INFORMATION NOTE

Foreign Direct Investment in Hong Kong

1. Overview

1.1 The foreign business community plays an important role in the Hong Kong economy. Foreign companies bring in capital, new technologies and new business practices, and create employment opportunities. The Government believes in, and supports a free market economy and a liberal investment regime.

1.2 According to the United Nations Conference on Trade and Development (UNCTAD), Hong Kong was the second largest destination for foreign direct investment in Asia in 2003. On a global scale, Hong Kong ranked 11th in foreign direct investment inflow in the same year. UNCTAD also pointed out that despite challenges brought by the Severe Acute Respiratory Syndrome and difficult economic conditions during the first half of 2003, foreign direct investment flow to Hong Kong in 2003 reached US$13.6 billion (HK$106.1 billion), up by 40% from an adjusted US$9.7 billion (HK$75.7 billion) in 2002. Further, for the 10th consecutive year, the Heritage Foundation[1] has rated Hong Kong as the freest economy in the world.

1.3 To foreign businesses, Hong Kong's attractiveness as a place to do business is mainly reflected by two local indicators, namely inward direct investment[2] and the number of foreign-owned regional headquarters[3] (RHQs) and regional offices[4] (ROs) of companies incorporated outside Hong Kong.

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1 The Heritage Foundation is a research and educational institute, whose mission is to formulate and promote public policies based on the principles of free enterprise, individual freedom, and limited government. It is one of the leading public policy organizations in the United States of America.

2 Direct investment covers investment which allows investors in one economy, on a long term basis, to influence or have an effective voice in the management of an enterprise in another economy. For statistical purpose, an effective voice is taken as equivalent to a holding of 10% or more of the equity in an enterprise. Inward direct investment refers to direct investment in a Hong Kong enterprise by a non-Hong Kong resident. Typical examples of inward direct investment are multinational corporations' branches and subsidiaries operating in Hong Kong.

3 Regional headquarters are organizations which have control over the operation of one or more other offices or subsidiaries in the region without the need to make frequent referrals to, or consult with, the parent companies or headquarters.

4 Regional offices are companies which are responsible for general business activities in one or more countries/territories in the region for the parent companies.

Inward direct investment

1.4 Based on the findings of the study conducted by the Census and Statistics Department (C&SD), at end-2002, Hong Kong had 8 978 enterprise groups[5] with inward direct investment, comprising 380 in the manufacturing sector and 8 598 in the non-manufacturing sector respectively. The stock of inward direct investment stood at HK$2,622.3 billion at market value[6], amounting to 2.08 times of the gross domestic product (GDP) in 2002, and representing a decrease of 19.8% from the corresponding investment stock of HK$3,269.7 billion at end-2001. The decline in the stock of inward direct investment was mainly due to the drop in market value of the Hong Kong affiliates of foreign enterprises.

1.5 The British Virgin Islands was the largest investor country at end-2002, accounting for 29.7% of the total stock of inward direct investment in Hong Kong, followed by the Mainland of China (Mainland) (22.7%), Bermuda (10.4%), the Netherlands (7.8%) and the United States of America (US) (7.1%). Altogether, these five investor countries accounted for 77.7% of the total inward direct investment stock at end-2002 (see Table 1). According to C&SD, the prominence of the British Virgin Islands and Bermuda in Hong Kong's stock of inward direct investment reflects in part a common practice of Hong Kong enterprises in setting up non-operating companies in the two tax haven economies to channel investment funds back to Hong Kong.

5 A Hong Kong enterprise group mainly consists of a Hong Kong parent company, its Hong Kong subsidiaries, associates and branches.

6 The investment figures published by UNCTAD and C&SD may not be directly comparable because UNCTAD and C&SD have adopted different methodologies when measuring the totals.

Table 1 — Position of inward direct investment in Hong Kong at market value by major investor economy, at end-2002

	Stock of inward direct investment (HK$ billion)	Percentage share
The British Virgin Islands	779.4	29.7%
The Mainland of China	594.6	22.7%
Bermuda	273.2	10.4%
The Netherlands	204.9	7.8%
The United States of America	186.6	7.1%
Japan	141.4	6.3%
Singapore	73.5	2.8%
Others	368.7	13.2%
Total	2,622.3	100%

Note : Individual figures may not add up exactly to the total due to rounding.
Source: Census and Statistics Department. (2002) *External Direct Investment Statistics of Hong Kong,* page 12.

