Chapter 3

The Economy

The Hong Kong economy attained another year of above-trend growth in 2011, although the external environment was increasingly plagued by the Eurozone sovereign debt crisis after the second quarter. With a vibrant domestic sector, the labour market saw full employment through the four quarters. Inflation rose further, driven by higher domestic cost pressure and imported inflation, but stabilised towards the end of the year.

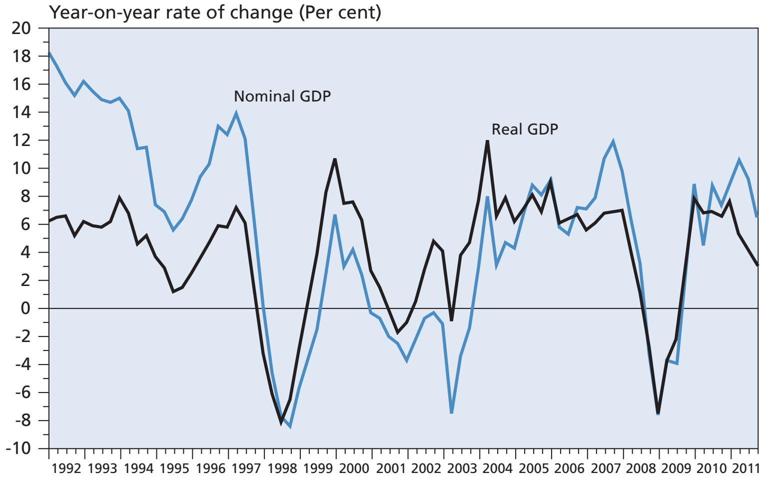
Hong Kong's economy posted another year of above-trend expansion in 2011, despite the contrasting performance of its external and domestic sectors since the second quarter of the year. Merchandise exports weakened as a result of sluggish demand in the major export markets, hit by the euro debt crisis, while the domestic sector performed remarkably well on the back of strong consumption and investment. The sustained strength of inbound tourism also rendered support to exports of services.

In 2011, the Gross Domestic Product (GDP) expanded by 5 per cent in real terms, on top of the 7 per cent in 2010. External factors, including the earthquake and tsunami in Japan, the worsening euro debt crisis and the US' unsteady economic recovery slowed Hong Kong economic growth progressively during the year, sliding from 7.6 per cent year-on-year in the first quarter to 3 per cent in the fourth quarter of 2011.

On a seasonally adjusted quarter-to-quarter comparison, real GDP expanded by 3 per cent in the first quarter, but shrank by 0.5 per cent in the second quarter, then grew only mildly by 0.1 per cent in the third quarter, and by 0.4 per cent in the fourth quarter (*Chart 1*).

Total exports of goods slackened markedly to only a modest growth in real terms in 2011, from the double-digit rebound in 2010. Goods exports slowed notably after the first quarter of 2011 and stayed sluggish through the year-end, due mainly to slackening demand in the advanced markets, notably the US and the EU, while exports to many Asian markets also decelerated.

Chart 1 **Quarterly Gross Domestic Product**



Hong Kong attained another year of above-trend growth in 2011, though the momentum tapered during the year.

Exports of services were more resilient, registering a solid performance for 2011 as a whole, although growth also moderated visibly towards the year-end. Vibrant inbound tourism and buoyant cross-border commercial and financial activities rendered the key impetus, but exports of trade-related and transportation services were more affected by the slowdown in merchandise trade flows.

The domestic sector performed remarkably well in 2011 and was the key growth driver. Private consumption expenditure grew robustly throughout the year, thanks to the notable job and income growth in the past year or so. Investment strengthened after the first quarter and held firm to the end of the year on hectic machinery and equipment acquisition and intensive public sector works, despite more cautious business sentiments in the latter part of the year.

The labour market was in a state of full employment. Job vacancies surged across many sectors amid the economic expansion, pushing total employment to successive new highs. The seasonally adjusted unemployment rate fell to a low of 3.2 per cent in the third quarter of 2011, only edging up to 3.3 per cent in the fourth quarter. The underemployment rate also fell successively to 1.4 per cent in the fourth quarter. Both wages and earnings recorded their largest increases since the mid-1990s, thanks to the vibrant labour demand, and an additional boost from the implementation of statutory minimum wage (SMW) since May 1, 2011.

The residential property market remained buoyant in the first half of 2011, but underwent some consolidation after mid-year amid heightened external uncertainties and successive mortgage rate hikes by local banks. Trading went sharply down, with the number of sale and purchase agreements falling to 84 462 in 2011, down 38 per cent from the high base in 2010. Overall flat prices in December 2011 fell by 4 per cent from the peak in June, but still rose by a rather notable 11 per cent year-on-year due to the hefty gain in the early part of 2011.

Staying mindful of the risk of a property market bubble, the Government has introduced a series of measures since early 2010 to ensure the healthy and stable development of the property market, and further stepped up its efforts throughout 2011. The various measures have achieved notable results in increasing land supply, curbing speculative activities, preventing excessive growth of mortgage lending and increasing transparency of the property market.

The local stock market underwent sharp volatilities and drifted markedly lower during 2011. The correction was mainly induced by market worries over the worsening debt situation in Europe since the second quarter as well as the increasingly bleak global economic outlook. With the sharp intensification of the euro debt crisis and heightened contagion risks in the ensuing months, the Hang Seng Index (HSI) hit a low of 16 250 on October 4, 2011, the level last seen in May 2009. With some subsequent rebound as a result of the co-ordinated efforts taken by the European governments and major central banks to tackle the crisis and stabilise the global financial situation, the HSI closed the year at 18 434, still 20 per cent lower than at end-2010. Against the market corrections worldwide and shifting market sentiments, fund-raising activities turned visibly quieter in the second half of the year. For 2011 as a whole, total IPO funds raised amounted to $258.9 billion, 42 per cent down from 2010. Yet Hong Kong still ranked as the world's top IPO centre in 2011, the third year in a row.

As part of a region-wide phenomenon, inflation went up visibly during most of 2011, driven by the feed-through of domestic cost pressures as well as higher imported inflation. Yet with the ease-back of global food and commodity prices since early 2011 and slower local economic growth, inflation stabilised towards the year-end. In 2011, underlying inflation averaged at 5.3 per cent, up from 1.7 per cent in 2010.

