

Chapter I

China's Conversion to a Market Economy and Problems with the Return of Hong Kong and Unification of China and Taiwan

Introduction

When considering the return of Hong Kong and the unification of China and Taiwan from the viewpoint of China, it is necessary to be aware of the extremely political nature of these problems in terms of the "restoration of sovereignty" and "resolution of the division of the state." It must also be acknowledged that unification of the state, which even Deng Xiaoping could not accomplish, is an issue which must be dealt with to enable the Jiang Zemin administration, which succeeded Deng Xiaoping, to strengthen its legitimacy. These conditions appear to have triggered the firm response, which could also be considered as "crisis policy," against Hong Kong and particularly Taiwan which the Jiang Zemin administration has expressed since last year (1995).

On the other hand, however, the Jiang Zemin administration has placed its highest priority on economic stability to ensure domestic political stability and is basing diplomacy with Hong Kong and Taiwan on the maintenance of stable relationships. Considered from the Hong Kong and Taiwanese stances, economic integration with China is beginning to be strongly encouraged, and based on these conditions, the only remaining policy lies in constructing a relationship with China. Accordingly, it is essential to analyze these individual economies and interdependent economic relationships in comparison with political and diplomatic factors in order to predict the relationships between China, Hong Kong and Taiwan.

The progress made in China's conversion to a market economy will form a precondition to the economic and political integration of the three parties in the medium to long term, as well as a factor in the fluctuating relationships between the three parties in the short term. Accordingly, this

chapter presents the current situation and issues involved in China's conversion to a market economy in Section 1, while Sections 2 and 3 examine the type of influence these conditions have on present Chinese economic policies and on China's economic relationships with Hong Kong and Taiwan. Section 4 confirms that economic exchange with China is changing the Hong Kong and Taiwanese economic structures and generating new issues in both regions, and finally, Section 5 attempts to present several future prospects regarding the issues of Hong Kong's return and the unification of China and Taiwan by incorporating the aforementioned analyses. The content of this chapter overlaps certain portions presented in the following chapters, but an effort is made to limit examination to those areas necessary for developing the theory presented in this chapter.

1. Progress in the Conversion to a Market Economy and New Issues

(1) Reform and Open-door Policy Facing a Turning Point

In the 17 years since a reform and open-door policy were implemented, the Chinese economy has experienced high growth at an average annual GDP growth rate of 10% (average from 1979 to 1995), although wide fluctuation in this rate has been experienced. As illustrated in Table 1-1, conversion to a market economy has also made favorable progress. Under present conditions, however, the high growth and progress since converting to a market economy are alone not sufficient to ensure future development of the Chinese economy, and development of the following problems has gradually become evident.

Table 1-1 Shift in the Ownership Share of Production, Investment and Commerce

						(unit: %)
Item/Year	1978	1980	1985	1992	1995	2000 (Prediction) ¹⁾
Gross Output Value of Industry						
State-Owned Enterprise	77.6	76.0	64.9	48.1	34.0	27.2
Collective-Owned Enterprises	22.4	23.5	32.1	44.8	36.6	47.7
Individual-Owned and Other Ownership Enterprises	—	0.5	3.0	7.1	29.4	25.1
Total Investment in Fixed Assets						
State-Owned Enterprise	N.A.	81.9	66.1	67.1	54.4	—
Collective-Owned Enterprises	N.A.	5.0	12.9	17.3	16.4	—
Individual-Owned and Other Ownership Enterprises	N.A.	13.1	21.0	15.6	29.2	—
Total Retail Sales						
State-Owned Enterprise	54.6	51.4	40.4	41.3	29.8	33
Collective-Owned Enterprises	43.3	44.6	37.2	27.9	19.3	17
Joint Enterprises	—	—	0.3	0.7	0.4	—
Individual-Owned and Other Ownership Enterprises ²⁾	2.1	3.9	22.2	30.1	50.5	50

Source: Compiled by author from *China Statistical Yearbook 1996* and other materials

Notes: 1) Represents estimates from the National Information Center.

2) Includes total sales from farmers to non-farmers

- (1) Lack of Macroeconomic Control. From the central government to outlying regions, reform and an open-door policy have been pursued on a number of levels through easing regulations and the transfer of power, but, unable to achieve mutual coordination, this standard has become a source of economic confusion. Although the establishment of a method for macroeconomic control is naturally necessary to manage economic confusion within an undeveloped market, efforts to establish this control have been lagging.
- (2) Recession in the State-owned Sector. The high growth and conversion to a market economy experienced to date have been generated by rapid development of the non-state-owned sector, while the state-owned sector has basically remained ineffective despite the implementation of a number of reform measures. The majority of state-owned enterprises continue to post operating deficits, pressuring state finances depending on these enterprises, and at the same time, contributing to the instability of the financial system through bad credit.
- (3) Stagnation in the Agricultural Sector. The agricultural sector improved productivity through liberalization measures (adoption of a production responsibility system, and an increased degree of operating freedom) in the initial stages of reform and open-door policy, promoting the conversion to a market economy by creating new management agents in township- and village-run enterprises as well. The effects of the initial liberalization measures, however, have been exhausted, production is stagnant, and like the case of state-owned enterprises, this is also beginning to emerge as a "protected sector."
- (4) Expanded Economic Disparities Between Regions and Sectors. Conventional open-door policy offered regional hospitality and was focused on the coastal region. The coastal region profited significantly with the introduction of foreign capital and the expansion of exports generated by this capital, but economic disparities between the coastal regions and inland regions, which did not similarly benefit, have tended to increase. The fact that this regional disparities duplicates the disparities between the non-state-owned sector, into which foreign capital is easily introduced, and the state-owned and agricultural sectors, into which the introduction of foreign capital is difficult, (for example, the northeastern region is typical in this respect) poses a problem.
- (5) Manifestation of Resource and Environmental Limitations. Past high growth has been largely accomplished through increased investment in production elements, but this type of

growth is naturally limited. Improved efficiency in the utilization of resources is also essential to continued growth within the naturally severe limitations of resources and the environment.

(2) Recommendations From the Ninth Five-Year Plan and Long-term Target for the Year 2010

The Ninth Five-Year Plan (from 1996 to 2000, referred to below as the 9/5 Plan) and the Long-term Target for the Year 2010 (referred to below as Long-term Target)⁽¹⁾ adopted at the Fourth Plenary Session of the Eighth National People's Congress in March 1996 offer recommendations for managing the issues just described. Among these, the following four items should be noted.