1.6 In terms of economic activity undertaken by foreign investor economies, investment holding, real estate and various business services was the most popular sector[7] for inward direct investment, amounting to HK$1,367.0 billion, or 52.1% of the total stock at end-2002. This was followed by wholesale, retail and import/export trades (with a share of 13.0%), banks and deposit-taking companies (12.4%), financial institutions other than banks and deposit-taking companies (3.5%), and insurance (3.3%). These major sectors together accounted for 84.3% of the total stock of inward direct investment at end-2002 (see Table 2).

[7] They are grouped into one economic sector for reporting purpose.

Table 2 — Position of inward direct investment in Hong Kong at market value by economic activity of major investor economy, at end-2002

	Stock of inward direct investment (HK$ billion)	Percentage share
Investment holding, real estate and various business services	1,367.0	52.1%
Wholesale, retail and import/export trades	341.4	13.0%
Banks and deposit-taking companies	325.4	12.4%
Financial institutions other than banks and deposit-taking companies	90.7	3.5%
Insurance	85.9	3.3%
Other activities	411.8	15.7%
Total	2,622.3	100%

Note: Individual figures may not add up exactly to the total due to rounding.
Source: Census and Statistics Department. (2002) *External Direct Investment Statistics of Hong Kong,* page 15.

Regional headquarters and offices

1.7 According to the *Report on 2004 Annual Survey of Regional Offices Representing Overseas Companies in Hong Kong* (Survey) published by C&SD, as at 1 June 2004, a total of 3 609 overseas companies[8] incorporated outside Hong Kong established their RHQs or ROs in Hong Kong, of which 1 098 were RHQs and 2 511 were ROs.

1.8 The US had the largest number of RHQs in Hong Kong (256 companies), followed by Japan (198), the Mainland (106), the United Kingdom (UK) (105) and Germany (67).

1.9 As regards ROs, the US also had the largest number of ROs (557 companies), followed by Japan (515), the UK (211), the Mainland (156) and Germany (135).

1.10 The major lines of business of both RHQs and ROs in Hong Kong were wholesale, retail and import/export trades; business services; finance and banking; manufacturing; and transport and related services.

[8] It was an increase of 13% from the corresponding figure of 3 207 in 2003.

1.11 The Survey also collected views on Hong Kong as the location for setting up RHQs or ROs. Among the factors identified, the five most important factors were:

(a) free flow of information;

(b) low and simple tax system;

(c) corruption-free government;

(d) absence of exchange controls; and

(e) communication, transport and other infrastructure.

2. Institutional arrangement for promoting foreign direct investment

Commerce and Industry Branch

2.1 The Commerce and Industry Branch of the Commerce, Industry and Technology Bureau is responsible for the formulation and co-ordination of policies and strategies in relation to inward investment promotion.[9] It also oversees the development of policies and programmes for the industrial and trade sectors, in particular for small and medium enterprises (SMEs), as well as the promotion of domestic business and services.

2.2 In discharging the function of promoting inward direct investment in Hong Kong, the Commerce and Industry Branch is assisted in its work by Invest Hong Kong, a network of overseas Economic and Trade Offices, and the Trade Development Council (TDC). Through these agencies, the Government provides a range of advisory and support services to companies interested in investing in Hong Kong as well as those already invested in Hong Kong.

Invest Hong Kong

2.3 Invest Hong Kong is a government department established in July 2002 to spearhead Hong Kong's efforts to attract inward investment. It works with the Economic and Trade Offices in North America, Europe, Asia, Middle East and Australia to offer solution-oriented investment promotion, facilitation and after-care services to ensure that foreign companies have the support required to establish or expand their operations in Hong Kong. Invest Hong Kong also provides information to facilitate investors in setting up RHQs and ROs in Hong Kong.

9 The two other major policy areas covered by the Commerce and Industry Branch are Hong Kong’s external commercial relations and intellectual property protection.