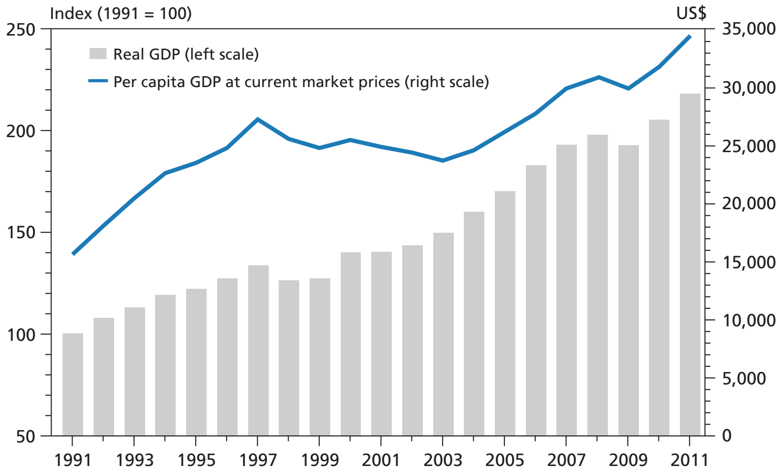
Structure and Development of the Economy

Hong Kong is a global centre for world trade, finance, business and telecommunications, strategically located at the doorstep of the Mainland's vast thriving 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 international air cargo handled. Hong Kong is also the world's 10th 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, superb transport and communications infrastructure, sophisticated support services, and a flexible labour market with a well-educated workforce and a pool of efficient and innovative entrepreneurs. Moreover, it has a sizeable amount of 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 been ranked by the US Heritage Foundation as the freest economy in the world for 18 consecutive years. Similarly, the Fraser Institute of Canada has also consistently ranked Hong Kong as the world's freest economy. Hong Kong is ranked the world's most competitive economy for the first time by the International Institute for Management Development (IMD) in 2011, side by side with the US, and remained to be the second easiest place to do business in the world according to the World Bank's Doing Business Report. Hong Kong has also been conferred the top triple-A credit rating by Standard and Poor's.

The size of the Hong Kong economy more than doubled over the past two decades, with its GDP expanding at an average annual rate of 3.9 per cent in real terms, faster than the average growth at 3.5 per cent of the world economy. Over the same period, Hong Kong's per capita GDP rose by nearly 80 per cent, posting an average annual growth rate of 2.9 per cent in real terms. Hong Kong's per capita GDP rose to a historic high of US$34,400 in 2011, one of the highest in Asia (*Chart 2*).

Chart 2 **Gross Domestic Product**



Over the past two decades, the Hong Kong economy grew by an average of 3.9 per cent in real terms, outpacing the 3.5 per cent growth for the world economy.

Under the growing influence of globalisation and bolstered by deepening regional integration and vibrant growth in Asia, Hong Kong's trade linkages with other parts of the world have grown by leaps and bounds. Trade in goods and services both expanded by more than three times in real terms over the past two decades. In 2011, the total value of visible trade (comprising re-exports, domestic exports and imports of goods) reached $7,255 billion, equivalent to 383 per cent of GDP. This was considerably higher than the ratios of 222 per cent in 1991 and 233 per cent in 2001. Including the value of exports and imports of services, the ratio of total trade to GDP was even higher, at 456 per cent in 2011, up significantly from 262 per cent in 1991 and 273 per cent in 2001.

The stock of inward direct investment in Hong Kong was enormous, at $8,840 billion in market value at the end of 2011, equivalent to 467 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, ranked Number 2 in Asia by the United Nations' World Investment Report 2011, just after the Mainland.

The corresponding figures for Hong Kong's stock of outward direct investment were likewise huge, at $8,122 billion and 429 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 $23,228 billion and $17,771 billion respectively at the end of 2011. The corresponding ratios to GDP in that year were 1 226 per cent and 938 per cent. Reflecting Hong Kong's sound international investment position, its net external financial assets amounted to $5,457 billion at the end of 2011, equivalent to 288 per cent of GDP.

The Gross National Product (GNP), comprising GDP and net external factor income flows, stood at $1,950.7 billion in 2011. This was higher than the corresponding GDP by 3 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 2011, at $1,019.7 billion and $962.9 billion respectively, equivalent to 54 per cent and 51 per cent of GDP respectively. This was attributable to the huge volumes of inward and outward investment in Hong Kong.

Contributions of the Various Economic Sectors

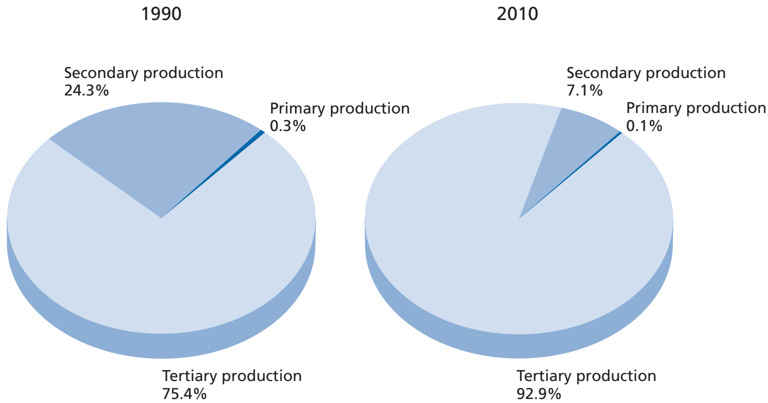
Primary production (including agriculture, fisheries, mining and quarrying) is insignificant in Hong Kong in terms of both value-added contribution to GDP and share in total employment, as the city is a predominantly urban economy.

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 17 per cent in 1990 to 5 per cent in 2000 and to only 2 per cent in 2010. The construction sector's contribution to GDP stayed at around 5 per cent between 1990 and 2000, then edging down successively, reaching 3 per cent in 2010. 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, more importantly, also created abundant business opportunities for a wide range of service providers. Hong Kong has continued to re-orientate itself towards service activities and 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 2010 (*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



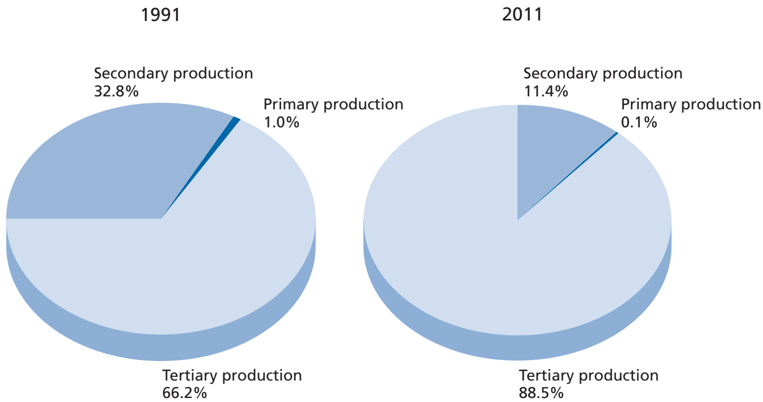
Over the past two decades, the economy has become increasingly service-oriented.

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 is where Hong Kong's competitive advantage lies, and displayed much resilience in 2011 notwithstanding the notable slowdown in merchandise trade. Over the past five years between 2006 and 2011, the value-added part of the services sector grew by a cumulative 21 per cent in real terms, outpacing the corresponding 19 per cent growth of the overall economy. Among the constituent service sectors, wholesale and retail trades showed the fastest cumulative growth of 53 per cent. Coupled with the solid growth of 11 per cent in accommodation and food services, this reflected the strength of domestic demand and the vibrancy in inbound tourism. The steep increase of 41 per cent in financing and insurance was a testament to Hong Kong's drive as an international financial centre. Import and export trade also performed impressively, with a 25 per cent increase in the value-added component of its trading activities over the period. This, together with a notable growth of 15 per cent in transport and storage services, underlined the competitiveness of Hong Kong's trading and logistics sector.

