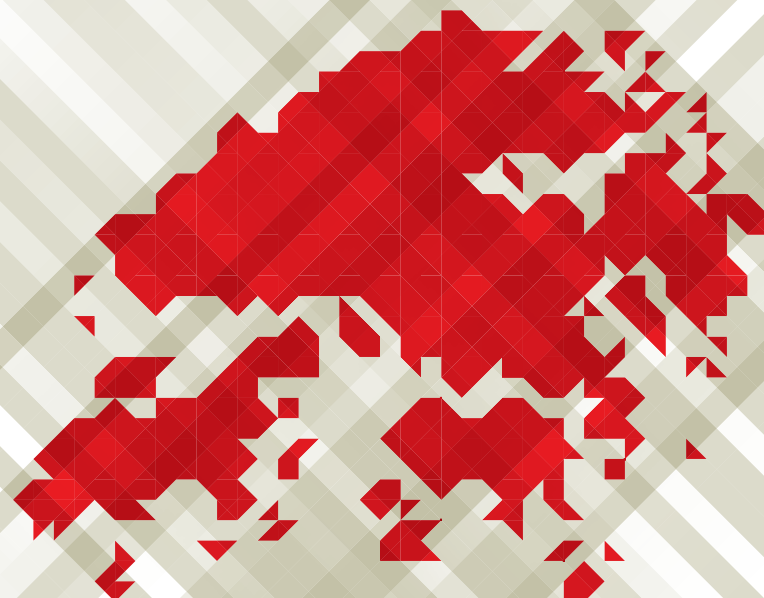
The Economist Intelligence Unit

Free trade frontier?

Hong Kong businesses and the future of FTAs

An Economist Intelligence Unit report



Sponsored by

HSBC

Contents

Executive Summary

Hong Kong's long history as a free and open economy means the city and its companies are more prepared than most for a region and world where trade barriers are steadily being whittled away. Largely unencumbered by revenue-generating tariffs or protected industries, the Special Administrative Region (SAR) is able to freely seek new trade alliances and lead by example in frequently competitive global and regional free trade negotiations.

At the same time, its very openness makes it difficult for Hong Kong to secure the trade pacts that would be of most relevance to its business community. Despite their familiarity with a free trade environment, Hong Kong businesses do not always fully understand and use the few trade agreements (FTAs) the government has concluded, and aren't necessarily advocates of more extensive trade liberalisation.

This paper will examine some of the factors behind this outlook, and how Hong Kong and its businesses may be affected as regional trade policy progresses. It is based on a comprehensive Economist Intelligence Unit (EIU) survey of exporters throughout the Asia-Pacific region that included 100 Hong Kong-based firms. The findings of the survey have been supplemented by independent research and interviews with executives and trade experts.

Key findings of the paper include:

- **Hong Kong firms reap positive results from FTAs:** Almost 90% of companies polled said the trade pacts they were using had increased exports to corresponding markets, while 61% said they had resulted in new business opportunities. Hong Kong firms seem particularly enthusiastic about the SAR's 2003 Closer Economic Partnership Arrangement (CEPA) with China, which allows them to establish fully owned operations on the mainland and in some cases tap into FTA networks they would not otherwise be able to access.

- **Usage rates of Hong Kong's FTAs vary widely:** Some 63% of exporters use the CEPA with the mainland, for example, while just 12% use the deal with New Zealand. For those that are less well used, some companies may be put off by their perceived complexity or a lack of internal resources, but this may also be because they so far largely fail to cover the markets most important to Hong Kong's exporters. (Along with the CEPA and New Zealand deals, Hong Kong has signed FTAs with Chile and the European Free Trade Area, a bloc that includes Iceland, Liechtenstein, Norway and Switzerland.)

- **Companies want more from the government:** While Hong Kong's government is generally seen as a trusted source of information on trade-related developments, 75% of firms are eager to receive more advice and guidance from the authorities on FTA matters. A majority of companies (52%) also feel officials don't accurately represent their interests in trade negotiations.

- **The trade policy outlook is mixed:** Hong Kong companies are keen to see the government sign more trade agreements, and also want it to prioritise efforts to get World Trade Organisation (WTO) talks back on track. However this hasn't consistently translated into strong support for free trade overall. A relatively low number of firms said they would welcome blanket tariff reductions—perhaps as this would undermine Hong Kong's own competitive advantage. Some companies are also sceptical about the prospects of regional trade initiatives under discussion, such as the Trans Pacific Partnership (TPP).

