Chapter 3

The Economy

The Hong Kong economy emerged swiftly from the 2009 global recession triggered by the financial crisis, achieving a full-fledged upturn in 2010. The external and domestic sectors both fared strongly and the labour market improved. Inflation rose, however, mainly due to higher import prices. Domestic prices also rose along with the robust economy.

2010 was a year of broad-based expansion for the Hong Kong economy, marked by flourishing exports, vibrant inbound tourism, strong consumer spending, and a bounce-back in investment. For 2010 as a whole, the Gross Domestic Product (GDP) expanded by 6.8 per cent in real terms, more than offsetting the 2.7 per cent contraction in 2009.

Economic activities sustained strong momentum throughout the year. On a year-on-year comparison, real GDP leaped by 8.1 per cent in the first quarter of 2010, 6.4 per cent in the second quarter, 6.7 per cent in the third quarter, and a still notable 6.2 per cent in the fourth quarter even against a higher base of comparison. On a seasonally adjusted quarter-to-quarter comparison, real GDP expanded solidly throughout the four quarters, by 1.8 per cent, 1.7 per cent, 0.9 per cent and 1.5 per cent respectively *(Chart 1)*.

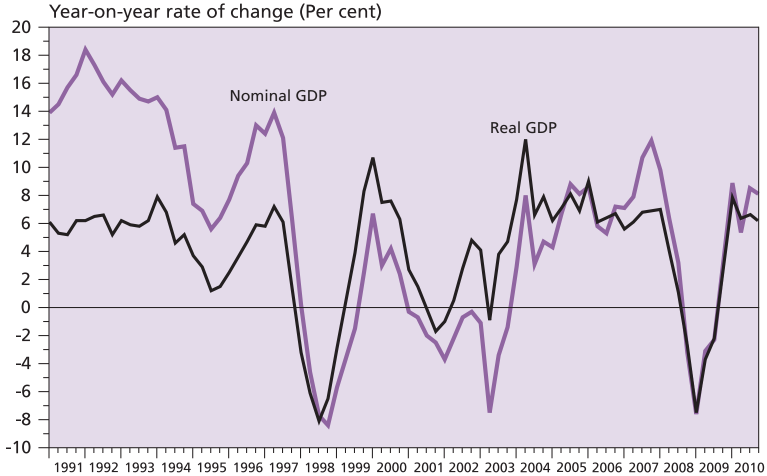
Merchandise exports sprang back sharply in 2010 from the plunge triggered by the collapse in global trade flows in early 2009. Vibrant growth in the Asia region, particularly the Mainland, provided the main impetus. Reviving demand from the advanced economies also contributed, although exports to these markets had yet to return to their pre-crisis levels.

Exports of services maintained strong growth across the board in all four quarters, amid buoyant inbound tourism, flourishing trade flows, and thriving fund-raising and other commercial activities.

The domestic sector also held up well. Private consumption expenditure was strong throughout the year, supported by improving labour market and income conditions. Investment staged a notable rebound amid sanguine business sentiments.

The surge in public sector building and construction activities also supported domestic demand.

Chart 1 **Quarterly Gross Domestic Product**



The labour market saw widespread and notable improvements during 2010. Total employment rose to an all-time high by the end of the year, surpassing the previous peak in early 2008. Vacancies likewise surged across many sectors. With improving labour demand, the seasonally adjusted unemployment rate fell successively from a high of 5.5 per cent in June-August 2009, to 4 per cent in the fourth quarter of 2010, the lowest since end-2008. The underemployment rate also declined steadily from a high of 2.4 per cent in mid-2009 to 1.8 per cent in the fourth quarter of 2010. Much of the slack in the labour market was worked off in 2010, resulting in a recovery in wages during the year.

Underpinned by further recovery of the economy, abundant liquidity and extremely low interest rates, the residential property market was buoyant in most parts of 2010. For the year as a whole, the number of transactions surged by 18 per cent to 135 778, the highest level since 1997. Overall flat prices in the fourth quarter of 2010 also soared by another 22 per cent over a year earlier, and flat rentals by 17 per cent.

The Government introduced successive packages of measures in February, April, August and November 2010 to ensure a stable and healthy property market. In October, the Chief Executive also announced a series of short, medium and long-term measures in his Policy Address. These packages of measures have achieved noticeable results in raising flat supply, increasing transparency of the property market, preventing excessive growth of mortgage lending and curbing speculative activities.

The local stock market ended 2010 higher than the previous year, but performance was interspersed with episodes of fluctuation in tandem with other markets worldwide. Sentiments in the stock markets waned in early 2010 on indications of exit strategies in the major economies. They were then hit by intensified concerns over the sovereign debt issue in Europe in April and May. The Hang Seng Index (HSI) fell to 18 986 on May 25, the lowest in 2010. Sentiments turned more bullish again in the autumn on another round of quantitative easing in the US (i.e. QE2). The HSI rose in early November to a peak close to 25 000, before retreating on renewed concerns over the fragile debt situation in Europe, notably Ireland. The HSI closed the year at 23 035, 5.3 per cent higher than at end-2009. Fund-raising activities were intense in 2010, amid the robust economic conditions and ample liquidity. Total Initial Public Offering (IPO) funds raised in 2010 amounted to $445 billion, 79.3 per cent more than in 2009, again making Hong Kong the top IPO centre in the world.

Inflation increased progressively in 2010, driven mainly by higher import prices amid the surge in global food and other commodity prices, rising inflation in import sources, and a slightly weaker US dollar. Domestic cost pressures, especially on the rental front, also emerged alongside the robust economic conditions. In 2010, the underlying Composite Consumer Price Index rose by 1.7 per cent, faster than the increase of 1 per cent in 2009. Yet the phenomenon of rising inflation also featured in many other Asian economies where economic growth was vibrant.

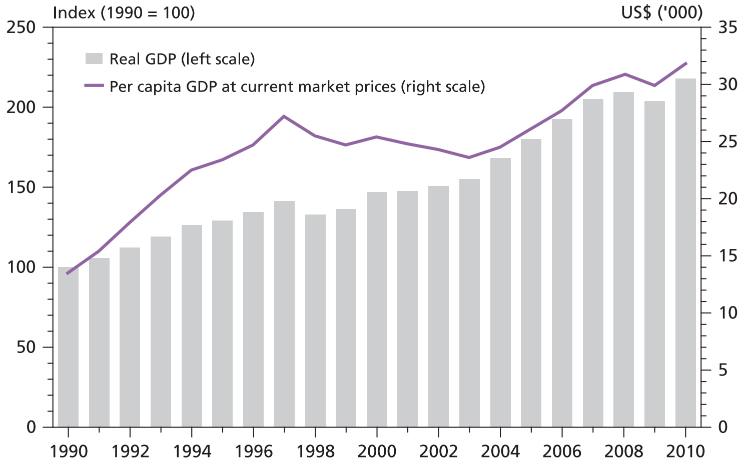
Structure and Development of the Economy

Hong Kong is a global centre for world trade, finance, business and telecommunications with its strategic location on the doorstep of the Mainland's vast booming economy. Hong Kong is currently the world's 10th largest trading entity. It operates one of the world's busiest container ports in terms of container throughput, as well as one of the world's busiest airports in terms of number of international passengers and volume of air cargo handled. Hong Kong is also the world's 13th largest banking centre in terms of gross external positions of banks, and the sixth largest foreign exchange trading centre. Its stock market is the third largest in Asia in terms of market capitalisation.

As an international business hub, Hong Kong has a business-friendly environment with the rule of law, free trade and free flow of information, open and fair competition, a well-established and comprehensive financial network, a superb transport and communications infrastructure, sophisticated support services, and a flexible labour market with a well-educated and highly motivated workforce complemented by a pool of efficient and energetic entrepreneurs. Moreover, it has substantial foreign exchange reserves, a fully convertible and stable currency, prudent fiscal management and a simple tax system with low tax rates. In view of these virtues, Hong Kong has retained its rating by the Heritage Foundation as the freest economy in the world, a position it has held since 1995. The Fraser Institute of Canada has also consistently ranked Hong Kong as the world's freest economy.

The size of the Hong Kong economy more than doubled in the past two decades, its GDP expanding at an average annual rate of 4 per cent in real terms, surpassing the world economy's growth of 3.4 per cent. Over the same period, Hong Kong's per capita GDP also rose significantly, posting an average annual growth rate of 2.9 per cent in real terms. At US$31,800, Hong Kong's per capita GDP was one of the highest in Asia in 2010 *(Chart 2)*.

Chart 2 **Gross Domestic Product**



Over the past two decades, the Hong Kong economy grew by an average of 4 per cent in real terms, outpacing the 3.4 per cent growth for the world economy. Hong Kong's per capita GDP is among the highest in Asia.