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.

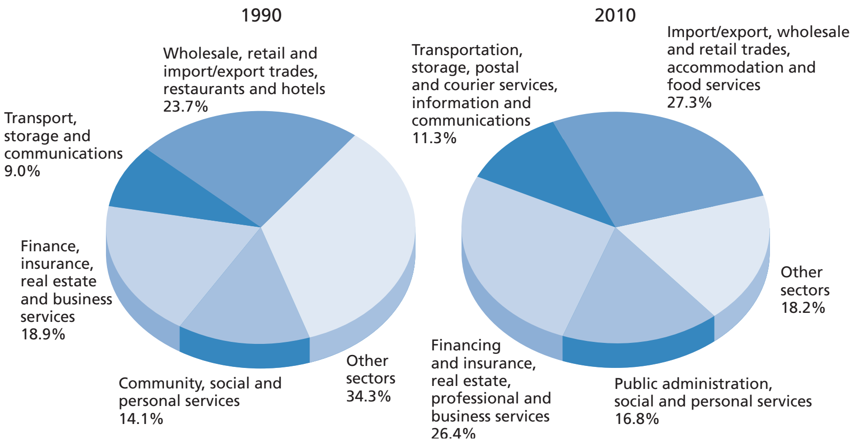
Starting from the first quarter of 2009, industrial classification of employment has adopted the Hong Kong Standard Industrial Classification Version 2.0 while that in the previous years is based on Version 1.1.

In 2010, the services sector contributed 93 per cent to GDP. Import/export, wholesale and retail trades, and accommodation and food services remained the largest service sectors, accounting for 27 per cent of GDP. This was followed by financing and insurance, real estate, professional and business services (26 per cent), public administration, social and personal services (17 per cent), transportation, storage, postal and courier services, and information and communications (11 per cent) (*Chart 5*). More specifically, of the four key industries, trading and logistics accounted for 26 per cent of value-added contribution to GDP in 2010, financial services 15 per cent, professional and other producer services 13 per cent, and tourism 4 per cent.

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 66 per cent in 1991 to 84 per cent in 2001 and 89 per cent in 2011. As for individual service segments, import/export trade and wholesale, retail, accommodation and food services accounted for 32 per cent of the total in 2011. 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*).

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 2010.

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.

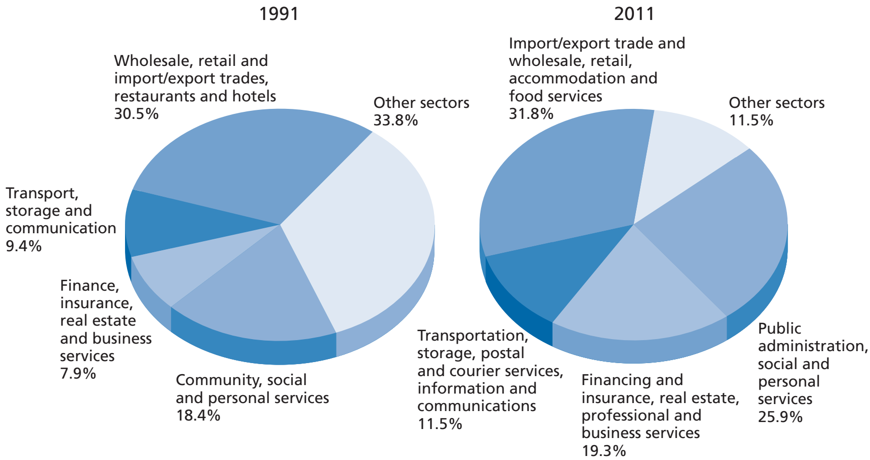
The Manufacturing Sector

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 technological advancement 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.

Economic Links between Hong Kong and the Mainland

Since the introduction of the Mainland's open door policy in 1978, the deepening economic integration between the Mainland and Hong Kong has yielded enormous mutual benefits to both places. Over the years, the massive 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.

Chart 6 Employment by Major Service Sector

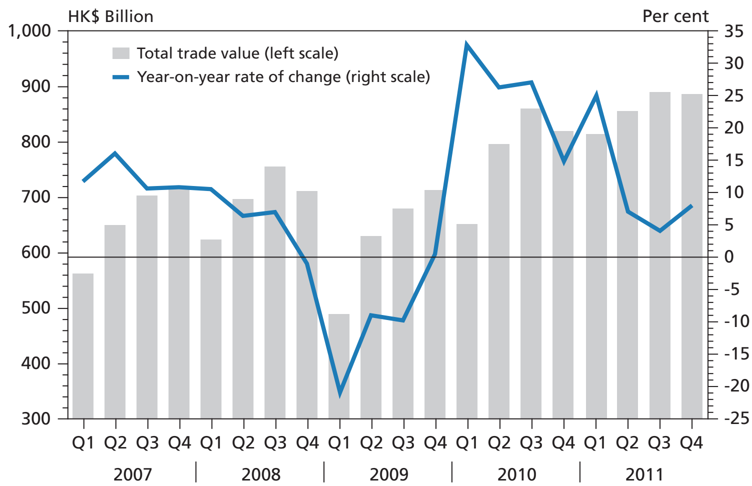


Import/export trade and wholesale, retail, accommodation and food services employed the most people in 2011.

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 the previous years is based on Version 1.1.

Chart 7 Visible Trade between Hong Kong and the Mainland



Since the Mainland adopted economic reform and an open door policy in 1978, there has been a rapid expansion in merchandise trade, especially in re-export trade, between Hong Kong and the Mainland.

Visible trade between Hong Kong and the Mainland is now 318 times that in 1978, representing a significant growth of 19 per cent per annum in value terms (*Chart 7*). In 2011, Hong Kong and the Mainland were ranked the world's 10th and second largest trading entities respectively.

The Mainland has long been Hong Kong's largest trading partner, accounting for 48 per cent of Hong Kong's total trade value in 2011. A total of 90 per cent of Hong Kong's re-export trade was related to the Mainland, forming 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 about 8 per cent of the Mainland's total trade value in 2011.

Hong Kong is 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 36 per cent in the past 10 years, totalling 4.3 million trips in 2011. The number of trips made by Mainland residents to or through Hong Kong rose at an average annual growth rate of 20 per cent, amounting to 28.1 million trips in 2011, which was more than six times the level a decade ago.

Hong Kong continues to be the largest external investor in the Mainland. According to the Mainland's statistics, the cumulative value of Hong Kong's realised direct investment in the Mainland reached US$527 billion at end-2011, accounting for about 45 per cent of the total inward direct investment there.

Reciprocally, Hong Kong is the first port of call for the Mainland's outward direct investment. Based on the Mainland's statistics, the Mainland's stock of outward direct investment to Hong Kong accounted for 63 per cent of its total outward direct investment as at the end of 2010, reflecting Hong Kong's role as a platform for Mainland companies to reach out and go global. Likewise, based on Hong Kong's statistics, the Mainland is also Hong Kong's largest source of foreign direct investment. At end-2010, the market value of direct investment from the Mainland to Hong Kong amounted to US$402 billion, accounting for 37 per cent of Hong Kong's total inward direct investment. Mainland companies have also maintained a strong presence in Hong Kong. As at mid-2011, Mainland companies have established 248 regional headquarters or regional offices and 557 local offices in Hong Kong, up from 242 and 160 respectively ten years ago.

