



# MADE IN PRD

Challenges & Opportunities for HK Industry



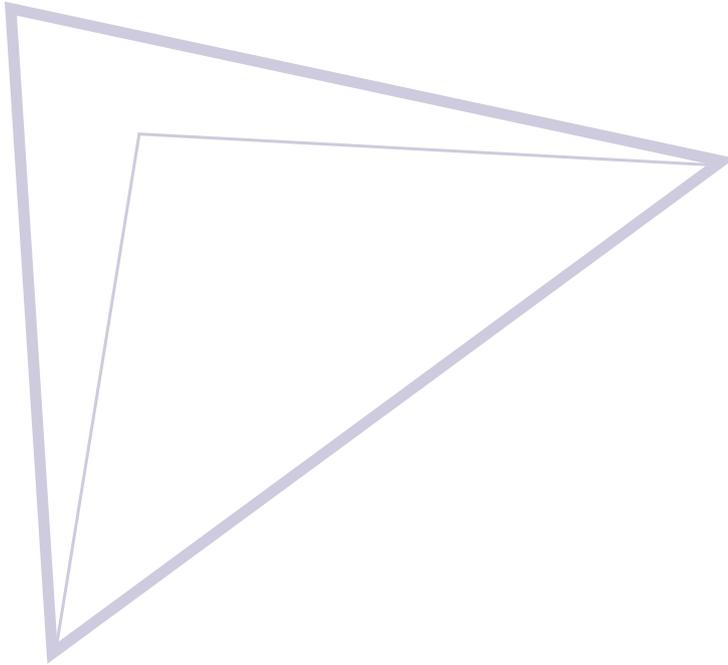
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The Hong Kong Centre for  
Economic Research

*Made in PRD* Study is a Federation of Hong Kong Industries project. The Hong Kong Centre for Economic Research was commissioned to carry out this two-year Study.

Printed in Hong Kong

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# **MADE IN PRD**



**Challenges & Opportunities for HK Industry**

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## Challenges & Opportunities for HK Industry

### Introduction

China's economy has continued to grow at a rapid rate. The trend has shown no signs of abatement with an average annual real GDP growth rate of 9.8%, recorded since the year 2000. In 2006, real GDP has continued to expand at an annualised rate of 10.7%. China's recent economic growth record is particularly impressive because it has been able to achieve significant growth without triggering consumer price inflation, which has averaged 1.36% since 2000. The subjects of this study were two of the most vibrant economic regions in China, the Pearl River Delta (PRD) and the Yangtze River Delta (YRD).

The PRD as an economic region emerged with the opening of China in the late 1970s. Manufacturers from Hong Kong began to cross the border to invest in export-oriented operations in the Guangdong region, primarily in Shenzhen and Dongguan. These started initially as export-oriented processing and assembly operations, and they have continued to the present time as an organisational and contractual form unique to Guangdong. The Greater PRD economic region is often used to describe Hong Kong, Macao and Guangdong. The three units are administratively distinct, with Hong Kong performing the role of a producer services economy, supporting the manufacturing hinterland in Guangdong and linking it to the rest of the world through foreign trade and investments. Hong Kong's role as an international financial centre is important not only for Guangdong, but for the whole of China and beyond.



By supporting the manufacturing hinterland in Guangdong, Hong Kong has linked it to the rest of the world through foreign trade and investments.

The YRD's emergence as a region open to foreign investments and as a platform for manufacturing exports began to occur in the late 1980s. It began in the township of Kun Shan in Jiangsu province, neighbouring Shanghai, with the coming of investors from Hong Kong and Taiwan. The opening of Shanghai in the early 1990s and the gradual integration with indigenous entrepreneurial activities in Zhejiang province created a very vibrant Greater YRD economic region embracing Shanghai, Jiangsu and Zhejiang. Since the mid-1990s, the Greater YRD has indeed been catching up very rapidly.

