Globalisation by Stealth

The proposed New Zealand-Hong Kong Free Trade Agreement and investment

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Summary

Introduction

The New Zealand and Hong Kong governments are currently engaged in "exploratory talks" with the aim of negotiating a free trade and investment agreement (FTIA). Though the government has failed to release any details of what is proposed to the public, this paper finds that if such an agreement is based on the recently ratified Singapore-New Zealand Closer Economic Partnership (SNZCEP), an existing Investment Promotion and Protection Agreement (IPPA), and the WTO, it presents the following dangers to New Zealand, among others:

- Destruction of the remaining textiles, clothing and footwear industry
- Litigation by investors in closed international tribunals against the effects and existence of laws and regulations that protect our environment and economic development, resulting in multi-million dollar compensation payments and possible reversal of local and central government policies.
- Further pressure to commercialise our social services such as education, health, public broadcasting, waste disposal and water.
- Further constraints on the use of central and local government procurement to encourage economic development.
- Growing constraints on local government in all these areas.
- Encouragement of large short term international capital movements, and further loss of the control of capital movements and foreign investment which are essential to develop New Zealand's economy and protect ownership of land and fishing quota.

Background

The Singapore-New Zealand Closer Economic Partnership (SNZCEP) came into effect on 1 January 2001. New Zealand has had an Investment Promotion and Protection Agreement (IPPA) with Hong Kong since 1995. Underpinning the agreement with Singapore is the WTO and APEC.

Like the SNZCEP, a FTIA would be seen as maintaining the momentum towards the government's declared intentions of building larger free trade areas in the Pacific, particularly one with ASEAN, and a "Pacific 5" agreement with Singapore, Chile, the U.S.A. and Australia – and possibly South Korea.

However an FTIA with Hong Kong would have the added significance of its close relationship with China, of which it is formally a part.

This paper looks primarily at the investment aspects of such an agreement.

Investment between New Zealand and Hong Kong

Investment flows between New Zealand and Hong Kong are heavily in Hong Kong's favour. At March 2000, companies with a presence in Hong Kong had NZ$1.067 billion invested in New Zealand according to Statistics New Zealand. However equivalent Hong Kong government figures show a startling discrepancy which highlights aspects of the investment relationship. As at 31 December 1998, Hong Kong authorities recorded NZ$9.2 billion of Hong Kong-sourced direct investment in New Zealand. On inquiry, Hong Kong authorities attributed the $8 billion difference to companies in Hong Kong seeking "tax advantages" by parking funds in New Zealand short term. Hong Kong investment flows show a very erratic pattern, and investment has fallen since the 1997 financial crisis. Hong Kong investors in New Zealand have regularly taken out more in dividends than they have earned.

Hong Kong investment in New Zealand is largely in business-oriented services: commercial property, hotels, construction, retail, importing and distribution. There are also many small investments in forestry and lifestyle properties, and some significant farms including Cecil Peak Station near Queenstown. However a large proportion of this investment is from other countries using Hong Kong as a convenient base – presumably for tax and other avoidance purposes. Countries investing in New Zealand through Hong Kong include Australia, Bangladesh, China, Indonesia, Luxembourg, Malaysia, Monaco, Saudi Arabia, Singapore, Switzerland, the U.K., and the U.S.A. They include major interests in commercial property, fish farming (including 80% of New Zealand's king salmon farming), forestry (including the 6th and 16th largest forest owners), pulp, plastics, and packaging manufacturers, hotels, and distribution.

New Zealand direct investment in Hong Kong is also unusual: its net investment is *negative*. At March 2000, that was made up of NZ$5.2 billion of equity investment, offset by NZ$5.8 billion owed in intra-company loans by New Zealand companies to their Hong Kong subsidiaries, leaving a net liability of NZ$583 million at March 2000. Hong Kong is being used as a major source of finance by a small number of companies in New Zealand. It is not clear what the very large equity investment represents, but it seems probable that it may also only represent paper companies set up to hold investments elsewhere in Asia, especially China. Much of it may be owned by New Zealand subsidiaries of overseas companies, not New Zealand owned companies.