Among the provinces in the Mainland, Hong Kong's economic links with Guangdong are the closest. Based on the Mainland's statistics, at the end of 2011, the cumulative value of Hong Kong's realised direct investment in Guangdong was US$170 billion, accounting for 61.7 per cent of its total inward direct investment. Hong Kong's huge direct investment in the Mainland has contributed to the latter's industrialisation, while at the same time, also propelling the rapid structural change in the Hong Kong economy over the past three decades.

Supported by 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 640

Mainland enterprises were listed on the Hong Kong stock market as at the end of 2011. Among them, 54 were listed in 2011. A total of $226.3 billion of equity funds was raised by Mainland enterprises during the year. These activities in turn reinforced Hong Kong's position as a major fund-raising centre in the region.

In 2011, Hong Kong achieved some milestone developments in consolidating its position as a premier offshore renminbi (RMB) business centre for the Mainland. Since August 2011, cross-border trade settlement in RMB has been expanded to cover the entire nation. Total RMB remittance for cross-border trade settlement conducted through Hong Kong amounted to RMB1,915 billion in 2011, more than five times the level recorded in 2010. Hong Kong is the first place outside the Mainland to develop an RMB bond market. By the end of 2011, there had been 120 RMB bond issuances with a total issuance size of about RMB182 billion. RMB deposits in Hong Kong amounted to nearly RMB590 billion at the end of 2011, representing an increase of 87 per cent over the end of 2010. In August 2011, the Central Government announced a package of 36 measures to boost Hong Kong's role as an offshore RMB centre and global financial centre. These include, among others, launching exchange-traded funds for Mainlanders to invest in Hong Kong stocks, allowing the repatriation of yuan via RMB qualified foreign institutional investors (RQFIIs) and foreign direct investment (FDI), and expanding RMB-denominated bond issuance in Hong Kong. The measures will broaden the scope of the offshore RMB market in Hong Kong and expand the channels for the flow and circulation of RMB funds between Hong Kong and the Mainland.

The economic co-operation and integration with the Mainland has been fostered through the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA). In December 2011, the Hong Kong Special Administrative Region (HKSAR) Government and the Central People's Government signed Supplement VIII to CEPA, introducing a total of 32 services liberalisation and trade and investment facilitation measures, which include 23 liberalisation measures in 16 service sectors, and strengthen co-operation in areas of finance, tourism, innovation and technology etc. Inclusive of the measures in Supplement VIII, Hong Kong service providers can enter the Mainland market in 47 service sectors under preferential treatment. The new measures will further assist Hong Kong service industries to enter the Mainland market, promote trade integration and enhance 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 with the commencement of the construction of the Hong Kong Boundary Crossing Facilities of the Hong Kong-Zhuhai-Macao Bridge at end-2011. Upon completion by 2016, the bridge will significantly reduce transportation costs and commuting time between Hong Kong and the Western Pearl River Delta (PRD) region. The improvement of cross-boundary infrastructure will facilitate the flow of people and goods within the Greater PRD 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. Thanks to the further integration of the

Mainland with the global economy, Hong Kong's role as an international financial, trade and shipping centre will continue to strengthen. This will in turn provide abundant opportunities to support Hong Kong's continuous transformation into a diversified high value-added, knowledge-based economy.

The Economy in 2011

External trade

2011 was a year full of vicissitudes for Hong Kong's merchandise trade, mirroring the rapidly changing global economic environment. For the year as a whole, merchandise exports (comprising re-exports and domestic exports) slackened markedly to a modest growth of 2.9 per cent in volume terms in 2011 amid an increasingly challenging external environment, following the strong rebound in 2010 (*Chart 8*). On a year-on-year comparison, total exports of goods showed a strong growth of 17.7 per cent in the first quarter of 2011, mainly driven by the vibrant Asian markets, but decelerated sharply to virtually no growth in the second quarter, partly dragged by temporary disruptions to regional supply chains arising from the March 11, 2011 earthquake in Japan. Slower demand growth in many export markets was also relevant. With the effect from weaker demand in the advanced economies increasingly felt across the Asian markets, total exports of goods slackened further to a decline of 4 per cent in the third quarter, before rebounding by 1.1 per cent in the fourth quarter. On a seasonally adjusted quarter-to-quarter comparison, merchandise exports grew strongly by 11.8 per cent in the first quarter, then fell by 11 per cent and 0.5 per cent respectively in the second and third quarters, before reverting to a 1.9 per cent growth in the fourth quarter.

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

Merchandise exports moderated over the course of 2011, dragged by sluggish demand in the advanced markets.

The global trading environment was rather robust in the early part of 2011, with the emerging economies across continents growing strongly. However, the situation deteriorated markedly since the second quarter of the year. The 9-magnitude Japan Earthquake on March 11, 2011 caused serious, albeit temporary, disruptions to the global supply chains and hence international trade flows. The encouraging signs displayed by the US and EU economies early in the year also proved to be short-lived, as many of them lost steam amid their weak fundamentals as well as the need for fiscal consolidation. Asia was hardly unscathed. The setbacks in the advanced economies led to region-wide deceleration in industrial activities and intra-regional trade flows towards the latter part of the year.

Against this background, Hong Kong's exports to the US and the EU showed renewed weaknesses in 2011, especially in the second half of the year. Private demand in the US was constrained by the depressed housing market, on-going deleveraging and persistently high unemployment, resulting in sharp year-on-year declines in exports to the US during most of 2011. Exports to the EU also reverted to decline in the second quarter and worsened notably in the second half of the year, alongside the deepening eurozone sovereign debt crisis. With the spillover effect of waning final demand in these markets increasingly felt across Asia, Hong Kong's merchandise exports to some Asian markets, including India, Korea and Singapore, slowed visibly in the second half of 2011, mainly dragged by exports of raw materials to the Mainland and other parts of Asia. Exports of consumer goods to Asia held up relatively better, however, though also with some moderation in the second half of the year.

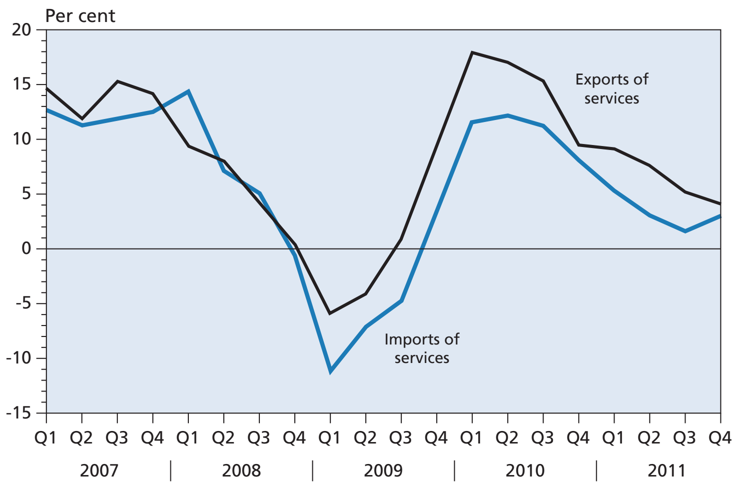
Imports of goods recorded a moderate growth of 5.1 per cent in volume terms in 2011, following an 18.6 per cent increase in the previous year, largely due to the sharp slowdown in re-export trade. Retained imports, which accounted for over one-quarter of total imports, nevertheless leaped by 9.2 per cent in volume terms in 2011, further to the 19.7 per cent growth in 2010. The sharp contrast between the lacklustre external demand and the strong domestic demand led to a notable divergence among import intakes of different end-use categories.

