

The Economy

The Hong Kong economy attained only modest growth in 2012, mainly slowed by sluggish external demand amid an austere global economic environment. Domestic demand nevertheless continued to display resilience and helped keep the unemployment rate at low levels. In tandem with the slower local economic growth and reduced external price pressures, inflation tapered progressively in 2012.

The Hong Kong economy showed a sub-par performance throughout 2012, having decelerated noticeably since mid-2011. Merchandise exports remained the weakest spot, amid a challenging external trading environment characterised by the unsettled euro debt crisis and the fragile recovery of the major advanced economies. Exports of services likewise slowed despite the further notable growth of inbound tourism. Yet the domestic sector fared rather well, with both consumption and investment attaining solid growth.

In 2012, the Gross Domestic Product (GDP) expanded by 1.4 per cent in real terms, moderating from the 4.9 per cent growth in 2011. In terms of the quarterly profile, real GDP posted an anaemic year-on-year growth of 0.8 per cent in the first quarter, before picking up to 1 per cent, 1.4 per cent and 2.5 per cent respectively in the second, third and fourth quarters, aided in part by the base effect and in part by some stabilisation of the euro debt crisis as well as the faster growth of the Mainland economy towards the year-end.

On a seasonally adjusted quarter-to-quarter comparison, real GDP grew by 0.4 per cent in the first quarter, fell back by 0.1 per cent in the second quarter, rebounded by 0.8 per cent in the third quarter and grew further by 1.2 per cent in the fourth quarter (*Chart 1*).

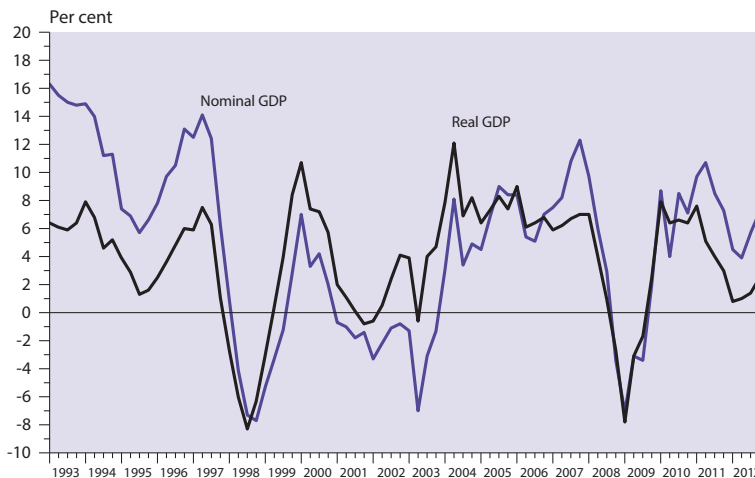
Total exports of goods saw only a small increase in 2012, with widespread weaknesses seen across almost all the major markets, as the recession of the eurozone economy and tepid recovery of the US economy weighed heavily on the production activity and trade flows of export-dependent Asia. But as the global environment stabilised towards the year-end, merchandise exports rebounded visibly in tandem.

Exports of services also moderated in growth. While exports of transportation and trade-related services were lacklustre amid the slowdown in goods trade, those of financial and business

services slackened on dampened market sentiment and quieter fund-raising activities. Exports of travel services nonetheless maintained notable growth.

Chart 1

**Quarterly Gross Domestic Product
(year-on-year rate of change)**



Hong Kong saw a below-trend growth in 2012, dragged by weak external demand.

The domestic sector stayed rather resilient. Private consumption expenditure grew steadily, thanks to largely stable employment and improved income conditions. Investment continued to see appreciable growth, as infrastructure works continued apace, private building and construction activity picked up strongly, and machinery and equipment acquisition sustained notable growth.

The labour market remained in a state of full employment. Job vacancies continued to surge across many sectors, in tandem with the continued notable growth in total employment to a fresh record high in the fourth quarter, with the seasonally adjusted unemployment rate staying low at 3.3 per cent. Amid the continuing generally tight job conditions, wages and earnings saw further solid broad-based growth, though the rates of increase narrowed in the latter half of the year amid the slower economic growth and waning of the boost from statutory minimum wage implementation.

Amid the low interest rates and a tight demand-supply balance of flats, the residential property market was buoyant during most of 2012. Market sentiment reached a high in September upon the announcement of further monetary easing measures in the major advanced economies, before showing some cool-off in November after the Government introduced further measures to combat speculation and manage demand from non-local buyers. Overall flat prices in the fourth quarter of 2012 surged by 24 per cent over a year earlier. Trading gathered momentum from February but plunged to very subdued levels after November. There were 81,333 sale and purchase agreements in 2012, 4 per cent lower than in 2011.

Raising flat supply through increasing land supply has been the Government's top policy priority in ensuring a healthy and stable property market. Much work was done in 2012 to manage demand and reduce the possible risks to financial stability arising from an exuberant property market.

