Part II
East Asia and Globalization

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The Greater China Growth Triangle in the Asian Financial Crisis

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This chapter focuses on economic cooperation between Hong Kong, China (henceforth referred to in this chapter as Hong Kong); Taiwan, China (henceforth referred to as Taiwan); and Mainland China to examine (a) the impact of the Asian financial crisis on trade and investment flows among the three entities and (b) their longer-term implications for China as a whole in the context of economic integration among nations. Throughout the chapter, the term Greater China will be used to refer to the three Chinese locations.

Greater China as a Process of Economic Integration

Hong Kong and Taiwan, small as they are in population and geographic area, are by no means unequal economic partners of their huge Mainland Chinese neighbor. Hong Kong's gross domestic product (GDP) per capita in 1997 stood at US$26,369 and Taiwan's was US$13,233, compared with probably not more than US$860, for Mainland China. Dollar for dollar, that is, without adjusting for possible implications of the purchasing power disparities between the respective currencies), the combined GDP of Hong Kong and Taiwan is surprisingly some 51 percent of China's (in absolute terms, China's GDP was US$900.88 billion in 1997). The Hong Kong government's budget expenditure alone, totaling US$22.4 billion in 1997, is equal to around 35 percent of China's national budget expenditure of US$64.81 billion. In short, the remarkable economic importance of both Hong Kong and Taiwan impinges significantly on their economic relationships with China.

There are several important aspects to the emergence of Greater China as a regional economic growth triangle in the past 20 years or so.

First, economic integration within Greater China has taken place essentially by way of foreign direct investment (FDI) flows from Hong Kong and Taiwan to Mainland China, especially to Guangdong Province. It is associated with the continuous relocation of export-oriented manufacturing activities from both Hong Kong and Taiwan to take advantage of low land and labor costs available across the border from Hong Kong, and hence has resulted in what Hong Kong government statistics refer to as outward processing trade flows to China. This is therefore a clear case of FDI and trade being "twin travelers," whereby together with FDI, industrial materials and semimanufactures are shipped together with machinery and equipment to the Chinese hinterland for export processing.[1]

Second, the processing trade covers a wide range of export manufactures. Some are often regarded as sunset industries; some are relatively new lines of production` but all are labor-intensive manufacturing undertakings. They include garments, clocks and watches, toys, games and sport requisites, electrical appliances, and video recorders. Taken together they represent the traditional backbone of light industry

[1] Viewed this way, FDI flowing from Hong Kong (and Taiwan) into Mainland China represents a complete migration of manufacturing plants.

in Hong Kong and Taiwan and, in each case, since the 1960s have been the single most important source of foreign exchange earnings and employment.[2]

Third, virtually all export commodities processed on behalf of Hong Kong and Taiwanese investors are shipped back to Hong Kong for re-export, as this represents the most direct and cost-saving transport route to final overseas markets. In addition, under Taiwan's "third country" rule (intended to avoid any direct contact with the Mainland authorities), virtually all Mainland-bound FDI and processing trade flows have also been channeled through Hong Kong. Similarly, Mainland Chinese exports to Taiwan, irrespective of the degree of control exercised by Taiwan in respect to commodity categories and quantities, also have to be routed via Hong Kong or elsewhere. Hong Kong therefore plays a pivotal role in linking Taiwan with the Mainland Chinese economy.

Fourth, since 1979, an increasing volume of Chinese exports has also been routed through Hong Kong to overseas destinations to take advantage of the international marketing expertise of Hong Kong and its highly efficient banking, finance, insurance, and telecommunications services, as well as its highly advanced shipping and port facilities (Hong Kong is the largest container port in the world). This is in addition to the huge quantity of intermediate input supplies from various overseas countries en route to the Mainland for export processing. Hong Kong has thus become the largest entrepôt of the entire Chinese economic complex, surpassing by far the importance of Shanghai.

Fifth, to take advantage of the many opportunities arising from the two-way trade flows between Hong Kong and Mainland China, Chinese capital has also increasingly moved into Hong Kong. Traditionally, there has long been a Chinese presence in Hong Kong's banking, finance, commerce, and retail trade sectors, associated with the regular massive Chinese shipments to Hong Kong of wage goods and clothing for local consumption or re-export and industrial, chemical, and mineral materials needed for the region's own highly export-oriented industries.[3] From the 1980s, however, not only has China's visibility in such trade-related investment in Hong Kong been greatly raised, but Mainland Chinese capital has also been diverted to a wide variety of activities, most notably to aviation (Cathay Pacific Airways and its affiliate, Dragon Air), power generation, highway construction, telecommunications, manufacturing, and real estate development. In addition to the highly visible China International Trust and Investment Corporation, which is a national agency, most major Chinese provinces also have their own international trust and investment corporations in Hong Kong, engaging in fund raising, portfolio investment, and equity sharing in large, long-term capital projects locally and abroad. These, together with internationally syndicated bank loans often arranged in Hong Kong for large Chinese national or provincial governments' infrastructure projects, have helped to make Hong Kong the financial center of Greater China (see Jao 1997 for an excellent discussion of the various aspects of Hong Kong as an international financial center).

The overall process of economic integration within Greater China has been so powerful that within a decade, from around 1985 when the relocation of Hong Kong's manufacturing activities to the Chinese

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[2] Because the complete transfer of manufacturing operations from Hong Kong to Mainland China is generally to take advantage of abundant cheap labor across the border, it is normally not associated with investment in new technology. That is not to say, however, that FDI's impact on Chinese economic growth is minimal. The fact is that in addition to employment and income creation in China, the highly export-oriented FDI from Hong Kong and Taiwan also helps to ease China's foreign exchange constraints, enabling the country to import more advanced technology from the West, as embodied in new machines and equipment, for accelerating industrial modernization. Note that more than 40 percent of China's total exports for 1997 were exports from various types of foreign-invested enterprises (State Statistical Bureau 1998).

[3] These used to be the single most important source of China's foreign exchange earnings in the past, accounting for one-quarter to one-third of the country's total. From the Hong Kong perspective, the imports were inputs needed for its own export manufacturing. With the relocation of Hong Kong factories to the hinterland, however, Chinese exports previously retained in Hong Kong for local consumption have now become China's liability in exchange for its claims on part of Hong Kong's foreign earnings in the form of what is commonly referred to by the Chinese as *gongjiaofei* (processing fees). For an elaboration and interpretation of this changing regional context of specialization within Greater China, see Kueh and Voon (1997).

hinterland started to gain momentum, the entire Hong Kong economy was radically transformed into a Manhattan-type services industry. By 1998, the manufacturing sector's contribution to GDP had fallen to a mere 8 percent from 29.6 percent in 1985 and 24.9 percent in 1991, while the share of the service sector had rapidly expanded to more than 90 percent in 1998, from 69.7 percent in 1985 and 74.8 percent in 1991.

Similar changes also took place in Taiwan, following political decontrol instituted by the Taipei authorities in 1987 that allowed residents to visit Mainland China. Taiwanese manufacturers moved swiftly to imitate their Hong Kong counterparts in investing in China. However, by 1992 the government in Taipei was already fearful of a "hollowing out" of the island's industrial structure through the relocation to Mainland China of such export earning industries as electrical, engineering, footwear, plastics, and textile production, having markedly curtailed the share of light industry in national income and employment.[4] Note that since 1992 Taiwan has surpassed both Japan and the United States as the second largest FDI supplier to Mainland China, although its accumulated FDI stock is still far behind that of Hong Kong.

Capital Flows within Greater China during the Asian Financial Crisis

Capital flows within Greater China are overwhelmingly dominated by FDI flows from Hong Kong and Taiwan to Mainland China. In 1998 their combined total made up nearly half of China's total FDI intake of US$ 45.6 billion (table 4.1). Taiwan does not allow any Mainland capital to be invested in the island. In 1997 the Taiwanese government recorded only a small amount of investment from Hong Kong, a mere US$73 million. By contrast, Mainland China's investment in Hong Kong totaled US$14.6 billion by the end of 1996, US$337 million in manufacturing and US$14.3 billion in nonmanufacturing industries (Hong Kong Trade Development Council 1998a,c). This makes China the second largest outside investor in Hong Kong, after the United Kingdom. Dollar for dollar, the Mainland's cumulative investment in Hong Kong amounted to as much as 11 percent of Hong Kong's cumulative FDI stock of US$135 billion in Mainland China as of the end of July 1998. The figures do not include Mainland-backed enterprises that have long been based in Hong Kong.

According to Chinese official estimates, more than 1,856 Mainland-backed enterprises are registered in Hong Kong, with an estimated gross asset value of US$185 billion and a net asset value of US$23.5 billion at the end of 1996 and employing more than 53,000 employees by the end of 1997). These include such relatively new arrivals as the China International Trust and Investment Corporation (HK) Holdings, China Everbright, and Guangdong Investment, as well as traditional Mainland-backed Chinese enterprises, such as the Bank of China and China Resources (the latter having operated in Hong Kong for many decades).

