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**JOINT REPORT TO THE EUROPEAN PARLIAMENT AND THE COUNCIL**

**Hong Kong Special Administrative Region: Annual Report 2013**

## **SUMMARY**

Since the handover of Hong Kong to the People's Republic of China in 1997, the European Union and its Member States have closely followed political and economic developments in the Hong Kong Special Administrative Region (SAR) under the 'one country, two systems' principle. In line with the commitment given to the European Parliament in 1997, an annual report is issued on developments in Hong Kong. This is the 16th such report, covering developments in 2013.

The EU believes that the principle of 'one country, two systems', enshrined in the Sino-British Declaration and the Basic Law of Hong Kong, continued to work well in 2013. The rights and fundamental freedoms of the people of Hong Kong continued to be respected, the rule of law was maintained and the market economy and business environment was preserved.

Bilateral relations between the EU and Hong Kong continued to deepen, with a visit to Hong Kong in November by the President of the European Commission, José Manuel Barroso. Trade and economic relations developed well and the EU and Hong Kong continued and expanded dialogue and cooperation in many areas of mutual interest, including financial services, customs, the environment, research, education and culture.

The EU attaches great importance to Hong Kong's stability, economic prosperity and democratic development. It believes that an accountable government contributes to stability and prosperity and helps maintain Hong Kong's position as a key international business centre.

The EU continues to support substantial progress towards the goal of the Hong Kong government and the Standing Committee of the National People's Congress of achieving universal suffrage by 2017 for the election of the Chief Executive and by 2020 for the election of the Legislative Council, in accordance with the Basic Law of the Hong Kong SAR and the wishes of the people of Hong Kong.

## **POLITICAL DEVELOPMENTS**

In his first policy address in January 2013, the Chief Executive Chun-ying Leung set out his long-term blueprint and objectives for Hong Kong under the motto 'seek change, maintain stability, serve the people with pragmatism'. He promised to uphold Hong Kong's core values, implement the 'one country, two systems' principle in accordance with the Basic Law and properly manage the relationship between Hong Kong and the mainland.

He said that, as an SAR of China, Hong Kong received strong and steadfast support from the central government. He believed that, capitalising on the advantages of the 'one country, two systems' principle, Hong Kong had not only opened up the vast mainland market as its economic hinterland, but also enhanced Hong Kong's status as an international hub.

Key policy initiatives focused on fostering economic development by, *inter alia*, strengthening economic relations with the Mainland and developing Hong Kong's financial

services, business and professional services, international shipping, innovation and testing; increasing land supply and offering subsidised housing in the short to medium term; introducing measures to alleviate poverty, improve care for the elderly, improve the position of women and ethnic minorities and further develop labour policy, and ensuring environmental protection and conservation by improving air quality, managing waste and encouraging the construction of green buildings.

As in 2012, relations between the executive and the legislature were difficult in 2013. Legislators blocked or delayed a number of initiatives. The executive and legislature were not able to reach final agreement on matters of vital interest for Hong Kong, such as solid waste management, particularly landfills. As in 2012, a few legislators of the Legislative Council used filibusters to achieve their goals. The debate on the 2013 budget was particularly affected by this as a small number of legislators proposed more than 700 amendments to the 2013 Appropriation Bill.

The President of the Legislative Council, Jasper Tsang, suggested a structural reason for the poor relationship between the executive and the legislature, noting that the current governance system did not provide the executive with strong, reliable majority support in the Council. He also noted that both the legislative and executive branches had to respect and consider public views. The choice of electoral system for Hong Kong's Chief Executive and Legislative Council should make Hong Kong's governance more efficient.

Hong Kong maintained its commitment to integrity and the Independent Commission Against Corruption (ICAC) works with the community to fight corruption through effective law enforcement, education and prevention. In 2013, the ICAC received 2 652 corruption complaints, a drop of 33% compared to the 3 932 complaints received in 2012, with the number of pursuable complaints down by 41%. The exact reasons for this decrease are hard to establish. The Chair of the Advisory Committee on Corruption suggested that one factor might be greater public awareness of corruption prevention, as a result of the ICAC's increased efforts in preventive education. Another factor may have been reduced public confidence in the ICAC, following the recent controversy regarding overspending on official entertainment by the former ICAC Commissioner. An Independent Review Committee on ICAC's Regulatory Systems and Procedures for Handling Official Entertainment, Gifts and Duty Visits, appointed by the Chief Executive, and the Public Accounts Committee of the Legislative Council dealt with the matter. The ICAC said it would implement all the recommendations the two committees made.

