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

Hong Kong Special Administrative Region (SAR) : Annual Report 2007

Executive Summary

10 years after the handover, implementation of the ‘one country/two systems’ concept continues to be satisfactory, upholding Hong Kong’s way of life, the rule of law and fundamental freedoms. Fostered by a mutually pragmatic approach, cooperation with the EU progresses well and has deepened in 2007. After a decline in the late 1990’s, Hong Kong’s economy was revived, notably through China providing a boost to the local tourism industry and giving Hong Kong privileged access to the mainland’s markets. The economy is now booming but the pace of progress towards the introduction of universal suffrage in the Hong Kong government’s institutions remains a cause for concern. The territory also faces a series of challenges in the longer term, especially in the environmental field.

Introduction

2007 marks the tenth anniversary of the handover of Hong Kong to China. The handover established the territory as a Special Administrative Region of the People’s Republic of China. The reunification of Hong Kong with the mainland is based on the ‘one country / two systems’ concept enshrined in the Sino-British Joint Declaration of 1984 and the Basic Law of Hong Kong adopted in 1990 by the National People’s Congress of the People’s Republic of China. The Basic Law took effect on 1st July 1997 and guarantees that Hong Kong’s previous capitalist system and way of life shall remain unchanged for 50 years. Preservation of the business environment and of the rule of law in the territory was the objective of the EU’s support of China’s ‘one country / two systems’ concept and this principle has generally worked well.

I. EU-Hong Kong cooperation in 2007

As was the case in 1997, Hong Kong is still the leading city in Asia in terms of the number of EU citizens residing and working there, more than 37000 in 2007, and the number of EU businesses and companies established in the territory. This is a motivating factor for the EU’s involvement in Hong Kong.

Indeed the EU’s presence in Hong Kong is on the increase and covers a large variety of sectors, notably in financial and business services, trading, transportation and construction (95%).

According to an official survey published by the Hong Kong authorities (September 2007), the number of foreign companies in Hong Kong has increased by more than 50% since the handover in 1997. As of June 2007 there were 1,246 regional headquarters, 2,644 regional offices and 2,550 local offices in Hong Kong representing their parent companies located outside Hong Kong.

EU companies have a total of 405 regional headquarters in Hong Kong, followed by the U.S. (298), and Japan (232).

Hong Kong plays an important role in facilitating trade between mainland China and Europe. Sino-EU trade through Hong Kong has been rising exponentially. According to Hong Kong trade statistics, trade between the EU and China via Hong Kong amounted to €37 billion in 2006, of which re-exports to the EU of goods of Chinese origin reached €29.6 billion, and re-exports to China of goods of EU origin totalled €7.5 billion. According to Chinese statistics, shipments through Hong Kong represent 17% of total trade between China and the EU.

However, as European business increasingly deals directly with China, the relative importance of trade via Hong Kong has been declining. EU-China trade via Hong Kong as a percentage of total EU-China trade has fallen from over one-third in 2002 to less than 15% in the first months of 2007, albeit the total trade volume has increased. Naturally, total trade between the EU and mainland China continues to grow faster than the re-exports through Hong Kong.

Since 1997 relations between the EU and Hong Kong have continued to develop, based on a shared understanding of mutual interests. This relationship is above all pragmatic and focuses on trade and investment. However it also encompasses educational, social, cultural and regulatory domains.

After the handover Hong Kong was confronted with a number of unforeseen challenges (including the Asian financial crisis, the avian influenza epidemic and the SARS pandemic) which adversely affected its economy. China came to Hong Kong's rescue by boosting tourism through easing the restrictions on mainlanders wishing to visit Hong Kong and by giving Hong Kong privileged market access through the CEPA (Closer Economic Partnership Agreement) concluded in 2003. The CEPA was supplemented by further agreements in the following years. This involvement has proved very effective and Hong Kong's economy is booming in the wake of the mainland's economic prowess. This success also translates into closer relations between the administrations of the two sides, with a widening scope for exchanges and consultations.

It now seems clear that the economic future of Hong Kong rests on deepening its economic relationship with mainland China. As a service-based economy, its future growth will rely, to a large extent, on successfully tapping the huge Chinese market. Developments in the financial sector reinforce this trend. The China Banking Regulatory Commission announced in May 2007 that the investment scope for the Qualified Domestic Institutional Investors scheme (QDII), a channel which allows mainland Chinese institutional investors to invest in foreign portfolio investments, was expanded to include Hong Kong equities. In August, the announcement of the so-called "through-train scheme"

allowing individual mainland investors to buy stocks in Hong Kong, sparked predictions of a cash “tsunami” threatening great volatility in Hong Kong’s stock exchange. The introduction of this scheme has now been delayed.

Following the endorsement by the Council on 12th December 2006 of the Commission’s proposals concerning possibilities for cooperation with Hong Kong for the period 2007-2013, the Commission has deepened cooperation in sectors other than trade, including customs, finance, people to people and academic exchanges, sport, the environment, health and food safety.

The first edition of the Structured Dialogue between Hong Kong and the EU was held on the 30th November 2007 in Hong Kong. This followed an agreement reached between the Chief Executive of the Hong Kong SAR and the President of the EU Commission in 2006 to establish this mechanism as an annual platform to develop broader and deeper cooperation in areas of common interest between Hong Kong and the EU.

This first meeting reached positive conclusions with respect to ongoing cooperation regarding trade, customs and immigration and acknowledged that the respective customs, visa free access and readmission agreements worked well. Hong Kong is meeting some of the EU’s concerns, in particular regarding IPR enforcement (counterfeit goods, trademark violations by “brand” free riding companies registered in Hong Kong), and also plans to hold a wide ranging consultation on a draft competition law with a view to tabling it in the Legislative Council after the September 2008 elections.