The first item concerns the maintenance of growth rate at an annual 8% level while prioritizing the containment of inflation and ensuring a stable macroeconomic environment. Second, stable agricultural growth, pursual of adjustment in the industrial structure, and ensurance of regional economic balance were recommended as the primary objectives for economic construction over the next 15 years. The third item concerns the reform of state-owned enterprises centered on reform of the economic system, and the fourth proposes the realization of "two conversions" in the medium to long term, (1) conversion from a planned economy to a "socialist market" economy, and (2) conversion from an "extensive" style of economic growth to "intensive" growth.

The reasoning behind the first recommendation would appear to be that, through maintenance of this level of growth, problems such as unemployment that cause social instability could be prevented without sacrificing the efficiency of the entire economy, and the experiences from the 1989 to 1991 period, during which time restraint of extreme rates of growth produced economic overkill, also appear to have supported this recommendation⁽²⁾. Adjustment to the industrial structure by subsidizing agriculture and basic industries (energy, raw materials, transportation and communications) and the promotion of strategic industries (machinery, electronic, petrochemical, automotive and construction and building materials) were proposed in the second item. Concrete measures (including a

policy of capital assistance to inland regions and inducement policies regarding relatively superior industries and foreign capital) to alleviate regional economic disparities are also offered. The third recommendation proposes promoting market policy, upgrading the social security system and converting government functions corresponding to the reform of state-owned enterprises.

Finally, the fourth point will be examined in more detail. The terms "unstructured" and "intensive" are used here to represent concepts somewhat different from their general use, referring to the conversion from growth through expanded investment of production elements, mainly capital and labor, to growth dependent on the improvement of economic efficiency and technological progress. More specifically, this conversion indicates raising the Total Factor Productivity (referred to below as TFP) and more efficient utilization of resources.

According to research which calculates the contribution ratio to economic growth for each of the production elements following the introduction of reform and the open-door policy, capital investment stood at 61.62%, labor investment at 9.65% and technological progress at 28.73% in the 1978 to 1989 period⁽³⁾. The contribution ratio for technological progress in China does not represent even 50-70% of this ratio in advanced nations, and attains only a moderate position even among developing countries. TFP did not exceed an annual average of 2.56% during this period. A report of State Planning Commission has suggested that each of these ratios should be increased, advocating an annual 4-5% rate of productivity increase and a 40-50% technological progress contribution ratio.

China's economy has always faced severe resource limitations, but without more efficient utilization of resources, economic growth will also stagnate. In this sense, the conversion to "intensive" growth is understood to be a conversion to "sustainable" growth.

(3) New Stage in the Conversion to a Market Economy

As just described, China is currently approaching a new stage in its conversion to a market economy. In response, large-scale adjustment in conventional reform and open-door policy (moving away from the path established by Deng Xiaoping) is being undertaken. The Jiang Zemin adminis-

tration has in fact been steadily pursuing this adjustment since 1995. In January 1995, Jiang Zemin published a lecture entitled "Continued Struggle for Acceleration of the Great Task of Unification of the Fatherland"⁽⁴⁾ which concerns the policy toward Taiwan and is directly related to the topic of this chapter. Although the use of weapons in the struggle for unification was not renounced in this lecture, Jiang Zemin did state that "Chinese soldiers will not fight each other" and proposed "the development of economic exchange" and "the exchange of visits by leaders on both coasts." These declarations were designed to display Jiang Zemin's leadership in policy toward Taiwan by this lecture known as "Jiang's Eight Viewpoints and Proposals," reflecting the fact that eight proposals were presented.

At the Fifth Session of the 14th Central Committee of Communist Party of China in September, a speech entitled "On the Correct Handling of Major Relationships in the Socialist Modernization" (known as the "On the Twelve Major Relationships")⁽⁵⁾ was presented. In this speech, Jiang Zemin organized the "new anomalies and issues faced by all departments in modernization under the conditions of a socialist market economy" into 12 "relationships" (items) and proposed principles for responding to these relationships. As suggested by the title, it should be noted that Jiang Zemin was offering "principles," revising the path established by Deng Xiaoping, while strongly invoking Mao Zedong publications, the "On the Ten Major Relationships" (1956) and "On the Correct Handling of Contradictions Among the People" (1957), which offer a general plan for constructing a unique system of socialism.

Presented in the following order, this speech advocated the revision of such items as (1) the relationship between reform, development and stability, (2) the relationship between the speed and effectiveness of economic growth, (5) the relationship between eastern and mid-western regions, (7) the relationship between the economy of a public ownership system and other economic elements, (9) the relationship between the expansion of an open-door policy and adhering to self-reliance, and (10) the relationship between central and regional government. The following represents the specific new "principles" which were set against the features of Deng Xiaoping's path: (1) emphasis on stability as opposed to prioritizing development, (2) empha-

sis on efficiency as opposed to prioritizing quantitative economic expansion (conversion from an "extensive" style of economic growth to "intensive" growth), (5) revision of regional disparities as opposed to prioritizing the eastern coastal region, (7) ensuring the leadership of the public ownership system economy as opposed to emphasizing a non-public ownership system economy, (9) adherence to self-reliance as opposed to prioritizing an expanded open-door policy, and (10) concentration of power in the central government as opposed to expanding the autonomy of local governments.

The Jiang administration is evidently advocating the stance of revision to the Deng path in response to economic realities and the dissatisfaction of all levels of society, and working through this revision to strengthen its power base. In addition, the majority of the items just described respond to China's economic problems that have been presented in this first section, and the 9/5 Plan and Long-Term Target also reflect these new "principles."

Before examining the influence of this policy revision on China's economic relationships with Hong Kong and Taiwan, the next section outlines the adjustment of current economic policy, focusing on "The National Programme for Industrial Policy in the 1990s"⁽⁶⁾ that was published in June 1994 and "Provisional Regulations Guiding the Direction of Investments by Foreign Companies"⁽⁷⁾ that was published in June 1995. Section 3 considers the influence of these publications on Hong Kong and Taiwanese investments in and trade with China.