The local stock market fluctuated in 2012. It rebounded on entering 2012 on the better-than-expected performance of the US economy, but nosedived in May on an abrupt worsening of the euro debt crisis. The Hang Seng Index (HSI) hit a low of 18,186 on 4 June 2012, the lowest since late-2011, but the stock market largely went on a rally from July upon some stabilisation of the euro debt situation following the European Central Bank President's pledge to safeguard the euro and the European authorities' efforts to stem the crisis, as well as the advanced economies' fresh round of quantitative easing in September. The HSI closed the year at 22,657, up 23 per cent from the end of 2011. Against an uncertain global economic outlook and dented market sentiments, the average daily turnover shrank to \$53.9 billion in 2012. Fund-raising activities also turned quieter, with total IPO funds raised shrinking by 65 per cent to \$89.8 billion. Hong Kong ranked as the world's third largest IPO centre in 2012, after taking the lead for three consecutive years.

Inflation was generally on an easing trend during 2012, thanks to moderated imported inflation and the feed-through of the earlier stabilisation of private housing rentals. In 2012, underlying inflation averaged 4.7 per cent, down from 5.3 per cent in 2011.

Structure and Development of the Economy

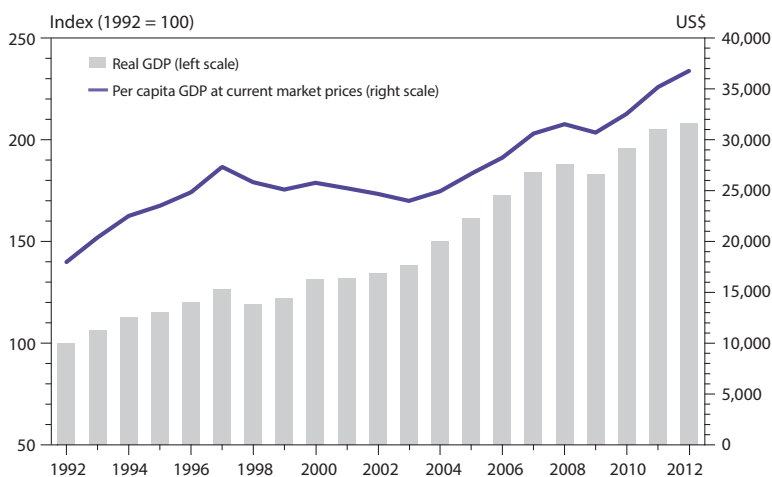
Hong Kong is a global centre for world trade, finance, business and telecommunications, strategically located at the doorstep of the Mainland's huge and vibrant economy. Hong Kong is currently the world's ninth largest trading entity. It operates one of the world's busiest container ports in terms of 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 eighth largest banking centre in terms of gross external positions of banks, and the sixth largest foreign exchange trading centre. Its stock market is the second 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 19 consecutive years. Similarly, the Fraser Institute of Canada has also consistently ranked Hong Kong Number 1 in the world in terms of economic freedom. In 2012, Hong Kong was ranked the world's most competitive economy by the International Institute for Management Development for the second consecutive year, and remained the second easiest place to do business in the world

according to the World Bank's Doing Business 2013 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 3.7 per cent in real terms, faster than the average growth at 3.6 per cent of the world economy. Over the same period, Hong Kong's per capita GDP rose by nearly 70 per cent in real terms, posting an average annual growth rate of 2.6 per cent. Hong Kong's per capita GDP at current market prices reached US\$36,800 in 2012, 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 3.7 per cent in real terms, outpacing the 3.6 per cent growth for the world economy.

Riding on the tides of globalisation and the further deepening of regional integration, Hong Kong's trade linkages with other parts of the world have grown appreciably. Trade in goods and services more than tripled in real terms over the past two decades. In 2012, the total value of visible trade (comprising re-exports, domestic exports and imports of goods) reached \$7,347 billion, equivalent to 360 per cent of GDP. This was considerably higher than the ratios of 233 per cent in 1992 and 245 per cent in 2002. Including the value of exports and imports of services, the ratio of total trade to GDP was even higher, at 430 per cent in 2012, up significantly from 273 per cent in 1992 and 288 per cent in 2002.

The stock of inward direct investment in Hong Kong was enormous, at \$11,024 billion in market value at the end of 2012, equivalent to 540 per cent of GDP. It served as another vivid manifestation of Hong Kong's increasing international focus. Hong Kong is among the most preferred destinations for inward direct investment in Asia, ranked second in Asia by the United Nations' World Investment Report 2012, just after the Mainland.

The corresponding figures for Hong Kong's stock of outward direct investment were likewise huge, at \$10,152 billion or 498 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 \$27,138 billion and \$21,463 billion respectively at the end of 2012. The corresponding ratios to GDP in 2012 were 1,330 per cent and 1,052 per cent. Reflecting Hong Kong's robust international investment position, its net external financial assets amounted to \$5,675 billion at the end of 2012, equivalent to 278 per cent of GDP.