2.4 Invest Hong Kong adopts a proactive investment promotion strategy by focusing on the economic sectors where Hong Kong has an edge over other places. The targeted sectors are financial services, trade-related services, transportation, telecommunications, media and multimedia, business and professional services, information technology, technology (especially electronics and biotechnology), and tourism and entertainment. In addition, Invest Hong Kong seeks to strengthen its after-care services with a view to retaining and expanding investments already made in Hong Kong.

2.5 Investment promotion activities organized by Invest Hong Kong include sponsoring and participating in several major international business/economic/financial conferences. Between June 2003 and September 2004, Invest Hong Kong supported a number of such international events held in Hong Kong:

(a) The Cable & Satellite Broadcasting Convention in October 2003 with 91 speakers and some 1 100 delegates from around the world;

(b) BusinessWeek's CEO forum in November 2003 featuring business executives and government officials, and attracted over 600 delegates;

(c) The World Pension Forum in May 2004 with prominent figures from the business, government and finance sectors; and

(d) Forbes Global CEO Conference in September 2004[10] with over 350 overseas, local and Mainland delegates, speakers and guests attending the conference.

Economic and Trade Offices

2.6 An important role played by the overseas Economic and Trade Offices is to attract foreign direct investment to Hong Kong. One of the means is to actively promote Hong Kong's enhanced business advantages and environment under the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA). (Please see paragraphs 3.6 – 3.16 below regarding the discussion on CEPA.)

2.7 These offices also promote economic and trade interests by facilitating investors to understand the current situation and latest developments in Hong Kong; monitoring developments that might affect Hong Kong's economic and trading interests, such as proposed legislation; liaising with the business and commercial sectors, politicians and the news media; and organizing events to promote the positive image of Hong Kong.

10 The 2002 Forbes Global CEO Conference was held in Hong Kong.

2.8 There are 11 overseas Economic and Trade Offices located in Brussels, Geneva, London, New York, San Francisco, Singapore, Sydney, Tokyo, Toronto, Washington and Guangdong respectively.

Trade Development Council

2.9 TDC, a statutory body, is mainly responsible for promoting Hong Kong's external trade in goods and services, and organizing investment promotion programmes. With a global network of more than 40 offices in major business centres around the world, TDC helps its customers, mainly local SMEs, develop marketing opportunities, trade contacts, market knowledge and competitive skills. It also seeks to project and uphold a positive image of Hong Kong as the international trade platform in Asia. To this end, it organized more than 350 promotional events in and outside Hong Kong in 2003.

2.10 Among its promotional events in 2003, TDC organized 18 international trade fairs (seven of which were the biggest of their kinds in the region), three public exhibitions and two special fairs for SMEs and CEPA. These events attracted more than 15 500 exhibitors and over 1.2 million visitors, including 150 000 from overseas. TDC also assists the participation of Hong Kong companies in major trade events around the world.

3. Articles of the Basic Law and bilateral arrangements relating to investment promotion and protection

Articles of the Basic Law relating to investment promotion and protection

3.1 Inward direct investment has played and will continue to play an important role in sustaining Hong Kong's economic growth, and in fostering Hong Kong's development as an international trade, financial and business centre. The Basic Law of the Hong Kong Special Administrative Region has provisions safeguarding the free enterprise system and liberal investment regime in Hong Kong.

3.2 Among other things, the Basic Law stipulates that private property, ownership of enterprises and foreign investment shall be protected by law. It also upholds the principles of low tax policy, free convertibility of the Hong Kong dollar and free flow of capital. (Please see the Appendix for articles 105, 108, 109, 110, 112, 114, 115, 118 and 119 of the Basic Law, which are related to investment promotion and protection.)

Bilateral investment promotion and protection agreements

3.3 To give additional assurance to overseas investors that their investments in the territory are adequately protected, and to enable Hong Kong businesses to enjoy similar protection in respect of their investments overseas, Hong Kong has been negotiating and concluding Investment Promotion and Protection Agreements (IPPAs) with other economies.