2. *Adjustment of Current Economic Policy*

(1) **Strengthening Industrial Policy**

Industrial policy is considered a key method for converting to an "intensive" style of economic growth. At present, "The National Programme for Industrial Policy in the 1990s" (referred to below as the "Programme") offers the most systematic policy, and its main points can be summarized as follows: (1) Prioritizing emphasis on agriculture and the rural economy (2) Strengthening the infrastructure and basic in-

dustries (including energy, transportation, communications and raw materials)

- (3) Establishing the machinery, electronics, petrochemical, automotive and construction industries as strategic industries ("mainstay industries" in Chinese) for the 21st century, and announcing the promotion of these industries.
- (4) Linking foreign trade structural adjustment to industrial structural adjustment. In other words, expanding exports of goods which have comparative advantage, including agricultural, textile and light industrial products and household appliances, and at the same time expanding exports of high value-added products and encouraging the import of new technologies and parts, but containing luxury consumption goods.
- (5) Suggestion of a policy framework with regard to industrial associations, technology and placement. In terms of industrial associations, this policy is concerned with "the economic characteristics of scale" and targets a market centered on large-scale enterprises in industries with obviously similar economic characteristics, the logical division of large enterprises and medium to small enterprises in the parts and assembly industries, and a competitive market comprising a number of enterprises in industries without similar economic characteristics. This policy suggests accelerating the introduction of industrial products by technological development and R&D support with regard to industrial technology. The industrial placement policy seeks the location and arrangement of industries intended to revise the economic disparities between eastern coastal regions and mid-western inland regions.

The 9/5 Plan and Long-term Target divide the entire country into seven large economic regions concerning the industrial placement already discussed, prioritizing and suggesting development strategies for each (figure 1-2).

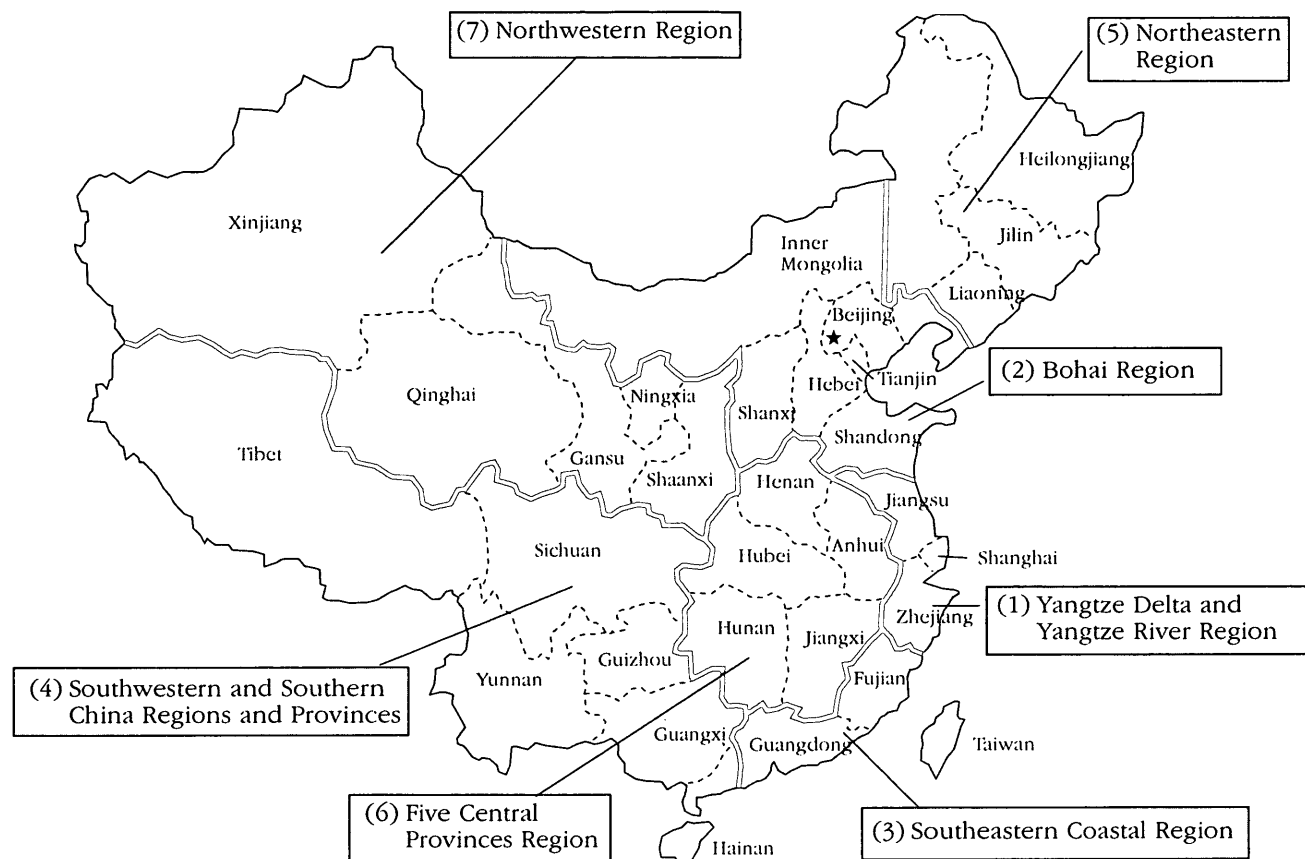
(2) Adjustment of the Policy on the Introduction of Foreign Capital

China's policy on the introduction of foreign capital has basically maintained the stance that "any foreign capital is welcome"⁽⁸⁾. Although an open-

door policy has been maintained for 15 years (in 1995), and a large number of foreign capital firms are operating in China, friction has emerged between policies protecting and fostering domestic industries and those welcoming foreign capital firms. In addition, with the implementation of a full-scale industrial policy, the first guidelines on the introduction of foreign capital have been recently announced in the form of national regulations as just discussed. The following outlines the items presented in "Provisional Regulations Guiding the Direction of Investments by Foreign Companies" (referred to below as "Regulations").

- (1) Specification of the selection based on the industrial policy for foreign capital introduction.
- (2) Division of industries into four categories, "Encouraged, Approved, Restricted, and Prohibited" for foreign capital introduction with all but the "approved" industries published in the attached "Index List." Regular re-evaluation of this list will be conducted in the future (table 1-3).
- (3) Specification of industries for which individual investment of foreign capital is prohibited, and industries for which Chinese investment should dominate.
- (4) Areas in which regulations are conversely eased, including the categorization of certain commerce, and trade, transportation, construction and finance industries for which the introduction of foreign capital was previously prohibited, as a "restricted" industry.
- (5) Incorporation of policies encouraging foreign capital in inland regions.