Portfolio capital flows within Greater China essentially involve listing China's 41 state-owned enterprises on the Hong Kong Stock Exchange. As of November 1998, total capital raised by these "H" share companies amounted to US$7.9 billion. Together with the 72 "red chips," Mainland-backed enterprises accounted for 16 percent of the stock market's total market capitalization of US$343 billion at the end of October 1998. An index called the Hang Seng China-Affiliated Corporation Index was introduced on June 16, 1997, for all red chips listed in Hong Kong, alongside the familiar Hang Seng Index.

Under the full impact of the regional financial turmoil, the red chips have been as volatile as, if not more vulnerable than, the broader Hang Seng Index, which plummeted to as low as 6,500 from a record high of around 16,500 shortly before the crisis. Amid persistent speculation in 1997–98 that a devaluation of the Chinese currency was imminent to maintain the country's export competitiveness against Southeast Asian rivals (whose currencies had been devalued by 40 to 70 percent against the U.S. dollar since July 1997), red chip prices suffered severely. As a result, the anticipated flotation of a number of significant state-owned enterprises on the Hong Kong Stock Exchange had to be postponed.

[4] According to the head of the Industry Bureau in Taipei, the large-scale transfer of sunset industries to the Mainland China has more than anything else accounted for the rapid increase of heavy industry's share in total manufacturing output in recent years from 47 percent in 1986 to 56 percent in1991 (see Kao, Lee, and Lin 1992).

Table 4.1. Shares of Hong Kong, Taiwan, and rest of the world in the realized FDI intake by the Mainland of China, 1987–98

	China FDI intake		Hong Kong			Taiwan			Rest of the world		
Year	*Total (US$ million)*	*Yearly change (percent)*	*Share (US$ million)*	*Percent*	*Yearly change (percent)*	*Share (US$ million)*	*Percent*	*Yearly change (percent)*	*Share (US$ million)*	*Percent*	*Yearly change (percent)*
1987	2,313.53		1,587.94	68.6					725.59	31.4	
1988	3,193.68	38.0	2,067.60	64.7	30.2				1,126.08	35.3	55.2
1989	3,392.57	6.2	2,036.90	60.0	−1.5				1,355.67	40.0	20.4
1990	3,487.11	2.8	1,880.00	53.9	−7.7	224.26	6.4		1,382.85	39.7	2.0
1991	4,366.34	25.2	2,405.25	55.1	27.9	469.89	10.8	109.5	1,491.20	34.2	7.8
1992	11,007.51	152.1	7,507.07	68.2	212.1	1,050.50	9.5	123.6	2,449.94	22.3	64.3
1993	27,514.95	150.0	17,274.75	62.8	130.1	3,138.59	11.4	198.8	7,101.61	25.8	189.9
1994	33,766.50	22.7	19,665.44	58.2	13.8	3,391.04	10.0	8.0	10,710.02	31.7	50.8
1995	37,520.53	11.1	20,060.37	53.5	2.0	3,161.55	8.4	−6.8	14,298.61	38.1	33.5
1996	42,350.00	12.9	20,677.32	48.8	3.1	3,474.84	8.2	9.9	18,197.84	43.0	27.3
1997	45,278.00	6.9	20,630.00	45.6	−0.2	3,290.00	7.3	−5.3	21,358.00	47.2	17.4
1998	45,582.00	0.7	18,508.00	40.6	−10.3	2,915.00	6.4	−11.4	24,159.00	53.0	13.1

Note: The 1997 share for Taiwan was obtained by applying the 1997/96 rate of increase of the broader category of to the 1996 figure.

Source: Ministry of Foreign Trade Economic Cooperation (various issues); for 1998, China Statistical Information and Consultancy Service Center (various issues).

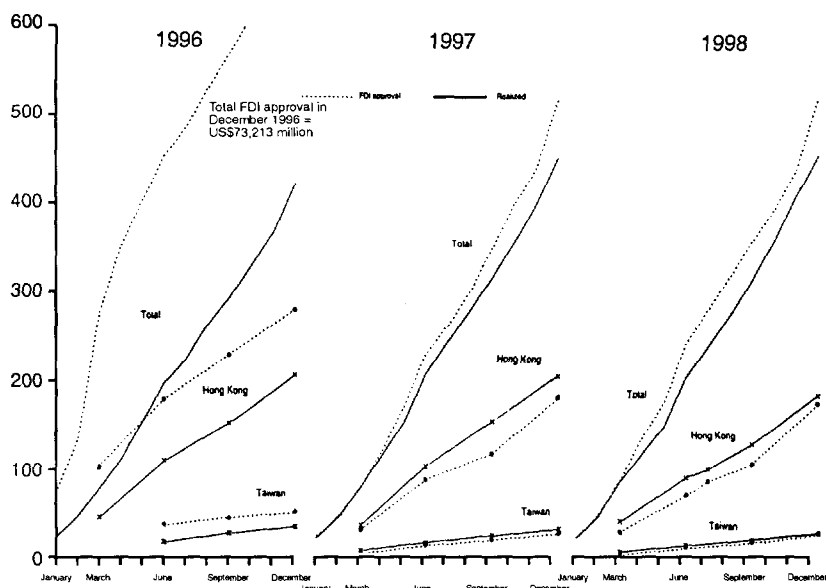
Moreover, as a result of the extreme volatility of the stock market and the withdrawal of billions of U.S. dollars from the Asian Pacific region because of the financial crisis, Hong Kong's role as a leading center for arranging syndicated loans in Asia (mostly for large government infrastructure projects in China) has also been seriously eroded. The total value of syndicated loans arranged by banks in Hong Kong plunged from a high of US$17 billion in the first half of 1997 to a mere US$2.1 billion in the first half of 1998, having previously accelerated from US$14.6 billion in 1995 to US$19.3 billion in 1996 (Hong Kong Trade Development Council 1998b).

Notwithstanding the volatility of portfolio flows and capital borrowing, FDI flows into China have emerged basically unscathed from the Asian financial crisis; indeed, they have exhibited a remarkable degree of resilience. This is certainly the case for global FDI inflows, and seems also to be the case for Hong Kong and Taiwan, even if the trends with respect to the two small Chinese entities are not fully endorsed by official Chinese statistics.

Specifically, total cumulative FDI intake by China, in terms of both approved FDI (contractually pledged value of investment) and utilized FDI flows (realized intake), showed a consistent growth trend in 1998 that was virtually as robust as that experienced in 1997 (figure 4.1). For the whole of 1998, both cumulative FDI approval and actual FDI flows were still marginally higher than those recorded for 1997. Similarly, monthly fluctuations in China's total FDI intake throughout 1998 did not reveal any noticeably adverse impact of the Asian crisis in relation to observed trends since January 1996 (figure 4.2).

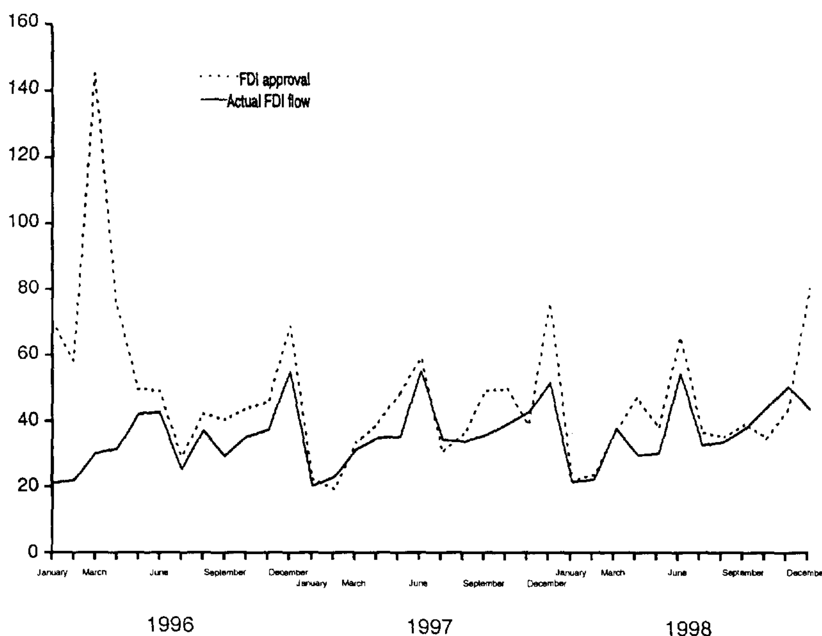
As for FDI inflows from Hong Kong and Taiwan alone, the 1998 quarterly, official, Chinese statistics so far available suggest some slowdown, albeit marginal, compared with trends in both overall FDI intake in 1998 and FDI inflows in 1997 (figure 4.1). Cumulative FDI approval was down by 4.2 percent for the first quarter of 1998 and down 8 percent for the second quarter. Actual FDI flows recorded an impressive 15 percent increase for the first quarter, but by June 1998 the cumulative gains had fallen by 11 percent compared with the record of the previous year. The decline continued through the fourth quarter, but the total reduction for Hong Kong and Taiwan combined for the whole of 1998 amounted to just around 10 percent.