In particular, retained imports of consumer goods maintained strong growth throughout 2011, up 24.2 per cent in volume terms for the year as a whole, reflecting buoyant local consumption and tourist spending. Retained imports of capital goods also grew notably by 15 per cent on the back of a resilient domestic economy. Retained imports of foodstuffs recorded a mild growth of 1.9 per cent for the year as a whole. On the other hand, retained imports of raw materials declined sharply by 8.5 per cent, conceivably dragged by dimmer export outlook. Retained imports of fuels also went down by 11.1 per cent after the sharp surge in 2010.

Exports of services made a 6.3 per cent growth in real terms for 2011 as a whole, markedly slower than the 14.6 per cent increase in 2010. With trade-related and transportation services significantly curtailed by the worsening global environment and slowdown in merchandise trade flows, the pace of growth in exports of services tapered over the course of the year, from a strong 9.1 per cent year-on-year growth in the first quarter to only a moderate expansion of 4 per cent in the fourth quarter. Yet exports of travel services stayed vibrant with very strong growth throughout the year, thanks to the rapid increase in visitor arrivals, especially those from the Mainland. Exports of financial and business services were likewise resilient during most of the year, on the back of buoyant cross-border financing, fund raising and other commercial activities. These two components provided a strong cushion against the slack in the trade-related components in 2011.

Imports of services grew modestly by 3.1 per cent in real terms in 2011, following a sharp increase of 10.7 per cent in the previous year. Growth in imports of financial and other business services moderated along with the worsening external environment. Imports of transportation and trade-related services slowed more conspicuously in tandem with the slowdown in regional trade flows. Meanwhile, imports of travel services showed only a small growth in 2011 (*Chart 9*).

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



Exports of services were more resilient, though also moderating in the latter part of 2011.

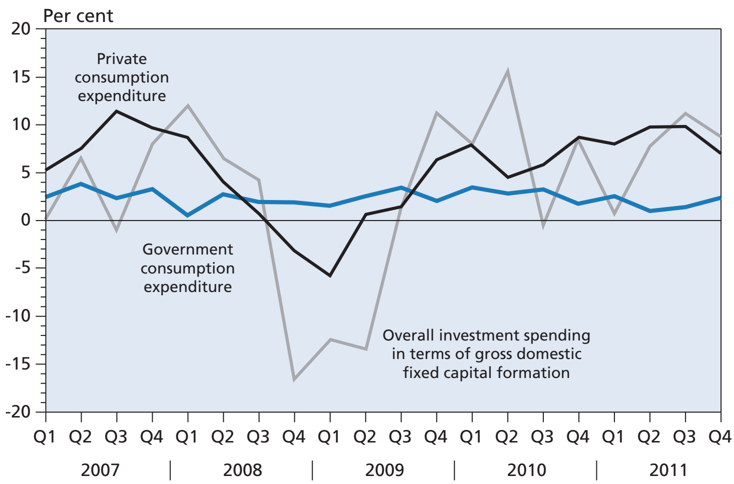
Due to the strong headwinds in the external environment and buoyant domestic demand, visible trade deficit widened in 2011. Nevertheless, the invisible trade surplus was still more than enough to offset the visible trade deficit. In 2011, the combined visible and invisible balance posted a surplus of $69.7 billion, or 1.6 per cent of the total value of imports of goods and services, though smaller than the surplus of $94.7 billion or 2.5 per cent in 2010.

Domestic demand

The domestic sector fared remarkably well in 2011, rendering the key impetus to overall economic growth. Local consumer sentiments were buoyed by the broad-based income and job growth over the past year or so. Private consumption expenditure (PCE) grew robustly in real terms in all four quarters of 2011. For 2011 as a whole, PCE grew by 8.6 per cent, further to the already strong growth of 6.7 per cent in 2010. Meanwhile, government consumption expenditure expanded steadily further in 2011, by 1.8 per cent in real terms, following the 2.8 per cent growth in 2010.

Overall investment spending in terms of gross domestic fixed capital formation posted a notable 7.2 per cent growth in real terms in 2011, following the 7.7 per cent expansion in 2010. Machinery and equipment acquisition, which tends to be rather volatile, displayed fluctuations during the year, relapsing to a year-on-year decline in the first quarter before rebounding to double-digit growth in the second through the fourth quarters. Meanwhile, public sector construction works continued apace throughout the year, offsetting the slack in private sector building activity, thereby rendering another important growth driver of domestic demand (*Chart 10*). However, with the global economic outlook clouded by the euro debt crisis, business sentiments saw some deterioration in the latter part of the year.

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

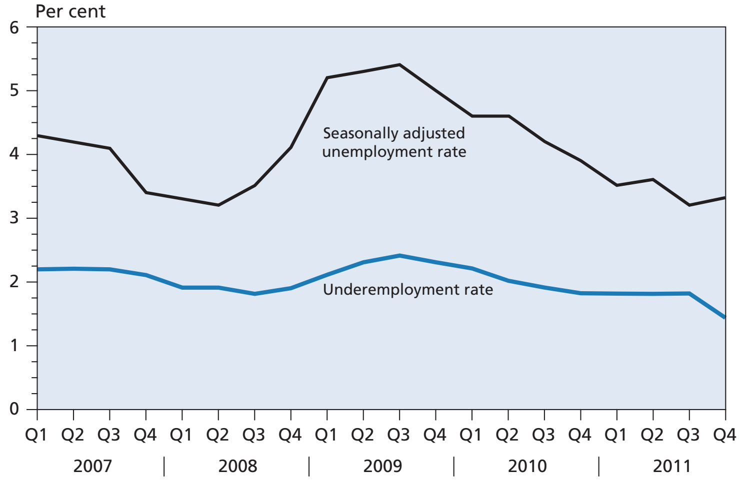


Domestic demand fared remarkably well in 2011, on the back of strong consumption and investment spending.

The Labour Market

The labour market continued to show broad-based improvements for the second consecutive year in 2011. With persistent strength in labour demand, total employment was on a strong uptrend during the year, reaching a historical high of 3 618 900 in the fourth quarter. In tandem with the tightening in manpower balance, the seasonally adjusted unemployment rate fell to a low of 3.2 per cent in the third quarter, and despite some subsequent slowdown in economic growth, remained at a low level of 3.3 per cent at the year-end, still signifying a full employment situation. Thanks to the hectic creation of full-time jobs in the business sector, the underemployment rate fell to 1.4 per cent at the end of 2011 (*Chart 11*).