Political discussions throughout 2013 were dominated by the debate on introducing universal suffrage for the 2017 Chief Executive election. A variety of initiatives in this area were launched by academic groups, civil society, business organisations and political parties. Most of them aimed to make the future system for nominating candidates more democratic. One initiative, Occupy Central, launched a campaign for a democratic electoral system, announcing it would occupy Hong Kong's central business district if the Hong Kong SAR government's reform proposal fell short of international standards.

Members of the Hong Kong SAR government and the director of the Liaison Office of the Central People's Government in Hong Kong joined the public debate about electoral reform. The director of the Liaison Office highlighted the legal basis for reform in the Basic Law and the decisions of the Standing Committee of the National People's Congress on the methods for selecting the Chief Executive and forming the Legislative Council. He also said the central government expected the future electoral system to ensure that only candidates who 'love the country and love Hong Kong' would be elected and appointed.

On 17 October 2013, Chief Executive announced the setting up of a Task Force on Constitutional Development, headed by the Chief Secretary for Administration, the Secretary for Justice and the Secretary for Constitutional and Mainland Affairs. On 4 December, the Hong Kong SAR government launched a public consultation on electoral reform for the 2017 Chief Executive election and the 2016 Legislative Council election. The consultation document<sup>1</sup> invited members of the public to send their views to the Constitutional and Mainland Affairs Bureau by 3 May 2014.

The launch of the public consultation gave more structure and direction to the debate on electoral reform. Views diverged greatly, especially on the procedure for nominating candidates. The positions taken on this matter by the Hong Kong SAR government and the central government on the one hand, and pan-democracy parties and sympathisers on the other, continued to be mutually exclusive. In 2015, a compromise will need to be found on this key topic, and other important issues, to ensure that electoral reform can be concluded in time for the 2016 Legislative Council election and the 2017 Chief Executive election, vital for the efficient governance of Hong Kong.

The maintenance of Hong Kong's high standards on the rule of law and the independence of the judiciary continued to be a subject of public debate. At the ceremonial 2013 opening of the legal year, the Chief Justice of the Court of Final Appeal, the Honourable Geoffrey Ma Tao-li, stressed the need for integrity of the law and the importance of the constitutional role of judges and transparency in the judicial process. Chief Justice Ma expressed strong confidence in the continuing independence of the judiciary in Hong Kong.

Two rulings of the Court of Final Appeal in 2013 bear out the Chief Justice's view that high standards for the rule of law in Hong Kong continue to be upheld. One confirmed the right of transsexual people who had completed sex-reassignment surgery to marry and declared that an existing legal impediment to this was unconstitutional. The other declared that the government's policy of limiting Comprehensive Social Security Assistance to those who have lived in Hong Kong for at least seven years was unconstitutional. Some legal provisions, such as provisions for legal aid for low-income individuals, could be improved.

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<sup>1</sup> 'Consultation Document on the Methods for Selecting the Chief Executive in 2017 and for Forming the Legislative Council in 2016.' This document relates to forming the Legislative Council in 2016, not in 2020.

European firms based in Hong Kong continued to cite the rule of law and the high quality of the judiciary as one of the key reasons for setting up their China or Asia headquarters there. Based on its rule-of-law credentials, the Secretary for Justice, Mr Rimsky Yuen, continued to promote Hong Kong as a regional hub for international arbitration and legal services. The China Maritime Arbitration Commission announced it would set up a branch office in Hong Kong, and arrangements are being made to facilitate arbitration hearings in Hong Kong by the Permanent Court of Arbitration, with headquarters in the Hague.

To better meet the changing needs of society, the Secretary for Justice, in his capacity as the Chairman of the Law Reform Commission, also undertook to study possible law reform in the areas of archives law, access to information and third-party funding for arbitration.