Figure 4.1. Monthly Cumulative FDI Inflows into China and the Quarterly Share of Hong Kong, 1996–98
(hundreds of millions of U.S. dollars)



Source: China Statistical Information and Consultancy Service Center and Hong Kong Trade Development Council.

Figure 4.2. Monthly Fluctuations in China's FDI Intake, 1996–98
(hundreds of millions of U.S. dollars)



Source: China Statistical Information and Consultancy Service Center and Hong Kong Trade Development Council.

While the implications of such random fluctuations remain ambiguous, one important factor, hitherto concealed, is likely to have a significant impact on any interpretation of the possible effect of the regional financial turmoil on FDI flows within Greater China. This critical factor relates to such unlikely FDI suppliers as Bermuda, the Cayman Islands, the Virgin Islands, and even Samoa in the remote South Pacific. In 1997, the year in which Hong Kong was returned to China, total utilized FDI flows into Mainland China from the Virgin Islands alone increased dramatically by more than threefold to half that of Taiwan, or nearly one-tenth of that of Hong Kong. Undoubtedly, the sources of such inflows were mostly, if not wholly, Hong Kong and Taiwanese investors in disguise (but also many Mainland-backed Chinese enterprises based in Hong Kong). For various reasons, these investors wanted to protect their anonymity by reregistering in the Caribbean islands. Their motivation was not, however, that which drove the earlier nominal removal from Hong Kong to Bermuda of Jardine Matheson, namely, the fear of possible political reprisals after the reversion of Hong Kong to Chinese sovereignty.

Specifically, if these "prodigy" shares were restored to the Hong Kong or Taiwanese account, their combined contribution to China's utilized FDI intake in 1997 (as reflected in figure 4.1), would undoubtedly rise sharply and substantially surpass their comparable share for 1996. A similar conclusion is likely to apply to the potential bona fide contributions of Hong Kong and Taiwan investors to China's FDI intake in 1998, accelerated increases in China's FDI approval for investors from the Caribbean islands tending to compensate for the reductions in officially recorded FDI approval for Hong Kong and Taiwan in recent years.

In 1997, for the first time, the value of China's FDI approval by both Hong Kong and Taiwan was notably lower than their utilized FDI flows into China (figure 4.1). There is little doubt that this signaled a continuing replacement by the Caribbean islands and many other similar puppet investors. Note, in particular, that compared with the lackluster trends in FDI approval for Hong Kong and Taiwan, global FDI inflows into China continued to accelerate impressively throughout both 1997 and 1998 (figure 4.1), although the absence of separate FDI approval statistics from China for the Caribbean islands for 1997 still makes it difficult to estimate the likely size of the true shares of Hong Kong and Taiwan investors in total realized FDI flows into China in 1998.

Overall, there seems little reason to suggest that FDI flows into China have been adversely affected by the Asian crisis to any significant extent compared with portfolio investment flows. The asymmetry is not wholly inspiring, because portfolio flows are vulnerable to stock market volatility, interest rate regimes, credit crunches, and the risk of foreign exchange fluctuations, particularly in the wake of increased global economic integration and interaction. FDI, however, represents long-term fixed commitments that require prudent cash flow planning to avoid the danger of liquidity traps, bankruptcy, and capital losses. Nonetheless, in the context of the Asian financial crisis as it has affected the Greater China triangle, the difference between portfolio and FDI flows cannot be explained by such simple textbook reasoning.

Several factors explain the relative resilience of the observed FDI flows within Greater China amid the regional financial turmoil. They offer a diversity of perspectives, but taken together are all related to the fact that most FDI flows from Hong Kong and Taiwan to China are, directly or indirectly, closely associated with export processing, as in the case of the power generation project established by the Cheung Kong Group in Shantou or the Hopewell highway project linking Guangzhou and Hong Kong. They all underpin the rapid development of the highly export-oriented industries dominated by outside investors in the region.[5]

[5] FDI in infrastructure (and in services) is still quite limited in China. For example, FDI pledged in electric power plant and gas and water supply declined from US$5.2 billion in 1996 to US$3.7 billion in 1997, while FDI approved for the combined category of transportation, storage, and postal and telecommunications services increased from US$1.2 billion in 1996 to only US$2.6 billion in 1997. Taken together, FDI in infrastructure and services amounted to only 12 percent of total FDI approval in 1997, compared with 53 percent for manufacturing (State Statistical Bureau 1998). Similarly, while an increased number of foreign firms have been able to gain a foothold in China's wholesale and retail trade and catering services in recent years (McDonalds; KFC; and notably the well-known garment brand,

The first and most important factor is that both the United States and Western European countries—the single most important export markets for China, Hong Kong, and Taiwan taken together—were not seriously drawn into the Asian financial whirlpool, except for difficulties associated with reduced import demand from affected Asian countries (members of the Association of Southeast Asian Nations [ASEAN] and the Republic of Korea, in particular). This helped guarantee a stable and continuous stream of export earnings for China-based Hong Kong and Taiwan exporters who were also investors.

Second, the continuous, albeit erratic, weakening in 1998 of the Japanese yen against the U.S. dollar (to which both the Hong Kong dollar, officially, and the renminbi, unofficially, are pegged) helped to enhance cost savings for Hong Kong and Taiwanese investors in Mainland China, as they all rely heavily on Japan for imports of equipment and machinery, as well as for industrial materials and semimanufactures for export processing. The savings have come in tandem with reduced credit costs from the yen depreciation for financing their imports, as well as their FDI ventures at large. Indeed, in conjunction with the massive import of intermediated goods from Japan, a substantial proportion of FDI flows from Hong Kong and Taiwan into China are financed by Japanese banks based in Hong Kong (personal communication from a former Japanese consul-general based in Hong Kong, who said that more than half of Hong Kong's FDI in China was so financed).

Third, in the interests of promoting exports and mitigating increased pressures for a devaluation of the renminbi, Mainland Chinese banks had begun, exceptionally, to grant renminbi credits to foreign-invested enterprises by Hong Kong and Taiwanese investors during the crisis. This helped to compensate for fund shortages associated with the severe credit crunch that accompanied the efforts of the Hong Kong government to defend the U.S. dollar peg (Mainland-backed Chinese banks based in Hong Kong were also fearful of a renminbi devaluation, and thus preferred to hold U.S. dollars, rather than lending to Hong Kong investors). Similarly, ad hoc increases in value added tax rebates for a wide range of export commodities were decreed both to promote export incentives and enhance the liquidity of foreign-invested enterprises (FIEs). The effect of a 1 percent increase in value added tax rebates is estimated to be comparable to a 1 percent reduction in the export costs for general merchandise trade, and hence tantamount to a devaluation of the renminbi against the U.S. dollar (*Ta Kung Pao Daily*, Hong Kong, June 24, 1998).

Fourth, from the perspective of China's FDI intake, it is fortunate that the Asian financial crisis was preceded by the Chinese government's restoration in mid-1997 of the customs duties exemption for imports by FIEs of the equipment, machinery, and industrial materials needed for export processing. Note that the 1996 suspension of this exemption may have contributed to the sharp reduction of FDI approval in early 1997, in addition to the observed nominal shift in favor of the Caribbean islands. However, by December 1997, FDI approval for Hong Kong investors, in value terms, had already been restored to the June 1996 level when the retraction was announced (figure 4.1). This, as well as the contributions made by Hong Kong and Taiwanese investors in disguise should have helped to sustain the actual FDI inflow in 1998.

Another important policy initiative the Chinese government took in the wake of the Asian financial crisis may not fall within the purview of promoting export-oriented FDI inflows, but it seems to have averted the possible rediversion of FDI flows from China toward the hard-hit Southeast Asian countries (which had become much more attractive to foreign investors following massive devaluations of their currencies). This relates to the deliberate attempt to open up industrial and service sectors hitherto closed to foreign investment. It is still too early to estimate to what extent FIEs, especially large transnational corporations, have already taken advantage of the new FDI regime. However, given that Hong Kong and Taiwanese investors have been anxious to move into retailing and other service undertakings in China, and that acquisitions of and mergers with Chinese state-owned enterprises have become quite popular in recent years as a way for transnational corporations to gain a foothold in the huge import substitution investment markets there, this is likely to become a crucial means of enhancing and stabilizing the growth of future FDI flows into China.

Goldlion, from Hong Kong), foreign capital registered by the end of 1997 for this sector was no more than 4 percent of the total, compared with 58 percent for manufacturing (State Statistical Bureau 1998).