Chart 11 The Unemployment and Underemployment Rates



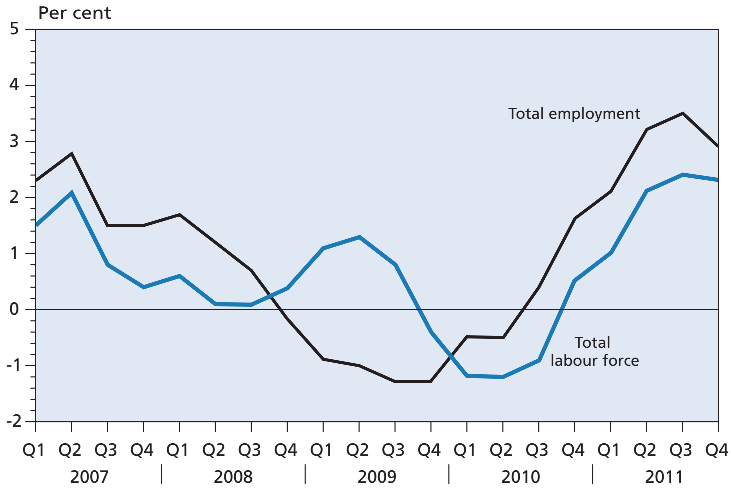
Unemployment rate remained low at end-2011, signifying a full employment situation.

The labour force increased markedly by 2 per cent in 2011, the strongest growth since 1997 and reversing the modest decline of 0.8 per cent in 2010. Conceivably, increased job opportunities amid economic expansion, coupled with the implementation of statutory minimum wage (SMW), had induced more job-seekers to enter the labour market. Total employment likewise grew at the fastest pace since 2000, by a remarkable 2.9 per cent in 2011, up distinctly from the meagre 0.2 per cent rise in 2010 and far outstripping the concurrent growth in labour supply. Employment growth was particularly strong in the domestically-oriented and consumption-related sectors such as retail, accommodation and food services; repair, laundry, domestic and other personal service activities; construction; financing and insurance; and professional and business services, which more than compensated for the meagre performance in the externally-oriented sectors (*Chart 12*).

Job vacancies in private sector establishments saw a further upsurge in 2011, when the number of private sector vacancies leapt by 19 per cent to reach the highest annual level since 1994. In December 2011, the ratio of job vacancies was 48 per 100 job-seekers, higher than that of 36 a year ago. Concurrently, the corresponding ratio for lower-skilled jobs rose from 35 to 45, and that for higher-skilled jobs from 63 to 84, signifying further tightening of the labour market.

Analysed by economic sector, the surge in number of job vacancies was across-the-board, with many sectors registering double-digit increases in December 2011 over a year earlier. In particular, more distinct year-on-year growth was seen among retail (up 27.2 per cent); transportation, storage, postal and courier services (up 20.2 per cent); social and personal services (up 19.9 per cent); and accommodation and food services (up 15.1 per cent), another manifestation of a buoyant labour market in full employment.

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



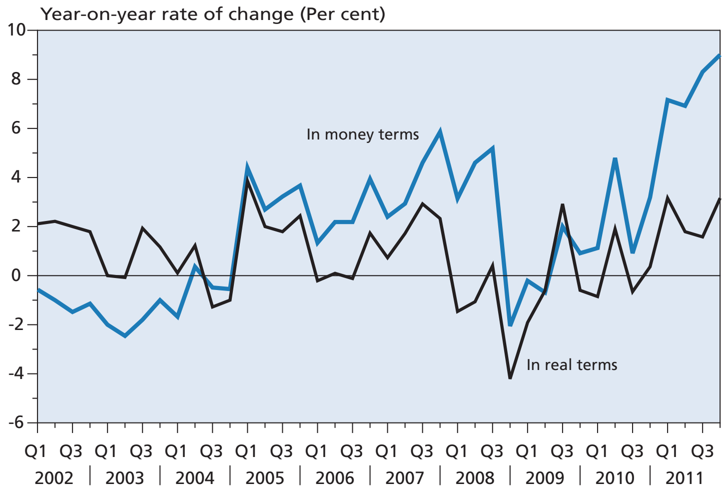
Manpower balance tightened up in 2011, with labour demand growth outpacing labour supply growth by a large margin throughout the year.

The tightness of the labour market, coupled with the additional boost from the SMW implementation, translated into a notable and broad-based improvement in incomes, especially of the lower segment. Specifically, labour earnings in the private sector increased markedly by 7.9 per cent in 2011, the fastest since 1997. After adjusting for changes in consumer prices, there was a real improvement of 2.5 per cent (*Chart 13*). Analysed by economic sector, nominal payroll picked up across almost all sectors in 2011, with more notable increases for workers engaged in retail; financing and insurance; real estate; and import/export trade and wholesale. Separately, data from the General Household Survey, though not strictly comparable to those from the business establishment surveys, indicated that average employment earnings for full-time employees in the lowest decile group registered a remarkable growth of 13.7 per cent in the fourth quarter of 2011 over a year earlier, or 8 per cent in real terms after adjusting for inflation. Over the same period, median household income rose by 11.1 per cent from $18,000 to $20,000, the largest increase since early 1997. After adjusting for inflation, there was still a notable increase of 5.1 per cent in real terms.

The Property Market

The residential property market started the year with further price upsurge, amid bullish sentiment and broad-based improvements in the labour market. However, sentiment turned more cautious since June, dented by successive negative developments, first the increasing worries over the sluggish growth in the advanced economies, then the escalation of the European debt crisis and increasing evidence that the fragilities in the advanced economies would hurt Asia's growth momentum. The successive increases in mortgage rates by the local banks also added to the cautious sentiment.

Chart 13 **Labour Earnings**



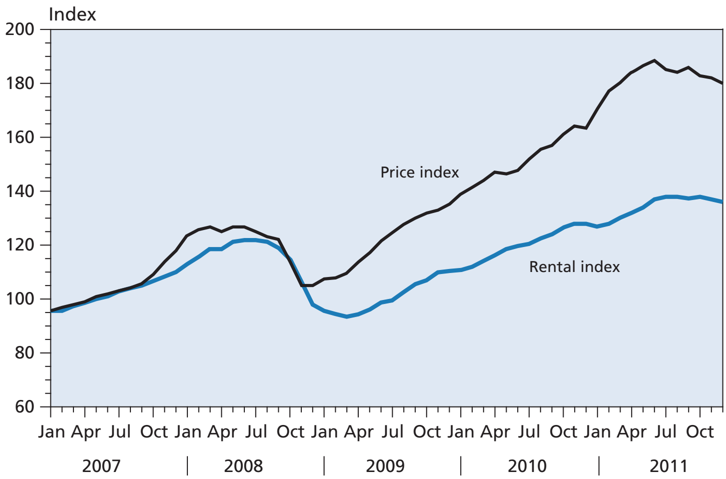
Labour earnings saw notable and broad-based improvements in both nominal and real terms in 2011.