Hong Kong's strength in relation to the PRD and YRD is its superior integration with the global market and its adoption of international standards and practices. Hong Kong provides an excellent platform and set of institutions to immediately facilitate Mainland China's financial reforms and development. Since China's opening, Hong Kong has been the single largest source of foreign direct investment (FDI) in Guangdong, Shanghai, Jiangsu and Zhejiang. At the end of 2005, 65% or USD105.4 billion of total cumulative FDI invested in Guangdong came from Hong Kong, making it the dominant foreign investor in the province. Although only 31%, or USD61 billion, of total cumulative FDI invested in Greater YRD came from Hong Kong, it shows that it is still the single largest source of foreign investment in the region.

Within the Greater PRD economic region, Guangdong's economy is highly integrated with those of Hong Kong and Macao, primarily through the manufacturing industries and producer services. Producer services in Hong Kong provide essential support for the export-oriented manufacturing operations in Guangdong. Since the open door policy was adopted, the Greater PRD has become a rapidly growing economic region in China whose economic growth and industrialisation owes much to the enterprising efforts of Hong Kong's businessmen and manufacturers from the very outset.

The economic relationship between Guangdong and Hong Kong is deep and broad. Because it embraces a great variety of organisational forms, including direct foreign investment and other contractual forms reported as domestic enterprises, the statistics continue to understate the diversity and extent of this relationship. Foreign investments from Hong Kong have had a major impact on the development of the industrial sector in Guangdong.

## Hong Kong's Manufacturing Operations in PRD

We conducted our survey on the PRD in August 2005, covering nine major cities. These nine major cities were Shenzhen, Dongguan, Huizhou, Guangzhou, Zhuhai, Zhongshan, Jiangmen, Foshan and Zhaoqing.

According to the survey, it is estimated that Hong Kong-funded enterprises and Hong Kong-funded enterprises in other contractual forms (OCFs) established about 55,200 manufacturing enterprises and 57,500 factories in the PRD. The total number of these two types of enterprises accounts for approximately half of the manufacturing enterprises in PRD, implying that one in every two enterprises in PRD is related to Hong Kong.

In these nine cities of the PRD, 22,900 manufacturing enterprises and about 23,700 factories were registered by Hong Kong-funded enterprises as foreign-funded enterprises or those funded by entrepreneurs from Hong Kong, Macao or Taiwan. Hong Kong-funded enterprises accounted for 72% of the total number of foreign-invested enterprises (FIEs).

Also in these nine major cities, Hong Kong-funded enterprises in OCFs registered about 32,300 enterprises and 33,800 factories in other forms such as collective enterprises, private enterprises and other forms of domestic enterprises. Hong Kong-funded enterprises in OCFs accounted for 41% of the total number of domestic enterprises (Table 1).

**Table 1: Number of Hong Kong Enterprises in the PRD**

	Hong Kong-Funded Enterprises	Hong Kong-Funded Enterprises in Other Contractual Forms (OCFs)
Shenzhen	4,900	6,600
Dongguan	8,200	6,100
Huizhou	2,200	1,200
Guangzhou	2,700	6,600
Zhuhai	1,200	1,000
Zhongshan	1,300	3,800
Jiangmen	900	1,600
Foshan	1,200	4,500
Zhaoqing	300	900
<b>Total</b>	<b>22,900</b>	<b>32,300</b>



Producer services in Hong Kong provide essential support for the export-oriented manufacturing operations in Guangdong.

The products of traditional enterprises engaged in three forms of processing/ assembly operations and compensatory trade (TFP) – are mainly for exports and are heavily dependent on imported materials. Therefore, these enterprises do business mainly in the trade form, processing customers’ materials. It is estimated that there were about 14,000 traditional enterprises engaged in TFP in the nine cities in the delta. About 29% of them were located in Dongguan, 28% in Shenzhen, 19% in Zhongshan, 11% in Jiangmen, and about 5% each in Zhuhai and Zhaoqing. Very few of the traditional enterprises engaged in TFP, or only 3%, were found in Huizhou, Guangzhou and Foshan.

