their raw materials and components necessary for production are listed under the restricted category, they would be required to pay customs duty deposit on such imports, which means their circulating funds needed would increase substantially. While this is not much of a problem for cash-rich big companies, for SMEs that are already cash-tight and have no assets to use as collateral for bank loans, the expanded restricted category would create great pressure on their cash flow. **The second round of the TDC survey shows that the switch from "nominal" to "actual" payment of customs duty deposit on imported materials and components would pose a heavy burden on the circulating funds of 55.3% of enterprises and affect their operation**.

Even if enterprises shift to using local raw materials for production, they still have to face heavier tax burdens due to the reduction in export VAT rebate, let alone the problem on

the source and quality of the supply. Hence, the expanded restricted category and reduced export VAT rebate rate would have a great impact on sectors with a small profit margin.

VAT Exemption, Deduction and Rebate for Garment Enterprises Processing with Imported Materials

FOB price: equivalent to RMB 10 million
Input tax on local purchases: RMB 1 million
Value of bonded imports: RMB 2 million
VAT rate: 17%
Export VAT rebate rate: 13% before adjustment and 11% after adjustment

Amount of VAT payable = sales VAT on domestic sales – (input tax – amount of export VAT not eligible for exemption, deduction and rebate)

Amount of VAT not eligible for exemption, deduction and rebate:
Before adjustment = (RMB 10 million – RMB 2 million) x (17% – 13%) = RMB 320,000
After adjustment = (RMB 10 million – RMB 2 million) x (17% – 11%) = RMB 480,000

VAT rebate for enterprise (absolute amount of VAT payable):
Before adjustment = 0 – (RMB 1 million – RMB 320,000) = RMB 680,000
After adjustment = 0 – (RMB 1 million – RMB 480,000) = RMB 520,000

4.4 Inclination of Hong Kong Manufacturers for Transformation and Upgrade and Their Difficulties

4.4.1 Transformation and Upgrade for Hong Kong Manufacturers

Hong Kong manufacturers generally agree that, on entering the 21st century, the golden era for using the PRD as a base for the production of low-price export goods is a thing of the past. **With rising costs in the PRD and increased export tax burdens as a result of the processing trade policy change, it is no longer possible for enterprises to use low price as a strategy for winning orders. To the contrary, transformation and upgrade are the way forward for the long-term development of enterprises. In fact, findings of the FHKI survey show that 35% of the Hong Kong-invested enterprises in the PRD have ventured into OBM and ODM**.

According to the TDC survey, **over 50% of Hong Kong manufacturers would opt for developing products of a better quality in their pursuit of upgrade, while 45.1% would improve their product design and make innovations. They believe that the only way to maintain their competitive edge is to make their products "unique".**

Some enterprises (35%) are considering developing their own brands so they can control their production, make it difficult for buyers to demand a lower price, and increase their profit margin. Meanwhile, about 40% of enterprises say they would strengthen internal management, including inventory control and production automation, to upgrade themselves and control cost.

Table 4-14: Strategies of Hong Kong Processing Enterprises for Transformation and Upgrade

	Percentage of Enterprises (%)
Develop own brands	**35.0%**
Invest in the R&D of high-tech products	17.8%
Develop related products in other industries	22.7%
Develop products of better quality	**53.1%**
Improve product design and make innovations	**45.1%**
Implement green production system	18.0%
Strengthen inventory control to enhance efficiency	36.7%
Achieve automation in production to reduce wage cost	35.9%
Switch from the mode of “processing with supplied materials” to “foreign-invested enterprise”	24.6%
Abandon production in favour of purchasing and marketing	12.2%
No action taken	8.7%

Source: TDC survey

4.4.2 Difficulties and Considerations

Transformation and upgrade require capital and time. However, in the face of intensifying market competition and lower profit margin, enterprises are cautious about projects that require a large investment and a long recovery period. Take for example a medium-sized plastics factory which costs RMB 100 million to set up. The average profit margin is 5%. So, even if it can make an annual profit of RMB 10 million (i.e. an annual business turnover of RMB 200 million), it will still take 10 years to recover the investment without taking interest cost into account.

Given the reality of rising costs and more stringent processing trade policy on the mainland and comparing the development potential between the mainland and low-cost countries like Vietnam, Hong Kong manufacturers would certainly take into consideration the success rate and return rate of different strategies and their own resource constraints when deciding which strategy to adopt. According to the enterprises surveyed by TDC, when they consider **developing new products and new designs, developing their**

own brands, and embarking on automated production and green production, their major concern is the market potential of the products and their own financial resources.

Table 4-15: Major Considerations of Hong Kong Processing Enterprises Seeking Transformation and Upgrade

Financial resources	57.2%
Management/technical know-how	54.4%
Policies of mainland government	44.4%
Market potential of products	59.8%
Others	1.5%

Source: TDC survey

Cases of Enterprise Transformation and Upgrade

Case 1 :
Company A, an electrical appliances company, has its own land and factories in Dongguan and at present 30% of its land is still unused. As production costs continue to rise in Dongguan, the city is no longer as competitive as places like Shunde and Ningbo. Thus, the company is contemplating whether or not it should slow down or even slash its investment. The company is currently engaged in OEM and ODM, but their own design of the products is relatively simple and low-end and the profits gained cannot compare with processing for big clients. The company is aware that since it does not have its own brand and the quality of its products is not widely recognised on the mainland market, it is not competitive enough to open up domestic sales. Just like other small electrical appliances manufacturers, the company has no idea how to upgrade or transform itself and sees no way out of its present predicament.

Case 2 :
Company B, a metal plastic products company established 35 years ago, started off as a plastic electroplating factory. When it found that the quality of the plastic products sent to it for electroplating was not very good, it decided to develop plastic injection moulding in a move towards vertical integration. It mainly produced bathroom accessories such as shower heads, as well as casings for mobile phones and other electronic products. The company began developing auto parts about 10 years ago and is now a primary supplier of US automobile manufacturers like GM. One of its development strategies is to form cooperative/equity joint ventures with overseas companies and import their technologies. The company encountered considerable difficulties in winning clients' trust when it first embarked on its auto parts business, but its track records in plastic injection moulding and electroplating helped it win partners for cooperative/equity joint ventures. Company B admits that the whole upgrading process involved considerable investment. For instance, a low-temperature lithium-plating facility alone cost over US$1.3 million and investment in other precision moulding equipment was also substantial.