As the earlier bullish sentiment switched to a more cautious tone, residential property prices in December 2011 fell by 4 per cent from the peak in June, but still rose by a rather notable 11 per cent over a year earlier due to the hefty gain in the early part of the year. Overall flat rentals in December rose by 7 per cent over a year earlier, though with most of the gain concentrating in the first ten months. Following the surge since mid-2009, overall flat prices in December were 5 per cent higher than the peak in 1997, and overall flat rentals were only 3 per cent below the peak (*Chart 14*).

Residential property transactions came down to a less hectic level in the first half of 2011 following the introduction of the Special Stamp Duty in late 2010, and turned very subdued in the second half. For 2011 as a whole, the number of sale and purchase agreements for residential property received by the Land Registry plunged by 38 per cent from the high base in 2010 to 84 462, and total consideration by 21 per cent to $442.5 billion (*Chart 15*).

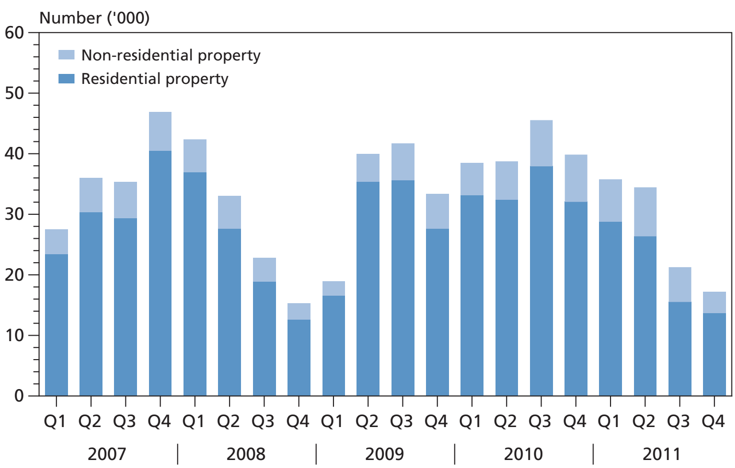
Despite the consolidation in the latter part of 2011, flat prices in December 2011 were still 73 per cent higher than the trough at end-2008. The home purchase affordability (i.e. the ratio of mortgage payment for a 45-square metre flat to median income of households, excluding those living in public housing) remained elevated at 46 per cent in the fourth quarter of 2011, and would exceed the long-term average of 50 per cent over 1991-2010 should interest rates return to a more normal level.

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



Flat prices retreated in the second half, while rentals turned steadier towards end of the year.

Chart 15 Sale and Purchase Agreements by Broad Type of Property



Overall trading in the property market contracted in 2011.

The Government has always been mindful of the ramifications that wild fluctuations in property prices would have on overall macroeconomic and financial stability. To ensure the healthy and stable development of the property market, the Government has introduced a series of measures since early 2010, and stepped up its efforts throughout 2011. In order to sustain the momentum of supplying steady and sufficient land to the market, the Government successively announced the quarterly land sale programmes in April, June, September and December 2011. In June the Hong Kong Monetary Authority further tightened the mortgage lending standards. In October the Chief Executive announced in the 2011-12 Policy Address the resumption of the Home Ownership Scheme and enhancements to the My Home Purchase Plan. The various measures have achieved notable results in raising land supply, curbing speculative activities, preventing excessive growth of mortgage lending and increasing transparency of the property market.

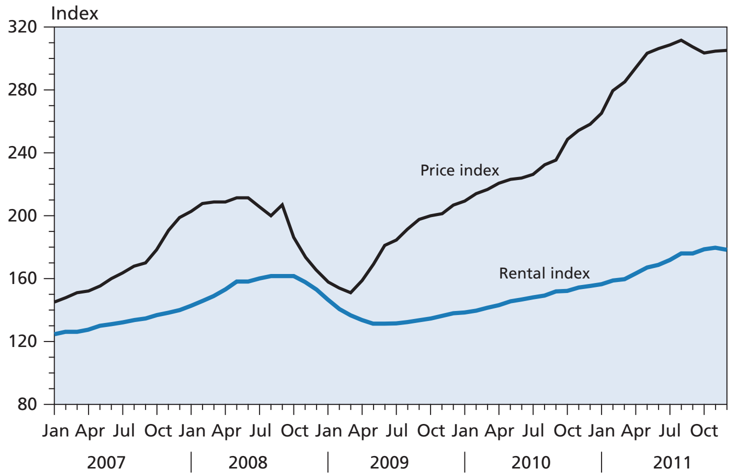
Take-up of private residential property soared by 42 per cent over 2010 to 11 400 units in 2011, while completions remained low at 9 400 in 2011. As a result, the vacancy rate for private residential property came down from 4.7 per cent at end-2010 to 4.3 per cent at end-2011. In 2012, completions are forecast at 11 900 units, 26 per cent higher than in 2011. In the medium term, 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) increased from 59 000 units as estimated at end-2010 to 62 000 units as estimated at end-2011.

Similarly, the non-residential property markets were buoyant in the first three quarters of 2011, but also eased in the latter part of the year. For office space, overall prices in December 2011 were 18 per cent higher than a year earlier. Within the total, prices of Grade A, B and C office space went up by 13 per cent, 21 per cent and 23 per cent respectively over a year earlier. Office rentals in December 2011 rose by 15 per cent over a year earlier, with Grade A, B and C office space registering gains of 17 per cent, 11 per cent and 11 per cent respectively. Nonetheless the uptrend in both office prices and rentals slowed towards the year-end, in tandem with heightened external uncertainties and the economic slowdown (*Chart 16*).

Underpinned by the buoyant local retail business, prices of retail shop space in December 2011 surged by 19 per cent over a year earlier, while rentals rose by 9 per cent. Meanwhile, prices and rentals of flatted factory space rose further by 24 per cent and 8 per cent respectively.

On transactions, the number of sale and purchase agreements for non-residential property fell by 10 per cent to 24 352 in 2011, though total consideration further increased by 13 per cent to $145.4 billion.

Chart 16 **Prices and Rentals of Office Space (1999=100)**



Prices and rentals of office space rose rapidly during the first three quarters, but showed signs of tapering thereafter.

Reflecting the solid take-up relative to completion, vacancy rates for office space and flatted factory space fell from 8 per cent and 6.7 per cent to 6.5 per cent and 6 per cent respectively. Meanwhile, vacancy rate for commercial space edged up from 7.9 per cent to 8 per cent.