About the research

The Economist Intelligence Unit surveyed 100 Hong Kong exporters, around a fifth of which were construction firms. The remainder were drawn from industries such as manufacturing, information technology, and logistics. The majority—80%—of the firms surveyed had annual revenues of between US$50m and US$150m, with the rest reporting revenues of over US$150m. Around a quarter of the respondents were C-level executives, and another quarter were department heads. The EIU also conducted in-depth interviews with a number of executives and trade experts. The EIU would like to thank the survey participants and interviewees for their time and insights.

The findings of this report are those of the EIU and do not necessarily reflect the views of the sponsor.

This report was written by Jonathan Hopfner and edited by David Line.

Introduction

In the global trade liberalisation race, Hong Kong has a substantial head start. The Special Administrative Region has a long history as an entrepôt and commercial centre, from its early days as a Tang Dynasty port, through its development into a manufacturing hub under British rule, to its emergence as China's financial window to the world. While other markets agonise over whether to lower trade barriers, potentially exposing their industries to the vagaries of international competition, Hong Kong consistently ranks as one of the freest economies on the planet. It charges no tariffs on the import or export of the vast majority of goods, imposes no foreign exchange controls and places no restrictions on foreign investment or ownership.

Many companies have based themselves in Hong Kong precisely because of the city's open-door policies, and have gone on to thrive because of them. Having experienced first-hand the possibilities free trade can create, one would expect Hong Kong firms to be staunch supporters of trade liberalisation overall, keen adopters of the region's expanding web of free trade agreements (FTAs) and eager to see more international markets follow Hong Kong's example.

The reality, as research for this paper shows, is more mixed. While their home base may be largely tariff-free, according to our survey most Hong Kong firms continue to struggle with duties and non-tariff barriers when trading internationally. Only a handful fully utilise all the trade agreements they have access to, and many profess only a limited understanding of these pacts. More interestingly, being the product of a free-trade environment doesn't seem have made Hong Kong-based companies any more positively disposed than their Asian peers towards the global free trade movement and its prospects.

That said, given their background Hong Kong's companies and government have an important contribution to make to the development of regional trade policy at a time when rising competition and protectionist instincts frequently threaten efforts to reduce obstacles between markets. This paper examines how the views and experience of Hong Kong companies may inform the Asian and international free trade debate, and how progress in that debate is likely to affect Hong Kong companies and the SAR as a whole.

1 Punching above its weight

Despite a quasi-independent status and lack of concessions to bring to the table, Hong Kong has proven adept at forging trade relationships.

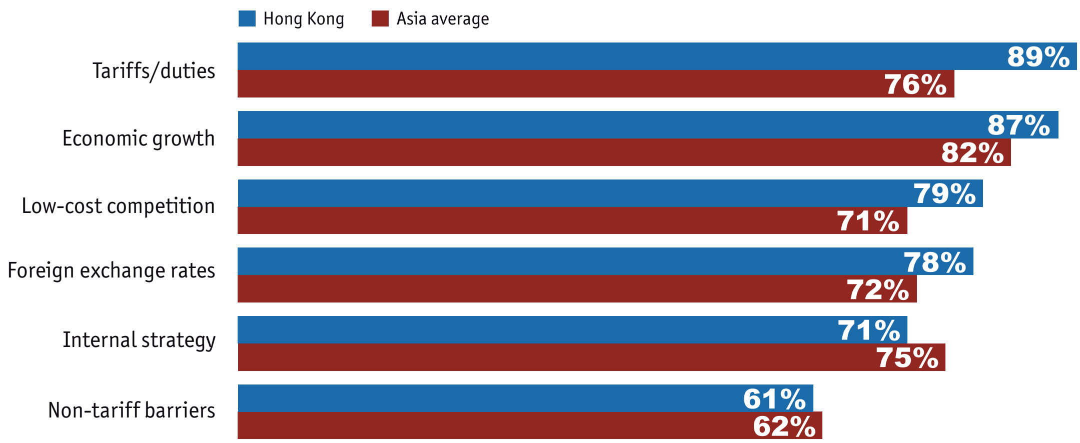
Like many of its Asia-Pacific counterparts, Hong Kong's government bills itself a "staunch supporter" of the World Trade Organisation (WTO)-driven, multilateral trading system, while simultaneously pursuing bilateral and regional FTAs that are seen as in Hong Kong's interests. In some respects, Hong Kong comes to these negotiations in a unique position. The city is free to pursue its own trade policy but it remains a special administrative region of China, a much larger economy. In addition, free-trade talks typically see the parties involved swap tariff concessions, and as Hong Kong's economic model means most other economies already enjoy tariff-free access to its market, on the surface it comes to the table with less to offer.