A total of 9.6 million employees were hired by Hong Kong-based enterprises in the nine major cities of the PRD. Among them, 5 million were employed by Hong Kong-funded enterprises and 4.6 million by enterprises in OCFs. As many as 2 million were hired by traditional enterprises engaged in TFP (Table 2).

The manufacturing enterprises among various Guangdong cities maintained close ties with Hong Kong. The surveyed enterprises in various cities in the PRD were mainly engaged in exports. However, enterprises in individual cities have speeded up their expansion in domestic sales in recent years. In Guangzhou, Foshan and Huizhou, the proportion of Hong Kong businesses in domestic sales was slightly higher than that of exports.

**Table 2: Number of People Employed by Hong Kong Enterprises in the PRD**

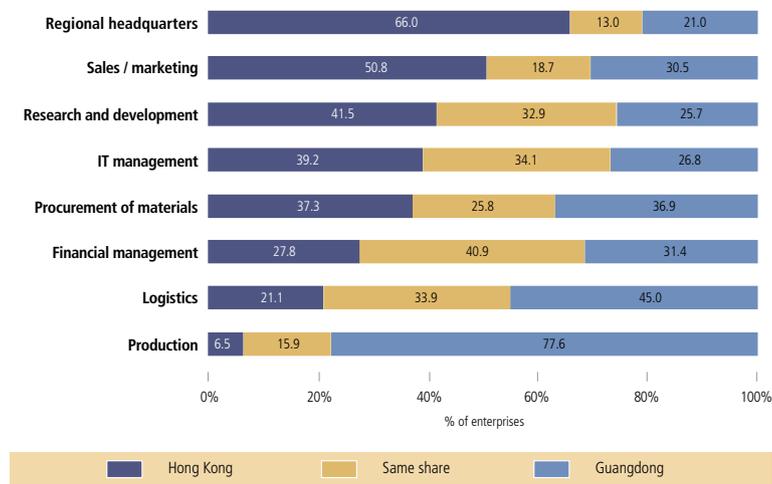
	Hong Kong-funded Enterprises (‘000 persons)	Hong Kong-funded Enterprises in Other Contractual Forms (OCFs) (‘000 persons)
<b>Shenzhen</b>	1,214	941
<b>Dongguan</b>	1,631	908
<b>Huizhou</b>	811	371
<b>Guangzhou</b>	530	660
<b>Zhuhai</b>	193	116
<b>Zhongshan</b>	260	558
<b>Jiangmen</b>	90	146
<b>Foshan</b>	231	828
<b>Zhaoqing</b>	74	92
<b>Total</b>	<b>5,034</b>	<b>4,620</b>

## An Evolving Partnership – PRD and Hong Kong

Only half of the surveyed enterprises had offices or factories in Hong Kong and it could be said that these enterprises were closer to the traditional mode of “a shop in the front and a factory in the back”. The other half had not set up offices or factories in Hong Kong, and Hong Kong acted only as their source of capital. Enterprises that had both their “shop” and “factory” in the PRD still made use of services provided by Hong Kong. The economic development of Guangdong, the advanced communication network and the convenience of customs clearance between Guangdong and Hong Kong made it possible for these enterprises to use Hong Kong’s services without setting up branches in the territory.

The offices or factories in Hong Kong of the surveyed enterprises mainly acted as regional headquarters and were engaged in sales and marketing, research and development (R&D), as well as information technology (IT) management. Procurement of materials was important in both places. Surprisingly, the number of enterprises that allocated their financial management to Hong Kong was fewer than those in Guangdong. Production and logistics were mainly conducted in Guangdong as before. Meanwhile, 30-40% of the enterprises assigned financial management, IT management, R&D and logistics equally between their Hong Kong offices and Guangdong factories (Figure 1).

**Figure 1: Choice of Location for Various Businesses**





The top five business services provided by Hong Kong companies to Hong Kong businesses in the PRD included imports and exports services, logistics, customer relationship management, retail and wholesale services, and financial and insurance services.

According to the estimation of this survey, the ratio of Hong Kong employees to Mainland employees was 1 to 170. In the last survey, *Made in PRD* (2003), the ratio was 1 to 120. This showed that the ratio of Hong Kong employees to Mainland employees was declining.