Hong Kong investment internationally – both outwards and inwards – is heavily dominated by tax havens. At the end of 1998 tax havens made up four of the top ten destinations of Hong Kong direct investment abroad, and four of the top ten sources of investment in Hong Kong. Surprisingly, New Zealand is number six of Hong Kong's investment destinations – ahead of the U.S.A. and just behind the U.K. However, it must be always borne in mind that much of what is called "Hong Kong" investment is that of a Hong Kong subsidiary of a company owned elsewhere. Much of the investment is not productive but for the purposes of tax avoidance.

Hong Kong's investment policies

Though often held up as the model of a free market, open economy, Hong Kong has a wide range of policies to encourage domestic investment, which often look more like Alliance policies than those of Labour or National. Hong Kong uses large projects (like a huge new airport) to stimulate the economy. It also has venture capital funds, financial and technical support, export credit insurance, and government-funded industrial estates and a Science Park, aimed at supporting and incubating businesses in areas considered growth areas (such as technology) by the government. To qualify, companies "have to be 'Hong Kong companies' and 'local companies'".

There is also widespread regulation of the domestic economy, including "schemes of control" for monopoly service providers, controls on banking and workers' accident insurers, membership of the Stock Exchange, ownership of coastal shipping, and restrictions on international telecommunications.

Externally it has virtually no controls on foreign investment or capital flows. However, Hong Kong has not been nearly as willing as New Zealand governments to open its services to overseas ownership: Hong Kong's commitments to the WTO's General Agreement on Trade in Services (GATS) are substantially less than New Zealand's. It has made no commitments in education or broadcasting, for example, where New Zealand's commitments have caused controversy. This wide gap will put New Zealand in a weak position in FTIA negotiations, in which services will almost certainly be a focus.

The relationship with China

Hong Kong is part of China, under China's "one country, two economic systems" policy. However Hong Kong's autonomy is used for their own convenience by China, Hong Kong, and the transnational corporations active in them.

Hong Kong handles about half of all exports to Mainland China, and accounts for about half of foreign direct investment there. China is also a major investor in Hong Kong, with a gross asset value approaching US$200 billion.

However, Hong Kong's main role is "intermediation". It is moving rapidly away from manufacturing based on low-cost labour, making money instead from organising production on behalf of buyers – mainly in the industrialised world – using the cheapest raw materials, factories and labour, wherever it can find them in Asia, the Middle East and West Africa. Since China is currently one of the cheapest sources of labour, Hong Kong is ideally placed for this function. Just one such trading house alone, Li & Fung, has offices in over 20 countries and oversees the entire fabrication of a good, from purchasing raw materials and planning production to monitoring manufacturing among 7,500 independent plants to which it subcontracts orders.

Hong Kong is no longer a low wage economy: its per capita GDP in 1999 was approximately NZ$45,600 – 70% higher than New Zealand's NZ$26,700. Though it is one of the most unequal societies in the world, the average daily wage for production workers in manufacturing is approximately NZ$104.

In 2000, 88.5% of Hong Kong's exports were "re-exports" – exporting imported goods that have undergone no further processing or only simple processing in Hong Kong. A third of those re-exports are to the mainland of China, and 43.6% of Hong Kong's imports are from the Mainland. Goods are processed partly or fully in China and then re-exported to Hong Kong, which puts large markups on the goods – averaging 24%. The markups amounted to 10% of Hong Kong's entire GDP in 1996 – more than manufacturing.

There is strong evidence that the use of Hong Kong is to allow transnational corporations who manufacture in China (which accounted for 41.9% of China's exports in 1998) to make their profits in low-tax countries, rather than where they sell the final goods. It may also enable them to avoid or take advantage of trade agreements such as the Multi-Fibre Agreement on footwear, clothing and textiles.