"Hong Kong's already open, and from that point of view it is wholly uninteresting [as an FTA partner]," says David Dodwell, chief executive of it-based communications firm Strategic Access and executive director of the Hong Kong-Asia-Pacific Economic Cooperation (APEC) Trade Policy Group, which presents the views of Hong Kong businesses in APEC talks. "Again and again Hong Kong would be willing to go into negotiations or discussions because it's relatively easy for Hong Kong to agree an FTA with pretty much anybody, but for the other side, there are just always higher priorities."

Because of these factors, according to Mr Dodwell, Hong Kong remains particularly committed to multilateral trade talks, and

Figure 1: Barriers to trade

% respondents citing as important or very important barrier to increasing exports



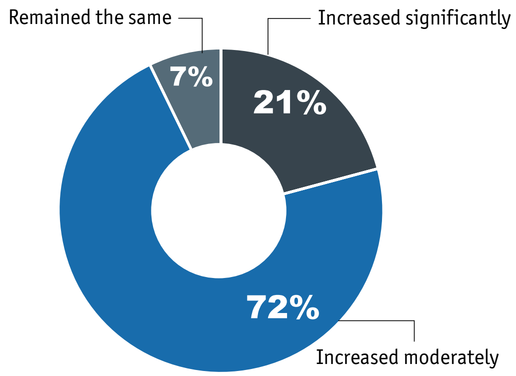
Source: EIU survey. Asia average includes responses from Australia, China, Hong Kong, India, Indonesia, Malaysia, Singapore and Vietnam has been an active player in regional trade forums like APEC. But it has also managed to finalise bilateral free trade pacts with New Zealand, members of the European Free Trade Association (EFTA; a bloc that includes Iceland, Liechtenstein, Norway and Switzerland) and Chile.

The agreement that has arguably had the most impact on the economy and Hong Kong companies is the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA). Concluded in 2003, it gives goods of Hong Kong origin tariff-free access to Mainland China, and also allows Hong Kong-based companies to establish fully owned China subsidiaries (see the Crown Relocations case study, below). Having a China presence also allows Hong Kong companies to take advantage of China's substantial and growing network of FTAs with partners like the Association of Southeast Asian Nations (ASEAN) (as the Lever Style case study, below, illustrates).

Figure 2: Trade surge

Impact on exports of FTA usage

(% Hong Kong respondents)



Source: EIU survey

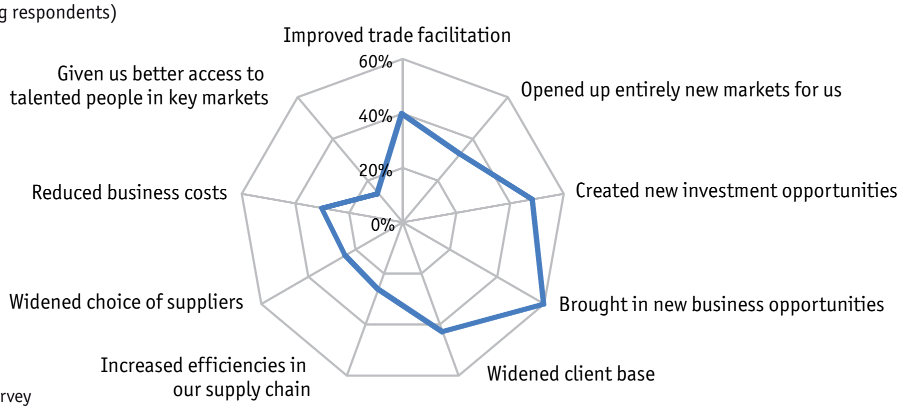
The tariff reductions agreements like CEPA have produced are of great value to Hong Kong's exporters. The vast majority—89%—of those polled said tariffs and duties are of importance or major importance to their ability to boost sales in international markets, one of the highest rates in the region (Figure 1). Non-tariff barriers, which include things like customs procedures and differing technical standards, were also cited as important or very important by 61% of Hong Kong firms.

Adoption rates of FTAs among Hong Kong firms appear to be fairly high by regional standards, with for example 63% of those polled saying they were already using the CEPA and 44% saying they use the EFTA deal. And when Hong Kong exporters use FTAs they evidently find them beneficial. Almost 90% of respondents said the trade agreements they were using had increased exports to the relevant markets (Figure 2), while 61% said the pacts had created new business opportunities (Figure 3).