Under the growing influence of globalisation and bolstered by deepening regional integration and vibrant growth in Asia, Hong Kong's trade linkages have risen continuously. Trade in goods expanded almost four times in real terms over the past two decades, and trade in services almost three times. In 2010, the total value of visible trade (comprising re-exports, domestic exports and imports of goods) reached $6,456 billion, equivalent to 369 per cent of GDP. This was considerably larger than the ratios of 212 per cent in 1990 and 244 per cent in 2000. Including the value of exports and imports of services, the ratio of total trade to GDP was even higher, at 440 per cent in 2010, compared to 253 per cent in 1990 and 282 per cent in 2000.

The stock of inward direct investment in Hong Kong was significant, at $8,533 billion in market value at the end of 2010, equivalent to 488 per cent of GDP. It served as another strong indicator of Hong Kong's increasingly international focus. Hong Kong is among the most preferred destinations for inward direct investment in Asia.

The corresponding figures for Hong Kong's stock of outward direct investment were likewise huge, at $7,374 billion and 422 per cent of GDP. As an international financial centre with huge cross-territory fund flows, Hong Kong's external financial assets and liabilities were also substantial, at $22,431 billion and $17,037 billion respectively at the end of 2010. The corresponding ratios to GDP in that year were 1 283 per cent and 975 per cent. Reflecting Hong Kong's sound international investment position, its net external assets amounted to $5,394 billion at the end of 2010, equivalent to 309 per cent of GDP.

The Gross National Product (GNP), comprising GDP and net external factor income flows, stood at $1,784.7 billion in 2010. This was higher than the corresponding GDP by 2 per cent. The difference represented a net inflow of external factor income. In gross terms, inflows and outflows of external factor income remained substantial in 2010, at $905.4 billion and $868.9 billion respectively, equivalent to 52 per cent and 50 per cent of GDP respectively. This was related to the huge volumes of inward and outward investment in Hong Kong.

Contributions of the Various Economic Sectors

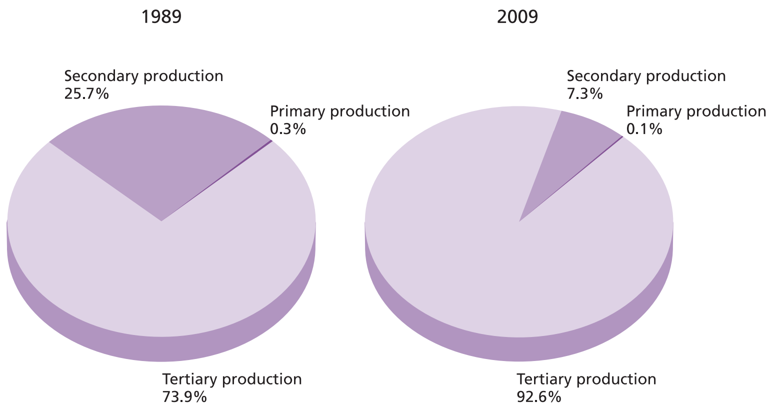
Primary production (including agriculture, fisheries, mining and quarrying) is insignificant in Hong Kong in terms of both value-added contribution to GDP and share in total employment, as the city is a predominantly urban economy.

Secondary production (comprising manufacturing, construction, and supply of electricity, gas and water), which contributed greatly to the value-added component of the total economy in the early 1980s, has since diminished in relative importance. Within this broad sector, the value-added contribution from manufacturing shrank from 19 per cent in 1989 to 5 per cent in 1999 and to only 2 per cent in 2009. The construction sector's contribution to GDP stayed at around 5 per cent between 1989 and 2000, before edging down in the following years to 3 per cent in 2009. The supply of electricity, gas and water held relatively stable, with a share of around 2-3 per cent of GDP over the past two decades.

Hong Kong's economy has become increasingly service-oriented since the 1980s. The Mainland's open-door policy and economic reforms have not only provided an enormous production hinterland and market outlet for Hong Kong's manufacturers, but also created abundant business opportunities for a wide range of service providers. Hong Kong has continued to re-orientate itself towards service activities, prompted by the changing regional and global economic environment and also by closer integration with the Mainland. In particular, while the thriving Mainland economy has provided ample business opportunities for Hong Kong's services sector, the availability of cheaper land and labour on the Mainland side giving rise to improved competitiveness and productivity there has also propelled Hong Kong's move up the value chain.

As a result, the share in GDP of the tertiary sector – comprising the import/export, wholesale and retail trades; accommodation and food services; transportation, storage, postal and courier services; information and communications; financing and insurance; real estate, professional and business services; public administration, social and personal services; and ownership of premises – has risen progressively over the years, to 93 per cent in 2009 *(Chart 3)*. Development on the employment front was similar. Over the past two decades, the tertiary sector employed significantly more workers while the share of employment in secondary production continued to shrink *(Chart 4)*.

Chart 3 Gross Domestic Product by Broad Economic Sector



Over the past two decades, the economy has become increasingly service-oriented.

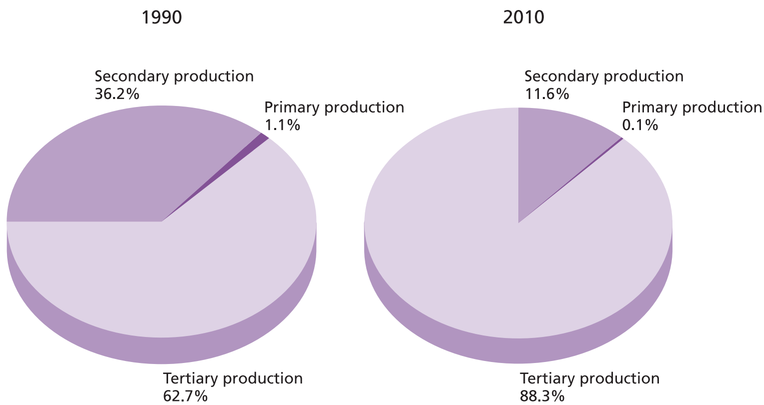
Note: Due to adoption of the Hong Kong Standard Industrial Classification Version 2.0, the series from 2000 onwards are not strictly comparable with those of the earlier years.

The Services Sector

The services sector has become the mainstay of Hong Kong's economy and the key driver of growth, having fared strongly on a broad front along with the economy's structural transformation in recent decades. Services related to trading and tourism; community, social and personal services; financial services such as banking and insurance; and a host of business and professional services such as real estate, have all grown significantly.

The services sector displayed much resilience against the downturn of 2009 triggered by the global financial crisis, and subsequently expanded robustly in 2010. Over the past five years between 2005 and 2010, the value-added part of the services sector grew by a cumulative 23 per cent in real terms, outpacing the corresponding 21 per cent growth of the economy. Among the constituent service sectors, financing and insurance showed the fastest cumulative growth of 56 per cent, a testament to Hong Kong's drive as an international financial centre. Import and export trade also performed impressively, with a 26 per cent increase in the value-added component of its trading activities over the period. This, together with a notable growth of 16 per cent in transport and storage services, underlined the competitiveness of Hong Kong's trading and logistics sector. The steep increase of 40 per cent in wholesale and retail trades, as well as the strong growth of 18 per cent in accommodation and food services, were underpinned by the strength of domestic demand and the vibrancy in inbound tourism.

Chart 4 **Employment by Broad Economic Sector**



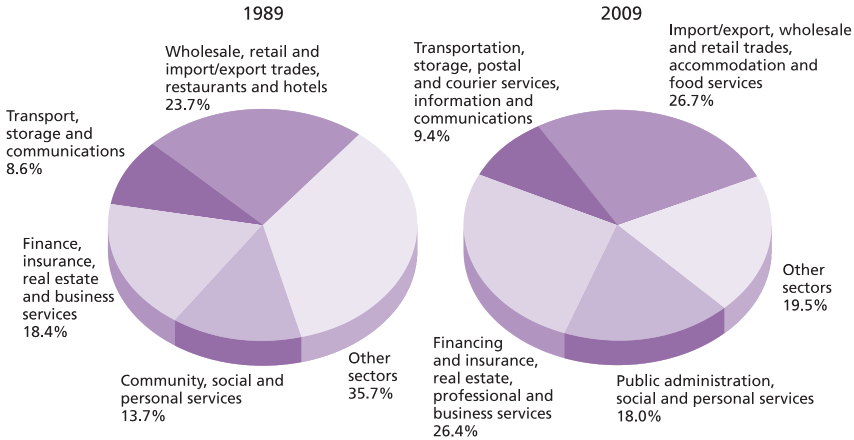
Over the past two decades, the share of the services sector in total employment greatly increased, whereas the share of the industrial sector kept on shrinking.