From a microeconomic perspective, and to understand the likely trends in Chinese FDI intake in the context of the Asian crisis, distinguishing between replacement and new investments in terms of FDI intake may be useful. For most of the 20 years that China has courted FDI, the value of realized FDI has moved closely in tandem with FDI approval in terms of investment contractually pledged. The implications are clear. After the initial period of any accelerated FDI expansion, subsequent FDI approval will, for the most part, become replacement investment needed to sustain existing undertakings, plus new investment for marginal capacity expansion to cope with secular growth in overseas markets. In short, aside from cyclical fluctuations, China's FDI inflows from Hong Kong, Taiwan, and the world at large will likely sustain their long-term pattern of growth in the years to come.

Impact on Trade Flows within Greater China

By virtue of the particular pattern of economic integration among Mainland China, Hong Kong, and Taiwan, trade flows within Greater China are overwhelmingly dominated by export processing. Thus, outward processing goods consistently make up around half of Hong Kong's total exports to Mainland China (table 4.2). Within the category of materials to be processed for export flowing from Hong Kong into China, the share of re-exports (goods imported from overseas without undergoing any minimal processing in Hong Kong) accelerated from 58 percent in 1989 to a startling high of more than 80 percent in 1998. The corresponding share of domestic exports meanwhile fell to a mere 19 percent, including many that could barely fulfill the country of origin requirements for exports to be classified as such.

Hong Kong's imports from China are even more heavily dominated by the shipment of processed export commodities and by 1998 accounted for more than 80 percent of total imports (table 4.2). At the same time, processed goods for export (outward processing goods) imported on behalf of Hong Kong investors based in China constituted nearly 90 percent of Hong Kong's re-exports of all goods of "Chinese origin" to all countries other than Mainland China, with an estimated export markup ranging from 18 to 24 percent for different years.[6] Given that Hong Kong's total re-exports of Chinese origin (comprising both outward processing goods and non-outward processing goods) are generally 11 to 14 percent higher than its total imports (of which only around 20 percent are non-outward processing goods) from China, it seems certain that virtually all outward processing goods flowing from China to Hong Kong are re-exported to third countries, especially the United States and Western European countries. Indeed, the United States alone has consistently taken up more than 40 percent of Hong Kong's re-exports of Chinese origin of these kinds of export commodities (Kueh and Voon 1997).

By contrast, about 50 percent of Hong Kong's total exports to China constitute commodities other than goods bound for export processing in Mainland China. That is, Hong Kong not only serves as a universal agency for China's processing trade, but also represents an important sourcing venue for end users in China of imports of equipment and machinery, vehicles, computer software, CD-ROMS, and the like from the West.

Overall, the economic significance of Hong Kong to China in terms of entrepôt trade is summed up in the fact that around 40 percent of the Mainland's foreign trade is currently handled via Hong Kong, excluding the trans-shipment of goods to and from the Mainland, which has also become an increasingly important service trade for Hong Kong. More important, China's export processing trade, which now accounts for more than 50 percent of China's total external trade, is virtually all channeled through Hong Kong.

Two additional points should be considered in assessing the potential impact of the Asian financial crisis on trade flows within Greater China. First, to the extent that under the third country rule adopted by Taiwan FDI flows and exports from the island to Mainland China for processing are channeled

[6] As a rough estimate, the export markup rate is simply taken as the percentage difference between the value of columns (9) and (7) in table 4.2. To the extent that part of the imports of outward processing goods from China may be retained in Hong Kong for local consumption, the estimated markup rate is clearly biased on the low side.

through Hong Kong, the outward processing goods flowing from Hong Kong to China, as shown in table 4.2, clearly also include Taiwanese contributions. Similarly, barring direct navigational links between Taiwan and Mainland China, the outward processing goods flowing from China to Hong Kong also cover imports made on behalf of Taiwanese exporter investors.

Table 4.2. Processing Trade in Hong Kong—China Economic Relations, 1989–98

	HK exports to China (HKD millions)					*HK imports from China (HKD millions)*					
		Share of OP goods		*Share in OP goods (percent)*			*Share of OP goods*		*HK re-exports of OP goods of Chinese origin*		*Implicit value-added proportion (percent) [(7)–(2)]/(7)*
	Total	*Value*	*Percentage (2)/(1)*	*Domestic exports*	*Re-exports*	*Total*	*Value*	*Percentage (7)/(6)*	*Value*	*Share in total re-exports (percent)*	
Year	*(1)*	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*	*(8)*	*(9)*	*(10)*	*(11)*
1989	146,764	76,868	52.4	41.58	58.40	196,676	113,581	57.8	—	—	32.32
1990	158,378	91,914	58.0	39.62	60.78	236,134	145,103	61.5	—	—	36.7
1991	207,722	113,931	54.9	35.43	64.57	293,356	187,384	63.9	221,450	74.1	39.2
1992	274,061	141,639	51.7	31.26	68.74	354,348	254,013	71.7	299,833	78.3	44.2
1993	337,928	160,678	47.4	28.09	71.59	402,161	295,203	73.4	364,536	80.8	45.7
1994	383,844	181,179	47.2	23.16	76.84	470,876	354,912	75.4	422,544	82.0	49.0
1995	444,108	217,613	49.0	20.17	79.83	537,052	399,567	74.4	492,461	82.2	45.5
1996	474,038	222,324	46.9	19.38	80.62	566,821	452,890	79.9	552,822	86.0	50.9
1997	503,881	244,886	48.6	19.22	80.78	604,855	491,142	81.2	595,511	88.4	50.1
1998(Q1)	109,806	48,095	43.8	18.23	81.77	126,403	101,628	80.4	126,082	87.8	52.7
1998(Q2)	125,857	61,106	48.6	20.00	80.00	147,212	120,821	82.1	133,292	84.5	49.4
1998(Q3)	112,261	56,355	50.2	19.42	80.58	157,700	131,364	83.2	155,327	88.7	57.1

— Not available.
OP Outward processing.
Q Quarter.
Notes: Outward processing statistics are not available before 1989, as the Hong Kong government did not start to compile such statistics until that year.
Source: Hong Kong Government Census and Statistics Department (various issues).

Second, the statistics in table 4.2 may not reflect the full magnitude of outward processing trade flows within Greater China. Thus, with FDI intake from Hong Kong and Taiwan being increasingly directed northward since the early 1990s (Kueh 1996), some processed goods must have also been directly exported through Shanghai and other major ports in north China to, for example, Japan and the United States. To the extent that this occurred, the estimated, implicit value added involving the export processing trade for Hong Kong may understate its true magnitude (table 4.2). Nonetheless, the estimated values for more recent years are generally in accord with the frequent official Chinese claims that imported input materials and components make up around 50 percent of the value of the Chinese processing trade. This seems to provide sufficient incentives for both Hong Kong and Taiwanese investors, as well as their Chinese collaborators, to sustain and further develop the processing trade.

It is difficult to gauge exactly the possible impact of the Asian financial crisis on trade flows among Hong Kong, Taiwan, and Mainland China. For one thing, the crisis did not really begin to seriously affect relationships within Greater China until mid-1998. Any assessment of the possible long-term implications of

the crisis on trade flows within Greater China must therefore be regarded as preliminary. In any case, the complexity of the problems involved simply do not permit definitive conclusions to be drawn at this stage.

One important question is whether the massive devaluation of the Southeast Asian currencies after July 1997 really eroded the price competitiveness of Greater China's labor-intensive export processing trade, and thereby broke the flying geese pattern of industrialization in Asia (see UNCTAD 1998). It would be premature to answer affirmatively. For example, the extent to which Greater China's exports to third countries, notably the United States and European Union (EU) countries, overlap, and thus compete directly with its Southeast Asian neighbors, is not clear. Dai Xianglong, the governor of China's central bank, estimated that the overlap was around 15 percent of China's total exports to the United States, and viewed this as a reason for not seeking to maintain export competitiveness by devaluing China's currency. That figure may, of course, also translate into a sizeable margin in China's total exports, and bear significantly on Hong Kong's re-export earnings, especially in the wake of enhanced Asian competition.

However, any increased export price benefits for Southeast Asian countries deriving from their currency devaluation may be offset by resultant increases in the cost imports needed for export processing. The reality is that as in China, most Southeast Asian export producers rely heavily on imported inputs.

More important, export producers in Indonesia, Malaysia, and Thailand—central actors in the regional financial turmoil—suffered enormously under the impact of high interest rates and an especially severe credit crunch that resulted from the International Monetary Fund's severe prescription for restoring monetary and fiscal order. Many export factories were forced to close down altogether. By contrast, in Hong Kong, while increased financial illiquidity resulting from the government's massive efforts to defend the U.S. dollar peg may have made it difficult to do business there, the disarray appears to have had only a marginal impact on the Chinese hinterland through its effect on the export processing undertakings of Hong Kong investors.