In cities where Hong Kong-funded enterprises and Hong Kong-funded enterprises in OCFs had a long history of investment, such as in Shenzhen and Dongguan, the proportion of past or future replacement of Hong Kong employees was higher due to sufficient Mainland talent being trained over the years. On the other hand, as less Hong Kong business invested in the western cities of the PRD, their trained human resources were insufficient to replace Hong Kong employees. Thus, the proportion of these businesses who believed Mainland employees would finally replace Hong Kong employees was relatively low.

In addition to the common division of labour between Guangdong and Hong Kong (where Hong Kong offices or factories provide services for the factories of the PRD), the PRD factories also make use of various services provided by other companies in Hong Kong. The top five business services provided by Hong Kong companies to Hong Kong businesses in the PRD included imports and exports services, logistics, customer relationship management, retail and wholesale services, and financial and insurance services.

The partnership between Hong Kong and Guangdong has gradually evolved into a highly complex division of labour that is no longer based on the original model of “a shop in the front and factory in the back”. This model was begun in the 1980s when the primary pattern of joint ventures in the PRD were the three forms of processing/ assembly operations and compensatory trade (TFP). In the past, joint ventures were primarily funded with Hong Kong capital, where clients and factories were controlled by Hong Kong businessmen. The business model gradually changed into a dual pattern, combining export and domestic sales instead of concentrating solely on an export-oriented mode. Hong Kong-funded enterprises and Guangdong enterprises today co-operate on a much more equal footing than they used to, and the lead positions are no longer necessarily taken by Hong Kong-funded enterprises.

## Business Environment in PRD

In the process, the distinction between FIEs and domestic enterprises became increasingly blurred in the PRD. Today, nearly half of the Hong Kong-funded enterprises and enterprises closely related to Hong Kong are not in the form of foreign investments and continue operating in the Mainland as domestic enterprises. In addition, the ancillary facilities for the industries in Guangdong are now so comprehensive that these enterprises need not rely on Hong Kong as their regional headquarters to handle import and export matters. Therefore, many of them no longer need to be involved in complying with complicated import and export regulations imposed by customs. Most of them were established as domestic enterprises from the start and spared no efforts in developing the domestic market. Like the Hong Kong-funded enterprises in OCFs established in the early days, these enterprises are considered to be domestic enterprises rather than FIEs.

Domestic enterprises that are jointly owned by Mainland and Hong Kong investors today do not have to be established in the form of enterprises engaged in TFP – processing, assembling operations and compensatory trade. In addition, the division of labour between partners is on a more equal footing than before. These days the Mainland Chinese are often better than their Hong Kong counterparts at managing factories. After more than 20 years of opening up to the world, China has trained a large pool of its own managerial talent to staff both foreign-invested and domestic enterprises so there is less need to rely on managerial talent from Hong Kong. Hong Kong's competitive edge there is its sensitivity to the market and its ability to source clients.

This survey measured the views of Hong Kong businesses on government policies, legal protection, production operations, infrastructure and support services, and the social, cultural and natural environment in the PRD. Of the five areas, “production operations” was the area Hong Kong businesses felt most satisfied with, followed by “legal protection” and “infrastructure and support services”. Satisfaction with “government policies” was ranked fourth. Satisfaction with “social, cultural and natural environment” was the lowest. In comparison with the findings of *Made in PRD* (2003), Hong Kong businesses showed the biggest increase in satisfaction for government policies and legal protection in the cities of Guangdong.

The surveyed enterprises considered the collection of various fees and charges by local government agencies, customs regulations on import and export, electricity shortage, labour shortage, and taxation (individual income tax) to be the five major problems, and they opined that three of the five issues originated from government policies, while electricity shortage and labour shortage were related to local resources.