Case 3 :

Company C, a PVC factory, mainly produces schoolbags and has been producing goods under its own brand for 35 years. Today, the brand of the company is already quite famous in Europe. Company C reckons that brand development requires a substantial input of capital and time, including marketing which aims to raise consumer awareness of and receptiveness to the brand. Continuous efforts are also required to improve the quality and design of the products. The company has been cooperating with the Institute for Enterprises of Hong Kong Polytechnic University in product and technology R&D in recent years and the programme has produced fruitful results. For example, their joint development of nano anti-bacteria coating applied to the company's schoolbags has not only received good market response but also won a product design award in Belgium.

5. Impact of the Processing Trade Policy Change on Hong Kong as a Trading Platform

5.1 Impact on Relocation of Enterprises from PRD

5.1.1 Impact on Hong Kong's Freight Forwarding Industry

The FHKI survey shows that many enterprises in Shenzhen, Dongguan and Zhuhai adjacent to Hong Kong tend to import and export goods via the SAR. TDC's survey finds that due to rising costs in the PRD and other factors, 37.3% of the enterprises plan to relocate all or part of their production from the PRD, with 33.6% indicating they intend to relocate to other parts of Guangdong outside the PRD, 63.1% saying they will move to provinces outside Guangdong, and 3.3% saying they will relocate to other countries or regions outside the Chinese mainland.

Due to transport costs and time considerations, **about 50% of the production enterprises indicate that they would reduce sea-freight forwarding via Hong Kong after relocating from the PRD, while 40% say they would cut air-freight forwarding via Hong Kong.** However, in the TDC survey, most of the enterprises with plans for relocation indicate that they will only relocate part of their production processes out of the PRD and that the final products will still be made in their PRD factories. This, coupled with the expansion of the overall production scale, would mean that products shipped via Hong Kong will ultimately register an increase. Some enterprises say that even if they shift their production out of the PRD, they will still export their goods via Hong Kong because Hong Kong offers better goods consolidation and logistics services while the mainland has yet to catch up in this respect.

Table 5-1: Anticipated Changes in Freight Forwarding Via Hong Kong and Other Logistics-Related Activities in Hong Kong After Relocation of Production Enterprises from PRD

	Increase	No Change	Decrease	N.A.
Sea freight forwarding	14.1%	31.4%	**46.9%**	7.7%
Air freight forwarding	8.2%	35.0%	**39.1%**	17.7%
Storage	10.9%	24.3%	**38.8%**	26.1%
Cargo consolidation	13.2%	27.7%	**39.5%**	19.5%

Source: TDC survey.

5.1.2 Impact on Other Roles as Trading Service Platform

Table 5-2: Changes in Functions of Hong Kong Offices Over Next Three Years After Relocation of Production Enterprises from PRD

	Increase	No Change	Decrease	N.A.
Corporate management & strategy formulation	**26.6%**	**63.0%**	8.1%	2.2%
Finance & accounting	**18.3%**	**71.7%**	9.7%	0.3%
Human resources	16.3%	47.4%	**32.5%**	3.8%
Product design & development	**35.4%**	**39.7%**	16.6%	8.3%
Sales and marketing	**44.6%**	**40.4%**	10.5%	4.5%
Raw materials sourcing	14.0%	35.8%	**42.7%**	7.6%
Production	9.0%	28.5%	21.6%	40.9%
Management and coordination of production	20.7%	41.8%	24.2%	13.3%
Quality control	23.3%	39.7%	19.9%	17.1%
Trade financing/insurance	**22.6%**	**61.0%**	10.4%	6.0%
Logistics	17.8%	44.9%	**33.0%**	4.3%
Trade documentation & customs declaration	18.3%	51.5%	**27.7%**	2.4%

Source: TDC survey

Although more enterprises would choose to cut their freight forwarding, raw materials sourcing and other related activities in Hong Kong after relocating their production lines from the PRD, the roles of Hong Kong as headquarters/control centre and service centre will not be weakened. To the contrary, according to the TDC survey, among those enterprises with plans for relocation, 44.6% indicate that they would increase the sales and marketing function of their Hong Kong office while 35.4% say they would increase the product design and development function of their Hong Kong office. As for the functions of headquarters/control centre often played by Hong Kong offices, including corporate management and strategy formulation, finance and accounting, and trade financing/insurance arrangements, most enterprises say these would remain unchanged or increase.

Generally speaking, for enterprises relocating from the PRD, after their relocation there are likely to be fewer day-to-day affairs that need to be handled in Hong Kong. Hence, compared with other enterprises, the percentage of enterprises with relocation plans and expecting a decrease in the overall activities of their Hong Kong offices over the next three years is noticeably higher.

Table 5-3: Changes in Overall Activities of the Hong Kong Offices of Hong Kong-Invested Enterprises over Next Three Years

	Enterprises planning to relocate from PRD	Enterprises not planing to relocate from PRD	Enterprises without production in PRD
Increase	37.9%	42.3%	43.7%
Decrease	33.2%	21.5%	15.2%
No change	28.9%	36.2%	41.1%

Source: TDC survey

5.2 Impact on Closure or Downsizing of Enterprises

Based on the above analysis, if the processing trade policy change further pushes up the production costs of Hong Kong processing trade enterprises, they may have to relocate from the PRD in order to control costs. As a result, their demand for Hong Kong freight forwarding services would dwindle and some of their day-to-day affairs handled in Hong Kong would decrease. However, as long as they continue their operation, the functions of Hong Kong as corporate headquarters and marketing and management centre will remain unchanged.