Hong Kong residents continued to exercise the right of freedom of speech and association. The annual 4 June and 1 July marches took place in 2013, as did two other large political demonstrations. The Chair of the Equal Opportunities Commission addressed the annual gay pride parade, and numerous smaller demonstrations on political or socio-economic issues, relating to Hong Kong and the mainland, were held throughout the year. The great majority of demonstrations were peaceful and in general the police acted proportionately.

The media, including the digital media, continued to be free and to give voice to a range of views. Nevertheless, there was a growing impression, recorded in the annual report of the Hong Kong Journalists Association, that both the print and the electronic media exercised self-censorship, especially when covering affairs concerning mainland China. Based on 2013 trends, the 2014 Press Freedom Index from Reporters without Borders downgraded Hong Kong by three places to 61st place, citing self-censorship and a growing influence exerted by the central government's Liaison Office. The continued functioning of the 'one country, two systems' principle, and Hong Kong's reputation as a territory where the business environment benefits from free flows of information, will continue to depend on media freedom. Statements by the Chief Executive in support of media freedom were therefore very welcome.

Hong Kong's relations with the mainland drew much public debate and media attention. Occasionally, the fast-growing economic and people-to-people links, including tourism, caused social disquiet in Hong Kong and posed policy problems for the authorities. These included issues such as increased demand from people from the mainland for housing and places in primary and secondary schools (especially close to the border between Hong Kong and the mainland), jobs for mainland jobseekers, the increased pressure on public transport due to fast rising numbers of mainland Chinese tourists (from 35 million in 2012 to 41 million in 2013<sup>2</sup>), and rising demand for certain consumer goods, including baby milk formula, which occasionally caused scarcity in Hong Kong.

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<sup>2</sup> Source: Hong Kong Tourism Board.

The government introduced various measures to safeguard the interests of Hong Kong residents and stabilise the market against fast rising prices and shortages. Such measures, however, did not halt the rise in the number of expressions of anti-mainland sentiment in the media (including on social media) and the emergence of a few radical anti-mainland groups.

## **ECONOMIC DEVELOPMENTS**

Hong Kong remains one of the world's leading financial centres and trading hubs. The four main industries in Hong Kong (financial services, trading and logistics, tourism, and professional and producer services) have been the driving force of Hong Kong's economic growth, providing the impetus for growth in other sectors and creating employment. Riding on China's economic boom, the city plays an important role in trade and investment with the mainland. Hong Kong has been able to prosper on the back of its core values — the rule of law, the free flow of information, transparency and its stance against corruption.

In 2013, Hong Kong performed well economically and continued to score highly on many of the global surveys measuring economic freedom and competitiveness.<sup>3</sup> Despite its economic achievements, Hong Kong also faces new competitive challenges from the economic liberalisation of China and the rise of other economic centres in the region. Its economy recorded steady growth of 2.9% in real terms in 2013. Domestic demand was the key growth driver, while the performance of the external sector remained modest due to weak global economic conditions. Employment levels were healthy, with the unemployment rate hovering around 3.3% for most of the year. Consumer prices rose by 4.3%<sup>4</sup>.

With the support of the central government, Hong Kong continued to be the largest offshore renminbi (RMB) centre in the world. It hosted the largest pool of renminbi deposits outside Mainland China, at more than RMB 1 trillion<sup>5</sup> as at the end of 2013. It continued to maintain its competitive edge over other financial centres in terms of market infrastructure and liquidity, with a good range of RMB investment products. The "CNH Hong Kong Interbank Offered Rate fixing (CNH HIBOR fixing)" was officially launched on 24 June 2013, setting benchmark rates for offshore lending and facilitating the creation of more hedging options. The mutual recognition of fund products between mainland China and Hong Kong is seen as the next step in establishing Hong Kong as the Asian hub for fund management. Regulators on the mainland and in Hong Kong have laid out plans for the upcoming launch of the scheme, which would allow international managers to sell fund products on the mainland and allow mainland funds to be sold in Hong Kong.

