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**REPORT FROM THE COMMISSION TO THE COUNCIL AND
THE EUROPEAN PARLIAMENT**

Macao Special Administrative Region : Annual Report 2005

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The political situation in the Macao Special Administrative Region (SAR) remained stable throughout 2005. The key political event of the year was the holding of legislative elections. Despite a number of allegations of electoral fraud during the campaign, the elections themselves proceeded in a fair and orderly manner. The record high turnout was a positive indicator of Macao's political development. The European Commission welcomes this and believes that the increasing political maturity of the people of Macao provides a good foundation for progressing towards universal suffrage.

In his annual address in November, Chief Executive Edmund Ho announced a number of new initiatives, including an increase in resources for education, welfare and housing. He also announced the likely launch of a democracy development plan in 2007, though at the same time implicitly ruling out direct elections and universal suffrage for the 2009 Chief Executive and Legislative Assembly elections. The Commission welcomes Mr Ho's new initiatives and looks forward to the launch of the democracy development plan.

Anti-Money Laundering and Anti-Terrorism Bills were put before the Legislative Assembly in October 2005. Both legislative proposals were passed in principle and are expected to be enacted before summer 2006. The Commission welcomes the SAR Government's swift response to these issues and, on the issue of money laundering, underlines the importance of eradicating illicit activity linked to money laundering in the territory.

Macao's economy continued to expand in 2005, although more slowly than the (double-digit) growth in the previous three years; nonetheless, there was strong GDP growth of 6.7 percent. Tourism and the gaming and entertainment sectors continued to expand and drove economic growth. Merchandise trade, on the other hand, declined primarily due to the lifting of global textile quotas in 2005. According to Macao statistics, exports to the EU dropped by 31% to 3.4 billion patacas (€340 million) or 17% of total exports.

On trade issues, the Commission recognises the continued efforts of the Macao SAR Government in upgrading its legislative framework and enforcement structure for the protection of intellectual property rights. However, the Commission has expressed its concern about TV signal piracy. The Commission urges the SAR Government to take the measures necessary to protect legitimate signal providers and copyright owners.

2005 was a good year for bilateral relations between the EU and Macao. President Barroso visited Macao in July - the first visit by a Commission President to the territory. President Barroso and the Chief Executive underlined the importance of further strengthening bilateral relations.

ANNEX

1. POLITICAL DEVELOPMENTS

The political situation within the Macao SAR remained very stable for another year, with the legislative elections being the year's political highlight.

Legislative Elections

Two previous legislative elections have been held in the Macao SAR, once under Portuguese administration and once in 2001, two years after the territory returned to Chinese sovereignty. The 2005 elections were characterised by the addition of two more directly-elected seats in the legislature, in accordance with the provisions of the SAR's Basic Law.

On 25 September, Macao's voters turned out in record numbers to elect 12 legislators to complete the 29-strong Legislative Assembly (LA). Election Day went relatively smoothly, despite a number of complaints made to the electoral office and some isolated election-related scuffles. Almost 130 000 voters cast their vote in Macao's third LA direct election, making a record turnout rate of 59% compared to 52% in the 2001 elections. The pro-democracy camp emerged as the winner in the direct election, gaining the support of approximately 25% of the electorate. However, due to Macao's complex election system of mixed proportional representation, they only managed to secure two seats. The traditional business, labour and civil service unions won six seats and casino-related candidates the remaining four.

A further ten legislators were elected unopposed through indirect election from Macao's four functional constituencies. Those candidates were elected by a small group of voters from business, labour and professional organisations whose total votes did not exceed 2,250. Finally, seven legislators were appointed directly by Macao's Chief Executive, Edmund Ho.

Although Election Day itself proceeded in an orderly manner, the two-week election campaign was marked by a series of allegations of vote buying and unfair practices, as well as the authorities' attempts to combat electoral graft. Observers believe that those incidents are related to the increasingly important role that business and casino-related legislators play in Macao's overall policies. The campaign was focused mainly on "livelihood issues", including public transport, education, health, the importing of labour, unemployment, social welfare, public security and care for the elderly. Unlike Hong Kong, Macao politics were dominated by mainly local issues, while democratisation and relations with the mainland received little attention.