According to the second round of the TDC survey, **10.5% of the enterprises most affected by the processing trade policy change indicate that if the raw and auxiliary materials needed for production or their products are included in the prohibited category under processing trade, they would have to cease or scale down the operation of the affected production lines, and 73.2% say they would wait and see. Meanwhile, 55.3% of the enterprises most affected by the processing trade policy change say if the raw and auxiliary materials needed for production or their products are included in the restricted category under processing trade, the shift from "nominal" to "actual" payment of customs duty deposit on imported materials and components would exert heavy pressure on their circulating funds and may even affect their operation. If these enterprises ultimately decide to cease their production or operation, the impact on Hong Kong's role as a trading platform will not just be a decline in freight volume, but also a drop in the number of business clusters using Hong Kong as headquarters or service platform.**

6. Conclusions on Impacts

It is the policy direction and objective of the state to restrict “high energy consumption, high pollution and resource consumption” industries and promote the “transformation and upgrade” of processing trade. Faced with widening trade surplus and external pressures on the Renminbi to appreciate, the mainland has made “trade surplus suppression” and “foreign investment diversion” the priorities of its economic policy. In 2006, China’s trade surplus registered an increase of US$75.5 billion, of which US$46.4 billion came from processing trade. Thus, adjusting the processing trade policy and making a break from the practice of attracting investment without cost considerations or thresholds has become the consensus of major policy-making ministries and commissions.

The underlying concept of the expansion of the lists of products under the prohibited and restricted categories in processing trade is to remove or reduce the preferential treatment of bonded import and export VAT rebate for production activities no longer welcomed or supported by the state, thereby raising the production cost of enterprises and forcing them to shift from competing on low price to competing on high value-added. This way, China can change the mode of its foreign trade growth and achieve the goal set in its 11th Five-Year Programme of turning from a large trading nation into a strong trading nation.

According to the two rounds of the TDC survey, 26.9% of the Hong Kong-invested enterprises engaging in production activities in the PRD indicate that the tightening of the processing trade policy has seriously affected their day-to-day production and operation, while 19.2% say the adjustment in export VAT rebates has seriously affected their day-to-day production and operation. After making allowance for overlapping answers, **a total of 30.9% of the surveyed enterprises indicate that their day-to-day production and operation have been seriously affected by the processing trade policy change and VAT rebate cut**. In 2006, the median amount of exports of these seriously affected enterprises in the form of processing trade contracts amounted to HK$20 million. The median number of workers employed by these enterprises on the mainland is 250 while that in Hong Kong is seven.

According to the FHKI survey, currently there are currently 46,800 Hong Kong-invested production enterprises in the PRD engaged in processing with imported materials or processing with supplied materials. Based on the assumption that 30.9% of these enterprises are seriously affected by the processing trade policy change, some 14,500 Hong Kong enterprises would be seriously affected by the expansion of the prohibited and restricted categories under processing trade.

If 10.5% (over 1,500) of the enterprises seriously affected by the processing trade policy change have to close down because the raw and auxiliary materials needed for production or products produced are included in the prohibited category under processing trade, the impacts brought about would include: (i) processing trade exports would drop by HK$30 billion; (ii) 375,000 mainland production workers would lose their jobs; (iii) 10,500 Hong Kong staff employed by these enterprises would lose their jobs. Under the worst scenario of the processing trade policy change, i.e. if all preferential treatments for bonded imports are to be removed, the 73.2% (over 10,000) of the surveyed enterprises indicating that they may cease or scale down their operation will have no choice but cease production, and the degree of the impacts will increase more than six times. In other words, another 2.5 million mainland workers and 70,000 Hong Kong workers may lose their jobs.

Due to rising production costs in the PRD, 37% (17,300) of the enterprises engaged in processing trade say they have plans to relocate all or part of their production activities in the PRD to other areas over the next three years. Their initial plan is to relocate to the eastern and western wings and the mountainous regions of Guangdong or to the Pan-PRD provinces outside Guangdong. However, if further tightening of the processing trade policy pushes production costs up nationwide, more enterprises may consider relocating to foreign countries such as Vietnam which are more cost competitive.

The closure or relocation of enterprises in the PRD will result in a reduction in the volume of goods imported or exported via Hong Kong. These enterprises will also use less of the logistics-related services offered by Hong Kong. For example, 46.9% of the enterprises with plans for relocation from the PRD say they would reduce their sea-freight forwarding via Hong Kong after relocation, while 39.1% say they would reduce their air-freight forwarding via Hong Kong.

Although enterprises will continue to keep their headquarters in Hong Kong after relocation and will even increase the sales, marketing, and product design and development functions of their Hong Kong offices, taking into account that 10.5% of the enterprises indicate they may cease operation while another 73.2% indicate they may cease or scale down their operation, the closing down of these Hong Kong-based enterprises would mean that their demand for commercial services will disappear altogether.

In the event that tax concessions for processing trade are removed 14,500 Hong Kong enterprises would be seriously affected	
● 1,500 enterprises would cease production ● 375,000 mainland production workers would lose their jobs ● 10,000 Hong Kong employees of the enterprises concerned would lose their jobs	● 10,000 enterprises may cease or scale down production ● 2.5 million mainland production worker jobs would be under threat ● 70,000 Hong Kong employees of the enterprises concerned would be affected

Actually, the majority of Hong Kong manufacturers hope to maintain or even expand the scale of their production and operation. They also understand that costs will inevitably go up as the Chinese economy continues to develop. Faced with steep competition from other regions and from different enterprises, many of them indicate that increasing the value-added of their products, improving internal management and enhancing production efficiency are their way forward and strategy for competition in the long run. The TDC survey shows that 53.1% of the Hong Kong manufacturers hope to develop products of better quality.

“Transformation and upgrade” are the common aspirations of both the mainland government and Hong Kong manufacturers. However, Hong Kong manufacturers generally opine that since transformation and upgrade require large capital investment, the policy and business environment must be stable and fair. This is particularly important these days as competition intensifies, profit margin diminishes, and it takes at least five years to develop a new brand and at least 10 years to recover the cost of investing in a new production line. Hence, Hong Kong companies are very prudent about what strategy to take. In the survey, 59.8% of the enterprises say when making a decision they would consider the market potential of the products, 57.2% say they would consider their own financial resources, 55.4% say they would consider their own management/technical know-how, and 44.4% say they would consider the policies of the mainland government.

In terms of product development capability and management/technical know-how, large enterprises have an advantage over SMEs since they have more resources and more channels at their disposal. For example, many large enterprises have been able to develop new products and apply new technologies through establishing contractual or equity joint ventures with overseas companies and importing their technologies, or through joint R&D projects with universities. However, most SMEs are not well-informed

and have no idea how to cooperate with overseas enterprises or with universities. Thus, it is more difficult for them to seek transformation or upgrade.