In addition, restrictions on the hospitality policies for foreign capital themselves are beginning to appear. Since 1994, low income tax rates (foreign capital taxed at 33% and at only 15% within open coastal urban economic and technological development regions as opposed to the 55% rate on domestic capital) and import tax exemptions (tax exemptions on production equipment, raw materials and office supplies) have been successively abolished, leaving the simplified "2-year exemption, 3-year decrease" tax measure (a measure offering tax exemptions for the first two years following the registration of profits and taxes reduced by half over the subsequent three years) and low tax rates in Special Economic Zones and open coastal cities; the only remaining hospitality measures.

Figure 1-2 Regional Economic Development Strategy of the Ninth Five-Year Plan

Region (Province/City/Autonomous Region)	Characteristic	Development Strategy/Future Image
(1) Yangtze Delta, Yangtze River Region (Shanghai, Jiangsu, Zhejiang, cities along the Yangtze river)	Well developed water transportation and agriculture, broad industrial base, high technological standards	Development of Pudong, comprehensive economic sphere made possible by construction of the Sanxia dam
(2) Bohai Region (Liaoning, Beijing, Tianjin, Hebei, Shandong, Shanxi, mid-western Inner Mongolia)	Well developed transportation and communications, concentration of large and medium-size cities, concentration of science and technology talent, resources including coal, iron ore and petroleum	Development of strategic industry, comprehensive economic sphere driven by the construction of an energy base and transportation route
(3) Southeastern Coastal Region (Guangdong, Fujian)	Borders Hong Kong, Macao and Taiwan, comprehensive large-scale open-door policy	Export-oriented economic region, including agriculture acquiring foreign currency, capital and technology-intensive foreign companies, and high value added industries
(4) Southwestern and Southern China Regions and Provinces (Sichuan, Guizhou, Yunnan, Guangxi, Hainan, Tibet, western Guangdong)	Borders, rivers and coastal areas, abundant resources for agricultural and marine products, minerals and tourism, location of munition industry	Formation of bases for energy and mineral production, tropical and sub-tropical agricultural products and tourism, making good use of the technical power of munition industry, centering on the construction of a route to foreign countries and the development of hydroelectric power and mineral resources
(5) Northeastern Region (Liaoning, Jilin, Heilongjiang, eastern Inner Mongolia)	Well developed agriculture, completed heavy industrial structure, abundant land and energy resources	Upgrading of former industrial base, development of the Tumen river region, development of agricultural resources, construction of heavy chemical industry and agriculture bases
(6) Five Central Provinces Region (Henan, Hubei, Hunan, Anhui, Jiangxi)	Well developed agriculture, completed industrial base, convenient transportation	Formation of agricultural, raw material and machinery industry bases and new economic zone by tying the region to main railway lines such as those running from Beijing to Kowloon and Guangzhou
(7) Northwestern Region (Shaanxi, Gansu, Ningxia, Qinghai, Xinjiang)	Passage to Central Asia, abundant agriculture and livestock, energy and mineral product resources, location of munition industry	Pursuing water supply, transportation and resource development and forming raw cotton, cattle raising, petroleum chemical industry and nonferrous metal bases by tying the region to a Eurasian landbridge

Source: Compiled by author from *Ninth Five-year Plan and Long-term Target for the Year 2010* and other materials

Table 1-3 Foreign Capital Introduction Index List

Classification	Industry
Encouragement	Includes new agricultural technology/comprehensive development, energy/transportation infrastructure, new materials, leading-edge electronic parts, precision instruments, private airplanes, automotive parts, bio-technology, energy conservation technology
Restricted	(A Class) Includes household electrical goods, electronic wristwatches and pharmaceuticals (B Class) Includes spinning, coal mining, petroleum chemicals, automobile assembly, motorcycle assembly, domestic commerce, foreign trade, travel, real estate, finance and services
Prohibited	Includes agriculture and forestry/cattle raising, traditional arts and crafts, mining of rare minerals, power supply, urban public projects, post, communications, radio/television broadcasting, film, arms and gambling

Source: Compiled by author from *Foreign Firm Investment Industry Index List*

Replacing these hospitality measures, the Chinese government is emphasizing "national treatment." This policy naturally includes both advantages and disadvantages, but advantages include the reduction of import barriers, the expansion of sectors for which the participation of foreign capital is approved (as previously mentioned) and the reduction of various service charges (including charges for meals, housing, transportation and facility use for foreigners).

(3) Re-evaluation of Special Economic Zones Policy

The 1995 dispute over whether Special Economic Zones (referred to below as the SEZs) should be maintained or abolished should be mentioned in connection with the "Programme" and "Regulations." Three points appear to have led to this dispute: (1) past SEZs policy as the most significant factor generating regional differences and corruption, (2) deep-seated criticism of this policy as contradicting the market economy principle of fair competition, and (3) recognition that policies welcoming foreign capital in certain regions will end

with membership in WTO (World Trade Organization). This dispute centered on proposals for abolishing the SEZs presented by the central government and opposition from the criticized SEZs⁽⁹⁾. It appears that the central government's objective is the restraint of Guangdong Province which embraces the SEZs policy and tends to defy the central government.

Although continuation of the SEZs policy was ultimately approved in the 9/5 Plan, this plan also specified the possibility of future "political adjustment." As described in this section, the Chinese economy is approaching a period of structural adjustment dependent upon industrial policy, and the consideration of international standards has also become necessary in foreign economic policy. The hospitality policy toward SEZs appears likely to be gradually abolished in the near future, and a policy hospitable to foreign capital will shift toward measures that lower customs duties and ease regulations throughout the entire country as promised for APEC (Asian Pacific Economic Cooperation) by the Chinese government. SEZs are nearing the end of their historical mission, which in turn will prompt changes in investment by Hong Kong and Taiwanese enterprises deeply tied to special and coastal regions.

3. Influence on Economic Relationships with Hong Kong and Taiwan

Strengthening the industrial policy, adjusting policies concerning the introduction of foreign capital and re-evaluation of the SEZs policy already outlined will naturally influence China's economic relationships with Hong Kong and Taiwan. The following section summarizes the influence on investment and trade.