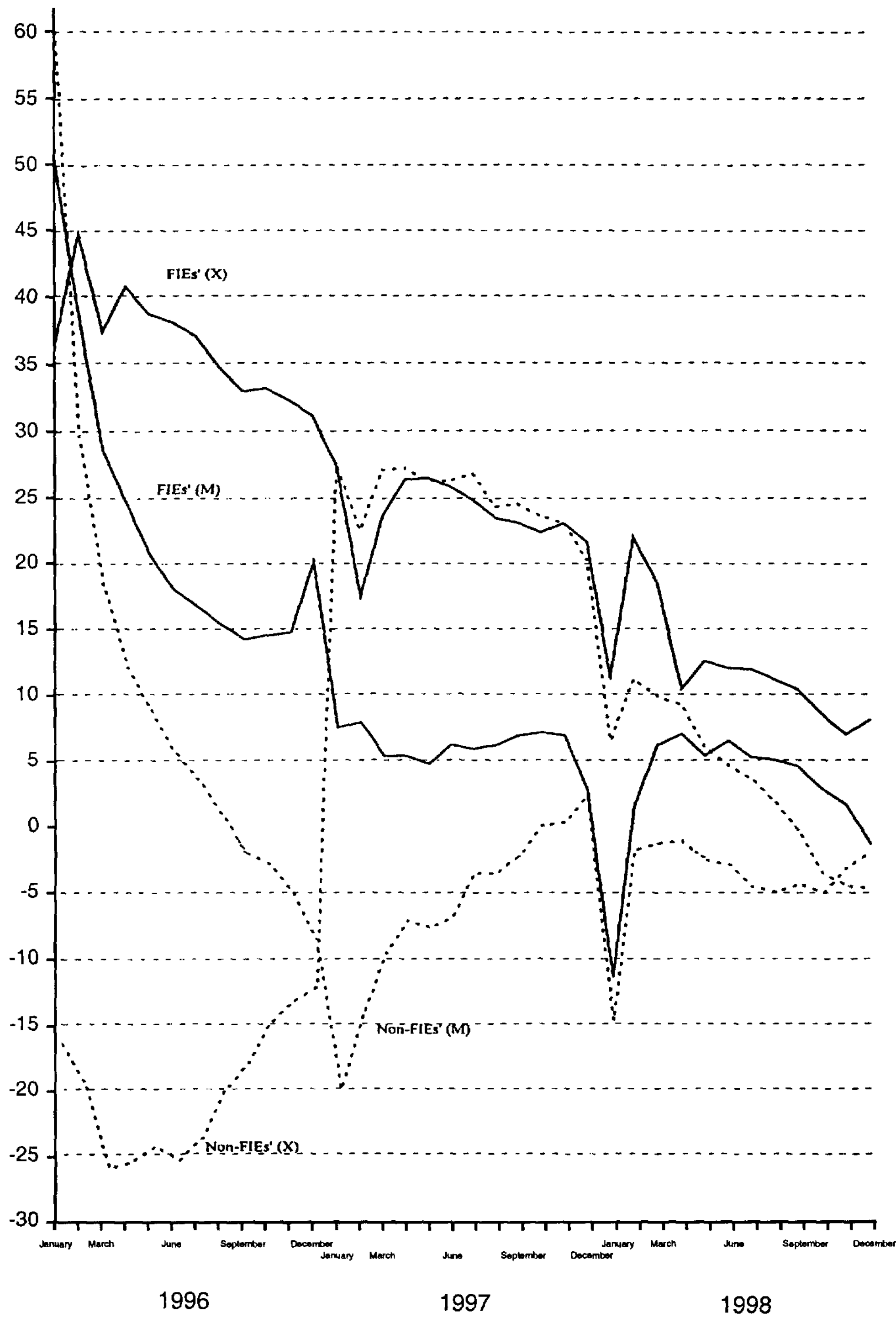
In fact, as part of the Mainland authority's policy to prevent potential export problems, Hong Kong and Taiwanese exporter investors based in Mainland China benefited from the rare privilege of obtaining renminbi advances from domestic Chinese banks, in addition to increased value added tax rebates for exports. Such privileges are, of course, not unrelated to the unusual circumstances prevalent in China in 1998 of declining interest rates coupled with negative inflation. Clearly, because of its capital account control, Mainland China was largely spared the contagion of the Southeast Asian financial crisis, thereby giving the Chinese government the luxury of being able to pursue its own, independent, export promotion policy.

Nonetheless, if despite the Asian financial crisis trade flows within Greater China generally succeeded in maintaining their established course, the single most important contributory factor was the economic sustainability of the final export destinations, that is, the United States and EU. The outward processing trade statistics provided by the Hong Kong government (table 4.2) do not provide country breakdowns in terms of re-exports, but the major proportion of outward processing goods flowing from China to Hong Kong are undoubtedly destined for the North American and Western European markets.

An alternative approach is to distinguish between exports and imports by domestic enterprises (non-FIEs) and FIEs. The latter clearly represent the thousands of U.S.- and EU-bound Hong Kong and Taiwan export producers. Thus, amid declining overall growth in Chinese exports, FIE exports performed remarkably well, in contrast to sharp declines suffered by non-FIEs in 1998 (figure 4.3). By December 1998, when the overall growth rate of China's exports had fallen to a mere 0.5 percent from a high of 20.9 percent a year earlier, the FIEs' exports were still increasing by 8 percent, compared with 22 percent for 1997. By contrast, the absolute level of cumulative exports by non-FIEs had declined by nearly 5 percent in 1998.

The background to this divergent export performance by FIEs and non-FIEs lay in the continuous growth of exports to the United States and EU, side-by-side with the declining or negative growth of exports to East and Southeast Asia as a result of sharply reduced import demand caused by the regional financial upheaval. This drained any foreign exchange reserves held by all these countries, except Japan.

Figure 4.3. Monthly, Year-to-Date Changes in Cumulative Exports (X) and Imports (M) by Nonforeign- and Foreign-invested Enterprises (FIEs) in China 1996–98
(percent)



Source: China Statistical Information and Consultancy Service Center

Recent Chinese customs statistics confirm that 85 percent of the total net increases in exports for the first three-quarters of 1998 derived from the processing trade. Exports to the United States and EU increased for the same period, year-on-year, by 16.5 percent and 22 percent, respectively, while those to Korea, ASEAN countries, and Japan fell, respectively, by 32, 16, and 6.5 percent (*Ta Kung Pao Daily*, Hong Kong, October 13, 1998). Note also that Chinese exports to Asian countries essentially consist of resource-based products, such as mineral fuel, iron and steel, and cotton, all of which witnessed substantial absolute declines in exports in the first half of 1998.

Government Policies, Economic Consequences, and Longer-Term Implications

The governments of Hong Kong and Mainland China shared one common feature in terms of their policy response to the Asian financial crisis. As noted earlier, both governments vigorously sought to maintain the existing exchange rate of their respective currencies in relation to the U.S. dollar. In Mainland China, under the managed float regime, the renminbi rate has consistently remained at around Y 8.27 to the dollar. This has been so despite frequent speculation that China would be forced to devalue. In Hong Kong, the U.S. dollar peg at HK$7.8 (intact since October 1983) also successfully withstood several massive currency attacks amid the escalating Asian crisis.

However, the shared desire to defend their currencies concealed widely divergent economic underpinnings in Hong Kong and Mainland China. Moreover, the implications of defending their currencies were also quite different. We will examine each case in turn to assess the economic implications and relative merits of the currency defense, especially as they relate to capital and trade flows between Hong Kong and China from a longer-term perspective.

In China, first, the inconvertibility of the capital account eliminated the fear of capital flight out of the country and rendered inoperative the associated need to defend the value of the renminbi. Attempts by individual Chinese exporting and importing enterprises to evade official foreign exchange control may have appeared to proliferate amid widespread fears since early 1998 of a renminbi devaluation, but the Chinese government was able to use familiar administrative fiats to deal relatively easily with any such instances.[7]

Second, a renminbi devaluation would almost inevitably trigger another round of competitive currency devaluations by the hard-hit ASEAN countries, which believed, rightly or wrongly, that the 1994 Chinese devaluation had severely undermined their export competitiveness and contributed to their current misfortune. From the Chinese perspective, therefore, any export price benefits to be derived from a renminbi devaluation in this context might be wholly offset by an emulative response by the ASEAN. This is quite separate from the questionable potential economic benefits of a renminbi devaluation as discussed earlier.

Third were the potential implications of a renminbi devaluation for Sino-Japanese economic relations. For China, as for the ASEAN countries, Japan is the single most important trading partner in the entire Asia Pacific region. As China's largest trade partner, in 1997 Japan accounted for 17 percent of China's global exports and nearly 20 percent of China's total imports. This compares with a mere 3.6 percent and 5.3 percent, respectively, for the ASEAN four combined (Indonesia, Malaysia, the Philippines, and Thailand), or 6 percent and 8.4 percent, respectively, if Singapore is included. A renminbi devaluation would merely have raised the cost of imports from Japan for domestic end-user industries that depended on Japan for supplies of advanced equipment and machinery, and thus for the much needed technology transfer for industrial upgrading. Equally important, China's vast export processing trade also relies heavily on Japan for input supplies, so that any export price advantage from a renminbi devaluation might have been offset by increased import costs.