In view of the attitude of Hong Kong's processing trade enterprises towards increasing competitiveness and the difficulties they face, the Hong Kong side (including the government, intermediaries and trade associations) and the mainland government should strengthen communication and cooperation and provide enterprises with a stable and encouraging environment as well as appropriate supporting services to support and assist them in achieving transformation and upgrade step by step.

7. Difficulties Faced by Hong Kong Manufacturers in Coping with Processing Trade Policy Change

7.1 Difficulties of Transformation and Upgrade

7.1.1 Market Risks

Section 4.4 above shows that the strategy chosen by most Hong Kong manufacturers in achieving transformation and upgrade is developing products of better quality, improving product design, making innovations and developing own brands. Their major concern in launching their own brands or new products is the market potential of the products. Since the majority of SMEs have been engaged in OEM only, they do not have much experience and ability in product design and development and brand management. For instance, SMEs have very little chance of coming into contact with US toy inventors and are not well-informed about market trends and developments. Therefore, the chance that they can develop/produce successful products and brands is slim.

Also, due to rampant pirating and counterfeiting activities on the mainland, new products launched by Hong Kong companies may only have a life span of a few months. This indirectly increases the cost of product development and results in unfair competition. As it takes a long time and huge promotional expenses for a new brand to gain recognition, the lack of IPR protection on the mainland poses an obstacle to brand and product development.

7.1.2 Financial Resources

Other strategies for transformation and upgrade to be adopted by Hong Kong enterprises include production automation, green manufacturing, and investment in developing high-tech products. However, all these require substantial funds. Therefore, when choosing the right strategies for transformation and upgrade, financial resources are an important consideration of enterprises.

When enterprises make investment, the source of their funds mainly comes from bank loans in addition to their circulating funds. According to the FHKI survey, at present 32,300 Hong Kong-invested enterprises in the PRD are not operating in the form of FIE, which means they do not have legal person status. That explains why even if they want to use their factory premises on the mainland as collateral to borrow from banks, no approval would be granted because of the legal person/property rights problem.

7.1.3 Management/Technical Know-How

Apart from financial resources and market risks, enterprises often shy from or fail in developing their own brands or other industrial products because they lack the relevant management or technical know-how. In particular, for the majority of Hong Kong-invested enterprises which are SMEs engaged in OEM, they have for years been concentrating all their efforts on producing the commissioned products and improving their production processes and have hardly switched to the production of other products or extended upstream or downstream along the production chain. The few that have successfully switched to the production of other products or extended upstream or downstream mostly owe their success to luck through the referral or guidance of their clients. Even if a small or medium-sized electroplating enterprise sees market opportunity for auto parts, it will at most extend its production from electroplated bathroom products to electroplated car door handles and is unlikely to switch to the production of car engines.

As for R&D, in recent years many large enterprises have increased investment in R&D and have cooperated with universities in developing new technologies or conducting studies on the application of new technologies. However, for the majority of SMEs, they do not only lack R&D capability but also have no idea which institutions in Hong Kong they can turn to for help or which of the existing research results of universities and research centres in Hong Kong they can make use of.

7.1.4 Mainland Government Policy

Since developing brands and investing in new equipment and new technologies are long-term investment requiring large capital, before enterprises make an investment decision they would look to the costs and expect a reasonable ratio of return, and require a clear and stable policy and investment environment for analysis on feasibility. Take processing with supplied materials for example. Although the Central Government has not yet given any indication that such processing will be abolished, some Hong Kong companies point out that there are signs that the mainland's policy governing processing with supplied materials is changing. For instance, recently when they applied for extension of their processing with supplied materials business licence, they were only granted one year instead of the six-year period granted before. In view of such uncertainties, most of the enterprises engaged in processing with supplied materials are not ready to invest in transformation and upgrade. In the case of the electroplating industry, since the mainland's policy on the industry is uncertain and yet one set of sewage treatment equipment costs over RMB 25 million, some industry players point out that even if they could afford to buy the equipment, they are worried that after they have bought the new

equipment they might be outlawed or forced to relocate as a result of policy change. They find themselves between the devil and the deep blue sea as they have no control over their chances of reaping investment returns. As a matter of fact, although the majority of the factories processing with supplied materials are SMEs, they are by no means backward. Many of them are providing supporting services to large export enterprises such as Foxconn, Acer and IBM. As such, they have to upgrade their production technology from time to time in order to meet the requirements of their clients. Hence, they are in need of a stable policy environment so that they can maintain their production and investment levels.

7.2 Difficulties of Converting from Processing Enterprise into Foreign-Invested Enterprise

7.2.1 Customs Supervision Regulations

As many enterprises processing with supplied materials provide supporting services to large export enterprises and high value-added industries, their existence is important to the whole production chain. However, when some of these enterprises, in response to the mainland's economic and market development needs, plan to convert their existing processing factories into "wholly-owned" or "joint-venture" factories, they find that the regulations, arrangements, and examination and approval procedures governing their application for conversion from "processing with supplied materials" into "FIE" unclear and confusing. They also find themselves at sea because policies differ from place to place.

For enterprises engaged in processing with supplied materials to convert into FIEs, they must go through complicated procedures of applying for removal from customs bonded supervision. Owing to the fact that some local governments are not too keen about handling applications by enterprises for conversion into FIEs and that there are a great number of processing enterprises applying for conversion into wholly foreign-owned or joint-venture enterprises at the same time, it normally takes a long time for the departments concerned to process the applications. **According to the enterprises, it normally takes six to nine months for them to transfer the materials and equipment for production from the processing factories to the new FIEs. For enterprises with only one factory, since they have to suspend production for customs to check the stock before discharging them from customs supervision, they would not be able to fulfil their orders and this brings about great difficulty.**

7.2.2 Market Access Restrictions

For enterprises processing with supplied materials to convert into FIEs, apart from the fact that it takes an unbearably long time, **enterprises in certain industries simply cannot make the change because of policy restrictions**. Enterprises in the electroplating and printing industries are the cases in point. For electroplating, currently Guangdong no longer **issues new business licences or sewage emission permits** to enterprises in the industry. As for printing, under state regulations, wholly foreign-owned or majority foreign-owned books and magazines printing enterprises are not allowed. These businesses have been operating on the mainland in the form of processing with supplied materials for a long time, if they are to convert into FIEs, they have to face great difficulties in terms of market access.