Despite the aforementioned incidents, the European Commission is of the view that, overall, the elections were conducted in a fair and orderly manner. The record high turnout, despite torrential rain and a typhoon warning, is a positive indicator of Macao's political development and a sign of a rising civic awareness in Macao and of its people's commitment to democracy. The European Commission welcomes this and believes that the increasing political maturity of Macao's citizens provides a good foundation for progress towards universal suffrage in Macao.

Chief Executive's Policy Address

Macao's Chief Executive delivered his 7th policy address on 15 November 2005. It focused mainly on the development of human resources, social welfare, economic development and civil service reform. One of the main innovations of this policy address is the introduction of a labour import surcharge, which will be used for retraining employees and subsidising SME's that employ local Macao citizens. This has been a very delicate issue over the years, as Macao opens its doors to more professionals in order to cope with its economic growth. This measure, running in parallel with a scheme giving priority in employment to Macao's citizens, should provide comfort to local people.

On the political front, the Chief Executive underlined the objectives of political pragmatism, continuity and gradual reform. However, although announcing that a democracy development plan is likely to be launched in 2007, he implicitly ruled out direct elections and universal suffrage for both the Chief Executive and Legislative Assembly elections in 2009. The Chief Executive, referring to the national security legislation under Article 23 of the Basic Law, said that the law is still being drafted.

Currently, 41% of the Legislative Assembly is returned by direct election, whereas the SAR's Chief Executive is elected by a 300-strong selected Election Committee. Under the Basic Law, Macao may change its methods for forming the LA "if there is a need in and after 2009". The European Commission welcomes the Chief Executive's comprehensive policy planning and his new initiatives on increased resources for education, welfare and housing and it awaits the announced democracy development plan with great interest.

Legislative efforts to combat money laundering and terrorism

To strengthen the regulatory framework on anti-money laundering activities, the Macao SAR Government tabled an Anti-Money Laundering Bill in the Legislative Assembly in October 2005. The aim of this Bill is to combat money laundering activities involving terrorism, organised crime, commercial crime, bribery, drug and human trafficking, and illegal trading of arms. In September 2005, a local Macao Bank, Banco Delta Asia SARL, was alleged by the US Department of the Treasury to be "a primary money laundering concern" with connections to financial activities of the Democratic People's Republic of Korea (North Korea). The Chief Executive, Edmund Ho, responded that "no conclusion should be drawn without any proof concerning such a grave allegation." The Macao Monetary Authority immediately set up a committee to investigate the matter. The bank was placed under the control of a management committee appointed by the Macao government.

At the same time, an Anti-Terrorism Bill was put to the Legislative Assembly. Both legislative proposals were passed in principle after general discussion, and are awaiting further legislative procedures before final enactment, which is expected before summer 2006. The European Commission welcomes the SAR Government's swift response to this incident and underlines the importance of effectively eradicating any illicit activities linked to money laundering in the territory.

2. THE ECONOMY

The very rapid expansion resulting from the liberalisation of the casino regime was well sustained. Following double-digit growth for the preceding three years, the economy continued to expand at a less rapid pace in 2005, with GDP growing by 6.7% in real terms. Huge investment inflows related to new casinos, entertainment facilities and property development emerged as the primary sources of growth last year. Visitor arrivals reached a new peak, boosting growth in the gaming and tourism sectors. On the other hand, merchandise trade recorded a marked decline due to the lifting of global textile quotas in 2005. The employment market improved significantly, although there were initial signs of inflationary pressure.

The number of casino operators is expected to increase from three to six in 2006. The new investors have already started to implement their large-scale investment plans for the next few years. Private investment surged substantially as a number of hotel and casino projects got underway. As at end of 2005, about 50 hotels were under construction or the subject of project assessment by the Macao authorities, adding over 28 000 new guest rooms to the current capacity of around 11 000. The operating environment of the gaming industry is expected to experience significant changes in the near to medium term, and in particular to become more competitive.