Approximately 66% of surveyed enterprises opined that they would scale up their local production

### Research and Development in Hong Kong, PRD and China

The respondent enterprises reported being greatly troubled by the various taxes and charges levied by local authorities. To calculate by the proportion of operation costs, the various types of taxes and charges paid by the surveyed enterprises accounted for 9.8% of their operating costs. The surveyed enterprises expressed that the percentage of taxes charged by each taxing body were: 38.7% by the Central Government, 44.9% were local taxes, and 16.5% were the charges and fines by district and township governments.

In spite of these issues, the business environment has continuously improved. In the present survey, 62% of the surveyed enterprises expressed that they encountered problems in business operation. In *Made in PRD* (2003), 97% of the Hong Kong businesses had encountered problems in business operation. It transpires from the above that the business environment of Guangdong province was improving progressively.

In this survey, 35.5% of surveyed enterprises expressed that they carried out research and development (R&D) activities. The median ratio of the R&D expenditure of the surveyed enterprises to their turnover was 2-3%. Surveyed enterprises with R&D activities were more inclined to hire employees with a tertiary education than those without R&D activities. Employees with tertiary education accounted for 13.7% of the employees of enterprises with R&D activities, and 7.3% of the employees of enterprises without R&D activities.

The surveyed enterprises believed that the supply of talent was the most important factor in R&D activities. The surveyed enterprises considered high R&D costs and insufficient supply of high-calibre R&D experts to be the two principal difficulties in carrying out R&D activities in Guangdong. In regards to R&D activities in Hong Kong, most of the enterprises considered high R&D costs to be the greatest difficulty.

When asked about their plans for production expansion, most of the enterprises were very optimistic about future prospects. 65.8% of them opined that they would scale up their local production and less than 1% opined that they would scale theirs down. Although the surveyed enterprises encountered various difficulties in R&D activities in Guangdong and Hong Kong, 45.3% of them would employ more R&D staff in the coming two or three years and 42.8% would increase their R&D expenditure. Only less than 2% of them would reduce their R&D activities.

## Policy Implication and Recommendations

The R&D expenditure to GDP ratio of Guangdong was 1.09% in 2005, ranking tenth in China. However, the achievements in R&D activities in the Greater PRD were no less prominent. For the number of invention patents, utility models and design patents granted by the Patent Office of China to Guangdong, Guangdong ranked third, first and first respectively in 2005. From 2001 to 2005, 1,296 utility patents and 1,783 design patents were granted by the United States Patent and Trademark Office to Hong Kong inventors.

From 1990 to 2000, because of the introduction of talent, the population with tertiary education in Guangdong grew at a rate higher than that of China and of the Greater YRD, although Guangdong did not have many research organisations or universities. From 2001 to 2005, population with tertiary education were attracted to Guangdong at a rate faster than the national average. However, during the same period, the Greater YRD experienced Guangdong's explosive development mode from the 1990s, whether it was regarding attracting foreign investments, increasing export volume, or attracting a population with tertiary education; and attracted tertiary education population at a rate faster than that of Guangdong. The Greater YRD is an attractive location to set up R&D centres because of the concentration of universities and the large population. These make it possible to draw on a large talent pool.

Hong Kong is an international business centre where multinational companies establish regional headquarters, regional offices and local offices. The parent companies of these multinational companies are mainly engaged in manufacturing, wholesaling, retailing, and import and export businesses. Their regional headquarters in Hong Kong manage businesses in four countries and regions on average, with a focus on business in Asian countries. About 87% of the regional headquarters manage business in Mainland China, of which about 72% are businesses in Guangdong. Meanwhile, these offices often manage businesses in other cities in Mainland China as well as in other Asian countries.

Hong Kong is the most direct and obvious liaison platform between the multinational companies and the Hong Kong-funded enterprises we surveyed in the PRD. Companies in Hong Kong provide the essential production services that create, bind and fuel these global supply chains to bring together the operations of the Hong Kong-funded enterprises in the PRD with the multinational companies in Hong Kong. The vibrancy and strength of this increasingly sophisticated global supply chain is one of the key elements of Hong Kong's economic competitiveness.