(1) Influence on Hong Kong and Taiwanese Investments in China

- (1) Reduction of conventional investments. The majority of investments in China by Hong Kong and Taiwanese enterprises in the past have been concentrated in labor-intensive industries, including textiles, sundries and the assembly of household appliances, and have

focused on commissioned processing. This tendency has been particularly strong in the case of the Hong Kong capital as is clearly evident in the high ratio of commissioned-processing in Hong Kong trade with China (table 1-4). As specified in "Regulations," however, this type of investment will cease to be welcomed in the future. Although the promotion of current exports in textiles and light industrial products was announced in the "Outline," domestic enterprises in these sectors are experiencing growth⁽¹⁰⁾, and Hong Kong and Taiwanese investments are certain to decrease.

- (2) Expansion of industries receiving investment. As described in Section 2, sectors for which the introduction of foreign capital has been prohibited are being opened. These include those industries for which investment is "encouraged," as in the construction of infrastructure, as well as "Restricted" (conditionally approved) industries including commerce, trade and real estate, tertiary industries such as finance, machinery industries such as automotive and motorcycle assembly, transportation and construction. This policy is attracting Hong Kong and Taiwanese enterprises.
- (3) Broadening those regions receiving investment. Investment regions have broadened as a result of the constriction of regional hospitality policy, including the policy concerning SEZs, and the beginning of a shift in investment targets from exports destined for third countries to participation in the Chinese domestic market. Investments in the Guangdong and Fujian provinces had, for example, dominated the investment by Taiwanese enterprises, but in 1994 and 1995 the leading investment regions were Shanghai and Jiangsu.
- (4) Diversification of investment style. A significant easing of regulations has taken place with the 1991 introduction of the issuance of B stocks approved for purchase by foreigners, the approval of H stocks for listing on the Hong Kong stockmarket in 1993 and approval for the establishment of investment firms through foreign capital in 1995⁽¹¹⁾. As previously mentioned, BOT-style (Build, Operate and Transfer) investments have been introduced in the infrastructure sector, and large-scale, long-term investments are now being

made in such items as highways and thermo-electric power plants which had previously been unimaginable.

(2) Influences on Hong Kong and Taiwanese Trade With China

Influences on trade are inseparable from influences on investments, and conditions differ somewhat between Hong Kong and Taiwan in this respect.

In Hong Kong, trade involving commissioned processing from China, which had previously accounted for a significant portion of trade, has reached its limit, and conversely, general trade is experiencing growth (table 1-4). This is a result, however, of the adjustment to China's policy on foreign capital, and this tendency appears likely to continue. The effect on China's economic direction by general trade and the future vulnerability of the Hong Kong economy to the Chinese economy poses problems for Hong Kong. Hong Kong's long-held leading position as an entrepôt base for trade with China is also beginning to destabilize due to rising costs (including labor costs and office expenses), regional diffusion of investment in China, and establishment of the infrastructure in neighboring countries including China. Hong Kong is also approaching the stage at which a re-evaluation of its own position is necessary.

Taiwanese trade with China, on the other hand, has always been strongly linked to its investment in China, and recent exports to China reveal a relative decline in the growth of raw materials and parts, including textiles, apparel and shoes, as opposed to the maintenance of high growth in machinery and electronic-related exports. This reflects a shift in the emphasis on new investments⁽¹²⁾. The importation of traditional products, including Chinese medicine and down, is declining, in comparison with the remarkable increase in industrial product imports (particularly of electrical machinery and electronic parts). This indicates that an industrial division of labor is establishing itself between China and Taiwan, which also results from Chinese trade and industrial policies. As China emerges as a powerful rival, concern over declining exports and the simultaneous hollowing out of domestic industry is an emerging issue in Taiwan. Taiwan is also

Table 1-4 Shift in Structure of Hong Kong Trade With China

(unit: %)

Year/Classification	Local Exports		Re-exports		Imports	
	Commissioned Processing	General	Commissioned Processing	General	Commissioned Processing	General
Distribution Ratio						
1989	75.9	24.1	43.6	56.4	58.1	41.9
1990	<u>79.0</u>	21.0	<u>50.3</u>	49.7	61.8	38.2
1991	76.5	23.5	48.2	51.8	67.6	32.4
1992	74.3	25.7	46.2	53.8	72.1	27.9
1993	74.0	26.0	42.1	57.9	73.8	26.2
1994	71.4	28.6	43.3	56.7	<u>75.9</u>	24.1
1995	71.4	28.6	45.4	54.6	74.4	25.6
Increase/Decrease Ratio Over Previous Year						
1989	8.5	14.2	16.0	-23.3	N.A.	N.A.
1990	13.9	4.4	23.6	-5.6	27.8	9.5
1991	10.8	27.8	32.6	44.1	36.0	5.4
1992	9.7	23.5	32.4	43.7	28.7	3.9
1993	2.0	3.9	18.1	39.4	16.2	6.8
1994	-7.0	5.9	21.0	15.1	20.2	7.7
1995	4.6	4.3	24.8	14.5	12.6	21.6

Source: *Hong Kong External Trade*, March each year

Note: The underlined figures indicate the highest value for each item.

finding conversion of its industrial structure to be necessary.

(3) Investment in Hong Kong and Taiwan by Chinese Enterprises

Foreign direct investment by Chinese enterprises has not been notable to date, but investment by these enterprises in Hong Kong has recently surged. This surge in investment in Hong Kong is backed by domestic investment by Chinese enterprises exploiting the hospitality policy in terms of "foreign capital" and pursuing further multinationalization. The adjustment of policy on foreign capital is likely to encourage strengthened cooperation between Chinese enterprises located in Hong Kong, local Hong Kong enterprises and those operated by overseas Chinese merchants.

According to recent reports, Chinese enterprises investing in Hong Kong numbered 1,756 at the end of 1994, with investments totalling \$42.5 billion. This figure exceeds the combined investment totals of Japan and the United States, placing China first among those countries investing in Hong Kong. Chinese enterprises located in Hong Kong also represent a significant presence in the Hong Kong economy, accounting for 22% of total trade, 55% of re-exportation to China, 23% of sav-

ings in banks, 21% of earnings from insurance charges, 25% of cargo transportation volume, 50% of the travel business to China, 12% of construction projects and 5% of the current investment price in the stockmarket⁽¹³⁾. It is true that this strong presence is advantageous in strengthening the ties between Hong Kong and China and in strengthening Hong Kong's position as a gateway to business in China, but this results at the same time in the disadvantage to the Hong Kong economy of being directed by China (Chinese enterprises) similarly to the generated changes in the trade structure that have already been discussed.