The Gross National Income (GNI), comprising GDP and net external primary income flows, stood at \$2,084 billion in 2012. This was higher than the corresponding GDP by 2 per cent. The difference represented a net inflow of external primary income. In gross terms, inflows and outflows of external primary income remained substantial in 2012, at \$1,069 billion and \$1,026 billion respectively, equivalent to 52 per cent and 50 per cent of GDP respectively. This was attributable to the huge volumes of Hong Kong's inward and outward investment.

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 had a significant direct value-added contribution to the economy in the early 1980s, has since diminished in relative importance. Within this broad sector, the value-added contribution from manufacturing shrank from 14 per cent in 1991 to 4 per cent in 2001 and to only 2 per cent in 2011. The construction sector's contribution to GDP stayed at around 5 per cent between 1990 and 2000, before edging down to 3 per cent in 2011. 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.

The Hong Kong economy has become increasingly service-oriented since the 1980s. The Mainland's open-door policy and economic reforms have not only provided a vast production hinterland and market outlet for Hong Kong's manufacturers but, more importantly, also unleashed ample business opportunities for a wide range of service providers. Hong Kong has thus leveraged its geographical proximity and cultural ties with the Mainland as well as its strong market institutions 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) rose progressively over the years, to 93 per cent in 2011 (*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.

Chart 4

Employment by Broad Economic Sector



Over the past two decades, the share of the services sector in total employment increased markedly, while the share of the industrial sector kept 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.

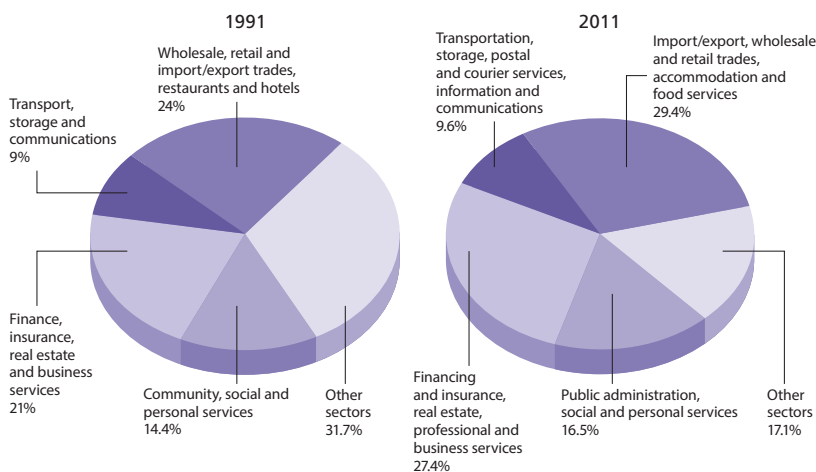
The Services Sector

The services sector is where Hong Kong's competitive advantage lies. Over the past five years between 2007 and 2012, the value-added part of the services sector grew by a cumulative 16 per cent in real terms, outpacing the corresponding 13 per cent growth of the overall economy. Among the constituent service sectors, wholesale and retail trades showed the fastest cumulative growth of 60 per cent. This, coupled with the 9 per cent growth in accommodation and food services, reflected the solid domestic demand and the vibrant inbound tourism. Notwithstanding the global financial crisis and the euro debt crisis during this period, financing and insurance recorded solid growth of 19 per cent, a testament to Hong Kong's position as an international financial centre. Import and export trade saw a 19 per cent increase over the period, while transport and storage services grew steadily by 12 per cent, underlining the competitiveness of Hong Kong's trading and logistics sector.

In 2011, the services sector directly contributed 93 per cent to GDP. Import/export, wholesale and retail trades, and accommodation and food services remained the largest service sectors, accounting for 29 per cent of GDP. This was followed by financing and insurance, real estate, professional and business services (27 per cent), public administration, social and personal services (16 per cent), transportation, storage, postal and courier services, and information and communications (10 per cent) (*Chart 5*).

Chart 5

Gross Domestic Product by Major Sector



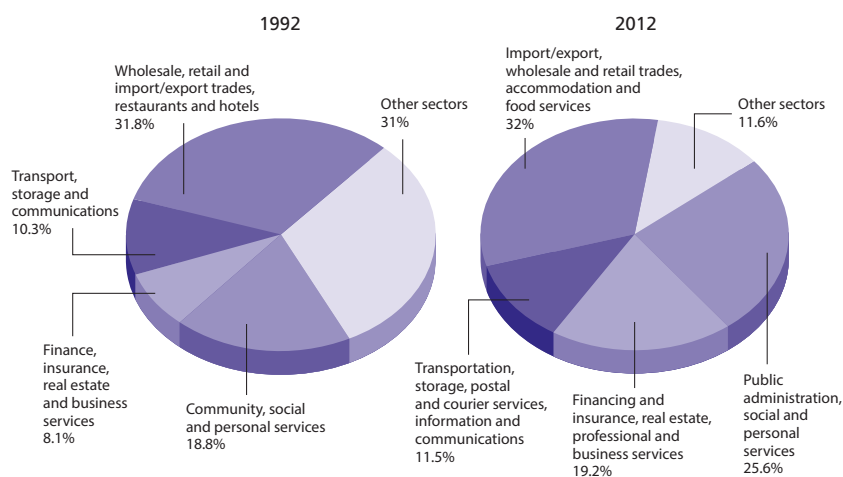
The import/export, wholesale and retail trades, accommodation and food services sector, and the financing and insurance, real estate, professional and business services sector remained the two largest service sectors in terms of net output in 2011.