There is therefore extremely close integration between companies in Hong Kong and China. Hong Kong traders have considerable control of the processing and can be expected to attempt to manipulate that to minimally satisfy whatever "rules of origin" requirements are stipulated in a trade agreement:

Yet it is notable that 58% of Hong Kong's "domestic exports" were still "articles of apparel and clothing accessories" and textiles in the year ended November 2000 – worth about NZ$25 billion. While these are in theory produced in Hong Kong, the move of Hong Kong out of manufacturing and its high and increasing integration with external subcontractors – especially in China – implies that the "manufacturing" of these items in Hong Kong is likely often to be minimal. A large part of the value is likely to be markup, with just enough processing to satisfy "Hong Kong origin" requirements of the importing country.

It will be exceptionally difficult to define rules of origin, for either goods or services, that are enforceable and distinguish Hong Kong-made "domestic" products from ones substantially made in China or elsewhere. There is huge potential for Hong Kong's exports to devastate the remaining New Zealand textile, clothing and footwear sector.

Implications of a Hong Kong FTIA

Services

Services will be a focus of negotiations. Education, and professions including architecture and engineering are likely to be targets for New Zealand in Hong Kong. Hong Kong can be expected to demand concessions in return. But New Zealand has relatively little to give in services: it already has one of the most wide-ranging commitments of any WTO member, including those areas, so concessions will be particularly painful. In the Singapore agreement, concessions in services included environmental and ambulance services among many others.

If Hong Kong asks for like-for-like concessions, then New Zealand's public education and health systems, both of which have become commercialised and open to private sector competition, are at risk of being locked opened to commercial competition from companies based in Hong Kong. That would undermine the government's proclaimed intention to restore the public dimension to these systems. It will also place a further block on backing out of the liberalisation in a number of services which is now regretted.

In any case, it is difficult to see New Zealand benefiting from opening Hong Kong's education system to New Zealand educational institutions. Hong Kong has a well developed tertiary education system, with considerably better student:teacher ratios than New Zealand, particularly in tertiary education. Though it has a shortage of facilities, costs and quality demands will be high, and will require significant capital investment – when most New Zealand institutions are critically short of funding. The institutions are already attracting Hong Kong students to New Zealand without the need of a full FTIA. Specialised agreements on mutual recognition of qualifications could be made without the wide-scale concessions an FTIA will entail.

Jobs created in service industries are of very mixed quality. Those created in the sectors favoured by Hong Kong-based investors are likely to be largely in hotels and distribution, such as supermarkets – jobs which are notoriously low paid, insecure, casualised and deunionised. Its investment in property and business services is unlikely to provide many jobs – if it is productive investment at all.

Government procurement

In the SNZCEP, all government procurement of goods and services over the equivalent of $125,000 were opened to Singapore on an equal basis to local companies. This area is particularly contentious because it directly affects local government. Local service suppliers – such as in "environmental services": rubbish collection, sewerage, and perhaps services in relation to water supply – may find themselves competing with companies from around the world using a Hong Kong base for tendering. Central and local government are prevented from imposing conditions on suppliers to encourage local development, gain technology, or earn foreign exchange.

The Investment Promotion and Protection Agreement

The New Zealand-Hong Kong Investment Promotion and Protection Agreement was signed in 1995, and is very similar to one signed with China in 1988. Both have the rigidity of minimum 15 year terms, with protection to continue for a further 15 years for any investment in place if the agreement is subsequently terminated. Similar agreements were signed by the previous government with Chile and Argentina which await only ratification.

Two features stand out: the expropriation provisions, and the disputes procedure. These provisions are very similar to ones at the centre of public concern in the OECD-sponsored Multilateral Agreement on Investment (MAI) which was defeated in 1998 after widespread international opposition. These were in turn modelled on the NAFTA agreement.

The expropriation provision in NAFTA has been interpreted by tribunals to include loss of an investment's value through loss of profitability. It means that any change in environmental regulations by central or local government which reduced the profitability of an enterprise could result in awards of compensation and perhaps reversal of a change in law or regulation. Even the threat of such costly actions is a brake on actions a government would otherwise have been taken in the interests of its citizens.