[7] For the first eight months of 1998, China's trade surplus and net FDI inflows amounted to US$58.7 billion, but total foreign exchange reserves increased by only US$1.2 billion (*Ta Kung Pao Daily*, Hong Kong, November 28, 1998). The leakage is attributed to defaults in bank clearing of foreign exchange earnings, illicit remittances overseas by way of fake import documentation, and other illegal practices.

It was only when the free fall of the Japanese yen against the U.S. dollar to around—145 in June 1998 threatened effectively to tilt the balance at the expense of Chinese exports to Japan that the Chinese authorities reconsidered their persistent pledge to uphold the external value of the renminbi. Fortunately, the unrestrained yen depreciation was eventually arrested before it could make the Asian crisis even worse.

Consideration of how the Chinese economy fared during the Asian crisis provides a useful context for assessing the longer-term implications for trade and investment flows within Greater China. The observed slowdown in China's export growth in 1998 was clearly more a matter of reduced import capabilities in East and Southeast Asian countries than a relative appreciation of the Chinese currency. Indeed, the reduction resembled the drastic curtailment in U.S. cotton exports to these countries since early 1998. Nonetheless, the Chinese government evidently saw the slowdown as impinging on its much celebrated target of 8 percent GDP growth in 1998, given estimates that between 1992 and 1997, net export earnings had contributed to about 16 percent of GDP growth (State Statistical Bureau various issues). The GDP target was of paramount importance to the Chinese leadership, as it was closely bound up with employment generation and other crucial macroeconomic variables. According to a high-level Chinese estimate, GDP growth of 1 percent would help to create 1.25 million jobs in the nonfarm sector (*Ta Kung Pao Daily*, Hong Kong, August 4, 1998). The difficulties of achieving this target growth were also compounded by the great Yangzi flood in mid-1998.

The remedial policy measures the Chinese government adopted included the following:

- Abolishing, in January 1998, the conventional bank loan quotas imposed by the People's Bank of China in order to extend fully-fledged lending autonomy to the commercial banks.
- Reducing the legal reserve ratio requirements from 13 to 8 percent in late March 1998, coupled with reforming the reserve system to enable the commercial banks to use their fiscal reserves, held by the Ministry of Finance, to fulfill the new, reduced reserve requirements. With the new bank deposits as estimated for 1998, this would have helped to enhance the commercial banks' total lending capacity by a massive US$18.5 billion.
- Reducing the central bank's interest rate in March, July, and December 1998, thereby enabling all industrial and commercial borrowers to save at least US$29 billion in interest cost payments from the five successive interest rate curtailments between 1996 and July 1998.
- Increasing by US$4.5 billion the amount to be extended by the state banks as fixed asset investment loans under the national guidelines for investments, as decreed by the central bank in April 1998.
- Resuming open market operations for repurchasing treasury bonds by more than US$6 billion in May 1998.
- Issuing treasury bonds totaling some US$33 billion in May 1998 to enhance the state banks' capital injection to the Basle capital adequacy ratio of 8 percent.
- Issuing treasury bonds amounting to US$12 billion in August 1998 to boost infrastructure investments, to be synchronized with bank loans of a similar amount for complementary projects.

The various monetary and financial policy measures may or may not have been directly targeted at compensating for the export earnings losses incurred (see Beijing University 1998 for a broader discussion of the policy measures adopted). However, taken together, they already represented an increase in financial liquidity of more than the national budget expenditure of US$69.5 billion for 1998. The vice-minister of finance estimated that the additional infrastructure investment expenditure alone would, via its income multiplier effect, help to raise the GDP growth rate by 2.5 to 3 percent (*Ta Kung Pao Daily*, Hong Kong, November 19, 1998). Together with the strictly imposed capital account control, the reflationary policy measures effectively protected China from becoming the next financial domino in the Asian crisis. The realized GDP growth rate for 1998 is now officially confirmed to have been 7.8 percent, only slightly lower than the original target of 8 percent.

It is against this background of continuous economic prosperity and stability that FDI has continued to pour into China at the expense of Southeast Asian countries (where, in the mind of foreign investors, potential political and economic instability seems to have outweighed the prospects for improved profitability arising from currency devaluation). It is apparent that throughout 1998, total FDI inflows into China showed little sign of abatement (figure 4.1), although admittedly large transnational corporations have increasingly played a key role in sustaining overall FDI inflows into China.

Against this background, let us look at the Achilles heel of Hong Kong during the context of the Asian financial crisis. By the end of 1997, Hong Kong was endowed with foreign exchange reserves to the tune of some US$92.8 billion, third only to Japan (US$220.8 billion) and China (US$139.9 billion). It had hardly any external debt or any serious balance of payments deficit. The government's budget was, as usual, in solid balance, and the economy had been enjoying robust GDP growth of around 5 to 6 percent per year for a number of years. Clearly, Hong Kong was dragged into the regional financial meltdown by virtue of being the world's most open economy.

Specifically, in the absence of any form of capital account control, the Hong Kong dollar became a prime destination of international hedge funds for speculative attacks, following the predators' spree through Indonesia, Korea, Malaysia, and Thailand. A surrender on the part of Hong Kong government to allow for a free fall of the Hong Kong dollar would obviously have prompted massive capital flight, as under such circumstances portfolio flows normally do not care about economic fundamentals. However, the decision by the Hong Kong Monetary Authority to put up a massive defense for its U.S. dollar peg sent the Hong Kong economy reeling.

Under the severe credit crunch and high interest rate pressures, both stock market and asset prices plummeted by 50 to 60 percent in 1997–98. While Mainland China was confidently looking toward meeting its 8 percent GDP target for 1998, by late November Hong Kong's GDP growth had already been forecasted to be a negative 5 percent for 1998 (confirmed to be –5.1 percent in March 1999), with the unemployment rate reaching a 25-year high of 6 percent by February 1999.

The Hong Kong government adopted a number of significant financial measures to cope with the economic meltdown. These include the unprecedented use of the Exchange Fund's money in August 1998 to purchase Hong Kong stocks to prop up the stock market and restore investors' confidence. The stake was later officially made known to be worth around US$15 billion, making the Hong Kong government by far the largest investor of its kind in the world, but nonetheless, the prestigious Heritage Foundation was poised to downgrade the status of Hong Kong as the freest economy in the world for 1999.[8]

Equally significant was the Hong Kong Monetary Authority's September 1998 package to directly fend off international currency speculators. The rescue measure had two main features. The first was to greatly reinforce the Currency Board's discipline by committing the government to convert the Hong Kong dollars held by all licensed banks in their clearing accounts with the Exchange Fund (rather than just the legal tender in circulation) into U.S. dollars at the fixed exchange rate of HK$7.50 to the U.S. dollar, which was even higher than the official benchmark of HK$7.80 for cash arbitrage. The second was to greatly enhance the financial liquidity of the entire banking system by replacing the restrictive liquidity adjustment facility with a discount window, whereby the banks could repeatedly borrow from the authority with their holdings of Exchange Fund bills and notes as collateral to cope with any drastic overnight demand for liquidity (see Hong Kong Monetary Authority 1998 for details and Hang Seng Bank 1998 for a brief interpretive study).

Clearly, the new measures were backed by the government's sizeable foreign exchange reserves. Prior to the stock market buy-up by the government in August 1998, reserves had stood at around US$96.5 billion, or quadruple the entire monetary base of US$23 billion. That position was eroded by no more than 15 percent by the massive stock market intervention.

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[8] Since 1995 the U.S.-based Heritage Foundation and the *Wall Street Journal* have compiled the Index of Economic Freedom for comparing more than 160 economies. Hong Kong was rated first for the first five consecutive years.

Subsequent to the launching of the Hong Kong Monetary Authority's package, the prime lending rate of the Hong Kong Association of Banks declined from a high of 10 percent in October 1998 to 9.25 percent in early December 1998. As a result, the gap with the comparable U.S. interest rate narrowed from 3 to 2.5 percent, although clearly the interest rate arbitrage for the U.S. dollar peg was still very much in operation. In essence, however, the interest rate reductions in Hong Kong seem to have been prompted by the similar move by the Federal Reserve Bank, and perhaps more so by the withdrawal of the international hedge funds following their collapse in Brazil, Russia, and elsewhere than by the enhanced financial maneuverability in Hong Kong arising from the authority's bold Currency Board reform measures adopted earlier in September. Similarly, both the stock market and the property market in Hong Kong rebounded quite remarkably, as elsewhere in the Southeast Asian countries, which have, in addition, also seen their currencies recover substantial ground against the U.S. dollar.