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 increasing service orientation of the economy 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 69 per cent in 1992 to 85 per cent in 2002 and 88 per cent in 2012. As for individual service segments, import/export trade and wholesale, retail, accommodation and food services accounted for 32 per cent of the total in 2012. 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 6

Employment by Major Sector



Import/export trade and wholesale, retail, accommodation and food services employed the most people in 2012.

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The Manufacturing Sector

Hong Kong's manufacturing sector continues to be versatile and resilient in coping with the changing global and regional economic landscapes. Thanks to the increased manufacturing arrangements in the Mainland and other neighbouring economies with lower land and labour costs, 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

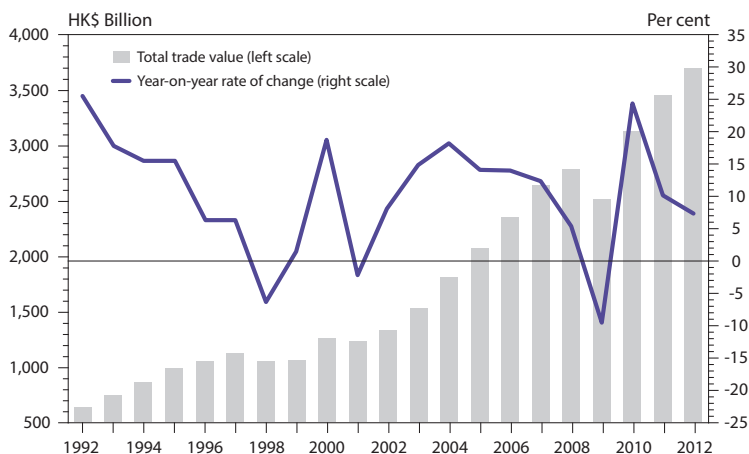
sector, its well-established linkages with the Mainland economy have underpinned the growth of Hong Kong's services sector, especially by driving the rapid development of trading and other supporting services.

Economic Links between Hong Kong and the Mainland

Since the Mainland launched its economic reform and open-door policy in 1978, the economic relationship between the Mainland and Hong Kong has grown steadily closer. 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 yielded enormous mutual benefits and contributed to the remarkable income and employment growth in the two places.

The Mainland plays an increasingly important role in the world arena and its total trade has surged 22-fold in the past two decades. Hong Kong has benefited substantially from the Mainland's phenomenal trade growth. Visible trade between Hong Kong and the Mainland in 2012 was about six times that in 1992, representing growth of 9 per cent per annum in value terms (*Chart 7*). In 2012, Hong Kong and the Mainland were ranked the world's ninth and second largest trading entities respectively.

Chart 7 Visible Trade between Hong Kong and the Mainland



Merchandise trade between Hong Kong and the Mainland registered notable cumulative growth in the past two decades.

The Mainland has long been Hong Kong's largest trading partner, accounting for about half of Hong Kong's total trade value in 2012. Reciprocally, Hong Kong was the Mainland's third largest trading partner (after the European Union and the United States), accounting for about 9 per cent of the Mainland's total trade value in 2012. Nearly half of Hong Kong's exports to the Mainland (mainly re-exports) in 2012 involved raw materials, reflecting the latter's role as a production hinterland and the highly integrated production network within the Asia region. Meanwhile, Hong Kong's exports of consumer goods (mainly re-exports) to the Mainland more than doubled in the past 10 years. With a population of over 1.3 billion (over 100 million in

Guangdong Province alone) and the Central Government's goal to rebalance economic growth towards domestic consumption, the Mainland market provides huge business potential for Hong Kong's exporters.

Hong Kong is a principal gateway to and from the Mainland for business and tourism. In 2012, foreign visitors to the Mainland made 4.1 million trips through Hong Kong. The number of trips made by Mainland residents to or through Hong Kong reached 34.9 million in 2012, with an average annual growth rate of 18 per cent.

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\$592 billion at the end of 2012, accounting for about 46 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 62 per cent of its total outward direct investment as at the end of 2011, 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 the end of 2011, the market value of direct investment from the Mainland to Hong Kong amounted to US\$392 billion, accounting for 36 per cent of Hong Kong's total inward direct investment. Mainland companies have also maintained a strong presence in Hong Kong. As at mid-2012, Mainland companies had established a total of 853 regional headquarters, or regional or local offices in Hong Kong, up from 556 ten years ago.