There are now many cases under NAFTA. They have been described by one U.S. attorney, Lydia Lazar, as "a strategic windfall for companies unhappy with actions taken by local or federal governments, actions that impede or thwart their corporate ambitions". Claims by corporations regularly amount to hundreds of millions of U.S. dollars, and settlements in the tens of millions.

In one example, the Ethyl Corporation sued the Canadian government for about US$250 million for restricting use of MMT, a petrol additive produced by the corporation, because of its danger to health and car emission systems. Ottawa was forced to repeal its ban, pay US$13-million in damages to Ethyl and withdraw its assertion that MMT caused damage.

In another case, Metalclad Corporation, a US waste disposal company, was awarded US$16.7 million when the Mexican state of San Luis Potosi refused it permission to re-open a waste disposal facility after it was revealed that subterranean streams supplying water to the local community ran under the landfill. According to the Mexican government, "Metalclad knew the local community opposed it and they decided to force the situation, ignored the issue of the local permit and built without having a permit." This case is doubly significant because it involved local government – not a signatory to NAFTA.

New Zealand examples in recent years that could spark such investor claims include the halting of the Britomart scheme in Auckland, the renationalisation of ACC, the slowing of fast ferries in the Marlborough Sounds, and the 1998 electricity "reforms".

It is particularly important to note that any company in the world could take advantage of the IPPA with Hong Kong: all they need is to own their investment through a paper subsidiary company in Hong Kong. In addition, any Hong Kong citizen in New Zealand can use it, while New Zealand citizens and companies cannot. An example (under the equivalent IPPA with China) is the principal of the Britomart project, Ji-hong Lu, who is a Chinese national.

As controversial as the expropriation provision is the disputes procedure under which such actions are taken.

Article 9 of the IPPA provides for investor enforcement: it gives investors the right to force such disputes to arbitration under the Arbitration Rules of the United Nation's Commission on International Trade Law (UNCITRAL). Effectively this gives corporations equal standing with governments and a potentially greater right to enforce outcomes of disputes arising under the agreement than the governments themselves – an unprecedented development in the history of nations' sovereignty.

The process can be seen as a privatisation of the commercial justice system. The arbitral tribunal is appointed by the parties to the dispute. No third parties, such as a local authority, affected neighbours, or employees, have any standing in hearings, if hearings do occur (all submissions may instead be writing). Indeed "hearings shall be held in camera unless the parties agree otherwise", and third parties will not normally even be aware that the dispute is being heard. There is no right for the public to listen to proceedings or view evidence or submissions presented. The final "award may be made public only with the consent of both parties" so the corporation party to the dispute can veto any decision being made public. So can a government which is embarrassed or nervous of public or investor reactions.

According to Lazar, "Substantively, arbitral decisions reflect the economic interests of businesses. Arbitrators do not explicitly incorporate any other interests, such as environmental, social, or political concerns." Yet their decisions have enormous impacts on such concerns.

Although the SNZCEP has no expropriation provision, it has an even stronger investor-government disputes procedure than the IPPA. The merging of the two in a FTIA, is likely to increase the danger provided by the existing IPPA.

The SNZCEP

Duplicating the provisions of the SNZCEP would have many further effects on investment.

There is more in the SNZCEP that investors can litigate. For example, its "national treatment" article means that that overseas investors must be treated at least as well as local investors – from the point of starting up their investment right through to its sale. National treatment obstructs policies aimed at the "incubation" of new industries and ensuring their longer term survival, which is part of the more active economic development policy of the Labour/Alliance government. To nurture such industries, preferential treatment in the way of grants and support are given. Under the SNZCEP those must be offered to investors with a presence in Singapore (and if agreed, Hong Kong).