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<sup>3</sup> Hong Kong was ranked as the world's second most business-friendly place after Singapore in the Doing Business 2014 report by the World Bank Group. According to UNCTAD's World Investment Report 2013, Hong Kong was the third largest FDI recipient in the world (US\$75 billion), and the third largest source of FDI in Asia (US\$84 billion) in 2012.

<sup>4</sup> All economic indicators pertaining to the Hong Kong economy are official statistics released by the Hong Kong Census and Statistics Department.

<sup>5</sup> According to the Hong Kong Monetary Authority, total RMB deposits and outstanding certificates of RMB deposits amounted to CNH1 053 billion at the end of 2013. Total RMB deposits and outstanding certificates of RMB deposit as at the end of 2012 stood at CNH720 billion.

At the same time, China increased the pace of renminbi internationalisation, with London, Paris, Frankfurt, Singapore and Taipei all now able to develop as hubs for offshore RMB business. Hong Kong was quick to forge alliances with other offshore markets. In December 2013, the Hong Kong and Singapore stock exchanges signed a cooperation pact on developing renminbi investment products. Nevertheless, external competition is expected to increase as new market players emerge.

China's economic reforms created opportunities and challenges for Hong Kong. Beijing's plan to create a pilot free trade zone in Shanghai sparked strong reactions in Hong Kong. The policy measures needed to allow Shanghai's new zone to pilot wider convertibility of the RMB and freer, market-oriented interest rates attracted much speculation from the media and business. Some fear that liberalisation in these areas would threaten Hong Kong's position as Asia's leading financial centre. The consensus in the business community was that Hong Kong needed to sharpen its edge in order to maintain its competitiveness.

Economic ties between Hong Kong and mainland China were further strengthened by expanding the scope of services covered by their free trade agreement. On 29 August 2013, Hong Kong and Mainland China signed Supplement X to the Closer Economic Partnership Arrangement (CEPA). Both parties have publicly stated that the scope and depth of liberalisation under the CEPA goes beyond any FTA that Mainland China has concluded with other partners. In total there are now 403 liberalisation measures for trade in services under the CEPA. The central government has pledged to achieve liberalisation of trade in services between the mainland and Hong Kong through the CEPA by late 2015, i.e. before the end of the 12th Five-Year Plan. The Guangdong provincial government launched its proposal to bring Guangdong, Hong Kong and Macao together in a free trade zone, aiming for liberalisation of trade in services between Guangdong province and Hong Kong by the end of 2014.

The governments of Hong Kong and Guangdong have jointly invested in large infrastructure projects, creating new transport links between Hong Kong and the Pearl River Delta. Construction of the Guangzhou-Shenzhen-Hong Kong Express Rail Link and the Hong Kong-Zhuhai-Macao Bridge, started in 2010 and is making steady progress.

In response to calls from the local business community, Hong Kong has become more active in regional and plurilateral initiatives to maintain its competitiveness as a regional trading/services hub. Hong Kong initially planned to join the Association of Southeast Asian Nations (ASEAN) - China free trade area but eventually accepted ASEAN's proposal to negotiate a bilateral agreement. In May 2013, Hong Kong announced that it would take part in negotiations for the Trade in Services Agreement (TiSA) involving 23 World Trade Organisation members. In addition to the CEPA, Hong Kong has signed free trade agreements with New Zealand, the European Free Trade Association and Chile.

Domestically, addressing the overheated property market was a key priority for the government in 2013. A series of measures were rolled out to dampen demand, including

sizeable stamp duties on property transactions and tightening up mortgage lending rules. The government also abolished a 14-year-old application list mechanism and resumed the lead in selling government sites in the annual Land Sale Programme through government-initiated land sale. House prices stabilised noticeably as a result and the volume of sales plunged by 37.7%<sup>6</sup> in 2013. Faced with the risk of an asset bubble in an extremely low interest rate environment, the government repeatedly voiced its determination to keep these stringent fiscal measures in place, despite pressure from the real estate sector. Chief Executive Leung also pledged to increase the housing supply to tackle the soaring house prices that were pushing home ownership out of reach of the general public and fuelling social discontent. The government announced a supply-led housing strategy with a target of creating 470 000 new housing units over the coming decade, of which 60% would be public housing.