Amongst the provinces in the Mainland, Guangdong's economic links with Hong Kong are the closest. Based on the Mainland's statistics, at the end of 2012, the cumulative value of Hong Kong's realised direct investment in Guangdong was US\$185 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, while at the same time also propelling the rapid structural transformation in the Hong Kong economy over the past three decades.

Financial links between Hong Kong and the Mainland have also strengthened substantially over the years, on the back of the surge in cross-boundary business activities and the Central Government's policy to enhance the global influence of Hong Kong as an international financial centre. Hong Kong is a major funding centre for Mainland enterprises, and 721 Mainland enterprises were listed on the Hong Kong stock market as at the end of 2012, with 45 of these listed in 2012. Mainland enterprises raised \$215.7 billion of equity funds in Hong Kong in 2012. These activities in turn reinforced Hong Kong's position as a major fund-raising centre in the region.

With the Mainland's staunch support for Hong Kong's development as the nation's premier offshore renminbi (RMB) centre, RMB business in Hong Kong continued to see appreciable growth in 2012. Total RMB trade settlements handled by banks in Hong Kong amounted to RMB 2,632.5 billion in 2012, a 37 per cent growth compared with 2011. At the end of 2012, the outstanding amount of RMB customer deposits and certificates of deposit issued amounted to RMB 603 billion and RMB 117.3 billion respectively, totalling RMB 720.2 billion, up 9 per cent

compared with RMB 661.6 billion at the end of 2011. Since August 2012, authorised institutions in Hong Kong have been allowed to offer RMB services to personal customers who are non-Hong Kong residents. Over 29,000 accounts were opened by non-resident personal customers by the end of 2012, with deposits exceeding RMB 4 billion. RMB bank lending also expanded significantly in 2012, with outstanding RMB loans amounting to RMB 79 billion at the end of 2012, a 157 per cent growth from a year earlier. Hong Kong is the first place outside the Mainland to develop an RMB bond market. By the end of 2012, there had been 220 RMB bond issuances with total outstanding amount of about RMB 237.2 billion.

Besides RMB bonds, a wide range of RMB investment products were launched in Hong Kong in 2012, including an RMB gold exchange-traded fund (ETF), an RQFII A-share ETF, RMB currency futures, shares traded in both RMB and HKD and RQFII A-share ETF derivative warrants.

In June 2012, the Central Government announced a series of measures to boost Hong Kong's role as an offshore RMB centre and global financial centre. These included developing the offshore RMB lending market and enriching the variety of offshore RMB products in Hong Kong, increasing the investment quotas, enlarging the range of participating entities, enriching the product variety and relaxing the investment restrictions in relation to the RMB Qualified Foreign Institutional Investors (RQFII) scheme. These 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.

Economic co-operation and integration with the Mainland has been continuously enhanced through the broadening of the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA). In June 2012, the Hong Kong Special Administrative Region (HKSAR) Government and the Central People's Government signed Supplement IX to CEPA, providing 43 services liberalisation and trade and investment facilitation measures, including 37 liberalisation measures in 22 service sectors, measures to strengthen co-operation in finance and trade and investment facilitation, and measures to promote the mutual recognition of professional qualifications. Inclusive of the measures in Supplement IX, there is now preferential treatment for Hong Kong service providers entering the Mainland market in 48 service sectors. The new measures will help Hong Kong service industries take advantage of the Mainland market's potential and assist integration and professional exchanges.

Construction of the Hong Kong Link Road for the Hong Kong-Zhuhai-Macao Bridge started in May 2012. When completed in 2016, the bridge will significantly reduce commuting time and transportation costs between Hong Kong and the western Pearl River Delta (PRD) region and help the flow of people and goods within the PRD generally.

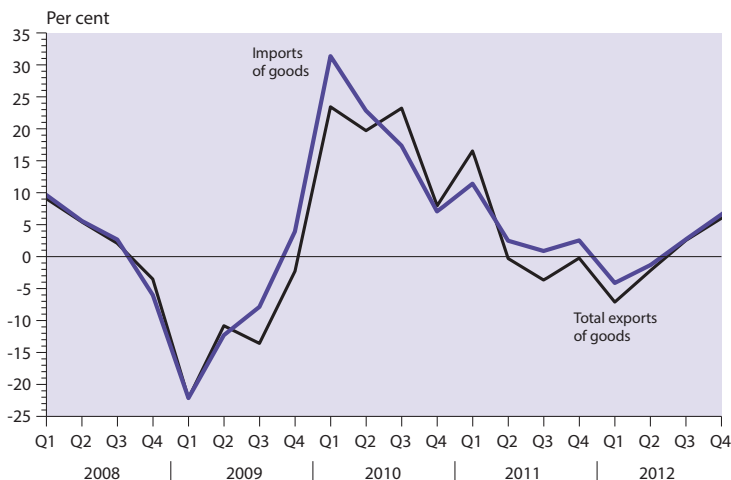
The Economy in 2012

External trade

The difficult and unsteady global trading environment continued to take its toll on Hong Kong's external trade in 2012. Total exports of goods slowed further to a small growth of 1.3 per cent in real terms in 2012, from the already moderate 3.4 per cent increase in 2011. The European Union (EU) market remained the weakest spot for Hong Kong's exports in 2012, as the eurozone