Notes: The compilation methodology of composite employment estimates was reviewed in June 2005. Employment figures from 1996 onwards have thus been revised accordingly. They are not strictly comparable with those of the earlier years.

Starting from the first quarter of 2009, industrial classification of employment has adopted the Hong Kong Standard Industrial Classification Version 2.0 while that in the previous years is based on Version 1.1.

In 2009, the services sector contributed 93 per cent to GDP. The import/export, wholesale and retail trades, and accommodation and food services remained the largest service sectors, accounting for 27 per cent of the GDP. This was followed by financing and insurance, real estate, professional and business services (26 per cent), public administration, social and personal services (18 per cent), transportation, storage, postal and courier services, and information and communications (9 per cent) *(Chart 5)*. More specifically, of the four key industries, trading and logistics accounted for 24 per cent of value-added contribution to GDP in 2009, financial services 15 per cent, professional and other producer services 13 per cent, and tourism 3 per cent.

Chart 5 Gross Domestic Product by Major Service Sector



The import/export, wholesale and retail trades, accommodation and food services sector, and the financing and insurance, real estate, professional and business services sector remained the two largest service sectors in terms of net output in 2009.

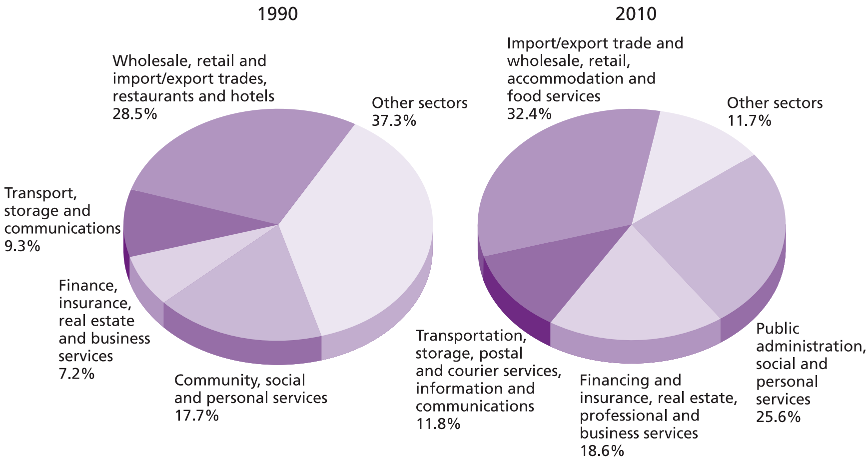
Note: Due to adoption of the Hong Kong Standard Industrial Classification Version 2.0, the series from 2000 onwards are not strictly comparable with those of the earlier years.

The profound structural change in the economy towards the services sector was also borne out by a shift in the sectoral composition of employment. Over the past two decades, the share of the services sector in total employment increased from 63 per cent in 1990 to 83 per cent in 2000 and 88 per cent in 2010. As for individual services, import/export trade and wholesale, retail, accommodation and food services accounted for 32 per cent of the total in 2010. This was followed by public administration, social and personal services with a share of 26 per cent; financing and insurance, real estate, professional and business services, 19 per cent; transportation, storage, postal and courier services, information and communications, 12 per cent *(Chart 6)*.

The Manufacturing Sector

Hong Kong's manufacturing sector continues to be versatile and resilient in coping with the changing environment. Thanks to the increased manufacturing arrangements in the Mainland, not only has Hong Kong's productive capacity been effectively expanded, its overall productive efficiency and product quality have also seen significant upgrading along with advances in technology and a shift towards production with a more knowledge-based and higher value-added content. It is also worth noting that although the direct value-added contribution of the manufacturing sector to the economy is not large relative to the services sector, its well-established linkages with the Mainland economy have provided ample business opportunities that go hand in hand with the growth of Hong Kong's services sector.

Chart 6 Employment by Major Service Sector



Import/export trade and wholesale, retail, accommodation and food services employed the most people in 2010.

Notes: The compilation methodology of composite employment estimates was reviewed in June 2005. Employment figures from 1996 onwards have thus been revised accordingly. They are not strictly comparable with those of earlier years.

Starting from the first quarter of 2009, industrial classification of employment has adopted the Hong Kong Standard Industrial Classification Version 2.0 while that in previous years is based on Version 1.1.

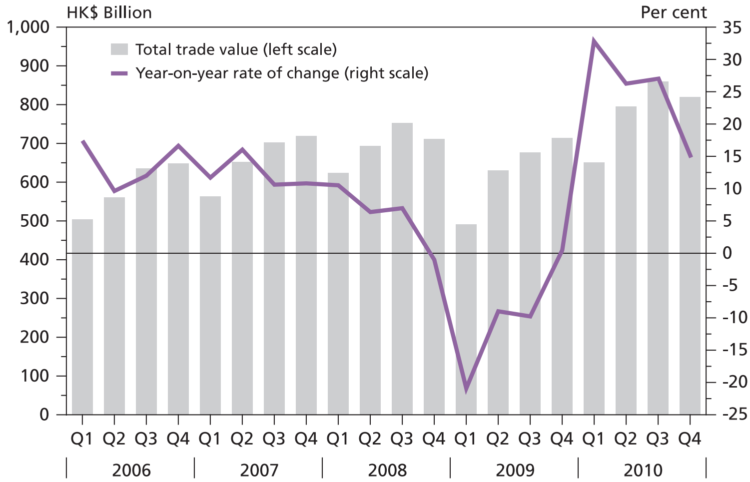
Economic Links between Hong Kong and the Mainland

Since the introduction of the Mainland's open door policy in 1978, the continuing economic integration between the Mainland and Hong Kong has brought enormous mutual benefits to both places. The huge flows of goods, services, people and capital between Hong Kong and the Mainland and between the Mainland and the world through Hong Kong have created remarkable growth in income and employment in both Hong Kong and the Mainland.

Visible trade between Hong Kong and the Mainland has soared by 288 times since 1978, at an average annual rate of 19 per cent in value terms *(Chart 7)*. Hong Kong and the Mainland are currently ranked the 10th and the second largest trading entities respectively in the world.

The Mainland has long been Hong Kong's largest trading partner, accounting for 49 per cent of Hong Kong's total trade value in 2010. Of Hong Kong's re-export trade, 91 per cent was related to the Mainland, making it the largest market for and the largest source of Hong Kong's re-exports. Reciprocally, Hong Kong was the Mainland's fourth largest trading partner (after the European Union, the United States and Japan), accounting for nearly 8 per cent of the Mainland's total trade value in 2010.

Chart 7 Visible Trade between Hong Kong and the Mainland



There has been a notable expansion in merchandise trade between Hong Kong and the Mainland, except for 2009 with the impact of the global financial tsunami.

Hong Kong is also a principal gateway to and from the Mainland for business and tourism. The number of trips made by foreign visitors to the Mainland through Hong Kong rose by a cumulative 42 per cent in the past 10 years, or at an average annual growth rate of 3.6 per cent, reaching 4.3 million trips in 2010. Correspondingly, the number of trips made by Mainland residents to or through Hong Kong rose by nearly five times over the decade, at an average annual growth rate of 20 per cent, to 22.7 million trips in 2010.

Hong Kong continues to be the Mainland's largest source of foreign direct investment. According to the Mainland's statistics, the cumulative value of Hong Kong's realised direct investment in the Mainland reached US$456 billion at end-2010, accounting for 42 per cent of the total inward direct investment there. Over the years, the composition of Hong Kong's direct investment in the Mainland has shifted gradually from industrial processing to a wider spectrum of business ventures such as hotels and tourist-related services, real estate, retail trade, infrastructure construction, and various business and communications services.

Hong Kong has closer economic links with Guangdong than other places on the Mainland. By the end of 2010, the cumulative value of Hong Kong's realised direct investment in Guangdong was US$156 billion, accounting for 62 per cent of its total inward direct investment.

Hong Kong's huge direct investment in the Mainland has contributed to the latter's industrialisation and, at the same time, facilitated the rapid structural change in the Hong Kong economy.

The Mainland is likewise Hong Kong's largest source of foreign direct investment. By end-2009, the market value of direct investment from the Mainland in Hong Kong reached US$341 billion, accounting for 36 per cent of the total external direct investment. Mainland companies also maintain a strong presence in Hong Kong. As at mid-2010, Mainland companies had established 261 regional headquarters or regional offices, and 528 local offices in Hong Kong. All these reflected Hong Kong's position as a regional services hub.

In tandem with the surge in cross-boundary business activities, financial links between Hong Kong and the Mainland have strengthened substantially over the years.