The government stepped up its efforts to address the widening income and wealth gaps. A major move was the publication, for the first time, of an official poverty line for Hong Kong in September 2013 which was set at half of median monthly household income. Analysis of the situation in 2012 showed that before intervention, there were 541 000 households with a total of 1 312 000 people falling below the line and the poverty rate was 19.6%. After intervention, around one million people lived below the poverty line, representing a poverty rate of 15.2%. The publication of the poverty line has raised expectations that the government would put more effective measures in place to alleviate poverty.

The government launched a four-month consultation on Hong Kong's population policy in October 2013, with a view to forging a consensus and formulating sustainable policy measures. It is estimated that the labour force will start declining from 2018. Alleviating poverty and helping the ageing population will both be key long term fiscal challenges. The government will need to manage a complex and controversial policy agenda in the coming years, including: increasing productivity; attracting talent; importing labour; assimilating new immigrants; social welfare; elderly care; fiscal sustainability; managing economic growth while maintaining a balanced and harmonious society.

Hong Kong's business community was vocal on the issue of manpower shortage, calling for relaxation of the labour import regime. The Hong Kong General Chamber of Commerce claimed that there were up to 110 000 unfilled vacancies (as of July 2013), close to the historic high of 122 000 in 1989. Construction, retail trade, catering and care consistently suffered from labour shortages. The issue may generate heated debates between labour unions, legislators and business leaders in the future. Against a backdrop of favourable labour market conditions, wages increased considerably in 2013. Lower-skilled workers also received significant wage increases, reflecting the generally tight labour market conditions. The statutory minimum wage was increased from HKD 28 to HKD 30 in May 2013.

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<sup>6</sup> The number of agreements for purchase of residential property declined to 50 676 in 2013 from 81 333 in 2012, according to the Hong Kong SAR government.

The government rolled out two important environmental policy plans in 2013: ‘A clean air plan for Hong Kong’ and ‘Sustainable use of resources 2013–22’. It also replaced its air pollution index with a new health-based air quality index providing people in Hong Kong with information on the short-term health risk based on real time readings of air pollution levels. With a target of reducing solid waste by 40% within ten years, the action plan on resources includes a possible waste-charging scheme, expanding the existing landfills and building a new incinerator, encouraging more recycling and waste reduction at source. The public is increasingly concerned by and interested in issues relating to the environment. Implementing these government plans would require a strong political commitment, public engagement, support from the community at large and cross-border cooperation within the Pearl River Delta, particularly for clean air initiatives.

## **EUROPEAN UNION — HONG KONG RELATIONS AND COOPERATION**

In 2013, bilateral relations and cooperation between the European Union and Hong Kong continued to develop and strengthen. Hong Kong remains an important player in the region and a key conduit for two-way trade and investment flows between the EU and mainland China.

The EU retained its position as Hong Kong’s second largest trading partner after mainland China<sup>7</sup>. Bilateral trade in goods between the EU and Hong Kong recorded growth of 3.9% to reach EUR 46 billion in 2013, with the EU enjoying a growing trade surplus<sup>8</sup>.

The EU was the largest source of foreign companies in Hong Kong, with a total of 1921 companies, comprising 452 regional headquarters, 725 regional offices and 744 local offices (as of June 2013)<sup>9</sup>. EU businesses are active in a wide variety of sectors, mainly financial and business services, trading, logistics, construction and retailing. EU companies are key players in Hong Kong’s banking, insurance and securities sectors. As home to one of the biggest European business communities in Asia, it continues to attract a considerable number of European citizens to live and work there.

Investment relations between the EU and Hong Kong have strengthened significantly in recent years. EU foreign direct investment (FDI) outflows to Hong Kong quadrupled from EUR 3.7 billion in 2009 to EUR 15 billion in 2012,<sup>10</sup> reflecting EU business’ sustained interest in Hong Kong as an investment hub. FDI inflows from Hong Kong to the EU recorded an annual average amount of EUR 5.3 billion over the same period. FDI stock held by the EU in Hong Kong rose from €0 billion in 2009 to €133 billion in 2012. Conversely, FDI stock held by Hong Kong in the EU almost doubled from €27.5 billion to €50 billion during the same period.