economy slipped back to recession amid the euro debt crisis. Reflecting the weak demand there, exports to the EU contracted at a double-digit rate in 2012. Exports to the US and Japan, where recoveries were fragile and uneven, were also subdued. The sluggishness of the advanced economies inflicted visible negative spillovers to the Asian economies in 2012, many of which saw a slowdown in their production and export activities. As such, Hong Kong's exports to such Asian markets as India, Korea, Singapore and Taiwan declined visibly in 2012. In the case of exports to the Mainland, there was nonetheless a visible improvement in the latter part of 2012, along with the rebound of economic growth there, leading to a modest increase for the year as a whole. In terms of the quarterly profile, total exports of goods contracted by 5.2 per cent and 0.2 per cent respectively in the first and second quarters over a year earlier, before bouncing up to grow by 4 per cent and 6.1 per cent respectively in the third and fourth quarters (*Chart 8*). On a seasonally adjusted quarter-to-quarter comparison, goods exports grew mildly in the first quarter, then fell back in the second quarter, before picking up strongly in the third and fourth quarters.

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



Merchandise exports remained sluggish in 2012 amid tepid demand in the advanced economies, but picked up towards the year-end on faster Mainland growth.

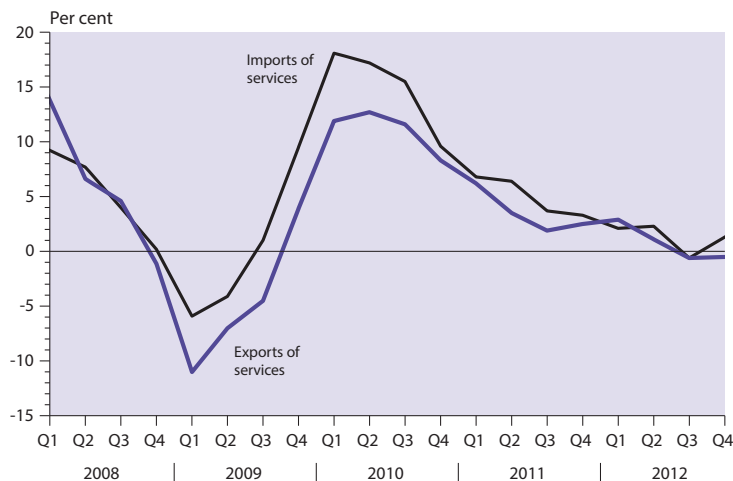
Imports of goods grew mildly by 1 per cent in volume terms in 2012. The slowdown from the moderate growth of 4.1 per cent in 2011 mainly reflected the fall-off in import intake related to re-exports. Retained imports, which accounted for more than a quarter of total imports, nevertheless grew moderately by 3.5 per cent in volume terms in 2012, though also slower than the 7.8 per cent growth in 2011. Analysed by end-use category, retained imports of consumer goods maintained solid growth of 6.4 per cent even against 2011's distinctly high base, thanks to the resilient consumption market. Those of capital goods accelerated further, reflecting the relatively sanguine local business sentiment during most of the year. Retained imports of foodstuffs posted mild growth, but retained imports of raw materials dropped for the second consecutive year, alongside the general economic slowdown. Retained imports of fuels also fell for another year, probably due partly to the slower transport activity and partly to continued energy-saving efforts.

Exports of services were likewise hit by the difficult external environment. Not only did exports of transportation and trade-related services turn lacklustre amid the setback in merchandise trade, but those of financial and business services also slackened visibly as fund-raising and other commercial activities were hampered by the overcast global economic prospects and more cautious market sentiment. On the other hand, exports of travel services maintained notable growth, thereby rendering the key impetus to overall exports of services, which grew by 1.2 per cent in 2012, still visibly down from the 4.9 per cent growth in 2011.

Imports of services also grew marginally by 0.7 per cent in real terms in 2012, further to a 3.5 per cent expansion in 2011. Imports of transportation and trade-related services both shrank in 2012, due to the strong headwinds in the trading environment. Those of financial and business services also weakened visibly in 2012. In contrast, imports of travel services picked up and grew appreciably in 2012, thanks to favourable local consumer sentiment and improved incomes (*Chart 9*).

Chart 9

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



Exports of services moderated visibly in 2012, in tandem with sluggish trade flows.

Against a difficult external environment and reflecting resilient domestic demand, the visible trade deficit widened in 2012, only to be roughly offset by the invisible trade surplus. As a result, the combined visible and invisible trade account in 2012 was virtually in balance, with a marginal surplus of \$1 billion, equivalent to a trivial share of the total value of imports of goods and services. This compared to the combined trade balance of \$60 billion surplus in 2011, or 1.4 per cent of the total value of imports of goods and services.