7.2.3 Access Requirements

Some Hong Kong hardware manufacturers point out that the large capital needed to set up FIEs has made it difficult for small factories to cope. For example, **in Dongguan, the minimum investment required by the government for the establishment of an FIE is US$1 million. But for factories processing with supplied materials, when they imported their equipment in the past the price quotation was low or the value of their equipment has depreciated, now that they have to apply for conversion into FIEs they have to inject extra capital.** Some other requirements also pose problems for small factories. For example, enterprises need a truck licence for their operation, but factories are required to have at least five trucks before they would be issued a licence. This has made things difficult for small factories which do not need five trucks.

7.2.4 Export Performance

Under the existing customs duty deposit system whereby enterprises are managed by category, **Category A enterprises must attain a certain level of export performance. When a processing factory classified as Category A converts into an FIE, since it is now treated as a new enterprise without any export performance records, it would be re-classified by customs as a Category B enterprise.** Since Category B enterprises are required to pay a **50% customs duty deposit** on imports of goods under the restricted category, this would pose pressure and difficulty on the cash flow of the enterprise.

7.3 Relocation Difficulties

7.3.1 Processing Zones

The mainland government hopes to relocate all processing enterprises to export processing zones for centralised management. However, the TDC survey finds that after long years of development, processing trade has formed a long industry chain with day-to-day operation involving one to five different processes and requiring many different kinds of raw and auxiliary materials purchased on the mainland. **For example, in deep processing transfers, currently commodities under more than 2,000 tariff codes are involved, accounting for 50% of the total number of tariff codes of commodities involved in processing trade. Moreover, there are over 70,000 processing trade enterprises in Guangdong.** Hence, it is impossible to relocate all the processing trade enterprises in Guangdong to export processing zones. **Even if only enterprises with 100% exports are relocated, the FHKI survey shows that about half of the FIEs (around 10,000) with Hong Kong funds are exporting 100% of their products, and this, added to the 33,800 Hong Kong-invested factories engaged in processing with supplied materials, gives a total of over 40,000 Hong Kong-funded processing factories needed to be relocated to export processing zones. Yet, at present the existing processing zones cannot accommodate all these enterprises.**

7.3.2 Supporting Industries

Even if enterprises do not relocate to export processing zones, they may opt to relocate to other areas in an effort to lower production cost. In both cases, supporting industries can pose a major obstacle. For example, SMEs in Dongguan require several factory transfers in the course of production. Thus, it can be seen that processing enterprises will have difficulty surviving or keeping their competitive edge in areas without a good network of supporting industries.

There are currently **about 1,500 Hong Kong-invested printing enterprises** (including enterprises engaged in processing with supplied materials and FIEs) **in Guangdong**. Most of them are concentrated in Dongguan and Shenzhen because there is **strong linkage between factories and they must stay close together in order to reduce cost. Take the printing of colour carton boxes for instance. The making of a product involves many processes and can only be completed through cooperation among different factories (factory transfers).**

The situation is more or less the same for metal electroplating enterprises. Generally speaking, since the clients (hardware factories) are relatively small in scale and electroplating factories are big operations, **an electroplating factory must have many clients in order to survive. Factories producing general goods also need different electroplating factories for different types of products (such as different metal electroplated components or plastic electroplated components).**

7.3.3 Resources and Cost

Relocation involves a lot of capital. Given the intense market competition at present and the long time it takes to recover investment, most SMEs find it difficult to decide whether or not to relocate. According to the calculation of an electroplating enterprise in Huiyang, relocating its **12 *mu* electroplating factory with 400 workers to the Mayong Electroplating Park, it will at least cost RMB 14 million.** There are also enterprises which point out that while some electroplating parks or eco parks have the support of the local government, it is not known whether these parks are recognised by the provincial or central government. It is also not clear whether these parks have the strength for sustainable development. **Under such circumstances, many manufacturers would rather "stay put" for the time being, and would choose to fold their business if they are forced to relocate by the authorities.**

8. Recommendations

8.1 Recommendations for the Central Government

On Policy Change

8.1.1 Clarify Processing Trade Policy and Sustain Policy Stability

Since transformation, upgrade and relocation are long-term investments involving large capital, enterprises must calculate their costs and returns and look to a clear and stable policy and investment environment before they make a decision. Thus, most Hong Kong companies hope that the Central Government can give clear directions on its processing trade policy, in particular the policy regarding processing with supplied materials, so that they can map out their investment plans and calculate the returns.

Before introducing major policy changes, such as offering preferential bonded import to enterprises in the central and western regions or export processing zones alone, requiring enterprises to meet minimum environmental protection requirements for their equipment and production technology, and suspending the issuance of operation licence for processing with supplied materials, it is suggested that the government should clearly announce the relevant policies and give enterprises a reasonable transition period, **just like enterprises were given a five-year grace period following the promulgation of the draft corporate income tax law**. This could give ample time for enterprises to map out their investment directions and for the mainland government to make the appropriate supporting arrangements.

8.1.2 Reasonable Notification/Transition Period Needed for Changes

A major problem with MOF Circulars No.139 and No.145 is that they were enforced too hastily. Enterprises hope that the ministries and commissions concerned could consult and communicate with them in the course of making adjustments to policies and before introducing the measures. It is also hoped that a longer notification or transition period can be given so that enterprises can have sufficient time to cope, such as (i) changing their mode of operation, (ii) completing the orders on hand, and (iii) switching the origin of their raw materials and adjusting their production processes.

In processing trade, the period of executing a general production order contract is usually six to 12 months, and no alteration can be made to the price or materials of the products at will. Moreover, processing with supplied materials cannot switch to general trade at

once. In the TDC survey, 46.3% of the enterprises say that if their products are affected by the adjustments made to the prohibited category under processing trade, they would need **a transition period of at least 12 months** to make the corresponding basic changes, including switching to export in the form of general trade.