Hong Kong is a major funding centre for Mainland enterprises. A total of 592 Mainland enterprises were listed on Hong Kong's stock market as of end-2010. Among them, 72 were listed in 2010. Driven by the strong economic performance of the Mainland, a total of $473.6 billion of equity funds was raised by Mainland enterprises during 2010. The listing and fund-raising activities further consolidated Hong Kong's position as one of the world's major fund-raising centres.

In addition, Renminbi (RMB) business in Hong Kong continued to develop steadily in 2010. At year's end, a total of 111 licensed banks engaged in RMB services business, and outstanding RMB deposits reached RMB314.9 billion, accounting for around 11.5 per cent of total foreign currency deposits in Hong Kong. The RMB bond market in Hong Kong has been growing steadily since its launch in June 2007. By the end of 2010, RMB bonds totalling RMB74 billion had been issued in Hong Kong. There has been a significant increase in the range of issuers from Hong Kong and multinational companies to international financial institutions. Moreover, the expansion of the RMB trade settlement pilot scheme announced on June 22, 2010 allows trade transactions of 20 provinces and cities in the Mainland to be settled in Hong Kong in RMB. A variety of RMB financial products also emerged in the market, including RMB fixed-income funds. In addition, life insurance companies in Hong Kong are now offering policies in RMB. The rapid expansion of RMB business in Hong Kong signified the Mainland's recognition of Hong Kong as its premier international financial centre.

The economic co-operation and integration with the Mainland has been fostered through the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA). In May 2010, the Hong Kong Special Administrative Region Government and the Central People's Government signed Supplement VII to CEPA, introducing 35 market liberalisation and trade and investment facilitation measures in 19 sectors. Among them, 27 are liberalisation measures in 14 service sectors, of which eight are measures for 'early and pilot implementation'. Inclusive of the measures in Supplement VII, Hong Kong Service Suppliers can enter the Mainland market in 44 service sectors under preferential treatment. The new measures will further assist Hong Kong service industries to enter the Mainland market, and foster integration and professional exchanges between the service industries of both sides.

There was also notable development in strengthening further the transport links between Hong Kong and the Mainland. The construction of the Hong Kong section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link commenced in January 2010 for completion by 2015. The improvement of cross-boundary infrastructure will enhance the flow of people and goods within the greater Pearl River Delta and help expedite the integration of Hong Kong with its hinterland.

Hong Kong has the unique advantage of having the Mainland as its hinterland while maintaining an international outlook. With the increasing integration of the Mainland with the global economy and urbanisation and industrialisation in the Mainland, Hong Kong's role as an international financial, trade and shipping centre will continue to be strengthened. This will also help Hong Kong's development on such fronts as financial services, logistics, tourism and information services.

The Economy in 2010

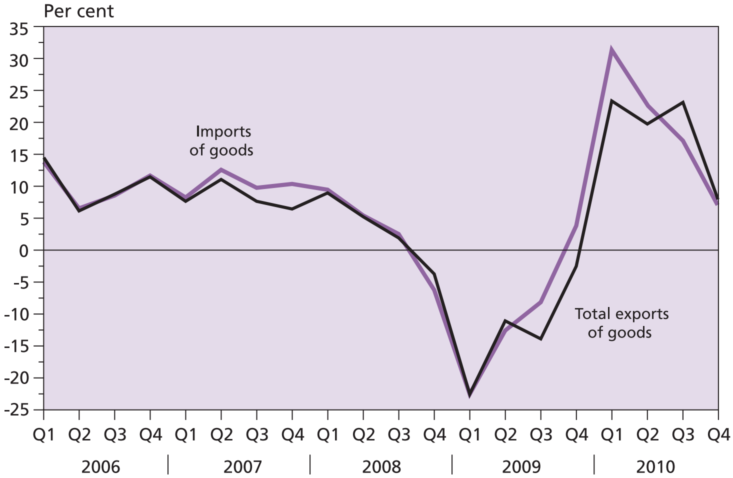
External trade

Hong Kong's merchandise exports maintained robust growth during most of 2010, having reverted to year-on-year growth in late 2009, capitalising on the sustained robust performance of Asian economies as well as the gradual recovery in the advanced economies. In 2010, total exports of goods (comprising re-exports and domestic exports) grew strongly, by 18.1 per cent in volume terms *(Chart 8)*. Such hefty growth partly reflected the depth of the trough in 2009, when there was a record decline of 12 per cent.

On a year-on-year comparison, export growth in the first three quarters of 2010 was particularly large, at 23.4 per cent, 19.7 per cent and 23.2 per cent respectively in volume terms. It then tapered to 7.9 per cent in the fourth quarter, amid the effect of a higher base of comparison and slower pace of expansion in some export markets. On a seasonally adjusted quarter-to-quarter comparison, total exports of goods leaped by 6.7 per cent in volume terms in the first quarter of 2010, and grew further by 3.6 per cent and 1.9 per cent respectively in the second and third quarters, before showing a 4.1 per cent decline in the fourth quarter.

The global economy continued to recover throughout 2010. However, growth pace remained diverse across regions. In the US and Europe, economic recovery proceeded at a moderate pace, partly supported by the earlier stimulus measures and restocking cycle, yet their labour markets were slow to improve. The US housing market remained in a depressed state, and the sovereign debt issue in Europe lingered on. On the other hand, many Asian economies, particularly the Mainland, displayed robust growth throughout 2010. The strong regional demand in Asia, coupled with a gradual revival in the advanced economies, propelled trade flows in the Asian region, rendering staunch support to Hong Kong's export performance in 2010.

Chart 8 **Hong Kong's Visible Trade (year-on-year rate of change in volume terms)**



Merchandise exports staged a sharp rebound in 2010 riding on robust performance in the Asian markets.

The performance of Hong Kong's merchandise exports to the major markets mirrored the two-speed recovery of the global economy. The Mainland and other Asian markets, which account for around 70 per cent of Hong Kong's total exports of goods, remained the key growth driver, registering an increase of around 20 per cent in volume terms in 2010. Exports to the Mainland, Singapore, Taiwan, South Korea and Japan all recorded double-digit growth for the year as a whole, in the region of 15-23 per cent. Exports of raw materials and capital goods to many Asian markets picked up strongly amid brisk production activities and robust investment demand in the region. Exports of consumer goods to the Asian markets also displayed strength, rebounding strongly in 2010, more than offsetting the decline in 2009. However, in the final months of the year, as the stimulus from the restocking cycle in the global economy gradually wore off and as growth in demand in the US and Europe remained modest, industrial production and export activities across Asia saw some moderation, resulting in some tapering of growth in Hong Kong's exports to these Asian markets.

Exports to the US and Europe also rebounded during most of 2010 from the collapse in 2009. However, exports to these markets still fell short of the pre-crisis peaks in 2008. In particular, exports of consumer goods, a dominant proportion of exports to these markets, had yet to make up for the decline in 2009 despite some recovery in 2010. Consumer sentiments remained rather cautious in these advanced economies amid the weak labour market conditions. In particular, the EU market still lagged behind others, as the sovereign debt problem lingered on. Exports to this market decelerated sharply to only a small year-on-year growth in the fourth quarter.

Imports of goods expanded markedly, by 18.6 per cent in volume terms in 2010 after a 9.4 per cent decline in 2009, in tandem with the strong rebound in re-export trade and the strengthening of local demand. Retained imports, referring to imports for domestic uses, went up by 19.7 per cent in volume terms for 2010 as a whole, following the 3.8 per cent decline in 2009. There was a strong year-on-year expansion of 42.1 per cent in the first half of the year, followed by a further increase of 3.8 per cent in the second half of the year as the effect of a much higher base of comparison set in.

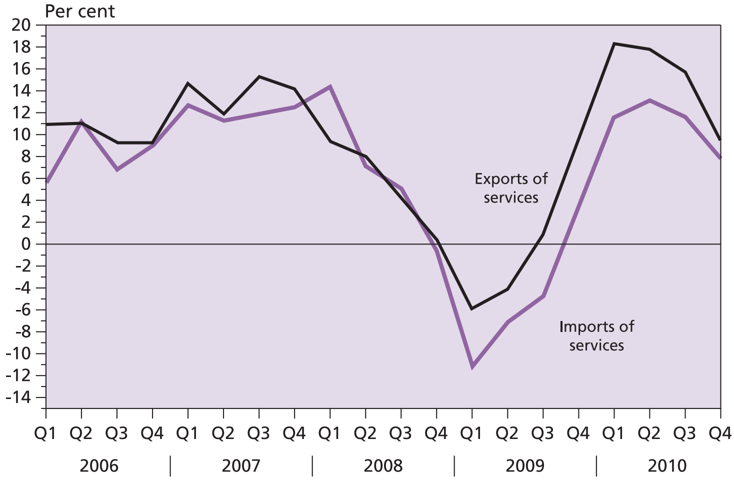
Analysed by end-use categories, retained imports of raw materials and semi-manufactures saw the fastest growth in 2010, at 31.3 per cent in volume terms, albeit reversing to decline in the second half of 2010. Retained imports of consumer goods also performed strongly, up 22.5 per cent amid sanguine consumer sentiments. Retained imports of capital goods surged by 15.5 per cent, in tandem with robust investment and economic activities. Retained imports of fuels and foodstuffs also grew notably by 13.9 per cent and 11.6 per cent respectively in volume terms.