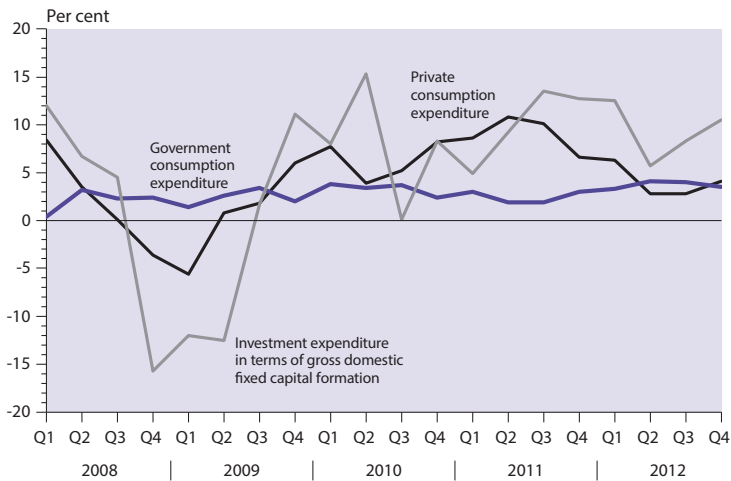
Domestic demand

The domestic sector still held up well in 2012 and helped cushion the weakness in the external sector. Thanks to largely stable employment conditions and broadly improved incomes, private consumption expenditure (PCE) grew solidly by 4 per cent in real terms in 2012, even after the strong 9 per cent growth in 2011. On a seasonally adjusted quarter-to-quarter comparison, PCE

registered growth almost throughout 2012. Government consumption expenditure grew by 3.7 per cent in real terms in 2012, following the 2.5 per cent growth in 2011.

Overall investment spending in terms of gross domestic fixed capital formation sustained strong growth of 9.1 per cent in 2012, following the 10.2 per cent expansion in 2011. As a number of large-scale infrastructure projects were under way, public sector construction activity grew markedly. Meanwhile, private sector building activity continued to thrive, growing strongly during the year. Overall building and construction expenditure grew by 12.3 per cent in real terms in 2012. Machinery and equipment acquisition grew appreciably through all four quarters, resulting in 10.6 per cent growth for 2012 as a whole, in spite of more cautious business sentiment (*Chart 10*).

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

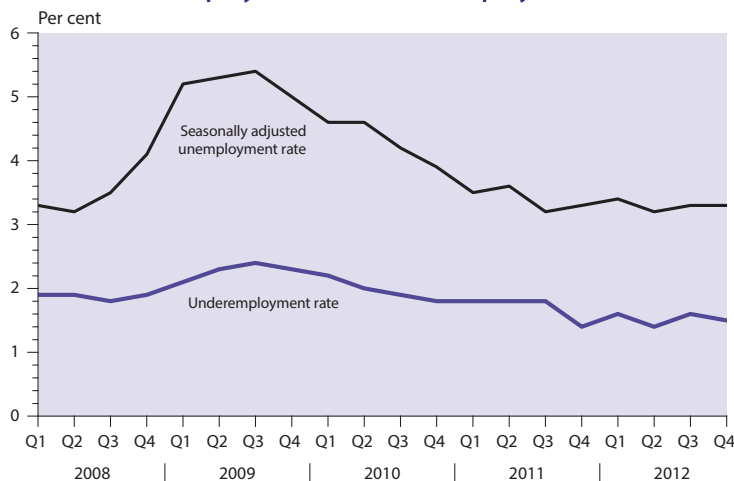


Domestic demand still fared well, on the back of solid consumption and investment spending.

The Labour Market

The labour market remained tight in 2012, signifying another year of full employment. Thanks to the buoyant domestic economic activity, labour demand grew briskly during the year and total employment hit a new historical high of 3,689,600 in the fourth quarter. The unemployment situation enjoyed a broad-based improvement despite the subdued economic growth, with the unemployment rate falling to a 15-year low of 3.3 per cent for 2012 as a whole, from 3.4 per cent in 2011. Meanwhile, the underemployment situation was also broadly favourable, finishing the year at 1.5 per cent (*Chart 11*).

Chart 11 **The Unemployment and Underemployment Rates**



The unemployment rate stayed low throughout 2012, signifying another year of full employment.

The labour force expanded by 2.2 per cent in 2012, even faster than the visible growth of 2 per cent in 2011. Better job opportunities coupled with improved income prospects following the implementation of the statutory minimum wage continued to attract more people to enter the labour market, especially women and those aged 50 and over. For 2012 as a whole, total employment grew by 2.4 per cent, after an increase of 2.9 per cent in 2011. Job expansion was broad-based across sectors, with job creation particularly notable in the construction sector. Employment in the domestically-oriented sectors such as retail, accommodation and food services, and wholesale also maintained solid growth throughout the year, thanks to buoyant local consumption and inbound tourism (*Chart 12*).