8.1.3 Policy Change Should Avoid Disrupting the Industry Chain

According to findings of both the TDC and FHKI surveys, after long years of development processing trade has formed a long industry chain with day-to-day operation involving one to five processes and requiring many different kinds of raw and auxiliary materials purchased on the mainland. **For example, in deep processing transfers, currently commodities under more than 2,000 tariff codes are involved, accounting for 50% of the total number of tariff codes of commodities in processing trade. The inter-dependent relations between different links of the industry chain are complicated and it is inadvisable to rashly eliminate or restrict the development of individual industries based on subjective considerations.**

Some analyses hold that factories engaged in processing with supplied materials, with their short industry chain and low value-added content, have little effect in boosting the local economy. However, the FHKI survey shows that factories engaged in processing with supplied materials are comparable to factories engaged in processing with imported materials in their enthusiasm and achievements in developing own brands. The products of factories processing with supplied materials, whether they are re-imported after export or transferred-out for deep processing, have become an important integral part of the industry chain in the PRD that cannot be easily separated or cut off.

In the past, continuous efforts had been made by processing trade enterprises to improve their product design and technological level under the pressure of rising costs and growing market competition. And in recent years they have also expedited their pace of transformation and relocation in order to keep their competitive edge. Hence, **sweeping measures to prohibit or restrict the development of certain products or industries and substantially increase the operating costs of enterprises will likely pose cash flow problems to some SMEs which are undergoing transformation and force them out of business.**

While products under the prohibited and restricted categories in processing trade are classified by tariff codes, whether a product falls under the high pollution, high energy consumption or low value-added category is not determined by its tariff code. For example, the papermaking industry will not cause pollution as long as

good measures are taken to protect the environment. Also, the same metallic raw material may be used in high-tech industries as well as traditional light industries, while low value-added industries can supply parts to high value-added industries. For instance, electroplating and packaging are supporting industries which are indispensable to most industries. Therefore, simply using tariff codes to determine whether a product or industry is prohibited or restricted in processing trade may end up "killing the innocent", cutting off the supporting industries from the production chain of certain high value-added or encouraged industries. In order to compensate the shortcomings caused by policy changes involving the categorisation of products by tariff codes, it is suggested that factors such as "production technology level", "proprietary brand" and "innovative design" should be taken into consideration when making policy changes. However, these are merely remedial measures. In the long run, transformation and upgrade should be determined by market forces and administrative means should not be used lightly to intervene.

8.1.4 Provide Explanations and Guidelines for Policy Change

After the issuance of Circular No.139, as customs and enterprises were not handed a clear and complete catalogue of products under the prohibited category in processing trade or relevant working guidelines, both enterprises and mainland frontline policy enforcement officers were unable to make prompt response. And the fact that different customs offices and different officers have different interpretations of the new policy also put enterprises in great difficulty and perplexity. It is hoped that in future when new policies are introduced the departments concerned can hold policy briefing sessions for the benefit of the public and the policy enforcers, providing them with clear policy guidelines and implementing rules. Also, there should be an office responsible for handling enquiries from the public about the policy.

<u>On Enterprise Transformation and Upgrade</u>

8.1.5 Provide Clear Guidance and Lenient Arrangements for Enterprises to Convert from Processing with Supplied Materials into FIEs

For those Hong Kong companies which intend to convert into wholly foreign-owned or joint-venture enterprises and develop domestic sales and general trade, they all hope that the Central Government can **bring together the customs, industry and commerce, and taxation departments to formulate and issue a set of policy guidelines on the procedures and measures for the conversion of factories**

engaged in processing with supplied materials into FIEs. The policy guidelines are to be provided to all foreign economic and trade departments, customs offices and other relevant departments across the country as the basis for handling such applications.

People in the trade also hope that the Central Government would consider providing simpler or lenient treatments for enterprises applying for permission to convert from processing with supplied materials into wholly foreign-owned or joint-venture enterprises on matters such as the removal of equipment and materials from customs supervision, the payment of retrospective tax on these equipment and materials, the placement of workers after the closure of the processing factory, and counting the export performance of the processing factory for the categorisation of the new FIE under the customs duty deposit system. Alternatively, it is hoped that processing enterprises established before a certain time may be allowed to change their business registration and legal person registration and continue their existing production activities by keeping their original location, original factory, original workforce and original export records without having to pay the relevant retrospective taxes.

8.1.6 Improve Payment Method for Customs Duty Deposit

Financial resources are another major difficulty and consideration of enterprises seeking transformation and upgrade. In the wake of the processing trade policy change, a great number of Hong Kong enterprises have to make “actual payment” instead of “nominal payment” of customs duty deposit for their processing trade activities. This would make their cash flow even tighter. **It is therefore suggested that the Central Government should loosen its grip on the actual payment of customs duty deposit by allowing processing enterprises to use letters of guarantee issued by Hong Kong banks as deposit, or even allowing processing enterprises to provide insurance policy in lieu of cash payment as in the case of “carnet”. This should help alleviate the cash flow problem of enterprises.** As long as the state is willing to accept letters of guarantee or insurance policy as a form of “actual payment” of customs duty deposit, details such as fees, insured amount and risks consideration can be left to the market.

8.1.7 Formulate Rules Encouraging Import and Domestic Sales

It has been said that one of the reasons for China’s expanding trade surplus in recent years is the extension of its processing trade industry chain and the increase in product value-added. In order to suppress the further expansion of trade surplus, relevant

policies should be formulated and the necessary supporting environment should be created, including strengthening IPR protection, to encourage enterprises to develop domestic sales and own brands.

8.2 Recommendations for the Guangdong Provincial Government

8.2.1 Provide One-Stop Service to Facilitate Enterprises in Their Application for Conversion from Processing Enterprise to FIE

People in the trade reflect that at present administration departments in different localities differ in their attitude towards the handling of applications by enterprises for conversion from processing with supplied materials into FIE. While some are very supportive, others are not keen about the idea, with some even imposing additional requirements to deter enterprises from seeking conversion. Therefore, it is the hope of enterprises that the Guangdong government can set up a one-stop inter-departmental office responsible for providing consulting service, assisting enterprises engaged in processing with supplied materials in their application for conversion, and offering help to enterprises that encounter difficulties in the process.