3.4 IPPA is a bilateral agreement which seeks to promote and protect investments by investors of a contracting party in the other party's area. It usually contains the following undertakings on the part of the contracting party:

(a) not to subject investors of the other contracting party to treatment less favourable than what it accords to its own investors or investors of any third party;

(b) to compensate (on the same basis as (a)) investors of the other contracting party whose investments suffer losses during armed conflicts or national emergency;

(c) not to deprive investors of the other contracting party of their investments except lawfully, for a genuine public need, and against proper compensation;

(d) to guarantee the free transfer of investments and returns by investors of the other contracting party; and

(e) in the event that investment disputes cannot be settled by bilateral consultation or negotiation within a specified period, to submit such disputes to arbitration under internationally accepted rules.

3.5 Hong Kong has signed IPPA with 14 economies, viz Australia, Austria, Belgium/Luxembourg, Denmark, France, Germany, Italy, Japan, the Netherlands, New Zealand, South Korea, Sweden, Switzerland and the UK.

Mainland and Hong Kong Closer Economic Partnership Agreement

3.6 Over the last two decades, Hong Kong has established itself as the platform for commercial activities between the Mainland and the rest of the world. In particular, the Government and the Central People’s Government (CPG) signed the main text of CEPA on 29 June 2003, and concluded the six accompanying Annexes on 29 September 2003.

First and second phases of CEPA: trade in goods

3.7 Under the first phase of CEPA, on 1 January 2004, the Mainland eliminated import tariff for 374 Hong Kong products under its 2004 tariff codes. The categories of products benefited include jewellery, textiles and clothing, electronic components, watch and clock parts and components.

3.8 The Government and CPG reached another agreement on 27 August 2004 to provide further liberalization measures on trade in goods under the second phase of CEPA. On top of the 374 products that have been enjoying zero import tariff status since 1 January 2004, the Mainland will apply zero tariffs to 529 Hong Kong products starting from 1 January 2005, which include jewellery, textiles and clothing, electronic components, watch and clock parts and components. In addition, 184 Hong Kong products such as artificial fur, gloves, leather products, man-made fibres and wooden furniture will enjoy zero tariffs no later than 1 January 2006.

3.9 To benefit from the zero tariff status, Hong Kong products are required to meet the CEPA rules of origin. Both the Government and CPG have agreed to adopt existing Hong Kong origin rules for most products. For certain products such as watches and clocks, a 30% value added requirement is adopted as the CEPA origin rule. The formula for calculating the value added percentage takes into account the costs of product development (e.g. design, research and development, and patent trademark, etc.) incurred in Hong Kong. This arrangement is believed to be able to attract investors to manufacture innovative, brand name, high value added and high intellectual property content products in Hong Kong.

First and second phases of CEPA: trade in services

3.10 On trade in services, under the first phase of CEPA which came into effect on 1 January 2004, the Mainland has given preferential market access to Hong Kong companies in 18 service sectors － accounting, advertising, audio-visual, banking, construction and real estate, convention and exhibition, distribution[11], freight forwarding agency, insurance, legal, logistics, management and consulting, medical and dental, securities, storage and warehousing, telecommunications, tourism and transport.

[11] This sector includes wholesaling, retailing and franchising.

3.11 On 27 August 2004, the Mainland agreed to provide further liberalization measures on trade in services under the second phase of CEPA. The liberalization of 11 out of the 18 service sectors − accounting, audio-visual, banking, construction, distribution, freight forwarding agency, legal, medical and dental, securities, transport, and individually-owned stores[12] enjoying preferential treatment under the first phase of CEPA − will be broadened. In particular, the Mainland has agreed to lift the geographical restriction and expand the business scope for the individually-owned stores set up by Hong Kong permanent residents with Chinese nationality.

3.12 In addition, under the second phase of CEPA, the Mainland has agreed to grant preferential treatment in eight new areas, namely airport, cultural and entertainment, information technology, job intermediaries, job referral, patent agency, trademark agency, and professional and technical qualification examinations.

3.13 The new liberalization measures will take effect on 1 January 2005. Taking the two phases of CEPA together, service suppliers from Hong Kong are now eligible for preferential treatment in a total of 26 services.