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<sup>7</sup> The ranking is based on the trade statistics released by the Hong Kong Census and Statistics Department.

<sup>8</sup> Source: Eurostat: Comext database.

<sup>9</sup> Source: Hong Kong Census and Statistics Department

<sup>10</sup> FDI data retrieved from Eurostat on 16 December 2013.

The EU business community prizes Hong Kong's respect for the rule of law, its high standards of transparency, its freedom of information and of the media, its preferential access to the mainland Chinese market and the availability of high-quality service providers. The EU considers these factors essential for Hong Kong's continued prosperity and for maintaining its strength as a regional and international business centre.

The seventh structured dialogue meeting between the European Union and the Hong Kong SAR government took place in Hong Kong on 14 November 2013. The structured dialogue is an effective platform that allows the EU and Hong Kong to discuss issues of mutual interest and identify areas for future cooperation. At the 2013 meeting, both sides agreed to strengthen collaboration and exchanges in relation to education, innovation, the environment and competition law. The EU appreciated Hong Kong's efforts to update its financial services regulations and its active engagement against money laundering activities and the financing of terrorism. The EU expressed its wish to engage Hong Kong in technical discussions about the automatic exchange of tax information taking into account international developments in the field of cooperation between tax authorities and to see swift progress on updating the air services agreements between the EU Member States and Hong Kong so that their bilateral air services agreements comply with the EU designation clause. The EU also expressed the wish to intensify regulatory dialogue in the area of investment funds.

2013 saw a number of high-level visits from the European Union institutions to the Hong Kong SAR. The most high-profile visit was that of European Commission President José Manuel Barroso in November, during which he met with the Hong Kong Chief Executive and the President of the Legislative Council. President Barroso spoke at an event marking the 20th anniversary of the European Union Office to Hong Kong and Macao, underlining the long-standing ties between the EU and Hong Kong and the EU's commitment at the highest level to continuing to develop this relationship. Another high-level visit was that of the Chair of the European Banking Authority, Andrea Enria, in March. Regular visits by senior officials have ensured exchanges in areas of common interest including European Union external relations, financial services regulation, macroeconomic issues, trade and investment, product and food safety and the environment and competition. Four delegations of the European Parliament also visited Hong Kong and helped to further improve bilateral relations and cooperation with the Legislative Council.

European business in Hong Kong is primarily represented by the European Chamber of Commerce, which carried out a number of activities to facilitate dialogue with the government and enhanced the profile of EU business and industry in 2013. Some of the Chamber's activities during the year were carried out in partnership with the Hong Kong EU Academic Programme (EUAP) which was launched on 1 September 2012. EUAP comprises a consortium led by the Hong Kong Baptist University, including the Chinese University of Hong Kong, the University of Hong Kong and Lingnan University. It promotes academic research, develops outreach activities to enhance the visibility of the EU and strengthens academic cooperation with EU higher education institutions.

To further strengthen ties with Hong Kong, diplomatic missions from the EU and its Member States continued to pursue public diplomacy efforts to raise the EU's profile in Hong Kong, increase knowledge of EU policies and provide more information about them. These policies include trade and regulatory policies, energy and climate change, financial services regulation, customs matters, gender equality policies, intercultural dialogue, academic matters and the EU's role in the world. A key vehicle for this has been the fruitful series of meetings between the EU Heads of Missions, senior members of the Hong Kong Government and Legislative Council and other leading figures.

The EU diplomatic missions also worked together to enhance people-to-people contacts and promote academic exchanges, with joint activities such as the EU Higher Education Fair, the EU Film Festival and the 'Model EU' initiative.

The EU will continue to nurture its relationship with Hong Kong, increase economic, trade and investment links, further cooperation with business and civil society and promote mobility and exchanges with the people of Hong Kong. Key priorities for 2014 include: financial services regulation and taxation; customs matters; intellectual property rights enforcement; further developing education, research, trade and investment ties.