Figure 3: Getting more out of them

Other benefits seen from using FTAs

(% Hong Kong respondents)



Source: EIU survey

Case study: Crown Worldwide Group—CEPA paving the way

Hong Kong-headquartered Crown Worldwide Group is the world's largest privately held collection of moving and relocation firms, with a presence in 60 countries. Despite being a major mover of goods between markets, it is not an active user of trade agreements—partly because many of the goods it ships are the personal effects of executives undertaking relocations, which are not usually subject to typical duty and tariff arrangements. "Do (FTAs) help us reduce costs or speed up services for customers? Well... not really," says Ken Madrid, Crown Worldwide's CEO for Asia-Pacific and CFO.

The exception is the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA), which Mr Madrid credits with transforming the way the company conducts business in China. Prior to the agreement, non-mainland logistics firms had to limit their China presence to a joint venture or representative office, and as logistics was not generally perceived as a high value-added industry by Chinese officials, "they were restrictive in terms of how companies could perform those services."

After CEPA paved the way for Hong Kong-based services companies to establish fully owned subsidiaries on the mainland, Crown moved quickly to open its own offices there. "It allowed us to reduce our costs because we were more in control, and it allowed us to be competitive, whereas before we would have had to work all through various agents and be taken advantage of, to a large degree. We wanted to really control our own destiny in China, so that's the big difference for us," Mr Madrid says.

The firm has also benefited from doing its own hiring and exerting more control over the goods it brings into the country. "In terms of what we can and can't do, we're never on a completely level playing field [in China], but we're on a better playing field."

What CEPA—and other—trade agreements have largely failed to change, according to Mr Madrid, is the complexity of customs procedures, in China and other countries around the region. Paperwork can pile up and some shipments still languish in ports before they're released, subject to verification or inspections.

"The major commodity we move is used household goods, so it doesn't have any real commercial value. If there's a tariff put on it, it is whatever the customs organisation *du jour* says it is," he says. "Our frustration with customs is the ambiguities of the rules. The rules in different districts might say exactly the same thing but the way the customs official in Shanghai, for example, might interpret them could be different from the way the official in Shenzhen does."

2 Lacking relevance?

Some of the FTAs Hong Kong has concluded have struggled to find relevance in the business context.

For all the positive views on FTAs, the survey also suggests many Hong Kong firms have yet to embrace them completely. Just 11% of respondents said they use all the FTAs they are aware of.

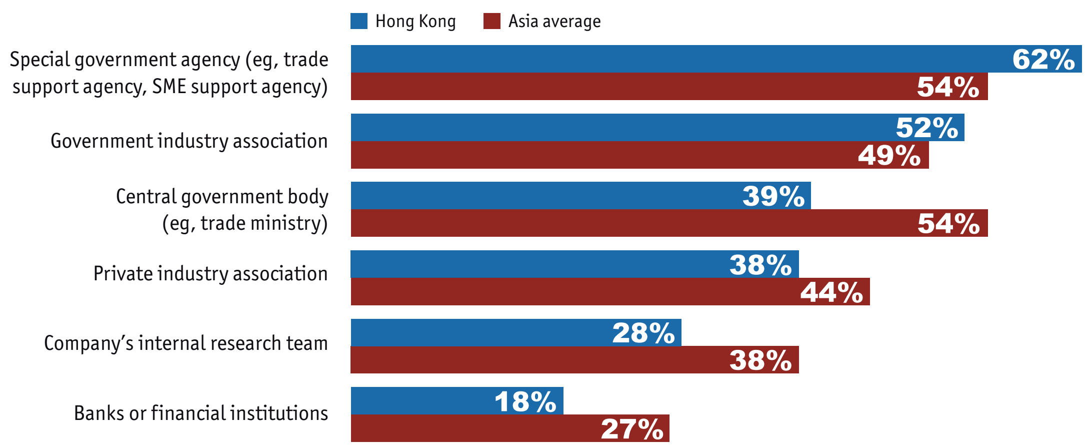
As in other markets, FTA adoption in Hong Kong seems to be hampered by knowledge and capacity gaps. Around one-third of firms admitted to having a limited understanding of some FTAs, with 44% of these saying they would like to find out more but felt the agreements and their details were not sufficiently publicised. (That said, the proportion of Hong Kong respondents with a poor understanding of one or more FTAs was well below the regional average of 44%.)