It prevents controls on "hot money". Such controls were used very effectively by Malaysia to prevent further damage during the 1997 financial crisis. In a Hong Kong FTIA, that would be even more constraining on future government actions: Hong Kong is a major financial centre attractive to speculators (from any country) and with no restraints on their activities. We have already seen $8 billion in "hot" money moved in and out, so the danger is real. It provides a huge back door for speculators and those wishing to withdraw investments quickly should a New Zealand government need to re-impose capital or exchange controls.

It also prevents more stringent criteria for foreign investment being required: it cements in the current threshold of $50 million for non-land investments requiring the approval of the Overseas Investment Commission, for example. As recently as November 1999 the threshold was $10 million.

The effect therefore is to immediately freeze or weaken the controls currently available, making it more difficult to put in place more stringent controls in future. Further, there is a commitment to progressively weaken even those controls that remain.

Conclusions

Hong Kong-based investors have been active in New Zealand, but rarely have Hong Kong-owned investors put money into areas that would be of most benefit to New Zealand. They will have produced few jobs, and those jobs are likely to be low-paid and insecure. Indeed, there is strong evidence that much of the investment is for tax avoidance purposes rather than any interest in productive investment. Those investments in New Zealand that have some productive purpose generally come from third countries whose investors are using Hong Kong as a port of convenience, presumably to avoid tax or other requirements – or perhaps to gain protection from the IPPA. None of this is a good reference for the activities of "Hong Kong investors" in New Zealand.

It is very difficult to see what gains can be claimed from a wider Hong Kong-New Zealand agreement. Both countries have very open economies. In some ways – particularly in the important services sector – New Zealand has liberalised faster than Hong Kong. That leaves little for a formal agreement to do. Agreements reached in the SNZCEP on recognition of qualifications, for example, could be negotiated separately. Any real concessions by Hong Kong in the services area must be bought at a high price in terms of further commercialisation of our social and environmental services here, or further tariff cuts in our textile, clothing and textiles industries which are extremely vulnerable to Hong Kong's exports.

Yet the dangers are very real. Such an agreement would reinforce the already dangerous IPPA, opening New Zealand to a high risk of continual threats of litigation by corporations who dislike environmental, economic and social policies that adversely affect them. Those threats will be very costly in money terms, and in intimidating central and local government, further reducing their options for policies that provide the social and economic development that New Zealanders need.

It would also reinforce the obstacles already in place against New Zealand being able to reinstate capital controls and effective regulation of overseas investment. Indeed, its intention would be to increase the speed of deregulation. Despite some signs of progress over the last year, New Zealand still has a mountainous foreign debt ($109.1 billion, or 105.3% of GDP at March 2000), and a precarious current account deficit ($7,336 billion, or 7.0% of GDP at June 2000). That could lead to crisis at any time.

Continued liberalisation in itself will conflict with the Labour/Alliance Government's economic and regional development policies. Many options for economic development, and closing social and regional gaps will be permanently foreclosed to New Zealand national and local governments. It is paradoxical that Hong Kong's own domestic policies for encouraging local development often look more like those of the Alliance than of Labour (let alone National).

The government should declare its intentions with regard to the Hong Kong negotiations with urgency. Rather than continue its current secretive "talking about talking" stance on the negotiations, it should emulate the Canadian and U.S. governments which have recently made public their negotiating positions on the Free Trade Area Of the Americas agreement, and have released a draft text.

If it decides to pursue these negotiations, it should make public its timetable, and periodically release draft texts for public comment. It should encourage and stimulate thorough public debate, rather than repeat its phoney consultation stance in the SNZCEP negotiations. There, “consultation” was a one-way briefing of hand-selected interested parties, and Parliamentary scrutiny was admitted by all involved to be simply an empty formality.

However from the evidence gathered here, there are considerably more dangers than benefits in such an agreement. The government is better advised to announce that it has decided not to proceed.

Instead, it should move to abrogate the Hong Kong-New Zealand and China-New Zealand IPPAs before the dangers of the expropriation and investor disputes provisions are exploited by corporations in the way that is occurring with increasing frequency under NAFTA.