Investment in Taiwan by Chinese enterprises is presently prohibited⁽¹⁴⁾, but in reality, intervention in the Taiwanese stockmarket and real estate market via Hong Kong is already an open secret⁽¹⁵⁾. Increased investment in Taiwan by these "Hong Kong" companies is inevitable when the increase in the number of Chinese enterprises based in Hong Kong and the fact that Hong Kong will return to China in 1997 are taken into consideration. Taiwan is also aware of this point and is currently preparing the "Ordinance on Relationships with Hong Kong and Macao" which incorporates the treatment of Hong Kong and Macao enterprises after Hong Kong's return⁽¹⁶⁾.

4. *Transition Period in the Economies of Hong Kong and Taiwan*

Investment and trade relationships between China, Hong Kong and Taiwan are deepening daily, and this economic integration will undoubtedly continue to develop. As indicated in the previous section, however, the economic integration process itself is altering the Hong Kong and Taiwanese economic structures and is generating new economic issues in both regions. This section will examine these points.

(1) **Issues in the Hong Kong Economy**

Following the implementation of reform and the open-door policy in China, Hong Kong has developed economically as a gateway to China and as a support in the economic integration with China. This development can be roughly divided into two stages.

In the first stage spanning the 1980s, the manufacturing industry shifted its production base to neighboring Guangdong Province in order to overcome rising production costs and labor shortages. Commissioned processing, in which equipment and raw materials were brought in from Hong Kong and goods processed in Guangdong were re-exported from Hong Kong, formed the major course of this shift. This arrangement is designated "foreground shops, background workshops," reflecting the location of the headquarters and business functions in Hong Kong and the use of Guangdong Province as a production base. Its effect, however, has been hollowing of the Hong Kong manufacturing industry and rapid conversion of the industrial structure to the service sector.

After Deng Xiaoping's "Talks on the Southern Tour" in 1992, large-scale Hong Kong enterprises within the business group structure confirmed that the development of China's reform and open-door policy was inevitable, and the second stage was subsequently characterized by the development of large-scale investment in real estate and infrastructure, an increase in the number of investments targeting domestic Chinese demand in response to further adjustment of the Chinese policy toward foreign capital, and the rapid expansion of regions targeted by investment. Backed by high growth,

Hong Kong real estate and stock prices surged during this period, and economic "bubble" conditions emerged.

As China, which had suffered similar bubble conditions, implemented a full-scale economic restraint policy from the summer of 1993, Hong Kong's economic bubble burst and a recession ensued which has continued to date (1996). It must be noted, however, that significant issues faced by the Hong Kong economy have manifested themselves during this recession.

The following factors have played a role in the current recession: (1) the beginning of struggling growth in entrepôt trade via Hong Kong due to diversification of the trade channels into China through the incorporation of the entire country in an open-door policy and improvements in the Chinese transportation infrastructure; (2) struggling growth of commissioned processing due to the constriction of China's hospitality policy on foreign capital and the growth of Chinese enterprises, as well as the beginning of commissioned processing trade reductions, and (3) the decreasing attraction of Hong Kong as an international business center due to surging costs which were also exacerbated by the bubble economy. A fourth factor lies in intensified competition with Singapore and Taiwan which are targeting Hong Kong's position to become new business centers⁽¹⁷⁾.

Factors which have supported Hong Kong's success and prosperity in the past are experiencing large-scale debilitation. Before discussing future economic instability in Hong Kong accompanying its return to China, measures countering existing domestic factors in instability are necessary. In other words, the Hong Kong economy has already been incorporated into the Chinese economy, and based on these conditions, domestic reform is the sole remaining alternative. Issues which Hong Kong must specifically deal with in the future are summarized below⁽¹⁸⁾:

- (1) Maintaining Hong Kong's still stable position as an international finance center
- (2) Upgrading both the soft and hard infrastructure, including harbors, airports and communications
- (3) Fostering human resources. Specifically in response to the economic conversion to the service sector, the fostering of a high-quality workforce is necessary to maintain the coun-

try's edge in competition with neighboring countries.

- (4) Upgrading the domestic Hong Kong manufacturing industry and positioning the southern China region as a R&D base.

Hong Kong can work to overcome the confusion which will accompany its return to China following the resolution of these issues.

(2) Issues in the Taiwanese Economy

As with Hong Kong, the Taiwanese economy has enjoyed high growth as its relationship with China's economy has strengthened. Trade statistics illustrate the present degree of dependence on trade with China with exports via Hong Kong accounting for 8.85%, imports for 1.52% and import/exports at 5.32% (1995). The Mainland Affairs Council of Taiwan, however, estimates these totals at 17.4%, 2.98% and 10.46% respectively⁽¹⁹⁾. Investment destined for China maintains a 35.5% share of Taiwanese foreign investment (1952-1995 totals) as well⁽²⁰⁾.

The following points explain the current depth of the economic relationship between China and Taiwan, despite the little more than 16 years since the restoration of this relationship through the implementation of China's reform and open-door policy. This includes (1) the strength of the complementary relationship between the two parties in terms of resource conditions, (2) increased overseas investment by Taiwanese enterprises from the middle of the 1980s in response to the rising exchange rate, jump in domestic production costs and labor shortages, and the frequent selection of China based on similarities in geographical conditions, language and culture, and (3) the welcoming of Taiwanese investment by China as a prerequisite for unification.

As the competitive aspect has recently become dominant, however, the Taiwanese economy is evidently facing a new turning point within a relationship which is no longer simply complementary. The following phenomena are emerging which may be connected with a hollowing of the Taiwanese economy: (1) the share of Chinese products has exceeded that of Taiwanese products in the United States and Japanese markets, which had represented export markets for Taiwan, as a result of investment in China by Taiwanese enterprises, (2)

investment in China by Taiwanese enterprises has gradually spread from downstream sectors, including processing and assembly, to upstream sectors which include raw materials, with the scale of investments also expanding; (3) investment by groups, including the business community, have emerged where only individual enterprises previously advanced, and (4) reinvestment in China by enterprises which have already advanced into the country have recently increased.

In addition to the continuing deterioration in the investment environment within Taiwan which is pushing investment to China as already discussed, another source of these phenomena is evident in the investment pull caused by the opening of the domestic market in China. In order to avoid excessive dependency on China, in 1993, the Taiwanese authorities drafted a "southern-oriented policy" and have attempted to promote overseas investment toward Southeast Asian countries. This policy, however, has not been effective enough to stop the wave of investment targeting China. The strength of China's pull on Taiwanese enterprises is evident from the fact that investment in China did not greatly decline, even during the period from 1995 to the first half of 1996 when military maneuvers were repeatedly conducted in the Taiwan Strait⁽²¹⁾.