Taiwan's story is quite different from that of both Hong Kong and Mainland China. The island is not as restrictive as the Mainland in terms of capital account control, but it nonetheless lags far behind Hong Kong in financial liberalization. Unlike Hong Kong, access by foreign investors to the Taiwanese capital market is still quite strictly regulated. By July 1997, foreign capital contributed only around US$6 billion to Taiwan's stock market. The subsequent capital flight of some US$4.86 billion toward the end of 1997 was therefore relatively limited in scale, causing the Taiwan Weighted Index to fall by a mere 0.4 percent during the year, compared with the 42 to 75 percent drops (in U.S. dollar terms) registered by all other Asian markets (Chen 1998)

The Taiwanese economy was also strongly underpinned by solid economic fundamentals. For example, its foreign exchange reserves stood at around US$90 billion by June 1997, trailing closely behind Hong Kong's. This is considerably more than triple the size of its external debt, while the reverse is generally the case with Korea and the ASEAN four (table 4.3).

The favorable macroeconomic setting clearly enabled the Central Bank of China in Taiwan to defend the new Taiwan dollar against speculative assaults following the eruption of the financial turmoil in July 1997, and eventually to leave it entirely to the foreign exchange market to find the equilibrium rate. By early January 1998 it had settled at NT$34.5 to the U.S. dollar, down only 19 percent, compared with the precipitous fall of the Indonesian rupiah by 70 percent, the Thai baht by 55 percent, the Korean won by 50 percent, and the Malaysia ringgit by 42 percent.

Compared with the high price of US$15 billion paid by the Hong Kong Monetary Authority to salvage the stock market in August 1998, the opportunity costs for the central bank in Taiwan to dispose of its foreign reserves (US$7 billion out of a total holding of some US$90 billion in July 1997) to defend the new Taiwan dollar were minimal.

To summarize, the remarkable success of the Taiwanese authorities in shielding the island's economy from the contagion of the Southeast Asian financial epidemic comprised the following basic elements: a workable policy endowed with adequate foreign exchange reserves and a continuous current account surplus to ward off currency attacks; a cautious approach to capital account liberalization that helped to contain the international hedge funds; and, perhaps most important, the courage of the Taiwanese authorities in eventually floating the new Taiwan dollar after the initial abortive attempt to defend it in late 1997. The Taiwanese approach therefore appeared to blend the relative merits of Chinese capital account control with elements of trade and financial liberalization as adopted by Hong Kong, without, however, being painfully trapped, like Hong Kong, by the Achilles heel of defending the U.S. dollar peg system.

An important question is how the divergent policy approaches adopted by the three Chinese economic entities in coping with the impact of the Asian crisis may bear on longer-term trends in capital and trade flows within Greater China. The answer hinges essentially on three major factors, all of which are basically external to the parties concerned.

By far the most fundamental factor is the sustainability of the U.S. and EU markets, which are the most important outlets for exports from Greater China. Undoubtedly, these export markets represent the ultimate *raison d'être* for the well-established pattern of FDI and trade flows from Hong Kong and Taiwan

to Mainland China for export processing since the 1980s. However, this regional framework of specialization is unlikely to be adversely affected by the Asian financial crisis to any substantial extent in the foreseeable future. This is to ignore Soros's (1998) apocalyptic scenario, in which a seemingly inevitable slowdown in economic growth in the United States from 1999 on would have eroded its capacity to tolerate the huge trade deficits, and hence undermined the global system of free trade.

Table 4.3. External and Internal Balances of Korea, Taiwan, and the ASEAN Four, 1996–97

Category	*Taiwan*	*Korea, Rep. of*	*Thailand*	*Malaysia*	*Indonesia*	*Philippines*
1. *Current account balance (US$ billions)*						
1990–94 average	9.1	–3.3	–7.1	–3.0	–3.0	–2.1
1995	5.5	–8.3	–16.3	–7.4	–7.0	–2.0
1996	11.0	–23.1	–14.7	–3.6	–7.0	–4.8
2. Foreign reserves, Jan–June 1997 (US$ billions)	90.0	34.1	31.4	26.6	20.3	9.8
3. External debt, Jan.–June 1997 (US$ billions)	25.2	116.8	92.9	45.2	113.6	44.8
4. (2) – (3)	64.8	–82.7	–61.5	–18.6	–93.3	–35.0
5. Domestic savings 1990–96 (percentage of GDP)	28.0	35.0	34.2	32.1	28.9	18.8
6. Fixed capital formation 1990–96 (percentage of GDP)	22.6	36.7	40.4	38.3	27.4	22.5
7. (5) – (6)	5.4	–1.7	–6.2	–6.2	1.5	–3.7

Source: Chen (1998).

For Hong Kong, despite its parlous situation, the latest government statistics have confirmed that for 1998 as a whole, total exports of goods were curtailed by a relatively small margin of 4.3 percent in real terms, consisting of a 7.9 percent fall in domestic exports and a 3.7 percent fall in re-exports (Hong Kong Government Financial Secretary 1999, p.3). The president of the Hong Kong Exporters Association was, however, reluctant to accept this as an indication of Hong Kong's deteriorating export performance, arguing that at least Hong Kong toy manufacturers based on the Mainland, whose exports were channeled directly through the Chinese ports (rather than Hong Kong) actually showed growth of 6 percent for the first nine months of 1998. These figures seem to be substantiated by official Shanghai statistics for the first ten months of 1998, which also indicated that the share of exports by FIEs increased to a remarkable 47 percent of the municipality's total exports of US$13.77 billion, and its total exports to the United States and EU grew by more than 20 percent during the same period, as against a drastic decline of 7.1 percent to US$6.132 billion for other Asian countries (*Ta Kung Pao Daily*, Hong Kong, December 6, 1998).[9]

The situation with Taiwan seemed to have been somewhat different. Unlike Hong Kong, Taiwan, which represents a more complete, independent economic structure, is not entirely dependent on Mainland China for export processing. The continuous exodus to Mainland China of its sunset industries in the past 10 years or so has served to precipitate an industrial upgrading in the island. By the late 1990s, capital- and technology-intensive products (electronic components, equipment, chemicals, and other

[9] This was also later confirmed by the financial secretary when he explained that "our exports to the United States and Europe grew, but this growth was unable to compensate for the marked shrinkage in our exports to East Asia. The growing volume of Mainland products being shipped out directly from Mainland ports instead of through Hong Kong also trimmed our export performance" (Hong Kong Government Financial Secretary 1999, p.3).

industrial materials) have made up more than 40 percent of Taiwan's total exports, increasingly squeezing the share of traditional labor-intensive products.

At the same time, however, coupled with Taiwan's increased FDI flows to ASEAN, the island has also become substantially dependent on these countries for its exports, to the tune of around 50 percent by 1998, compared with only 25 percent in 1996. As a result, the financial crisis severely affected Taiwan's exports. For the first 11 months of 1998, the island's exports to Indonesia, Malaysia, the Philippines, Singapore, and Thailand fell by a hefty 30 percent to around US$9.63 billion, compared with a more modest fall in shipments to Japan by 21.3 percent and to Hong Kong by only 11.9 percent (*South China Morning Post,* Hong Kong, December 9, 1998).

Under such circumstances, the longer-term questions are clearly whether Taiwan would really further substitute Mainland China for ASEAN as a target of FDI outflow. Such a move would almost certainly compromise its politically inspired South-oriented strategy for avoiding any significant economic dependence on the Mainland. Given that probably only secular, marginal export growth can be expected to both U.S. and EU markets, a breakthrough in this regard may only come around with a turnabout in China's FDI strategy to allow for greater import substitution foreign investment in place of export-oriented FDI. Undoubtedly, both Hong Kong and Taiwan investors have long been poised to cash in on such a prospect.

The second important factor that might affect capital and trade flows within Greater China in the near future is the pace at which potential rivals in Southeast Asian may emerge from their difficulties to reactivate their economic and export activities. There are two aspects to the implications of an early recovery. The first is that it will help to enhance demand for Greater China's exports. For Hong Kong and Mainland China, this may not be essential given the small share of ASEAN in China's external trade. However, for Taiwan it definitely is important. A speedy Southeast Asian economic recovery may well help Taiwan to generate additional export earnings for possible recycling as FDI for Chinese investment markets. Perhaps even more important, the second implication is that an early ASEAN recovery, especially in terms of a reappreciation of the various currencies, may help to mitigate the countries' potential export competitiveness against Greater China exporters.

The third important factor for a sustainable early recovery from the Asian crisis for Greater China and Asia as a whole is clearly whether a new global financial order can be put in place. As Harvard economist Dani Rodrik remarked, it is simply inept to subject the policy of any government to "what 20 or 30 foreign-exchange dealers in London, New York and Frankfurt think" (*New York Times,* September 4, 1998). In fact, the consensus that arose from the 1998 annual meeting of the World Bank and International Monetary Fund was that a new global system of financial regulation should be put in place to counter the international hedge funds, in particular.

Prospects for Further Economic Cooperation within Greater China

In the wake of the Asian economic crisis, how can the three Chinese entities cooperate with each other, formally or informally, to promote Greater China as a regional economic entity in the global context of economic integration? Any realistic solutions must be sought against the broader Chinese economic background, which sets the overall parameters for the existing mode of capital and trade flows within Greater China. There are two main aspects to this.