Promoting and sustaining the development of a vibrant production base for Hong Kong industry in the PRD region is crucial if Hong Kong is to continue to establish itself as a hub for logistics and financial and production services. Such a hub will need a very large and growing production base to generate a sufficient volume of money, goods and service flows. It is also important that the production base



It is important that the production base be geographically close to Hong Kong so that the demand for services can be directed to and serviced by Hong Kong service providers in the first instance.

be geographically close to Hong Kong so that the demand for services can be directed to and serviced by Hong Kong service providers in the first instance.

Notwithstanding this, industry participants thought that progress had been made in the formulation and implementation of Mainland policies, and the scope of arbitrary decisions was giving way to more rule-based management methods. The rule of law was gradually replacing the rule of man as an adopted concept of governance; nevertheless, many of them still pointed out that they had yet to adapt to the new changes. For the Mainland government, formulating feasible rules that are in line with actual development and unifying the standards of law enforcement represents the biggest challenge. The feedback from and responses of the industry participants channelled through the various chambers of commerce was recognised as the most effective way in improving these evolutionary changes.

For some cities, for example, Dongguan, attracting foreign investment is no longer a top priority. Instead, these cities are more concerned with optimising industry structure and upgrading the industries. The increasing shortage of resources of all kinds in the nine major cities of the PRD means that these economic zones have little choice but to accept the discipline of the market based on the principle of “survival of the fittest” in order for industrial upgrading to evolve naturally. The government will have to consider its traditional role in such a process and decide whether to continue upgrading industries by administrative fiat or

to perform its role as a market regulator and facilitator. The exercise of excessive administrative direction and guidance may not always be the best approach to retaining the most suitable cluster of enterprises to stay in the region to advance economic development and maintain competitiveness. It may even inadvertently ruin the original natural industrial clustering that has evolved in the PRD and which makes it one of the most competitive industrial bases in the world. The upgrading of industrial structure is a very important step in the next stage of the PRD’s evolution, but it has to be managed in a manner that is evolutionary and market driven, and in a manner that seeks to reduce the scope of arbitrary and sudden policy changes that disrupt the existing competitiveness before new comparative advantages have been fully developed and realised.

In both surveys, *Made in PRD* (2003) and in the current one, surveyed enterprises were least supportive of policies that grant direct subsidies or land to facilitate the development of certain industries or enterprises and that pick or target certain industries for development. This reflected that most of the enterprises did not expect the government to grant direct subsidies or provide particular support to any industry. Most of them indicated that the government was able to perform its duties and formulate relevant and feasible policies catering to the actual needs in the areas of government taxation, cross-border infrastructure, logistics, people and investment flows, a level playing field based on the market competition, and a favourable business environment. 

## What Can be Done by the Hong Kong SAR Government?

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1. Maintain a good business environment with a simple tax system and low tax rates, a free flow of information, an absence of foreign exchange control, a clean government, a stable and secure policy environment and an implementation of the rule of law and judicial independence.
2. Formulate a strategy to work with Guangdong and the cities in the PRD to promote and sustain the Greater PRD region as a vibrant and growing industrial base for Hong Kong companies and build up the “Made by Hong Kong” brand internationally.
3. Strengthen Hong Kong’s role as a financial, trading and services hub supporting the manufacturing and logistics development for the region to continue attracting multinational companies to Hong Kong.
4. Co-ordinate Hong Kong’s infrastructure development with Guangdong, especially the transportation and aviation network.
5. Provide assistance to Hong Kong companies encountering commercial disputes in Guangdong and to co-ordinate initiatives to help Hong Kong companies to open up the domestic market on the Mainland.
6. Strengthen Hong Kong’s R&D capabilities throughout the region and help build R&D centres in partnership with the private sector and encourage investment in R&D.
7. Reduce the barriers relating to admission of Mainland talent and technology personnel to Hong Kong for work and study, and relax visiting arrangements for residents from neighbouring cities such as Shenzhen and Zhuhai.
8. Assist Hong Kong’s traditional companies to move up the value-added chain by focusing the efforts on R&D centres, enhance their design and brand building capabilities and nurture a robust creative industry in Hong Kong.
9. Identify and support promising new emerging industries by maintaining close tripartite government-academia-business relations to enhance information exchange and to provide appropriate support to encourage collaborating projects in these areas undertaken by research institutes in Hong Kong and the PRD.
10. Enhance management-production efficiency and environmental standards in the PRD region by helping government-funded NGOs to establish themselves across the border in order to provide training and technical consultation services to Hong Kong manufacturers operating across the border to support them to upgrade the environmental standards of their factories.