Perhaps because of Hong Kong's tradition of transparency, the government is seen as a credible source of trade intelligence, with 62% of companies citing dedicated government agencies as a key source of information on FTAs and their benefits—the second-highest rate among Asian markets surveyed (Figure 4). At the same time, 85% felt the government providing more education and advice on existing FTAs could play an important or very important role in increasing their exports.

Even when companies are fully informed about trade pacts, they are frequently seen as too difficult to take advantage of. When asked why they decided not to use FTAs they were aware of, 33% of respondents cited the

Figure 4: Info straight from the source

% respondents citing as main source of information on FTAs

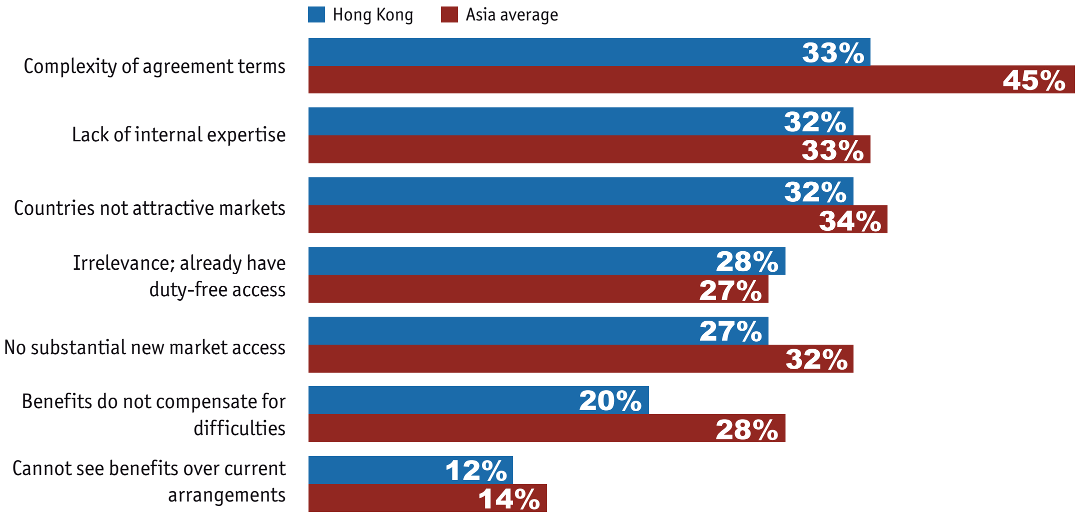


Source: EIU survey

Figure 5: Worth the effort?

Reasons for not using FTAs

(% respondents)



Source: EIU survey

perceived complexity of agreement terms—a low proportion compared to other markets in the region, but still making it the most commonly cited reason in Hong Kong (Figure 5). A similar number cited a lack of internal expertise, despite almost two-thirds of respondents employing a person solely responsible for managing and analysing trade issues.

Many companies also felt some agreements provided little or no new market access, with 89% of those who cited this reason saying it was of importance or major importance to their decisions to leave FTAs on the shelf. This may be partly a result of the limited number and scope of FTAs Hong Kong has concluded. Apart from the CEPA, Hong Kong lacks pacts with most of its biggest trading partners, which include the US, Japan, Taiwan and Singapore.

"If you asked the very large majority of business leaders here in Hong Kong about the value of FTAs, the extent to which they use them to direct business activity, the very large majority, and I'm talking 90-plus per cent, would say they're of no relevance to us," says Mr Dodwell. "We're looking at other factors, and more often than not, the 'spaghetti bowl' confusion that arises from FTAs are more trouble than they're worth."

Nevertheless, Hong Kong companies that do use FTAs overwhelmingly report the benefits of doing so. They want more of them. And the SAR aims to be at the heart of future negotiations to liberalise trade in goods and services in the region, and across the world.

Case study: Lever Style—Shifting supply chains

Textiles were once a cornerstone of Hong Kong's vibrant manufacturing sector, but in line with other industries production has largely shifted to cheaper markets, particularly the mainland. Many textile firms however remain headquartered in the SAR and base finance and administrative functions there—as is the case with Lever Style, a garment maker with an over-50-year history in Hong Kong that produces clothes for top brands like Armani, Calvin Klein and Ralph Lauren.