Along with the opening of more casinos and entertainment facilities, the tourism sector performed favourably in 2005. Visitor arrivals rose by 12% to a record level of 18.7 million. Mainland China was the main source of visitors, accounting for over half of the arrivals, followed by Hong Kong (30%) and Taiwan (8%). In July 2005, Macao won the bid to include “the Historic Centre of Macao” on the United Nation’s World Heritage list. This prestigious status will help broaden Macao’s appeal, reputation and visitor base.

The gaming sector directly benefited from buoyant tourism growth. Gross revenue from all gaming activities in 2005 totalled 45.8 billion patacas¹(€4.6 billion), of which 98% were contributed by 17 casinos. Casinos in Macao pay 35% of their gross receipts as direct gaming taxes, which accounted for 72% of fiscal income last year. The Macao SAR government thus enjoyed a comfortable fiscal surplus position and was able to introduce a series of social welfare and education policy initiatives.

Thanks to strong investment sentiment and a robust economic performance, the property market continued to boom. Average residential prices and transaction volumes went up markedly, by 20% and 30% respectively in 2005. On the other hand, inflationary pressure became a cause for concern, rising rapidly from around 1% in 2004 to 4.4% in 2005 due to strong domestic demand, higher prices of imported goods and rising oil prices.

The employment market became tight as the demand for manpower increased in a fast growing economy. The unemployment rate dropped steadily from 4.8% in 2004 to 3.9% in the last quarter of 2005 - the lowest in eight years. Macao faces some structural problems in the labour market, where it lacks adequate professional staff and possesses a large group of under-employed middle-aged, lower-skilled workers who are finding it difficult to work in the emerging service economy.

¹ average exchange rate for 1 euro to patacas in 2005=9.9721.

There were about 10 000 unemployed persons and 39 000 imported labour in the fourth quarter of last year

Merchandise trade was the weakest sector of Macao's economy last year. Total exports declined by 12% to 19.8 billion patacas (€1.99 billion) due to the lifting of global textile quotas after the WTO Agreement on Textiles and Clothing expired in January 2005. Nevertheless, textiles and clothing continued to make up the bulk of Macao's merchandise exports, accounting for 77% of total exports. Concurrently, the strong domestic demand brought about a 12% increase in imports, which reached 31.3 billion patacas (€3.1 billion), resulting in an enlarged trade deficit of 11.5 billion patacas (€1.15 billion). According to Macao statistics, exports to the EU fell sharply by 31% to 3.4 billion patacas (€340 million) or 17% of total exports. The US, Mainland China and Hong Kong were the other major markets, taking up about 48.7%, 14.9% and 9.8% respectively of Macao's total exports.

3. TRADE ISSUES

CEPA III

The Closer Economic Partnership Arrangement (CEPA) between Mainland China and Macao entered its third phase in 2005. A framework agreement (CEPA I) which sets out a platform for on-going discussion on trade liberalisation between the two places was concluded in 2003, and a supplementary protocol (CEPA II) was signed in 2004. Under CEPA III, all goods currently originating from Macao enjoy tariff free treatment. Taking the agreed rules of origin of 91 products under the Mainland Customs Tariff codes negotiated in 2005, a total of 600 Macao products enjoy tariff free treatment starting from 1 January 2006. For trade in services, further relaxation in market access in 10 of the total 26 service sectors was introduced. As CEPA does not commit to potential trade or "other" tariff lines, it is characterised by a very low tariff line (or product) coverage.

Only a small amount of goods was exported under CEPA in the first two years of implementation (about 8.3 million patacas or €920,000). The service industry made greater use of the opportunities offered by the free trade arrangement than the manufacturing sector. The transport and logistics industries were the most active service sectors in applying for CEPA certification to expand their business in Mainland China.