3.14 Similar to trade in goods, both the Government and CPG have reached agreement that, to be eligible for enjoying the benefits offered by the Mainland under CEPA, a company must have substantive business operations in the Hong Kong Special Administrative Region (HKSAR) as assessed on the following criteria:

(a) the company must be incorporated under the laws of HKSAR;

(b) the company must pay profits tax in HKSAR (or be exempted by law from paying such tax or no need to pay profits tax because of business loss);

(c) the length of the company's substantive business operations in HKSAR;

(d) the size and nature of business activity of the company's office in HKSAR; and

(e) the proportion of the company's staff force employed in HKSAR.

The Government and CPG have agreed to adopt a sectoral approach to take into account the unique characteristics of each individual service sector.

[12] This sector is split from the distribution sector.

3.15 Under CEPA, the Mainland permits Hong Kong companies to have earlier access to its service sectors, ahead of the World Trade Organization (WTO) timetable. In some service sectors such as audiovisual, construction, distribution, legal, logistics and transport, the Mainland's offer extends beyond its WTO commitments. Hence, Hong Kong companies have a "first mover" advantage to capture the business opportunities. Overseas companies may also consider establishing or expanding their operations in Hong Kong to gain greater access into the Mainland market, which will induce business activities and generate direct and indirect economic spin-offs for Hong Kong.

Further liberalization

3.16 The Government and CPG will continue to pursue further liberalization on trade in goods and services in the subsequent phases under CEPA through the established liaison mechanisms. The Joint Steering Committee of CEPA, jointly led by the Financial Secretary of the Government and the Vice Minister of Commerce of CPG, was established in December 2003 for the co-ordination and effective implementation of CEPA.

<u>Investment Facilitation Measures for Mainland Enterprises</u>

3.17 On 6 September 2004, the Ministry of Commerce (MOC) announced a new investment facilitation policy to encourage and support Mainland enterprises to invest and expand business in Hong Kong[13]. The new policy allows Mainland enterprises more freedom in making investment decisions in Hong Kong based on commercial consideration. MOC has set out the approving procedures for Mainland enterprises setting up business in Hong Kong, which are summarized below.

Approving procedures for Mainland enterprises setting up business in Hong Kong

3.18 Business to be set up in Hong Kong will be approved by the provincial authorities of commerce as delegated by MOC, except for those seeking to engage in external indirect listing and investment business which will be approved by MOC.

3.19 Mainland enterprises seeking the approval of MOC are required to submit their applications to the provincial authorities of commerce. A decision as to whether an application is approved or not will be made within 15 working days from the date of application.

3.20 Mainland enterprises whose applications are approved will be issued a Certificate of Approval for Mainland Enterprises to Invest in Hong Kong and Macao ("the Certificate of Approval") by the provincial authorities of commerce.

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13 The new policy is also applied to Macao.

3.21 After obtaining approval, the enterprises may proceed with such matters as foreign exchange, banking, customs and external dealings by virtue of the Certificate of Approval and relevant endorsed documents.

3.22 Having registered in Hong Kong, approved enterprises are required to submit the relevant registration documents to MOC and the Hong Kong and Macao Affairs Office for record, and report to the Liaison Office of the Central People's Government in HKSAR.

Invest Hong Kong One-Stop Service initiative

3.23 Responding to the new facilitation policy for Mainland enterprises to invest in Hong Kong, Invest Hong Kong has expanded its existing services for Mainland enterprises.

3.24 Under the new Invest Hong Kong One-Stop Service initiative, the following services will be available to Mainland enterprises, free-of-charge:

(a) Invest Hong Kong Hotline: a nation-wide, toll-free investment hotline is set up to handle enquiries from Mainland enterprises about investing in Hong Kong;

(b) Investment Service Centre: a new service centre, located at the head office of Invest Hong Kong, is set up to provide assistance to Mainland enterprises, including consultation and the most up-to-date information about regulations and procedures of setting up business in Hong Kong;

(c) Invest Hong Kong Guidebook: Mainland enterprises will be provided with an information kit containing most current information about the investment environment in Hong Kong, including setting up procedures, funding schemes, visa requirements and taxation; and

(d) Step-by-step Guide: a step-by-step guide will be jointly produced by Invest Hong Kong and MOC to set out the approving procedures for Mainland enterprises to invest in Hong Kong.