## What Can be Done by the Guangdong Government?

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1. Streamline and reduce various fees charged by the government.
2. Accelerate the construction of electricity and transportation infrastructure, in particular, in areas designated for new industrial parks/processing zones in the eastern, western and northern parts of Guangdong.
3. Establish an efficient and effective communication mechanism and forum with the Hong Kong SAR government as well as Hong Kong manufacturers, so that Hong Kong investors will have sufficient time to adapt to the new industrial policies and the changing investment environment.
4. Provide specific incentives and general support to manufacturers who are committed to transforming their businesses to meet the targets of the Eleventh Five-Year Plan, including the enhancement of the industrial structure, speeding up the development of the service sectors, and attaining a sustainable development environment.
5. Ensure a smooth process when undergoing the transformation from labour-intensive to knowledge-based, technology-intensive industries. Special attention has to be given to the efficient transfer of semi-products along the interconnected production chain of up-stream industries and down-stream industries to avoid disruption to the production chain-clusters in the PRD.
6. Reduce red tape and bureaucratic procedures that obstruct foreign investors from entering the domestic market.
7. Open the vocational and professional training sector to Hong Kong institutes.
8. Speed up the entry of overseas banks.

## What Can be Done by the Guangdong and Hong Kong SAR Governments?

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1. The Guangdong and Hong Kong governments should join hands to promote the Greater PRD region's strategic position as a gateway for international companies to enter the Mainland market and a springboard for Mainland companies to reach out to the world market.
2. Both governments should ensure good co-ordination on the planning of transportation and aviation infrastructures so that the development of the Greater PRD is carried out as a whole rather than fragmented into individual cities and sub-regions.
3. Both governments should address the issue of environmental degradation in the Greater PRD together and come up with a policy that provides practical solutions to enhance the prospect of sustainable development for the whole region. The solutions should be based on guidelines that are clear, transparent, predictable, consistent, as well as applicable across industrial sectors and different local jurisdictions. It is also important for enterprises to have sufficient lead time to put such changes in place and to consult affected industries for the formulation of appropriate fit for purpose policy guidelines.
4. Both governments should co-operate to increase the cross-border transport efficiency to help maintain the existing volume of passenger and goods flows, and to further attract more traffic, into the Greater PRD region.
5. Increase the feasibility of Hong Kong service providers to do business or practise in Guangdong and pan-PRD under CEPA and to further facilitate investment flows between Hong Kong and Guangdong.
6. Facilitate processing trade (TFPs) operations to enter the Mainland market, such as setting up of "one-stop shop" agents to simplify tax-paying procedures.
7. Facilitate the flow of people and goods across the Hong Kong-Shenzhen border, in particular by investing in the software and hardware arrangements at border and checkpoint facilities.
8. Support the development and upgrading of manufacturing industries in Guangdong through a market-driven mechanism rather than administrative fiats.
9. Assist industry participants to mitigate policy risk through greater transparency and communication in matters relating to policy changes and adopt a gradual evolutionary approach to allow industry participants to prepare for policy changes. 

# Acknowledgements

We would like to thank the Steering Committee of the *Made in PRD* Study for their input and guidance during the course of the project; Professor Y C Richard Wong and his team from the Hong Kong Centre for Economic Research for their commitment and professionalism in conducting the research work; the Guangdong Provincial Bureau of Statistics in helping us create the sample framework; Guangdong Urban Survey Organisation of the National Bureau of Statistics for conducting the interviews; and our co-ordinating team for their hard work and dedication to the project.