Offshore tax regime revised

From 14 June 2005, the Macao SAR Government has amended its offshore company tax regime to cool down its overheating economy. The offshore regime was introduced by the former Macao Government in 1999 to help develop Macao into an offshore commercial centre. The scope of the approved offshore activities has been reduced from the original 20 sectors to eight sectors, which mainly involve technical support activities. The majority of the offshore companies are believed to be Hong Kong-based companies taking advantage of the lower tax regime. The Hong Kong SAR Government has welcomed the change.

Macao-Zhuhai Cross-boundary Industrial park

The Cross-boundary Industrial Zone located in between Macao and Zhuhai was endorsed by the State Council of the People's Republic of China Central Government in late 2003 and was acclaimed as an innovative experiment in regional cooperation within the Pearl River Delta. The zone is divided into the Zhuhai Park and the Macao Park, managed respectively by the Zhuhai municipal government and the Macao Industrial Park Development Co. Ltd. It is noted that no preferential treatment (in terms of labour import arrangements and tax concessions) will be given to the park tenants. As far as rules of origin are concerned, CEPA rules of origin will apply to products made in the Macao Park and exported to Mainland China. For products exported elsewhere, the Macao certificate of origin will be issued in accordance with WTO rules or the origin rules of the importing countries.

The Macao Park is under construction and is expected to be operational by the end of 2006. The Macao Government hopes that the industrial park will attract higher-end industries into the SAR. The first phase development met with a favourable response from the industry. Major tenants mainly concentrate on pharmaceutical and garment manufacturing. It remains to be seen whether the future industrial park will be able to diversify the narrow industrial base and cushion the impact of the global abolition of textile quotas. The textile and clothing sector employs close to 80% of Macao's manufacturing workforce and accounts for 77% of its exports.

Protection of intellectual property rights

While recognising the continued efforts being made by Macao in upgrading its legislative framework and enforcement structure for the protection of intellectual property rights, the European Commission is concerned about the current situation of TV signal piracy in Macao. It notes that antenna companies have for years been providing pirated TV signals for channels with European and American content without a licence or authorisation from the respective copyright owners. Macao Cable TV has signed a contract with the Macao SAR Government for the exclusive provision of pay TV services, covering worldwide and European channels. The company has filed complaints with the Macao authorities against the antenna companies and for several years has been seeking civil remedies, without much progress. Despite repeated diplomatic efforts by the European Commission and the host countries of right holders, Macao has yet to find solutions to redress the situation. The European Commission urges the Macao SAR Government to take the necessary measures to effectively protect the legitimate signal provider and copyright owners.

4. EU-MACAO RELATIONS

To highlight the importance that it attaches to the "one country, two systems" principle that is applied to the Macao SAR, the European Commission maintained its active bilateral relations with the Macao SAR Government in 2005.

The President of the European Commission, Mr Jose Manuel Barroso, visited Macao on 17 and 18 July as the last stop of a 5-day China tour, which included Beijing, Shanghai and Hong Kong SAR. This was the first visit to the territory by a Commission President. He took the opportunity to visit the enclave's land reclamations, major new casino and industrial zone developments and

to meet with European residents in Macao Mr Barroso held talks with Macao's Chief Executive, Mr Edmund Ho, and Secretary for Administration and Justice, Ms Florinda Chan. In a brief statement the two leaders underlined the importance of further strengthening EU-Macao relations, identifying new areas of co-operation and continuing to co-operate closely on areas of mutual interest.

On 2 June, the 11th EC-Macao Joint Committee took place in Brussels. Both parties expressed their willingness to develop their co-operation in areas such as the new general system of preferences, translator and interpreter training and continued legal co-operation. The EC encouraged Macao to participate in EC worldwide programmes such as the Erasmus Mundus Higher Education programme, building on Macao's role as a bridge builder between Europe and Asia. Both parties also agreed to explore new fields of co-operation.

In order to discuss and explore possible content and means to deepen, develop and broaden cooperation between the EU and Macao, the Office of the European Commission in Hong Kong accredited to Macao held a seminar in Macao on 26 October 2005 with over 30 representatives of various sectors of Macao society.