While low costs and well-established infrastructure and cultural links once made mainland China a natural production base for Hong Kong companies, trends are changing—and FTAs are playing a role in that process. Lever Style chairman and CEO Stanley Szeto says rising wages and other factors are making China increasingly uncompetitive, and for the last four years the firm has been shifting manufacturing to supplier factories in South-east Asia, particularly Vietnam.

The nature of its business means Lever Style finds little use for the trade agreements to which Hong Kong itself is a direct party, such as the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA), since it rarely ships products from Hong Kong. However it has successfully used the China-ASEAN free trade agreement to lower production costs for goods sold in China, which is increasingly a market for the company as well as a manufacturing centre. With most goods now enjoying duty-free access between China and Vietnam, it is now cost-effective for Lever Style to ship fabric from China to lower-cost factories in Vietnam, then re-export the finished products back to China to sell there.

However, the strategy has had its hiccups. "It took a while just to get the hang of it, how to fill in all the forms at customs," Mr Szeto says. "Clearance may take days—sometimes they want to inspect the cargo and it takes another week, so you have to allow for that bureaucracy."

Internationally, duties in the textile sector remain relatively high, especially for synthetic product categories, where they can top 30%. Mr Szeto says Lever Style is therefore watching progress on the US-led Trans-Pacific Partnership (TPP) with a mix of excitement and trepidation. China has yet to join talks on the agreement, and if it suddenly results in sweeping tariff cuts in other markets, some companies could face short-term difficulty as a result.

"For companies which are still quite heavily reliant on China, the sooner it [TPP] happens, the worse it is for them, because they become less cost competitive, while their competitors become cheaper," says Mr Szeto.

As the firm's ongoing efforts to move more production out of China to South-east Asia progress, however, the TPP becomes a more compelling proposition. Multiple ASEAN countries, including Brunei, Singapore, Malaysia and Vietnam, have signed on to the initiative, opening the possibility of Lever Style's Vietnam-produced goods enjoying lower-tariff access to what is still the company's biggest market—the US. "If we can [shift more production] before TPP comes into effect, then we would be in a better position."

3 Charting a future trade course

As multilateral discussions and regional initiatives proliferate, there are more trade policy developments competing for Hong Kong's focus.

Hong Kong's government is working actively to expand the city's trade network, both as independently and as a participant in regional initiatives. In July 2014 it launched negotiations on a comprehensive FTA with ASEAN intended to cover areas like intellectual property rights enforcement and the simplification of customs procedures as well as tariff reductions. Hong Kong officials see the pact enhancing the city's role as trading hub and as a gateway for trade and investment between ASEAN and mainland China.

Coming from a strong free trade tradition, Hong Kong is also generally seen as a proactive force in international trade forums. It is for example at the forefront of efforts to strike a supplementary WTO agreement eliminating tariffs on environmental goods, and it is a provider of technical and financial assistance to APEC. It has also enthusiastically supported an effort to promote free trade in services—an area many trade deals in the region have so far failed to tackle satisfactorily (see box). Mr Dodwell says Hong Kong is perceived as a rare "honest broker" in international trade negotiations, which are frequently driven by efforts to protect domestic interests.

"[In APEC] there's a lot of capacity-building and best-practice learning that Hong Kong leads on, which others take away and which is underpinning liberalisation across the region," he says. "That's a kind of liberalisation commitment that isn't noticeable because it's not enshrined in FTAs or formal agreements, but it's extremely important... We have a depth of experience and expertise in a bunch of areas that's valuable."

Hong Kong companies' views of the government's efforts in the trade sphere are mixed. Just over 50% of those surveyed agreed or strongly agreed that the government does not consider their needs when conducting FTA negotiations. At the same time, though, 83% hoped to see the government sign more FTAs, saying this would play an important or very important role in increasing their exports.

Firms were also keen for the government to sign FTAs with more comprehensive provisions, and with larger economies (Figure 6). Wide-ranging trade arrangements such as the WTO, however, seem to trump more limited agreements in the eyes of exporters. Sixty per cent of those surveyed agreed or strongly agreed that the government should stop signing more limited FTAs and instead focus on global agreements.

The policy landscape has also been complicated by the emergence of plans for so-called "supra-regional" free trade zones, particularly the US-backed Trans-Pacific Partnership (TPP) and the Free Trade Area of the Asia Pacific (FTAAP), which is being studied within APEC at China's urging.

Both initiatives include most major Asia-Pacific economies, though the TPP does not yet include

Focus on TiSA: Services' saviour?