We also wish to thank the many manufacturers who responded to the project's questionnaires, and the companies that we visited and interviewed. The information provided by them had been crucial to the success of this Study.

Finally, if not for the generous support of the 118 sponsor organisations, the *Made in PRD* Study would not have been possible. The FHKI wholeheartedly thanks them for their commitment.

**Federation of Hong Kong Industries**  
April 2007

## **FIEs (Foreign Invested Enterprises)**

FIEs (外資企業) refer to those joint ventures or co-operatives established in the Mainland with foreign investment, as well as establishments wholly funded by foreign capital. Statistical data usually categorise foreign invested enterprises (FIEs) into either foreign-funded enterprises or Hong Kong, Macao and Taiwan-funded enterprises, based on the source of capital.

## **Domestic Enterprises**

Domestic Enterprises (內資企業) refer to those enterprises registered in forms such as state-owned enterprises, collectively owned enterprises, private enterprises, co-operative enterprises, share-holding enterprises etc.

## **OCFs (Other Contractual Forms)**

OCFs (其他合同形式) refer to three forms of processing and assembly operations, compensatory trade and any other processing arrangements or relationships into which a foreign company enters with a Mainland factory. OCFs include OFIs and OTHs.

## **Three Forms of Processing/ Assembly Operations and Compensatory Trade (TFP)**

Three forms of processing and assembly operations (三來一補) refer to processing with supplied materials (來料加工), assembly with supplied parts (來件裝配) and processing in accordance with supplied samples (來樣加工).

## **OFIs (Other Foreign Investments)**

OFIs (外商投資) refer to “three forms of processing and assembly operations and compensatory trade” (三來一補), in which the foreign partner does not have legal ownership of the companies. In China, they are classified as domestic enterprises even though the management of these companies is controlled by their foreign partners.

## **OTHs (Other Arrangements)**

OTHs (其他安排) refer to other arrangements by means of which Hong Kong based companies have share in, control of, or manage domestic enterprises.

## **Hong Kong-Funded Enterprises**

As per FIEs, Hong Kong-funded enterprises (港資企業) were selected with any one of the three conditions: (1) if they had offices or branches in Hong Kong; (2) if major decision-making, management or operation rights were controlled by Hong Kong residents; or (3) if the source of capital was Hong Kong.

### **Hong Kong-Funded Enterprises in OCFs**

As per domestic enterprises, Hong Kong-funded enterprises in other contractual forms (OCFs) (其他合同形式的港資企業) were selected with any one of the two conditions: (1) if major decision-making, management or operation rights of the enterprises surveyed were controlled by Hong Kong people or (2) if they had offices or branches in Hong Kong.

### **General Trade\***

General trade (一般貿易) refers to the import or export of goods by enterprises in China with import-export rights.

### **Processing trade\***

Processing trade (加工貿易) refers to the business activity of importing all or part of the raw and auxiliary materials, parts and components, accessories, and packaging materials from abroad in bond, and re-exporting the finished products after processing or assembly by enterprises within the Mainland. It includes (1) processing and assembly with supplied materials and (2) processing and assembly with customers' materials.

### **Processing and Assembly with supplied materials/ Processing and Assembly with customers' materials\***

Under processing and assembly with supplied materials/ processing and assembly with customers' materials (來料加工), the imported materials and parts are supplied by the foreign party which is also responsible for selling the finished products. The business enterprise does not have to make foreign exchange payment for the imports and only charges the foreign party a processing fee.

### **Processing and assembly with imported materials\***

Under processing and assembly with imported materials (進料加工), the business enterprise makes foreign exchange payment for the imported materials and parts and exports the finished products after processing.

### **Compensatory Trade**

Compensatory trade (補償貿易) is an arrangement whereby a foreign company provides a loan (either in the form of money, equipment or technology) to a Mainland enterprise to either set up a factory (or factories) or to explore resources. When the project is completed, the domestic enterprise uses its products or other products to pay back the loan by instalments within an agreed period of time.

\*Source : Hong Kong Trade Development Council, *Guide to Doing Business in China*, September 2006