The concept of an "Asian Pacific Operational Center" announced at the end of 1994 specified the intention of the Taiwanese authorities to check the economic hollowing by encouraging domestic investment, sustaining economic development by upgrading the domestic industrial structure, and requesting cautious investment in China on the part of Taiwanese companies. Specifically, this "Operational Center" would "position Taiwan at the center of various regional economic activities including manufacturing, collection and distribution, finance, communications and media activities" with East Asian markets, particularly Southeast Asian and Chinese markets, as hinterland⁽²²⁾. It should be mentioned, however, that Taiwan's choices are not large in number as, even in this policy, Southeast Asian and Chinese markets had to be specified.

5. Future Prospects

This chapter has examined (1) China's choice to pursue further conversion to a market economy as its economic development strategy spanning the

beginning of the next century and its entry into a new adjustment stage of its conventional reform and open-door policy, (2) the strong influence of these policies on China's economic relationships with Hong Kong and Taiwan, (3) the evident stagnation of Hong Kong and Taiwanese economic policy due to the Chinese policy change just described, despite having experienced high growth together with China resulting from an investment-oriented strategy by which the expansion of investment in China is expanding trade with China, and (4) the central role played by Hong Kong and Taiwan upgrading their domestic economies in response to China's new economic situation. Utilizing this analysis, this final section will present the future prospects for the return of Hong Kong and the unification between China and Taiwan. As discussed in the Preface section, these future prospects are focused on the beginning of the next century.

First, economic integration between China and Hong Kong and between China and Taiwan is likely to deepen in the future. The degree of dependence on China by the Taiwanese economy will likely increase, as it certainly will in Hong Kong after the return. In the case of Taiwan, however, the degree of integration remains too low to designate its relationship with China as an economic sphere (for example, a "bicoastal economic sphere"), and progress made in developing the "Asian Pacific Operational Center" concept may intensify competitiveness within the relationship between Taiwan and China.

Second, despite the limitation just described, Chinese leadership is likely to strengthen in the future in respect of this issue. Although the Jiang Zemin administration has recently relaxed its policy toward Hong Kong and Taiwan based on the decision to avoid societal instability in Hong Kong as return nears, as well as reevaluating the ineffectiveness of the country's policy toward Taiwan, this policy also appears to be an affirmation by this administration of the future of Chinese economy and economic integration of China, Hong Kong and Taiwan.

Third, the development of economic integration will also restrict China. Hong Kong and Taiwan play invaluable roles in the introduction of foreign capital, technology, and operation knowledge to China, and if China is to continue benefiting in this way, its policy toward Hong Kong and Taiwan must maintain the present conditions. Hong Kong's re-

turn will be handled particularly cautiously as the formula of "one country, two systems" will serve as a test case for the unification of China and Taiwan.

The likelihood that economic integration of China, Hong Kong and Taiwan will continue along present lines is generally strong. This does not, however, ensure immediate political integration. This aspect will be discussed in detail from Chapter 2 onward, but as a fourth prospect for the future offered in this chapter, it should be noted that a great deal of time will be necessary for the political integration of China, Hong Kong and Taiwan.

The destabilization of Hong Kong society caught up in its return to China is unavoidable. This is due not only to the transition which will accompany its return, but also to the predictable heightened demand for political democratization and substantial social welfare within Hong Kong society which is backed by an economy which has attained advanced nation standards⁽²³⁾. Both the Special Administrative Region (SAR) government and the central government are likely to be pressured to respond to these specific issues. The conditions of multiple political parties centering on the "unification/independence problem" (whether to unify with or become independent from China) is also likely to continue⁽²⁴⁾.

In Taiwan, even if the majority of the public maintains an "anti-unification/anti-independence" (maintenance of present conditions) stance with regard to this problem, many domestic political and diplomatic issues are involved as well, and conflict concerning these issues could possibly lead to political reorganization.

Finally, China is likely to implement one type of political pluralization in order to pursue conversion to a market economy as well as to adjust the pluralistic relationship of profit and loss, but it is unlikely that this will develop to the point of undermining the current structure of Communist party control⁽²⁵⁾. When these three societies are viewed impartially, any discussion of political integration which would ultimately lead to a unified state would appear to be premature.

In conclusion, the following scenarios can be envisaged within the "development of economic integration and difficulties of political integration."

Hong Kong will maintain its position as the leading international finance base (the gateway for capital procurement and introduction of foreign capital) for China following its return. On the other

hand, it is likely to be transformed from a trade and distribution base incorporating the entire country to a base only for the southern China region. Political contributions to the central government will strengthen with the formation of the Special Administrative Region (SAR) and may lead to tension in Hong Kong's relationships with Guangdong province and Taiwan. The investment and trade relationship between Taiwan and China will deepen under leadership by the private sector, and it is possible that the "three exchanges" (direct exchange of navigation, commerce and communications with China) will become reality after the return of Hong Kong to China. As Taiwanese authorities pursue the "Asian Pacific Operational Center," however, a phase of competition over the introduction of foreign capital (particularly the capital from overseas Chinese merchants) may emerge. President Li Teng-hui will certainly continue with practical independent diplomacy. China's main attention can be expected to focus on Hong Kong throughout Li's term (until 2000), and little progress is likely to be made in direct high level discussions between China and Taiwan.

Conclusion

Visits were made during the same time period to China, Hong Kong and Taiwan as field research for this project, and this period ironically coincided with the intensification of friction between Japan and China, Hong Kong and Taiwan over the Senkaku Islands (Chinese name: Diaoyutai). These visits afforded the opportunity to observe at first-hand the regional political conditions in China, Hong Kong and Taiwan within the context of response to the Senkaku Island dispute, and the following three points are relevant to the purposes of this chapter.

First, China, Hong Kong and Taiwan, which superficially maintained a combined front in their criticism of Japan, are experiencing complex internal conditions, and contrary to other impressions, difficulties in the political integration of the three parties are evident. Chapter 2 will deal with this in detail, but the Chinese government's stance is to use the Senkaku problem as a means for diplomatically pressuring Japan and is characterized by government leadership which includes the repression of spontaneous public demonstrations. On the other hand, backed by emotional reports in the indepen-

dent media including *Ming Pao Daily News*, pro-democracy groups led the demonstrations in Hong Kong. The intention of both parties was to manifest their own existence under conditions difficult for Chinese political leadership as the return of Hong Kong approaches. In addition, the New Party, formed by a split from the Kuomintang, led the demonstrations in Taiwan which developed to include the participation of fishermen concerned about the issue of fishing rights. The political objective of these new parties, however, was to attack President Li who took a moderate stance to this problem.