Hong Kong is a participant in negotiations on the Trade in Services Agreement (TiSA), which began in 2013 when a subset of WTO members, led by the US, Australia and the European Union, decided to spearhead discussions on services trade liberalisation that could feed back into the broader—and largely stalled—WTO talks. The TiSA has since expanded to include 23 parties that together account for around three-quarters of the global trade in services. Their aim is a "comprehensive" pact that substantially reduces major barriers to international services delivery, such as restrictions on cross-border data flows.

TiSA is particularly important for Hong Kong given the city's dependency on services, which account for over 90% of the economy. The government has hailed TiSA as a "significant trade agreement" that will "create more business opportunities beneficial to [Hong Kong's] long term growth," as the majority of the city's services exports, particularly in the financial sector, go to other TiSA members.

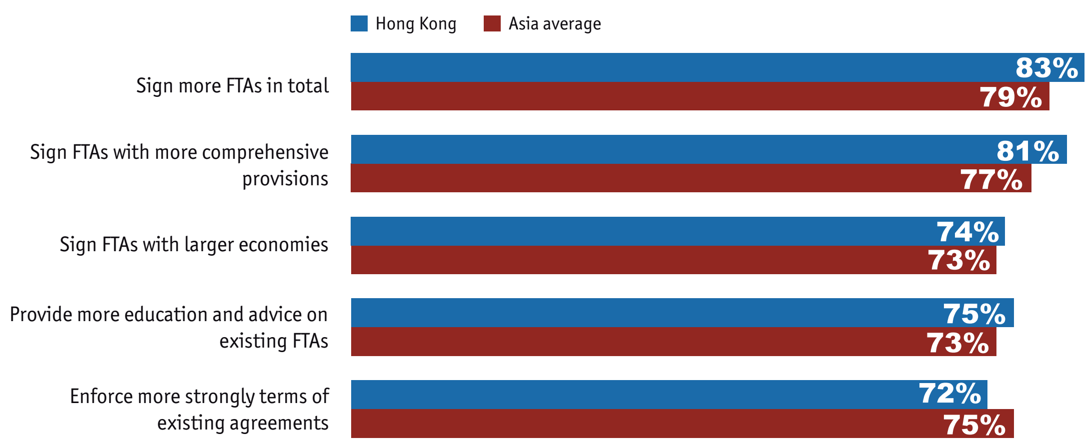
Views in the business community seem more cautious. The Hong Kong Institute of Directors has expressed concerns the agreement could make it easier for investors to sue the government over policy matters, and more difficult to regulate and provide public services. Mr Dodwell points out that most economies are embarking on services liberalisation unilaterally regardless, "in response to the pressures involved in attracting investment and trade."

Participants in TiSA sound upbeat, with US Trade Representative Michael Froman remarking in June 2014 that the talks had produced a framework agreement and were making progress in sectors like telecommunications and finance.

However, Mr Froman also made it clear that TiSA is tackling issues that could make reaching a consensus difficult. Questions remain about how TiSA will fit into the WTO and other international trade frameworks. While members have pledged to model a TiSA agreement on WTO standards and hope to extend it to other WTO members in future, it is not part of the WTO architecture and has been referred to as a "closed shop." By carving out another separate trade arrangement Hong Kong and other parties to the TiSA may add yet another strand to the "noodle bowl" of trade deals confusing many companies and commanding the attention of diplomats.

Figure 6: What the government should do next

% respondents picking issue as very important or important



Source: EIU survey

China. Nonetheless, officials have insisted they are complimentary rather than competitive, and some have even suggested they could converge. Hong Kong has so far steered clear of the TPP talks, and the special administrative region's chief executive, CY Leung, has expressed strong support for the FTAAP. Businesses are aware of the potential of both and watching developments with interest, but they are also far from optimistic about the chances of the rhetoric becoming reality.

"It's great to introduce [the TPP]… but [governments] actually need those tariff dollars or those customs fees, so if you suddenly say you're not going to have those tariffs, who's going to support all the people who are being supported by them today?" says Ken Madrid, CEO for Asia-Pacific and CFO at logistics group Crown Worldwide. "That's where you're going to have trouble, both at the taxation level and with the industry groups that won't want to give something up."