8.2.2 Assist in Solving the Problem of Legal Person Status

Guangdong is the first province in China to open to the outside world, it is also the province with the largest number of “processing and compensation trade” enterprises in the country. In “processing and compensation trade” enterprises where the Chinese party is the legal person representative of the enterprise, the property rights are not clear, the enterprise easily falls under the control of the Chinese legal person, and operation is inconvenient. Moreover, it is difficult to use the assets of a “processing and compensation trade” enterprise as collateral to borrow from banks. It is therefore hoped that assistance can be given by the Guangdong government to Hong Kong companies to solve the problem of legal person status and property rights.

8.2.3 Be Fair to All Enterprises in Policy Implementation

In general, Hong Kong processing enterprises are very supportive of environmental protection as well as transformation and upgrade. In environmental protection, for example, some electroplating enterprises say they would invest RMB 600,000 every two years to upgrade their equipment. However, many Hong Kong enterprises find that mainland law enforcement officials tend to be very selective in their enforcement of

environmental regulations and are more lenient towards some enterprises than others. They reckon that such unfair treatment in law enforcement increases the cost of law-abiding enterprises and puts them in an unfavourable position when competing with enterprises that do not observe the law. Also, some local governments grant the status of high-tech enterprise to enterprises which have good relationships with them, making these enterprises eligible for tax concessions so they can compete at lower prices. Thus, Hong Kong firms hope that the Guangdong government can strengthen its supervision of the law enforcement departments at local levels so that Hong Kong enterprises can be given fair treatment and can compete in a level playing field.

8.2.4 Establish Export Processing Zones to Give Enterprises an Option

According to the TDC survey, 38% of the Hong Kong-invested processing enterprises in the PRD have plans to relocate from the PRD in a move to reduce cost. If further adjustments are to be made to the processing trade policy thereby increasing the tax cost of enterprises, the urgency for relocation will augment. Taking into account that the Central Government is considering offering preferential processing trade policies only to enterprises in export processing zones in a bid to attract processing trade to these zones yet there are only two export processing zones under closed customs supervision in the whole of Guangdong, it is suggested that the Guangdong provincial government should build more export processing zones to accommodate enterprises with the need to relocate. Alternatively, action can be taken to apply to the Central Government for permission to turn the existing industry relocation parks that are being promoted with great enthusiasm into export processing zones to increase their appeal to enterprises. This can also help expedite the relocation of enterprises in the PRD to the eastern and western wings and the mountainous regions of Guangdong, thereby upgrading the industrial structure of the province. Furthermore, in order to remove the obstacles to relocation created by the lack of supporting infrastructure, the authorities concerned should improve the transportation network serving the parks and strengthen the links and synergy with other manufacturing industry clusters.

8.2.5 Expedite the Construction of Government-Recognised Eco Parks

The Guangdong provincial government provides that central planning is implemented in heavily polluting industries such as chemical pulp, electroplating, textiles printing and dyeing, tanning, chemicals and building materials, which have to be relocated to specialised parks for centralised treatment of pollutant emissions. For instance, the Dongguan city government stipulates that by the end of 2007 all high pollution industries must be relocated to specialised parks for central management. But on the whole, the

progress of eco park construction in Guangdong province is slow. For example, it generally takes two to three years to build a specialised electroplating park, but at the moment most of the electroplating parks which have passed environmental assessment are still at the earth levelling stage and it is impossible for enterprises to move in. Also, a few years ago some less developed areas devoted a lot of efforts to building industrial parks, which attracted a large number of high energy consumption and high pollution industries to relocate there from the PRD. However, since the problem of environmental protection cannot be solved properly, the enterprises in these parks have to face the fate of moving again in the near future. **Hence, the enterprises hope that the Guangdong government can announce, approve and expedite the construction of a batch of eco parks with central pollutant emission facilities as an option for relocation by enterprises. The provincial government is also called on to improve the transportation links and supporting infrastructure serving these parks.**

8.3 Recommendations for the Hong Kong Government and Relevant Intermediaries

On Policy Change

8.3.1 Strengthen Liaison between Hong Kong Manufacturers and the Central Government on Processing Trade Policy

According to the TDC survey, 32% of the production enterprises in the PRD say the processing trade policy change has affected them seriously, but **when asked whether or not they would switch to production and export in the form of general trade if the raw and auxiliary materials needed are classified under the prohibited category in processing trade, 45.8% indicate they have no idea and would wait and see. When asked whether or not they would consider purchasing the affected products on the mainland instead, 23.4% indicate they have no idea and would wait and see.** To a certain extent, this shows that Hong Kong enterprises **are not sensitive enough about policy developments on the mainland, have little knowledge about the direction of policy change, and do not have a firm grip of the urgency of their own adjustment.**

In order to help Hong Kong manufacturers accurately grasp the situation, plan ahead and miminise the impact of the mainland policy change on processing trade and the Hong Kong economy, it is suggested that the HKSAR government should **strengthen liaison and communication between the Hong Kong business community and relevant departments and their mainland counterparts** in regard to the processing trade policy**.**

While assisting in offering **consultation before the introduction of new policy or adjustment measures by the mainland**, the Hong Kong government can also **serve as a window for disseminating news on the latest policies to Hong Kong processing trade enterprises.** Through establishing ties with the trade, the Hong Kong government can collect information on the developments and difficulties of the trade which can be used as references by the mainland and Hong Kong departments concerned in the formulation of policies.

8.3.2 Assist Hong Kong-Invested Enterprises in Moving their Production Base in Entire Clusters

According to the TDC survey, 37.3% of the enterprises in the PRD have plans to relocate their production lines to other places. The survey also finds that their major considerations for relocation are wage level, labour supply, land, infrastructure, transportation, supporting industries and closeness to clients.

Large factories can normally take an active role in relocation, with their major considerations being wage and labour. But for small factories, the role they take is rather passive as they have to go where their clients go. Take the toy industry for example. Due to cost considerations, many big factories started relocating a few years ago to the mountainous regions of Guangdong as well as to Jiangxi, Hunan and other provinces with lower labour cost. When these factories moved, they usually asked their supporting factories, such as outsourcing factories providing colour carton boxes, moulds and other production support, to relocate with them. Since at present supporting industries outside the PRD have yet to mature, most factories would only invest in one or two production lines when they begin relocation and would only relocate all their production lines when the opportunities or conditions are ripe.