Pan-Pearl River Delta Region Co-operation

3.25 The Pan-Pearl River Delta (Pan-PRD) region[14], known as "9+2", or Fujian, Jiangxi, Hunan, Guangdong, Guangxi, Hainan, Sichuan, Guizhou and Yunnan Provinces, plus Hong Kong and Macao, has emerged as one of the world's most dynamic economic regions.

[14] The Pan-PRD region, including Hong Kong and Macao, had a collective GDP of US$630 billion in 2003, accounting for about 40% of China's total economic output.

3.26 In June 2004, the governments of the Pan-PRD region jointly established the Pan-PRD Regional Co-operation and Development Forum (Forum) to strengthen co-operation and enhance overall competitiveness of the Pan-PRD region through closer partnership. The Forum is currently working on a number of tasks:

Opening the channels

(a) Improving the flow of goods, capital, information and personnel in the Pan-PRD region, and removing barriers originated from the difference in economic systems and other unnecessary obstacles;

(b) Expanding the container terminals and the sea, land and air transport facilities to better serve the whole region;

(c) Improving the overall efficiency of customs clearance, the central customs authorities and other departments concerned;

(d) Using information technology and the Internet more effectively to facilitate efficient flow of information across the region; and

(e) Assisting private enterprises in the Pan-PRD region to establish operation in Hong Kong.

Improving the business environment

(a) Setting up one-stop service offices to attract/facilitate foreign investment, provide "post-investment" services and handle complaints;

(b) Increasing the transparency of trade policies, laws and regulations, tax policies and other measures; and minimizing uncertainties and non-commercial risks for businesses in the Pan-PRD region; and

(c) Considering setting up a Pan-PRD intellectual property rights protection department to enforce the relevant rules and regulations on intellectual property rights.

3.27 The Forum is committed to establishing a unified and open market in the region. So far, the specifics of the co-operation arrangements have not been finalized.

Prepared by Jackie WU
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Tel: 2869 9644

Appendix

Articles of the Basic Law Relating to Investment Promotion and Protection

Article 105

The Hong Kong Special Administrative Region shall, in accordance with law, protect the right of individuals and legal persons to the acquisition, use, disposal and inheritance of property and their right to compensation for lawful deprivation of their property.

Such compensation shall correspond to the real value of the property concerned at the time and shall be freely convertible and paid without undue delay.

The ownership of enterprises and the investments from outside the Region shall be protected by law.

Article 108

The Hong Kong Special Administrative Region shall practise an independent taxation system.

The Hong Kong Special Administrative Region shall, taking the low tax policy previously pursued in Hong Kong as reference, enact laws on its own concerning types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation.

Article 109

The Government of the Hong Kong Special Administrative Region shall provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre.

Article 110

The monetary and financial systems of the Hong Kong Special Administrative Region shall be prescribed by law.

The Government of the Hong Kong Special Administrative Region shall, on its own, formulate monetary and financial policies, safeguard the free operation of financial business and financial markets, and regulate and supervise them in accordance with law.

Appendix (cont'd)

Article 112

No foreign exchange control policies shall be applied in the Hong Kong Special Administrative Region. The Hong Kong dollar shall be freely convertible. Markets for foreign exchange, gold, securities, futures and the like shall continue.

The Government of the Hong Kong Special Administrative Region shall safeguard the free flow of capital within, into and out of the Region.

Article 114

The Hong Kong Special Administrative Region shall maintain the status of a free port and shall not impose any tariff unless otherwise prescribed by law.

Article 115

The Hong Kong Special Administrative Region shall pursue the policy of free trade and safeguard the free movement of goods, intangible assets and capital.

Article 118

The Government of the Hong Kong Special Administrative Region shall provide an economic and legal environment for encouraging investments, technological progress and the development of new industries.

Article 119

The Government of the Hong Kong Special Administrative Region shall formulate appropriate policies to promote and co-ordinate the development of various trades such as manufacturing, commerce, tourism, real estate, transport, public utilities, services, agriculture and fisheries, and pay regard to the protection of the environment.

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