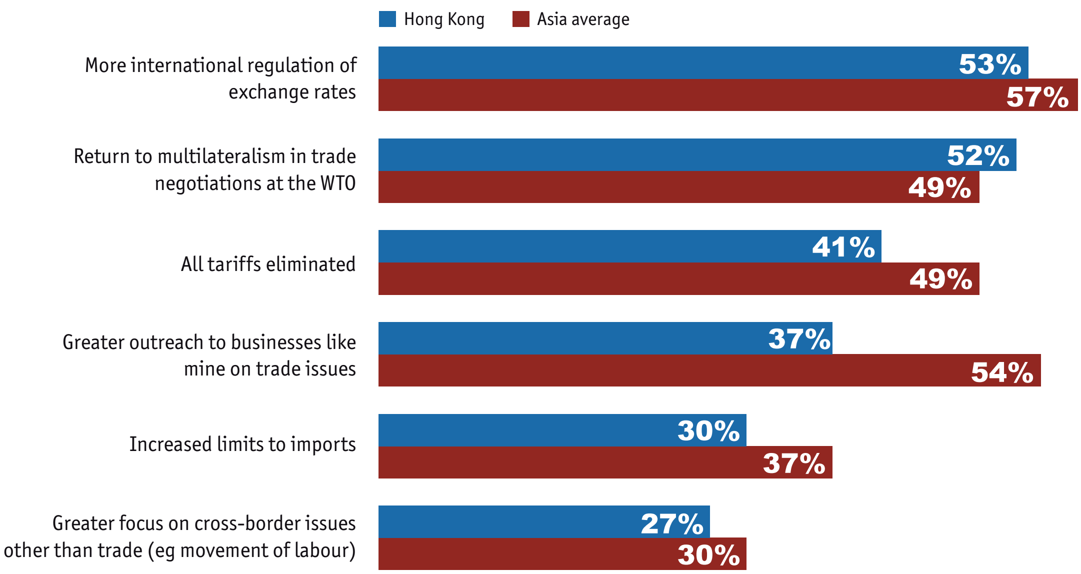
Stanley Szeto, chairman and CEO of Lever Style, a Hong Kong-based textiles firm, also questions whether the ideals behind such agreements will work in reality. "In an ideal world there's zero tariffs for everybody, so everybody can compete based on their own merit… but the world is not ideal and such an arrangement is extremely difficult to put together; just look at how the Doha Round and all those WTO arrangements take years if not decades to move along," he says.

In terms of his views on tariffs, among Hong Kong executives Mr Szeto may be in the minority. Just 41% of Hong Kong companies said they would like to see all tariffs eliminated globally, the lowest rate among all markets polled (Figure 7). By contrast, over half would welcome more international regulation of exchange rates—hardly the hallmark of a free market.

Since Hong Kong firms, based in a zero-tariff market, would presumably have little to lose from more tariffs being dropped, this aversion seems strange. But it may have to do with what some trade watchers paint as a uniquely Hong Kong paradox. On the one hand, the city is a success story and strong international advocate of free trade. On the other, if free trade advances

Figure 7: In an ideal world...

% respondents saying they would like to see the following in future



Source: EIU survey

globally to the stage where tariffs are largely a thing of the past and goods and services flow effortlessly almost everywhere, Hong Kong will lose one of its main differentiators.

"Hong Kong's competitive advantage for a long time has rested on being immensely liberal," says Mr Dodwell of the Hong Kong-APEC Policy Group. "If other economies were to get to the same place, if they were to liberalise in the way Hong Kong's liberalised, then a lot of Hong Kong's competitive advantage would be eroded."

For all these concerns, free trade is perhaps more deeply rooted in Hong Kong than anywhere else—and that gives the city and its companies a depth of experience and expertise that will stand both in good stead in a steadily liberalising global trade environment. Hong Kong should therefore view the emergence of a regional free trade regime as an opportunity to serve as a model and mentor for the many markets now attempting to follow in its footsteps.

The Economist Intelligence Unit

LONDON
20 Cabot Square
London
E14 4QW
United Kingdom
Tel: (44.20) 7576 8000
Fax: (44.20) 7576 8500
E-mail: london@eiu.com

NEW YORK
750 Third Avenue
5th Floor
New York, NY 10017, US
Tel: (1.212) 554 0600
Fax: (1.212) 586 0248
E-mail: newyork@eiu.com

HONG KONG
6001, Central Plaza
18 Harbour Road
Wanchai
Hong Kong
Tel: (852) 2585 3888
Fax: (852) 2802 7638
E-mail: hongkong@eiu.com

GENEVA
Rue de l'Athénée 32
1206 Geneva
Switzerland
Tel: (41) 22 566 2470
Fax: (41) 22 346 9347
E-mail: geneva@eiu.com