Since large factories need the support of small and supporting factories while small and supporting factories need a sufficient number of steady clients before they would relocate, if the authorities concerned can, taking into consideration the current need of a large number of enterprises for relocation, organise and coordinate entire industry clusters of big, small and supporting factories and put them all in an industrial park that can accommodate a critical mass of manufacturers, it would help ease the relocation pressure confronting Hong Kong processing enterprises in the PRD. The relocation of entire clusters can increase the power of bargaining with the local governments, including the power of bargaining with the customs in streamlining the formalities and arrangements for cross-customs area

equipment transfer, and minimise the impact of insufficient supporting industries on production after relocation.

8.3.3 Assist Hong Kong Companies in Alleviating their Financial Difficulties during Transition

Many enterprises engaged in processing with supplied materials own a lot of production equipment which have already been paid for. But owing to the problem of legal person status and property rights, such equipment cannot be used as collateral for obtaining bank loans. It is therefore hoped that the HKSAR government can assist these processing enterprises in consulting with the mainland authorities or assist them in quickening their pace of converting into FIEs so that the problem of legal person status and property rights can be resolved. Moreover, the **HKSAR government can also consider revising the existing "SME Loan Guarantee Scheme" to help alleviate the financial difficulties of enterprises.**

On Developing Brands and Domestic Sales

8.3.4 Promote and Encourage Cooperation between Enterprises and Universities and Research Centres

In the face of an increasingly competitive market environment, Hong Kong enterprises were able to maintain their export growth in the past through unremitting efforts to improve their production technology and develop new products. However, with the rapid growth of mainland enterprises, today Hong Kong enterprises are no longer competing with rivals in Asia or Europe and America but private enterprises in mainland cities such as Yiwu and Shantou. As a result, export prices have become more competitive and profit margins continue to diminish. Take the toy industry for instance. Most OEM/ODM manufacturers are faced with the problem of rising costs but no increase in the price of products. As they can only develop products at existing price levels, their profit margin is only in the region of 5%. **According to the TDC survey, the average profit margin of Hong Kong exports has dropped by nearly 50% over the past five years.**

In view of rampant piracy on the mainland, Hong Kong enterprises cannot maintain their competitive edge by relying on design alone, but have to make better use of new technologies and new techniques. People in the trade suggest that in order to strengthen the application of technologies by Hong Kong enterprises, efforts should be made to encourage and promote cooperation between enterprises and universities, such as the Institute for Enterprise of Hong Kong Polytechnic University, to increase the ability of

enterprises in developing and applying new technologies, new materials, new technological processes and new products. Also, since there are different types of government subsidised research centres and technology centres in Hong Kong, people in the trade hope that the government can provide a platform for these centres to introduce their research results to enterprises or introduce these centres to enterprises so that they can discuss the chances of cooperation.

8.3.5 Provide Enterprises with Better Market Information

The TDC survey shows that when enterprises seek transformation and upgrade, the **market potential of the products** is their biggest difficulty and consideration. In view of the fact that SMEs have fewer market information channels and that there is a growing trend for enterprises to increase sourcing on the mainland, open up the mainland market and develop their own brands, related organisations should provide enterprises with information on relevant laws and regulations, market situation, consumer demand and trends, and assist them in making rational assessments of market opportunities and risks.

8.3.6 Assist Hong Kong Companies in Shifting from Export to Domestic Sales

One of the major difficulties facing Hong Kong companies in expanding the mainland market is the lack of sales channels. The authorities concerned should help Hong Kong companies wishing to shift their business focus from export to domestic sales to build sales channels. According to the TDC survey, in 2006, only 25.7% of the Hong Kong-invested enterprises in the PRD were engaged in domestic sales; while 48.6% indicate they have plans to sell to the mainland market in the next three years.

8.3.7 Strengthen the Awareness and Recognition of “Hong Kong Brands”

Another difficulty facing Hong Kong companies in developing domestic sales and own brands is the lack of market recognition. The authorities concerned should further strengthen publicity and promotion of Hong Kong brands on the mainland in a move to enhance the awareness of mainland consumers of Hong Kong branded products.

8.4 Recommendations for Trade Associations

8.4.1 Strengthen Efforts in Keeping Members Posted of Processing Trade Policy Change and the Urgency of Transformation and Upgrade

It is the established policy direction of the mainland to restrict “high energy consumption, high pollution and resource consumption” industries and promote the transformation and upgrade of processing trade. Hong Kong processing enterprises should prepare themselves for this change and get ready for transformation and upgrade. In addition to converting from enterprises processing with supplied materials into FIEs, they should also consider changing their business model. For instance, they may consider concentrating on the upstream (product design and tooling) and downstream (quality control and product testing) activities along the production chain and outsourcing the production processes in between. Some enterprises may even consider conductng trading alone and giving up production.

8.4.2 Promote Strategies of Transformation and Upgrade to Members

Trade associations should step up efforts in publicising, explaining and promoting the importance of transformation and upgrade to members, offering strategy options to them, and providing them with information on successful case studies for reference. Trade associations should also cooperate with the Hong Kong Productivity Council, Science Park and other institutions in introducing to members new technologies, new materials and new products that may be applied to production so that enterprises can have more innovative ideas and develop more competitive products.

8.4.3 Assist Members in Understanding and Using New Technologies, New Materials and New Products

Some enterprises indicate that many manufacturers wish to incorporate new technological elements in their product design. However, when individual manufacturers purchase such patented technological products from technology developers, very often the prices tend to be high because their purchase volume is small. It is suggested that trade associations could provide assistance by grouping together several enterprises that wish to purchase the same technology and negotiating for a lower bulk purchase price with the supplier. By so doing, enterprises will be able to develop new products at a lower cost.

8.5 Recommendations for Hong Kong Enterprises

In view of the processing trade policy change and the urgency of transformation and upgrade, it is suggested that enterprises should no longer hold a wait-and-see attitude but should:

- quick the pace of transformation and upgrade;
- convert from enterprises “processing with supplied materials” to “FIEs”;
- expedite and strengthen expansion of the mainland domestic market.

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