The first is that, astonishing as the pace has been at which Mainland China has been drawn into the worldwide process of globalization during the past two decades or so, the vast Chinese economy can at best be described as half reformed and half opened. We can view it as being divided into two disparate entities to form a system of two economies within one country. Specifically, a highly protected, strictly import substitution industrial system co-exists with a widely open, export-oriented sector catering to foreign investment and exports (for an elaboration see Kueh 1990, 1997). Clearly, Hong Kong is now fully,

and Taiwan increasingly, integrated with the new economic system along the Chinese coastal belt, which has in turn become part of the integrated global system of free trade.

The second aspect is that the two-economy dichotomy not only implies absolute denial of a strategy of full integration of the real economic sector with outside economies, but, by extension, it also precludes capital account convertibility (as is indeed the case), so as not to deprive the protected priority industry sector of necessary investment funds. The chief objective of the open, export-oriented sector has been to use FIEs to help generate sufficient foreign exchange earnings to finance industrial investment.

The foregoing illustration of the Chinese strategy may overlook some crucial elements, to the extent that, for example, China has welcomed selective "intrusion" by transnational corporations with favored high technology into the closed industrial system. In addition, China has shown clear signs of relaxing its policy with respect to the lesser industrial and services sectors, retail trade in particular, to allow for investments from Hong Kong and Taiwan. However, there is little doubt that the current account convertibility, in effect since December 1996, is essentially meant to be for the open export processing sector principally involving Hong Kong and Taiwanese investment.

The World Trade Organization ranks Hong Kong as the seventh largest trader in the world. Hong Kong derives virtually all its trading opportunities—of which the processing trade is predominant—from Mainland China. China itself ranks 10th as an exporter and 12th as an importer, while Taiwan is 14th for exports and imports combined. Taken together, the Chinese entities have amassed a foreign exchange reserve of some US$300 billion, around 25 percent higher than that of the long-established trading giant, Japan.

This may be seen as a matter of Confucian frugality and prudence or, in the case of Hong Kong, the legacy of British conservatism in hedging against eventual political uncertainty surrounding the handover of Hong Kong, and for Taiwan, perceived political imperatives for ensuring the island's security in relation to the Mainland. Whatever the imponderables may be, the stakes could turn out to be enormous for any drastic departure from the proven exchange rate regimes adopted by all three Chinese entities, which are all basically tied one way or the other to the U.S. dollar.

In more practical terms, given the basic Chinese policy orientation and the fundamental economic rationale underlying capital account control, restricting currency convertibility to the processing trade at a fixed rate to the U.S. dollar, there seems little room left for the Hong Kong or Taiwanese authorities to engage in an independent exchange rate policy, because of their heavy dependence on the Mainland for FDI outflows for export processing activities. For example, a depegging of the Hong Kong dollar from the U.S. dollar would almost surely result in a devaluation, and in the absence of a simultaneous move on the part of Mainland China, would inevitably result in increases in new FDI costs on the Mainland. However, the processing trade, which caters to Western export markets, may not be affected, to the extent that imported materials for processing and the exported commodities are both priced in foreign currency.

More seriously, perhaps, a devaluation of the Hong Kong dollar or new Taiwan dollar would only help to thwart the emerging access, long fought for by investors from Hong Kong and Taiwan, to the domestic Mainland market. The devaluation of the new Taiwan dollar in late 1997 is a good case in point, in that, as a result, many consumer goods industries of Taiwanese origin operating on the Mainland, especially food processing, which relies extensively on Japan and Taiwan for imports of spices and packaging materials, had to immediately suspend their production because of their inability to withstand price competition from domestic producers (personal communication from a major Taiwanese investor in the food processing industry).

Thus, to enhance stability in the processing trade and to facilitate further economic integration, a Bretton Woods type of agreement among Hong Kong, Taiwan, and Mainland China, tacit or otherwise, would seem to be desirable. Whether this should develop further to a formal monetary integration in the direction of, say, a yuan bloc, following full convertibility of the renminbi by 2020 or before (China's pledge to Asia-Pacific Economic Cooperation in 1997), is, of course, a matter for conjecture.

A more sustainable form of economic cooperation within Greater China should be sought in the real sectors against the background of increased economic interaction between the three Chinese entities

during the past two decades or so. To recapitulate, for Hong Kong, conventional labor-intensive, export-oriented manufacturing activities have almost wholly relocated to Mainland China. The process has not, however, resulted in any degree of technological upgrading for the remaining, dwindling number of factories in Hong Kong. In addition, the sunset industries that were removed to the Mainland have not received any policy impetus from the Mainland authorities for technological innovations. Rather, the enormous pressures for generating employment on the Mainland have tended to postpone indefinitely the application of any capital-intensive, labor-saving production techniques to these industries.

It was not until after the 1997 handover that the new Hong Kong government looked for ways to cooperate with the Mainland in developing new technology and high value added industries to create a new industrial profile for the Special Administrative Region (SAR).[10] While new and practical technological frontiers may eventually be identified and new marketable products with high value added created, the new initiatives represent, nonetheless, a lag of more than 10 years behind Korea, Singapore, and Taiwan, which have all gained strong footholds in the global market in electronics and computers. The new approach adopted by the Hong Kong government is, therefore, not entirely uncontroversial. Apart from relative abundance in capital supply and perhaps some comparative advantage in accessing global technological and market information, it seems questionable that, in the long run, the Mainland collaborators will have to continue to depend on the SAR for such new ventures. Against this background, many major Hong Kong industrialists prefer rather to see Hong Kong developed into a fully-fledged Manhattan for the whole of China.

Taiwan appears to be quite different from Hong Kong with respect to industrial cooperation with the Mainland. While similar to the Hong Kong exodus, a wide range of labor-intensive light manufactures (garments, toys, games and sport requisites, clocks and watches, metal products, plastic articles, and so on) have been removed to the Mainland, the vacuum has been rapidly filled by the high valued added new industries alluded to earlier. This is a clear case of regional specialization within the Greater China context. More important, the relocating of the sunset industries to the Mainland has also been increasingly accompanied by larger upstream industries from Taiwan, and increasingly matched by the necessary input supplies from Mainland sources as well to substitute for imports from Japan and elsewhere.

The upshot is that the export processing industry on the Mainland involving Hong Kong and Taiwanese investors is now basically divided into two different sectors. The first, lower-tier sector (comprising conventional export processing lines) relies essentially on input supplies from Taiwan and Mainland sources. The second, higher-tier sector, (which includes food products, pharmaceuticals, metal processing, machine parts and components, and the like, continues to derive its input supplies from overseas, principally from Japan. This clearly reflects increased sophistication in regional economic specialization in East Asia, and there is little doubt that the evolving pattern of regional cooperation will transcend the Asian financial crisis to become even more firmly established in the 21st century.

In retrospect, economic cooperation within Greater China as it has evolved over the past two decades was single-handedly triggered by China's drastic policy reorientation in 1978–79 in favor of reintegrating China with the global economy. It was also greatly facilitated by the equally unexpected political relaxation in Taiwan in 1987 that allowed Taiwanese residents to visit China, and eventually to invest on the Mainland. Viewed this way, two crucial factors may eventually trigger another significant breakthrough to bring the Chinese economy fully into the aegis of globalization. The first is the Taiwanese authorities' possible abandonment of the third country rule, coupled with full liberalization of FDI and trade flows across the straits.

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[10] A high-powered Commission on Innovation and Technology was established under the Chief Executive's Office in late 1997. Headed by the prominent American-Chinese scholar Tien Chang-Lin, former president of the University of California at Berkeley, the commission's objective is to draw up a blueprint for long-term technological development in Hong Kong. A special mandate is to explore feasible ways to capitalize on the Mainland's expertise in high technology and basic research for commercial applications and international marketing.

The second crucial factor relates to the admission of China into the World Trade Organization, with all the ensuing implications for trade and investment liberalization in relation to the highly protected Chinese industrial system. Given the increased size of the Chinese economy, this might help to alter the global context of FDI and trade flows in the longer term, and both Hong Kong and Taiwan would clearly be the first to be fully integrated with the entire Chinese economic system to ensure an even more stable and sustained economic relationship.

Given also current Chinese economic relationships with the outside world, admission into the World Trade Organization is likely to further enhance China's integration with the advanced, industrial West, rather than to affect its relationship with its Southeast Asian neighbors. That is not to say, however, that growing Chinese economic power will eventually marginalize the importance of the Southeast Asian countries. A more likely scenario is that as China gradually becomes an industrial powerhouse in Asia, it will fuel growth and industrialization, and join Japan to become a crucial supplier of the bulk of industrial producer goods to their Asian neighbors. Moreover, the huge and highly diversified Chinese economy promises to provide sufficient market niches for the highly export-oriented ASEAN countries to diversify their overseas markets. This will all help to create a more integrated Asian Pacific economic setting, with enhanced and sustainable economic stability for all countries concerned.

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