In the framework of EU action to strengthen cooperation with industrialized countries, the Commission has offered to provide funding for establishing in Hong Kong a business cooperation project for disseminating information on the EU, stimulating discussion, enhancing visibility as well as developing outreach activities. The Commission hopes to begin implementation in 2008.

II. Political developments

The Commission monitors institutional and societal development in Hong Kong, based on a formal commitment entered into in 1997 with the European Parliament. The EU has consistently voiced its support for further democratic development in Hong Kong. The Basic Law, building on the institutional legacy of the pre-1997 colonial period, states that the ultimate aim is the election of the Chief Executive and the election of all members of the Legislative Council by universal suffrage (articles 45 and 68 of the BL).

2007 saw much discussion regarding the government’s plans for gradual reforms that would have the way for universal suffrage to be introduced at a later stage (2012 or 2017). Chief Executive Donald Tsang, who started a new term of 5

years on the 1st of July, launched a popular consultation on a Green Paper on Constitutional Development.

A by-election for a Legislative Council seat, held on 2nd December, showed a high turn out and resulted in the victory of Mrs Anson Chan (former Chief Secretary) backed by the Democratic Party and its affiliates over Mrs Regina IP (former Secretary for Security) backed by the DAB(Democratic Alliance for the Betterment of HK) party and some business lobbies. This indicates that people in Hong Kong have not lost their appetite for having a direct say in their own affairs and for an accountable government. District elections earlier in November had seen substantial gains by the DAB whose candidates campaigned emphatically on livelihood issues.

Concluding the consultation on his Green Paper Chief Executive Donald Tsang submitted on 12th December a report to the Standing Committee of the National People's Congress. On 29th December the NPC took the view that the Chief Executive and the Legislative Council could be elected by universal suffrage from 2017 on. In practice this means that there can be direct elections for the Chief Executive in 2017 and for the Legislative Council in 2020.No substantive changes to the current system will be made before 2017.To give effect to the NPC's decisions legislation will be introduced in the Legislative Council, probably after the 2012 elections. To be adopted this legislation will require endorsement by a two thirds majority of all the members of the Legislative Council, the consent of the Chief Executive and the approval of the NPC.

The Chief Executive acknowledged that opinion polls conducted during the consultation process showed that about half of the People of Hong Kong supported introducing universal suffrage in 2012 but he felt that deferring any such change until 2017 would stand a better chance of being accepted "by the majority in our community".

The European Parliament continued to follow developments and several of its members visited Hong Kong during the year 2007. The EU's support for democracy is an important part of its commitment to develop its relationship with Hong Kong. Legitimacy, stability and accountability of government are seen as essential factors for sustaining a favourable business environment. Indeed they guarantee that the rule of law is upheld and protect the freedoms and rights of the people without which entrepreneurship and innovation would wilt.

The NPC decisions announced on 29th December sustain China's commitment to the ultimate goal of universal suffrage, as set out in the Basic Law, for the election of the leaders and lawmakers of Hong Kong. The Commission has consistently expressed support for early progress towards this goal. It notes the specific gradualism of the NPC's approach to implementing these decisions and

states that it will continue to show support for not only gradual but also significant progress. Early measures towards transforming the functional constituencies and transparent procedures for defining electorates and selecting candidates for public office would appear relevant.

The Commission notes that the judiciary and law enforcement services in Hong Kong continue to have a good track record and generate case law consistent with the best common law practices. The effective protection of freedoms and fundamental rights through competent and independent law courts is an essential backbone of Hong Kong's way of life. Some currently pending court cases that address issues of freedom of expression in the context of disputed broadcasting licences may well test the quality of the protection afforded to such fundamental freedoms.

III. Perspectives for the future

However the Commission recognises that in general the “one country, two systems” principle has been respected and is working well for the people of Hong Kong. It is important that the SAR government continues to enjoy a high degree of autonomy in economic, trade, fiscal, financial and regulatory matters, and that the people of Hong Kong benefit from their own legal - an independent rule of law, individual property rights, freedom of speech - and market economy systems.

At the same time, it should be noted that Hong Kong's situation has changed since 1997. Two of the most striking developments in world affairs over the past 10 years are China's economic achievements and her ensuing international assertiveness and the global acknowledgement of climate change and its catastrophic consequences. These issues directly impact Hong Kong and must be taken fully into account by the S.A.R.'s policy makers. They need to address a number of immediate and medium term challenges. The recent recommendation to Hong Kong by China's Premier Wen Jiabao to prioritize innovation, education, talent development and the environment encapsulates these challenges well.

Hong Kong indeed faces a whole range of issues concerning the quality of its environment: most notably air quality, water quality, biodiversity, energy efficiency, waste treatment and low emission standards for vehicles and power plants. It has yet to formulate and implement a coherent long term strategy on this front. European expertise, relayed through networking and academic circles could contribute to a genuine vision for Hong Kong's 2047 horizon and beyond.

The concept of Hong Kong's position in the region as a gateway to China and an Asian hub for financial services is still relevant. However it must also take into account the need for ever closer links and cooperation with the mainland,

notably Guangdong province, Shenzhen and Zhuhai and with Macao. Such cooperation is indeed necessary for dealing with trade flows as well as for law enforcement and for tackling environmental challenges. The Commission believes that the EU can, and is willing to make a contribution by offering experience and technology. The potential for relevant input from sciences through the collaborative opportunities on offer in the EU's 7th Research Framework Programme should be also considered. These matters should be on the agenda for the next edition of the Structured Dialogue in 2008.

The main operational conclusion of this year's report on the situation in Hong Kong is the continued need to strengthen pragmatic cooperation between the EU and its member states and Hong Kong, and to promote people to people exchanges in the areas most relevant to Hong Kong's future well being.