Exports of services sustained strong growth throughout 2010, leaping by 15 per cent in real terms for the year as a whole, following the 0.3 per cent growth in 2009. Despite the higher base of comparison, exports of services still grew at a rapid pace in the fourth quarter of 2010. Among the major service components, exports of travel services showed the strongest performance, thanks to the sizeable influx of visitors from the regional as well as long-haul markets. Exports of trade-related services, reflecting mainly offshore trade, grew sharply in 2010, benefiting from the improved trading environment for Asia. Exports of transportation services likewise surged along with the expansion of trade flows and flourishing passenger flows. Exports of financial and business services were also strong, on the back of intensive fund-raising activities in the financial market and the brisk expansion of business activities.

Imports of services likewise were robust, up 10.9 per cent in real terms in 2010, in contrast to the 4.9 per cent contraction in 2009. Imports of travel services grew solidly along with improving economic conditions. Imports of trade-related services and transportation services both thrived on the strong rebound in offshore trade amid vibrant intra-regional trade flows. Imports of financial and business services also picked up markedly to a double-digit increase in 2010 *(Chart 9)*.

With strong import intake amid the robust upturn in the Hong Kong economy, the visible trade deficit widened in 2010. Nevertheless, this was more than offset by the gain in invisible trade surplus, thanks to vibrant service exports across a broad front. As a result, the combined visible and invisible trade balance in 2010 recorded a surplus of $104.6 billion, equivalent to 2.8 per cent of the total value of imports of goods and services. This compared with the corresponding figures of $121.3 billion and 4 per cent in 2009. The favourable trade balance continued to underline Hong Kong's strong external competitiveness.

Chart 9 **Hong Kong's Invisible Trade (year-on-year rate of change in real terms)**



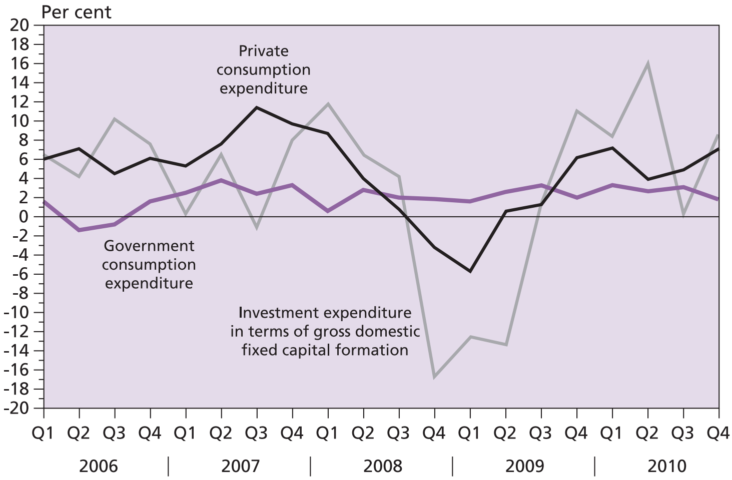
Exports of services sustained strong growth throughout 2010.

Domestic demand

The domestic sector expanded strongly in 2010. Local consumer sentiments stayed upbeat throughout the year, supported by improving job and income prospects, as well as the better performance of the asset markets. Private consumption expenditure (PCE) grew in real terms in all four quarters of 2010. For the year as a whole, PCE grew by 5.8 per cent, up strongly from the 0.6 per cent growth in 2009. On a seasonally adjusted quarter-to-quarter comparison, PCE also expanded throughout 2010. Meanwhile, government consumption expenditure grew steadily in 2010, by 2.7 per cent in real terms, following the 2.3 per cent growth in 2009.

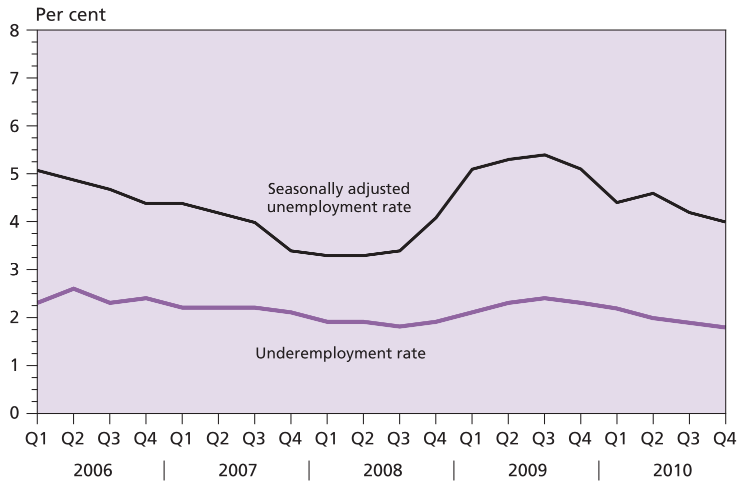
Overall investment spending in terms of gross domestic fixed capital formation showed a notable 8.1 per cent growth in real terms in 2010, the fastest annual expansion after 1997. Private sector investment in machinery and equipment increased for 2010 as a whole, supported by growing business volumes and strong regional economic prospects. After a temporary slowdown in the third quarter, this investment picked up again in the fourth quarter. Indeed, business sentiments among large enterprises as shown by the Quarterly Business Tendency Survey conducted by the Census and Statistics Department generally stayed optimistic in 2010. On the other hand, small and medium enterprises (SMEs) turned somewhat cautious towards the year-end in view of the still elevated level of uncertainty in the external environment. The surge in public sector building and construction activities, driven by the expedition of public sector works and successive implementation of large-scale infrastructure projects, was also a major supporting factor behind the rapid increase in overall investment spending. However, private sector building and construction activity was still weak in 2010 *(Chart 10)*.

Chart 10 **Main Components of Domestic Demand (year-on-year rate of change in real terms)**



Domestic demand held up well in 2010, on the back of strong consumer and business confidence amid improved labour market conditions and brighter prospects.

Chart 11 **The Unemployment and Underemployment Rates**



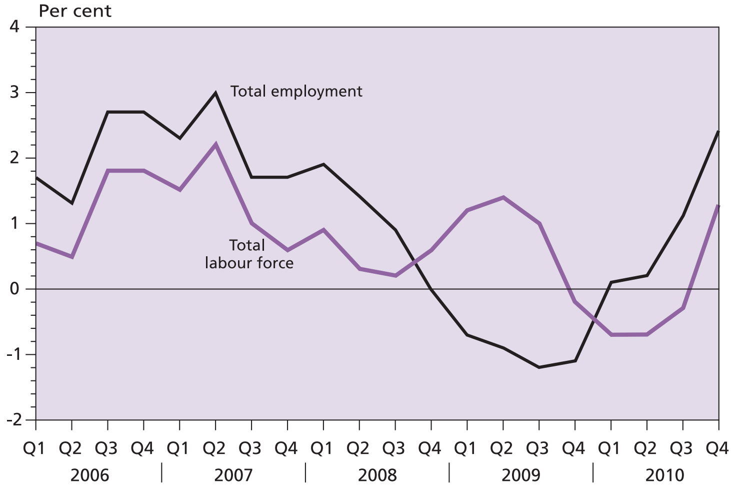
The unemployment rate declined for most of 2010, led by a significant upturn in labour demand.

The Labour Market

Labour market conditions, having staged a gradual turnaround in the second half of 2009, witnessed a noticeable pick-up in the recovery pace in 2010, amid sustained economic growth and job creation. Total employment rose to a historical high of 3 563 700 by the end of the year, while the seasonally adjusted unemployment rate fell to the 4 per cent mark, the lowest level since September–November 2008. Meanwhile, as more and more full-time jobs became available in tandem with the entrenched economic recovery, the underemployment rate also edged lower to 1.8 per cent at year-end *(Chart 11)*.

The labour force showed a slight decrease of 0.6 per cent in 2010, which contrasted with the annual expansion of around 1 per cent in the past few years. This slowdown was attributable to a reduction in the supply of youth labour, which neutralised the effect of increases in the other age groups. On the other hand, total employment went up by 0.4 per cent in 2010, reversing the decrease of 1.1 per cent in the preceding year. The disaggregated data showed that the growth impetus came primarily from new jobs created in the domestically-orientated sectors, including retail, accommodation and food services; real estate; and repair, laundry, domestic and other personal service activities *(Chart 12)*.