Second, in relation to the first point just offered, these demonstrations allowed a glimpse of the "Chinese nationalism" associated with China, Hong Kong and Taiwan as it could be understood from each country's popular uprising. The possibility must be considered that this nationalism will force Japan to make a difficult diplomatic decision.

Third, China, Hong Kong and Taiwan must now formulate responses to the recent "Chinese nationalism." For China, the Senkaku Islands dispute is an extremely delicate issue which has the potential to develop into a pretext for anti-government demonstrations. The concern in Taiwan is likely to focus on the connection with "unification" under Chinese leadership.

Events leading to the recent dispute over the Senkaku Islands are complex, but the possibility of deepening economic integration between these three regions that has been examined in this chapter and that would form the base for "Chinese nationalism" cannot be dismissed. "Chinese nationalism" is a factor which cannot be ignored when considering the issues concerning post-return Hong Kong and the unification of China and Taiwan.

Notes:

* Pin'yn romanization has been applied to those Chinese names whose original spellings could not be ascertained.

- (1) "The Ninth Five Year Plan for National Economy and Social Development and the Long-term Target for the Year 2010 of the People's Republic of China," *People's Daily*, March 20, 1996 (Japanese translation *China Communications Daily*, April 1-3, 1996).
- (2) For example, "How fast is appropriate for the economic development in the '9/5' Plan?" compiled by Li Jingwen (*Economic Daily News*, September 11, 1995) examines the influence on the industrial

structure of five cases with GDP growth rates of 6-10%, investment efficiency, inflation rates and unemployment rates, and concludes that "8-9% is the most appropriate level."

- (3) Zhang Junkuo, "Comprehensive Analysis of Economic Effectiveness During the '7/5' Period – Contribution Ratios of Each Element to Economic Growth," *Economic Research Journal*, April 1991, Economic Research Journal Publishing.
- (4) Jiang Zemin, "Continued Struggle for Acceleration of the Great Task of Unification of the Fatherland," *People's Daily*, January 31, 1995 (summarized Japanese translation *Peking Review* Issues 6 and 7, 1995).
- (5) Jiang Zemin, "On the Correct Handling of Major Relationships in Socialist Modernization," *People's Daily*, October 9, 1995 (Japanese translation *China Communications Daily*, October 24, 1995).
- (6) "The National Programme for Industrial Policy in the 1990s," *People's Daily*, June 23, 1994 (Japanese translation *China Communications Daily*, June 29, 1994).
- (7) "Provisional Regulations Guiding the Direction of Investment by Foreign Companies," *People's Daily*, June 28, 1995 (Japanese translation *China Communications Daily*, July 4, 1995).
- (8) An internal list (unpublished) classifying industries into four types "Encouragement, Approved, Restricted, Prohibited" for the introduction of foreign capital was compiled in 1987. Reference: Satoshi Imai, "Chinese Policy on Foreign Capital – Changing From the Easing of Regulations to Selected Acceptance," *World Affairs Weekly*, August 8, 1995.
- (9) In the dominant controversy, the *Shenzhen Special Economic Zone News* in Shenzhen City published articles on August 7, and September 5 and 16 of 1995 in opposition to the issues raised in the *Economic Daily News*, associated with the State Council, on reevaluation of the Special Economic Zones policy on July 2-4 and 6, 1995.
- (10) Toyojiro Maruya, "Issues on the Hong Kong Economy As Return Approaches – Conditions for Prosperity and Stability," *Ajiken World Trends*, July 1996, Institute of Developing Economies. This issue featured the return of Hong Kong.
- (11) Ministry of Foreign Trade and Economic Cooperation, "Provisional Regulations Concerning the Establishment of Foreign Stock Investment Company," *Chinese Economy*, May 1995, Japan External Trade Organization.
- (12) *Bicoastal Economic Statistics Monthly* 46 (Taiwan), Mainland Affairs Council, June 1996.
- (13) *Wen Hui Bao* (Hong Kong), March 17, 1996.
- (14) From regulations presented in "Public Relationship By-Laws Between the Mainland Region and the Taiwan Region" (July 30, 1992 announcement).
- (15) Reference – Liu Wenfu, "Active Advancement Into Taiwan of Chinese Capital," *World Affairs Weekly*, November 12, 1996.
- (16) From the author's interview at the Straits Exchange Foundation (September 1996). These ordinances state that the relevant agencies have the authority to approve or reject the operation in Taiwan of enterprises with more than a 20% ratio of investment with Chinese capital.
- (17) Toyojiro Maruya, "Hong Kong Economy as Return Nears – Present Conditions and Future Prospects," *Chinese Economy*, July 1996, Japan External Trade Organization.
- (18) Ibid.
- (19) See note 12.
- (20) Ibid.
- (21) According to the Ministry of Economic Affairs Investment Commission (Taiwan), investment in China by Taiwanese enterprises decreased in 1995 over the previous year with 490 cases, but the approved investment total stood at \$1.093 billion (an increase of 13.1% over the previous year). Although the number of investment cases from January to July 1996 totalled 238 (a 20.7% decrease over the same period in the previous year), approved investments totalled \$787 million (a 17% increase over the same period in the previous year).
- (22) *Taiwan Yearbook 1995*, Taiwan Research Institute.
- (23) Yukari Sawada, "Rising Cost of Social Welfare: Bill Coming Due on Laissez-Faire Policy," *Ajiken World Trends*, July 1996, Institute of Developing Economies. "Welfare and Political Changes in Hong Kong," *Chinese Economy*, July 1996, Japan External Trade Organization.
- (24) Masahiro Wakabayashi, "Reading the Presidential Election in the 'Voting Ratio,'" *World Affairs Weekly*, April 16, 1996. Reference – "Taiwanese Political Realities Concerning the Senkaku Islands," *World Affairs Weekly*, December 3, 1996.
- (25) Tatsumi Okabe, "Nation State and Local Economic Spheres – Focusing on a Greater Hong Kong," Kazuko Mori, Editor, *China in the Midst of Conversion to a Market Economy*, Japan Institute of International Affairs, 1995.