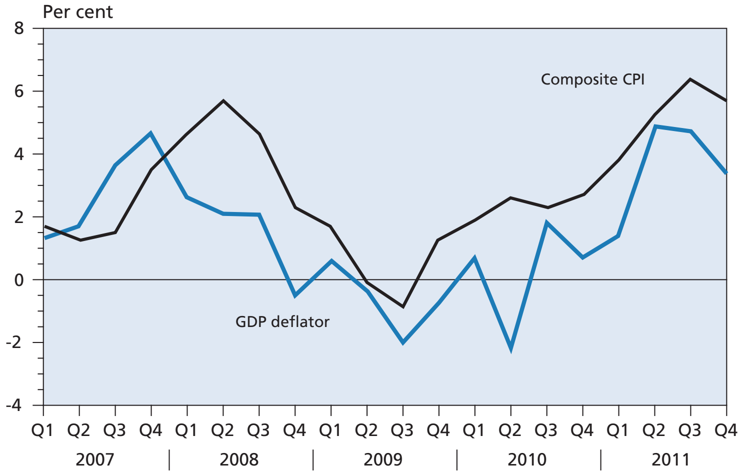
Price Movements

Inflation was on a notable uptrend during most of 2011 under the influence of both external and domestic factors. On the external front, the notable increases in import prices, driven by the surges of global food and commodity prices from late 2010 through early 2011, played a significant role in driving up local inflation. Domestically, the strong economic upswing in 2010 and early 2011, coupled with the one-off effect from the implementation of SMW in May 2011, resulted in higher local business costs and added further inflationary pressures. Nevertheless, with global food and commodity prices generally easing back after the first quarter and with the moderation in local economic growth over the course of the year, inflation stabilised on entering the fourth quarter.

The Composite Consumer Price Index (Composite CPI) rose by an average of 5.3 per cent in 2011, up from 2.4 per cent in 2010. Netting the effects of the Government's one-off relief measures to give a more accurate indicator of the inflation trend, underlying consumer price inflation also averaged at 5.3 per cent for 2011 as a whole, up from 1.7 per cent in 2010. In terms of the quarterly profile, underlying inflation went up visibly from 3.7 per cent in the first quarter, to 5 per cent and 6.1 per cent respectively in the second and third quarters, and slightly further to 6.4 per cent in the fourth quarter.

As a broad measure of the overall change in prices in the economy, the GDP deflator rose by 3.6 per cent in 2011, following an increase of 0.3 per cent in 2010, in line with the further pick-up in domestic cost pressure. The domestic demand deflator went up by 4.3 per cent in 2011, notably faster than the 2.1 per cent increase in 2010 (*Chart 17*).

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



Inflation went up progressively during most of 2011 before stabilising towards the year-end, driven by both higher local cost pressures and imported inflation.

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 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 (GRA) and various funds established under the PFO. The GRA 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 GRA and eight of the above Funds (excluding the Bond Fund) represent government revenue and government expenditure, and the total balance of the GRA and the eight funds constitutes Government's fiscal reserves.

Financial Results

For 2010-11, the Government recorded a surplus of $75.1 billion. Fiscal reserves at the end of March 2011 stood at $595.4 billion. Government revenue in 2010-11 amounted to $376.5 billion and expenditure $301.4 billion. For details of revenue by source and of expenditure by component for 2010-11 and 2011-12 (Revised Estimate) see Appendix 6, Table 6.

Public expenditure includes government expenditure and expenditure by the Trading Funds and the Housing Authority. In 2010-11, public expenditure totaled $320.6 billion, an increase of 4.4 per cent over the previous year, within which some $236.7 billion(or 73.8 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 tax rates are low. The cost of administration is relatively low. To protect tax revenue, the Government takes vigorous measures to combat tax evasion and prevent tax avoidance. The major sources of revenue include profits tax (25 per cent), land premium (17 per cent), stamp duties (14 per cent) and salaries tax (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 government 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 38 per cent of the total government revenue in 2010-11, are levied under the Inland Revenue Ordinance.

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 2010-11, profits of unincorporated businesses were taxed at 15 per cent and profits of corporations at 16.5 per cent.

Profits tax is charged provisionally on the basis of profits made in the year preceding the year of assessment and is subsequently adjusted according to the 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 2010-11, the total profits tax collected was about $93.2 billion (about 25 per cent of total government revenue).

Salaries tax is charged on emoluments arising in, or derived from, Hong Kong. Same as profits tax, a provisional tax mechanism is in place. Salaries tax is calculated at progressive rates on the net chargeable income (i.e. income less deductions and allowances). In 2010-11, the first, second and third segments of net chargeable income of $40,000 each were taxed at 2 per cent, 7 per cent and 12 per cent respectively, and the remaining at 17 per cent. No one, however, needed to pay more than the standard rate of 15 per cent of his or her total income after deductions.

The earnings of husbands and wives are reported and assessed separately. However, where the deductions and allowances of either spouse exceed his or her income, or when separate assessments would result in an increase in their total salaries tax payable, the couple, may elect to be assessed jointly. Salaries tax contributed some $44.3 billion (about 12 per cent of total government revenue) in 2010-11. Owing to the generous personal allowances under the Hong Kong tax law, only about 1.4 million people or 40 per cent of the workforce were liable to salaries tax for the year of assessment 2009-10.

Owners of land and buildings in Hong Kong were charged to property tax in 2010-11 at the standard rate of 15 per cent on the actual rent received after 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 the profits it derived from the properties are chargeable to profits tax. Property tax contributed some $1.6 billion (about 0.4 per cent of total government revenue) in 2010-11.

The Stamp Duty Ordinance imposes fixed and ad valorem duties on different classes of documents relating to transfers of immovable property, leases and share transfers. In 2010-11, the revenue from stamp duties was some $51 billion, or about 14 per cent of total government revenue.

Betting duty is charged on the net stake receipts from betting on horse races and football matches and on the proceeds of Mark Six lotteries, all administrated by the Hong Kong Jockey Club. These are the only legal betting activities in Hong Kong. Betting duty on horse races is charged at progressive rates. In 2010-11, the rates of duty are 72.5 per cent on the first $11 billion of net stake receipts, 73 per cent, 73.5 per cent, 74 per cent and 74.5 per cent for each segment of $1 billion thereafter; and 75 per cent on the remaining net stake receipts. The duty for betting on football matches is 50 per cent on the net stake receipts. The duty on the proceeds of Mark Six lotteries is 25 per cent. The yield from betting duty in 2010-11 totalled some $14.8 billion, about 4 per cent of total government revenue.

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 2010-11, the department collected duties of $7.55 billion (about 2 per cent of total government 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 2011-12 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, 2011, with rateable values reflecting the rental values on October 1, 2010.

The Valuation List contained about 2.4 million assessments on March 31, 2011. The revenue from rates in 2010-11 was $9 billion, accounting for about 2 per cent of total government revenue.

To help ease the pressure on people arising from inflation, the Government waived rates for the four quarters from April 2011 to March 2012, subject to a ceiling of $1,500 per quarter for each rateable property. As a result, about 82 per cent of properties would be subject to no rates in 2011-12, while the rates payable of the remaining 18 per cent of properties were reduced by the full concession amount of $1,500, costing the Government about $9.9 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, 2011. Total

Government rent collected in 2010-11 was $6.3 billion, or about 2 per cent of total government revenue.

Fees and charges for services provided by government departments generated about $11.4 billion, or about 3 per cent of total revenue, in 2010-11. 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 $3.5 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 $33.9 billion from investments and interest income on the fiscal reserves in 2010-11, amounting to about 9 per cent of the total government revenue.

Lastly, some $65.5 billion, or about 17 per cent of the total government revenue in 2010-11, 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 align with international standards. The liberalised arrangements came into force on March 12, 2010, following which Hong Kong signed 17 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 2011, the GLD awarded contracts with a total value of $5.39 billion. The goods and related services were procured from 30 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