Chart 12 **Total Labour Force and Total Employment (year-on-year rate of change)**



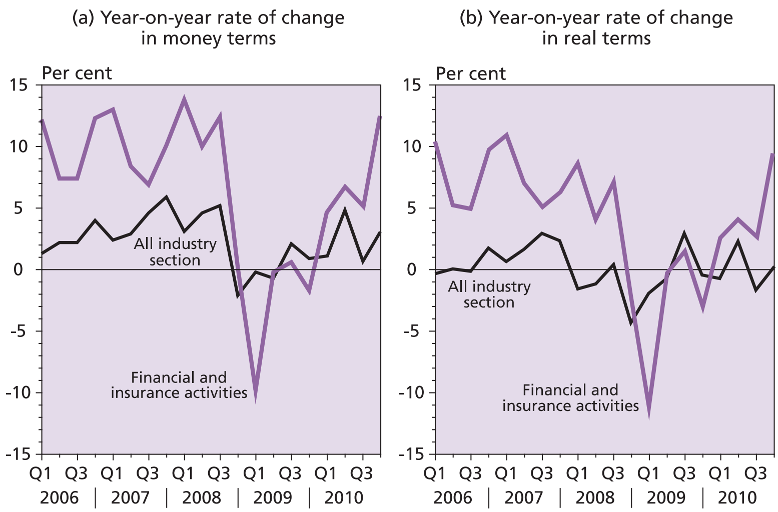
Employment growth outpaced the labour force growth in 2010.

Job vacancies in private sector establishments remained strongly on the increase over the course of 2010, amid reviving business activity and hiring sentiment in the corporate sector. On a year-on-year comparison, private sector vacancies jumped by 39.3 per cent in December 2010, following notable increases of 43.4 per cent and 31.7 per cent in June and September. Meanwhile, the ratio of job vacancies per 100 job-seekers was 35 in December 2010, higher than that of 32 in September. The corresponding ratio for lower-skilled jobs climbed from 31 to 35, and that for higher-skilled jobs from 63 to 64.

The latest surge in job vacancies, while occurring almost across the board, was most visible in the accommodation and food services; financing and insurance, real estate, professional and business services; information and communications; and transportation, storage, postal and courier services sectors.

In tandem with continued improvement in the economy and the labour market, labour earnings in the private sector rose by 2.4 per cent in money terms in 2010, albeit with a slight increase of 0.1 per cent in real terms *(Chart 13)*. Within the workforce, employees engaged in financial and insurance activities enjoyed a distinct increment of 7.2 per cent in their nominal earnings in 2010, followed by those in retail; transportation, storage, postal and courier services; and accommodation and food service activities, with corresponding increases of 3.9 per cent, 3.4 per cent and 3.3 per cent.

Chart 13 **Labour Earnings**

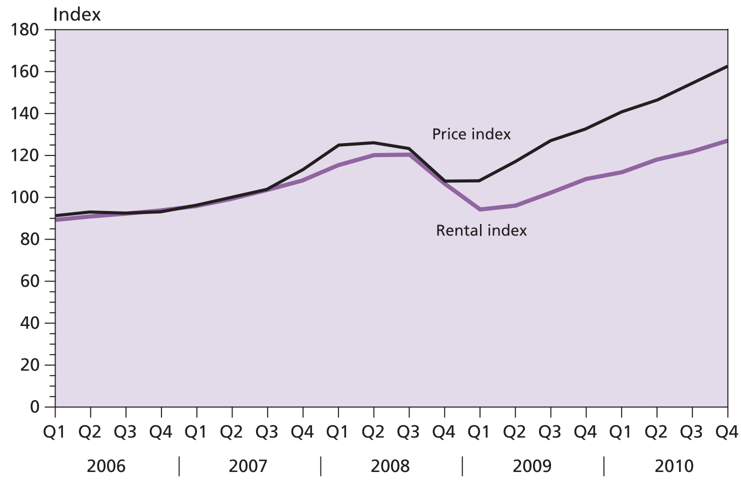


Overall labour earnings reverted to moderate increases both in nominal and real terms in 2010.

The Property Market

The residential property market was buoyant during most of 2010 on the back of further recovery of the economy, abundant liquidity and extremely low interest rates. Residential property prices in the fourth quarter of 2010 soared by another 22 per cent over a year earlier, following a 23 per cent rebound in the preceding year. Overall flat rentals gained by a further 17 per cent over the same period. As a consequence of the rally since early 2009, overall flat prices and rentals were only 4 per cent and 9 per cent respectively below their peaks in 1997 *(Chart 14)*.

Chart 14 **Prices and Rentals of Residential Property (1999=100)**



Both flat prices and rentals soared further in 2010.

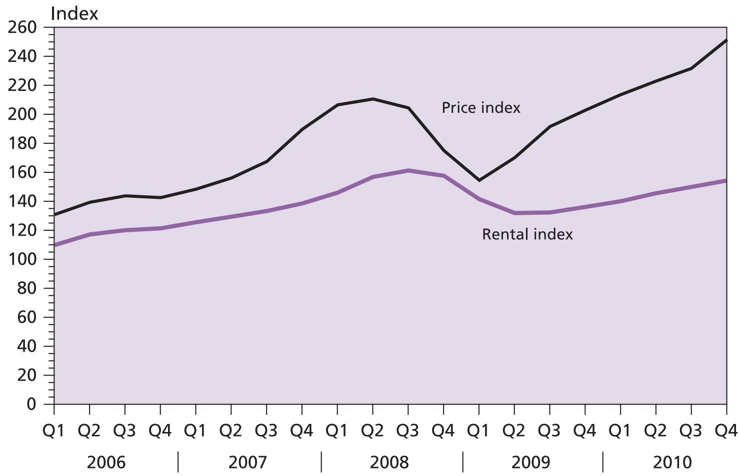
As home prices continued to rise faster than income, the home purchase affordability (i.e. the ratio of mortgage payment for a 45-square metre flat to median income of households, excluding those living in public housing) rose from 38.4 per cent in the fourth quarter of 2009 to 44.5 per cent in the fourth quarter of 2010, and would move even closer to the long-term average of 51.3 per cent over 1990-2009 should interest rates return to a more normal level.

The Government has always been mindful of the risk of a property market bubble, as well as the repercussions of wild fluctuations in property prices on overall economic and financial stability. The Government introduced successive packages of measures in February, April, August and November 2010 to ensure a stable and healthy property market. In October, the Chief Executive also announced a series of short, medium and long-term measures in his Policy Address. The latest package of measures, mainly targeted at curbing speculative activities through the introduction of a Special Stamp Duty (SSD) on short-term resale transactions and further tightening of the loan-to-value ratios for mortgage loans, was announced in November 2010 after the US Federal Reserve introduced the second round of quantitative easing measures. The successive packages of measures have achieved noticeable results in raising flat supply, increasing transparency of the property market, preventing excessive growth of mortgage lending and curbing speculative activities.

Regarding supply, completions of private residential flats rebounded sharply by 87 per cent to 13 400 units in 2010, and are forecast at 10 700 units in 2011. Over the medium term, reflecting the Government's effort in boosting land supply, the total supply of flats in the coming few years (comprising unsold completed flats, flats already under construction but not yet sold and flats on disposed sites where construction has yet to commence) picked up from 53 000 units as estimated at end-2009 to 59 000 units as estimated at end-2010.

Underpinned by the sustained economic recovery, the non-residential property market also firmed up further. For office space, overall sale prices in the fourth quarter of 2010 soared by 24 per cent over a year earlier, with Grade A, B and C office space recording respective gains of 24 per cent, 24 per cent and 25 per cent. Office rentals also rose, albeit by a less rapid 13 per cent. The rise in rentals of Grade A, B and C office space was broadly similar, at 13 per cent, 13 per cent and 14 per cent respectively. Following the rally since 2009, overall office prices have already exceeded their 2008 peak by a wide margin, but rentals were still slightly lower *(Chart 15)*.

Chart 15 Prices and Rentals of Office Space (1999=100)



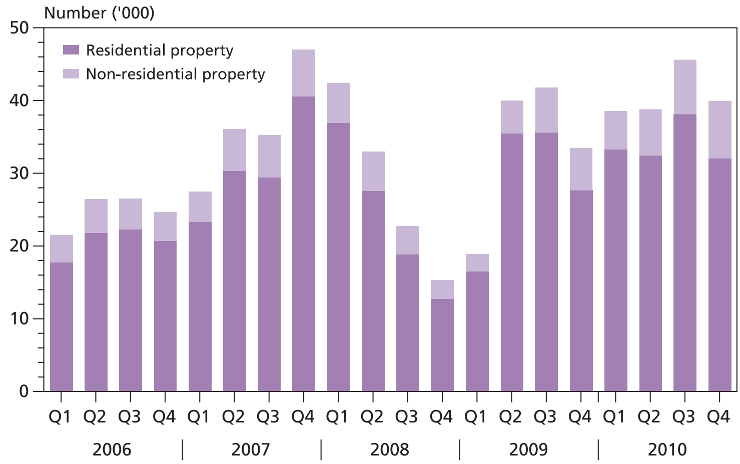
Prices of office space continued to rise at a faster pace than rentals in 2010.

On the back of the robust retail sector, sale prices of retail shop space in the fourth quarter of 2010 soared by 28 per cent over a year earlier, while rentals rose by a less rampant but still substantial 10 per cent. Both prices and rentals of retail shop space have fully recouped the losses suffered during the global financial crisis. Meanwhile, prices and rentals for flatted factory space rose by 30 per cent and 10 per cent respectively. Compared with the 2008 peaks, prices of flatted factory space were already much higher, while rentals were roughly on par.

The vacancy rate for residential property rebounded from a low level of 4.3 per cent at end-2009 to 4.7 per cent at end-2010. Over the same period, vacancy rates for non-residential property fell across the board, from 10.3 per cent to 8 per cent for office space, from 8.7 per cent to 7.9 per cent for commercial space, and from 8 per cent to 6.7 per cent for flatted factory space.

On transactions, the number of sale and purchase agreements for residential property received by the Land Registry surged by 18 per cent to 135 778 in 2010, and total consideration by an even sharper 32 per cent to $560.7 billion, both the highest levels since 1997. Likewise, the number of sale and purchase agreements for non-residential property jumped by 43 per cent to 26 961, and total consideration also by 43 per cent to $128.8 billion *(Chart 16)*.

Chart 16 **Sale and Purchase Agreements by Broad Type of Property**



Overall trading in the property market was active in most parts of 2010.

Price Movements

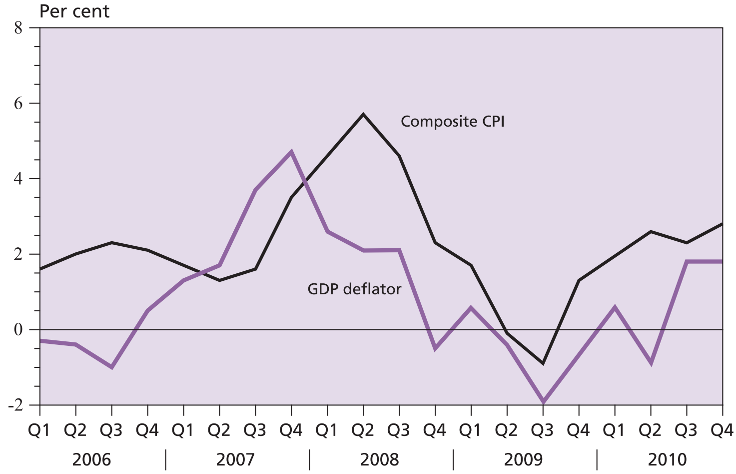
Inflation went up progressively in 2010. Higher imported inflation was a major contributing factor, due to the strong rebounds in food prices and other commodity prices in the international markets on the back of continued global economic recovery and a loose global monetary environment. Domestic price pressures, though still contained, were also on the rise in 2010, being a natural consequence of the brisk expansion of the local economy. In particular, the feed-through of the earlier surge in housing rentals into consumer prices became more evident in the latter part of 2010. During the year, business cost pressures from rising commercial rentals also increased. Labour costs, on the other hand, were still kept in check. The phenomenon of rising inflation over the course of 2010 was not unique to Hong Kong. Indeed, many Asian economies with robust economic growth likewise experienced higher inflationary pressures.

The Composite Consumer Price Index (Composite CPI) rose by an average of 2.4 per cent in 2010, up from 0.5 per cent in 2009. (The figures quoted refer to the 2004/05-based series. The Composite CPI rose by an average of 2.4 per cent in 2010 by reference to the new 2009/10-based series). Netting out the effects of the Government's one-off relief measures to give a more accurate indicator of the inflation trend, underlying consumer price inflation averaged at 1.7 per cent for

2010 as a whole, up from 1 per cent in 2009. This annual increase was relatively moderate, particularly when viewed against the strength of the economic upturn. However, underlying inflation turned more visible towards the latter part of the year, rising from 0.8 per cent year-on-year in the first quarter, to 1.5 per cent and 2 per cent respectively in the second and third quarters, and further to 2.6 per cent in the fourth quarter. (The figures quoted refer to the 2004/05-based series. The corresponding figures of underlying inflation for the fourth quarter and for 2010 as a whole are 2.4 per cent and 1.7 per cent by reference to the new 2009/10-based series).

As a broad measure of the overall change in prices in the economy, the GDP deflator rose by 0.9 per cent in 2010, in contrast to a decrease of 0.6 per cent in 2009. The rebound reflected a reversal to mild inflation from prior deflation in overall prices during the economic recovery. The domestic demand deflator went up by 2.4 per cent in 2010, after a decline of 1 per cent in 2009. On the other hand, the terms of trade deteriorated slightly by 0.8 per cent in 2010, as compared to the 0.2 per cent improvement in 2009 *(Chart 17)*.

Chart 17 **Main Inflation Indicators (year-on-year rate of change)**



Inflation went up progressively and turned more visible towards the latter part of 2010, along with higher import prices and the brisk expansion of the local economy.

Public Finance

Management of Public Finance

The principles underlying the Government's management of public finances are enshrined in the Basic Law, which stipulates that:

- The Hong Kong Special Administrative Region (HKSAR) shall have independent finances, and shall use its revenues exclusively for its own purposes.

- HKSAR shall practice an independent taxation system, taking the low tax policy previously pursued in Hong Kong as reference.
- HKSAR shall follow the principle of keeping expenditure within the limits of revenues in drawing up the budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of the Gross Domestic Product.
- The Legislative Council of HKSAR shall exercise the power to approve taxation and public expenditure.

The Government implements these constitutional provisions by striving to maintain a low and simple tax regime, and exercising fiscal prudence.

Consistent with these constitutional provisions, Hong Kong's local legislation, the Public Finance Ordinance (PFO), stipulates a system for the control and management of Hong Kong's public finances and defines the respective powers and functions of the legislature and the executive. Pursuant to the PFO, the Financial Secretary submits to the Legislative Council an annual set of estimates of revenue and expenditure. The estimates are developed against the background of a medium-range forecast to ensure that full regard is given to the longer-term trends in the economy. The financial year starts from April 1 and ends on March 31.

A government department can only incur expenditure up to the amounts stated in the expenditure estimates and for the purposes approved by the Legislative Council. If during the financial year a department needs to change the expenditure estimates and spend more money, it must obtain authorisation from the Legislative Council.

The Government controls its finances through the General Revenue Account and various funds established under the PFO. The General Revenue Account is the main account for day-to-day departmental expenditure and revenue collection. Funds are established by resolutions of the Legislative Council for specific purposes. They include the Capital Works Reserve Fund, Capital Investment Fund, Civil Service Pension Reserve Fund, Disaster Relief Fund, Innovation and Technology Fund, Land Fund, Loan Fund, Lotteries Fund and Bond Fund. The total revenue and expenditure of the General Revenue Account and eight of the above Funds (excluding the Bond Fund) represent government revenue and government expenditure, and the total balance constitutes Government's fiscal reserves.

Financial Results

For 2009-10, Government recorded a surplus of $25.9 billion after repayment of bonds and notes issued in 2004. Fiscal reserves at the end of March 2010 stood at $520.3 billion. Government revenue in 2009-10 amounted to $318.4 billion, expenditure $289 billion and repayment of bonds and notes $3.5 billion. For details of revenue by source and of expenditure by component for 2009-10 and 2010-11 (Revised Estimate) see Appendix 6, Table 6.

Public expenditure includes government expenditure and expenditure by the Trading Funds and the Housing Authority. In 2009-10, public expenditure totalled

$307.2 billion, a decrease of 7.2 per cent over the previous year, within which some $234.3 billion(or 76.3 per cent) was of a recurrent nature. Table 7 gives an analysis of public expenditure by policy area group and Table 8, the growth rate of public expenditure as compared with the rate of economic growth.

Revenue Sources

Hong Kong's tax system is simple and relatively inexpensive to administer. Tax rates are low, and the Government gives a high priority to curbing tax evasion and minimising opportunities for tax avoidance. The major sources of revenue include profits tax (24 per cent), land fund, properties and investments (13 per cent), stamp duties (13 per cent), salaries tax (13 per cent) and land premium (12 per cent). All major sources of revenue are presented at Appendix 6, Chart 1.

The Inland Revenue Department collects about 56 per cent of total revenue, including profits tax, salaries tax, property tax, stamp duties and bets and sweeps tax. Profits, salaries and property taxes (including tax under personal assessment), which together accounted for about 39 per cent of the total revenue in 2009-10, are levied under the Inland Revenue Ordinance. Persons liable to these taxes may be assessed on three separate and distinct sources of income: business profits, salaries and income from property.

Profits tax is charged only on profits arising in or derived from Hong Kong, from a trade, profession or business carried on in Hong Kong. In 2009-10, profits of unincorporated businesses were taxed at 15 per cent and profits of corporations at 16.5 per cent.

Profits tax is paid initially on the basis of profits made in the year preceding the year of assessment and is subsequently adjusted according to profits actually made in the assessment year. Generally, all expenses incurred in the production of assessable profits are deductible. There is no withholding tax on dividends paid by corporations. Interest income, other than that received by financial institutions, and dividends received from corporations are exempt from profits tax. In 2009-10, the Government received about $76.6 billion in profits tax (about 24 per cent of total revenue).

Salaries tax is charged on emoluments arising in, or derived from, Hong Kong. The basis of assessment and provisional tax mechanism are similar to profits tax. Tax payable in 2009-10 was calculated on a sliding scale that progressed from 2 per cent, 7 per cent and 12 per cent on the first, second and third segments of net income (i.e. income less deduction and allowances) of $40,000 each, respectively, and then to 17 per cent on the remaining net income. No one, however, needed to pay more than the standard rate of 15 per cent of his or her total income.

The earnings of husbands and wives are reported and assessed separately. However, where either spouse has allowances that exceed his or her income, or when separate assessments would result in an increase in salaries tax payable by the couple, they may elect to be assessed jointly. Salaries tax contributed some $41.2 billion (about 13 per cent of total revenue) in 2009-10. Owing to the generous personal allowances under the Hong Kong tax law, only 1.4 million people or 40 per cent of the workforce were liable to salaries tax for the year of assessment 2008-09.

Owners of land or buildings in Hong Kong were charged property tax in 2009-10 at the standard rate of 15 per cent of the actual rent received, less an allowance of 20 per cent for repairs and maintenance. There is a system of provisional payment of tax similar to that for profits tax and salaries tax. Properties owned by a corporation carrying on a business in Hong Kong are exempt from property tax, but profits derived from ownership are chargeable to profits tax. Property tax contributed some $1.7 billion (about 0.5 per cent of total revenue) in 2009-10.

The Stamp Duty Ordinance imposes fixed and ad valorem duties on different classes of documents relating to assignments of immovable property, leases and share transfers. The revenue from stamp duties was some $42.4 billion, about 13 per cent of total revenue, in 2009-10.

A duty is imposed on the gross profits on horse racing and football betting administered by the Hong Kong Jockey Club, and proceeds of Mark Six lotteries. These are the only legal forms of betting in Hong Kong. The duty on horse racing is charged on a sliding scale, starting from the rate of 72.5 per cent on the first $11 billion of the gross profits. The rate progressed to 73 per cent, 73.5 per cent, 74 per cent and 74.5 per cent for each segment of $1 billion of gross profits thereafter, up to 75 per cent on the remainder of gross profits exceeding $15 billion. The duty on football betting is charged at a rate of 50 per cent of gross profits. The yield from betting duty in 2009-10 totalled some $12.8 billion, about 4 per cent of total revenue.

From July 1, 2008, the tax rate for hotel accommodation tax was revised to 0 per cent.

Under the Dutiable Commodities Ordinance, excise duties are levied on only four types of commodities to be consumed locally — hydrocarbon oil, liquor, methyl alcohol and tobacco, irrespective of whether they are manufactured locally or imported. The Customs and Excise Department is responsible for collecting these duties. In 2009-10, the department collected duties of $6.46 billion (about 2 per cent of total revenue).

The Rating and Valuation Department is responsible for the billing and collection of rates, which are levied on landed properties at a specified percentage of their rateable values. The rates percentage charge in 2010-11 was 5 per cent.

The rateable value of a property is an estimate of its annual open market rent at a designated date. Rateable values are reviewed each year to better reflect prevailing market rents. The current Valuation List took effect on April 1, 2010, with rateable values reflecting the rental values on October 1, 2009.

The Valuation List contained about 2.4 million assessments on March 31, 2010. The revenue from rates in 2009-10 was $10 billion, accounting for about 3 per cent of total revenue.

To alleviate people's burdens in the aftermath of the financial tsunami, the Government waived rates for the four quarters from April 2010 to March 2011, subject to a ceiling of $1,500 per quarter for each rateable tenement. As a result, about 85 per cent of ratepayers were not required to pay any rates, while the remaining 15 per cent of ratepayers had their rates bills reduced by the full concession amount of $1,500, costing the Government about $8.6 billion.

The Rating and Valuation Department is also responsible for the billing and collection of Government rent for properties held under land leases granted on or after May 27, 1985, or on the extension of non-renewable land leases. Government rent is levied at 3 per cent of the rateable value of the property and is adjusted in step with any subsequent changes in the rateable value. There were about 1.8 million assessments in the Government Rent Roll on March 31, 2010. Total Government rent collected in 2009-10 was $5.9 billion, or about 2 per cent of total revenue.

Fees and charges for services provided by government departments generated about $10.5 billion, or about 3 per cent of total revenue, in 2009-10. It is government policy that fees, in general, should be set at levels sufficient to recover the full cost of providing the services. Certain essential services are, however, subsidised by the Government or provided free of charge. Government-operated public utilities generated about $3.4 billion, which accounted for about 1 per cent of total revenue; the most important of these, in revenue terms, is provision of water supplies.

The Government also collected $33.6 billion from investments and interest income on the fiscal reserves in 2009-10, amounting to about 11 per cent of the total revenue.

Lastly, some $39.6 billion, or about 12 per cent of the total revenue in 2009-10, was generated from land transactions. All revenue from land transactions is credited to the Capital Works Reserve Fund to help finance the Public Works Programme.

Network of Agreements for Avoidance of Double Taxation

Comprehensive agreements for the avoidance of double taxation (CDTAs) with major economies help improve the business environment and facilitate flows of trade, investment and talent between Hong Kong and the rest of the world. They help reduce tax burdens on individuals and enterprises and eliminate uncertainties over tax liabilities. They also enhance Hong Kong's position as an international business and financial centre.

To expand further Hong Kong's network of CDTAs, the HKSAR Government liberalised arrangements for exchanging tax information under the CDTAs to correspond with international standards. The liberalised arrangements came into force on March 12, 2010, following which Hong Kong signed 13 CDTAs applying the new standards.

Government Procurement

Hong Kong, China is a signatory to the World Trade Organisation Agreement on Government Procurement (WTO GPA). Government procurement is undertaken in accordance with the principles of openness, transparency, fairness, public accountability, value for money and non-discrimination. Open tender procedures are widely used. Restricted or single tender procedures may be used under exceptional circumstances where open competitive tendering would not be appropriate, such as in cases involving compatibility with existing equipment, patent or proprietary items. For complex and critical purchases, pre-qualification exercises may be conducted before tendering to ensure that suppliers are technically competent.

Purchases of goods and related services with values above pre-determined thresholds of the WTO GPA are undertaken by the Government Logistics Department (GLD). These purchases are normally made by competitive tendering to ensure that user departments' needs are met at the best possible price, having regard to the life-time cost and reliability of supply. Consideration is given to purchasing environmentally friendly products where available and appropriate. In 2010, the GLD awarded contracts with a total value of $3.96 billion. The goods and related services were procured from 28 different countries or territories (including Hong Kong).

To facilitate sourcing and market research, the GLD maintains and regularly updates the Supplier Lists comprising suppliers both in and outside Hong Kong for different categories of goods and services.

Notices for open and pre-qualification tenders are published in the Government Gazette and put on the Internet. Suppliers on the relevant Supplier Lists and, in case of procurement covered by WTO GPA, consulates and overseas trade commissions will also be informed where appropriate. Tender documents may be downloaded and tender offers may also be submitted through a prescribed internet system.

Websites

Economic Analysis and Business Facilitation Unit, Financial Secretary's Office: www.eabfu.gov.hk
Financial Services and the Treasury Bureau: www.fstb.gov.hk
Government Logistics Department: www.gld.gov.hk