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



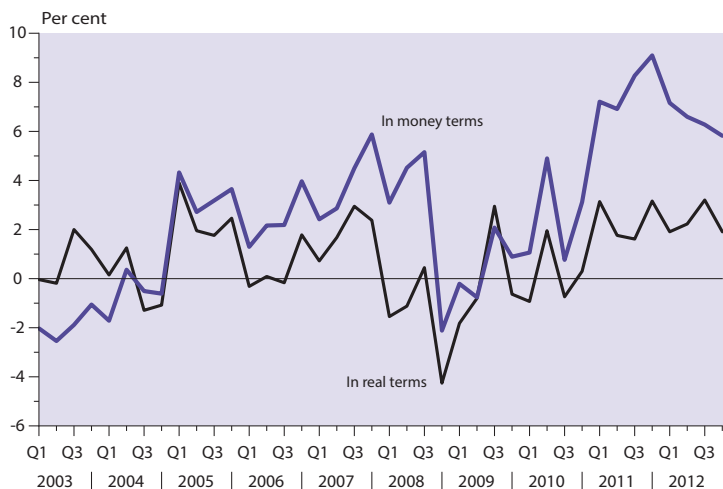
Employment and labour force growths generally stayed strong in 2012.

Reflecting increasing tightness in the labour market, job vacancies in the private sector establishments continued to stand high across occupations and economic sectors in 2012, with the number of private sector vacancies jumping by 21.5 per cent to 68,800. In December 2012, the ratio of job vacancies was 56 per 100 job-seekers, higher than that of 48 the year before. Concurrently, the corresponding ratio for lower-skilled jobs rose sharply to 63 from 45, but that for higher-skilled jobs dropped to 63 from 84. Analysed by economic sector, job vacancies increased substantially in December 2012 in accommodation and food services (up 31.9 per cent year-on-year), professional and business services (excluding cleaning and similar services) (up 22.3 per cent), and retail (up 20.4 per cent) on the back of vibrant local consumption and domestic demand. These figures suggested that manpower shortages in some segments became more evident amidst the relatively tight labour market.

Thanks to the favourable labour market and the effect of the statutory minimum wage, wages and earnings sustained solid and broad-based growth in 2012. Labour earnings in the private sector increased by 6.5 per cent in 2012, though not as much as in 2011. After adjusting for inflation, there was a real improvement of 2.3 per cent (*Chart 13*). Analysed by economic sector, nominal payroll rose across almost all sectors in 2012, more prominently in retail, manufacturing and information and communications. Separately, data from the General Household Survey, though not strictly comparable to those from the business establishment surveys, indicated that the average employment earnings of full-time employees in the lowest decile group went up by 6.7 per cent in nominal terms and 2.4 per cent in real terms in the fourth quarter of 2012 over a year earlier. Over the same period, median household income rose by 5 per cent from \$20,000 to \$21,000. After adjusting for inflation, there was still an improvement of 1.2 per cent in real terms.

Chart 13

**Labour Earnings
(year-on-year rate of change)**



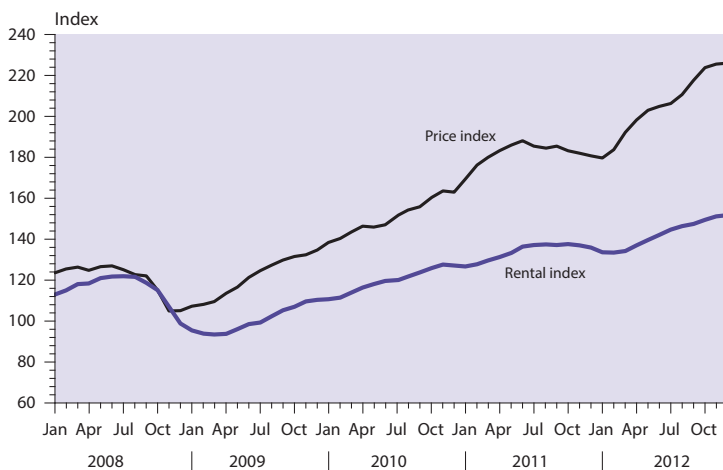
Labour earnings continued to improve in both nominal and real terms in 2012.

The Property Market

With abundant liquidity, exceptionally low interest rates and a tight demand-supply balance of flats, the residential property market was buoyant during most of 2012. After entering the year on a soft note, the market picked up momentum from February, with sentiment reaching a high in September upon the announcement of another round of monetary easing measures by the US Federal Reserve and other central banks in the major advanced economies. The market showed some cool off in November and December after the Government announced the enhanced Special Stamp Duty to further curb speculation, and the Buyer's Stamp Duty to manage demand from non-local buyers.

Reflecting the upbeat sentiment throughout most of the year, overall flat prices in the fourth quarter of 2012 surged by 24 per cent over a year earlier and overall flat rentals rose by 10 per cent. Following the surge since mid-2009, overall flat prices in the fourth quarter of 2012 were 33 per cent above the peak in 1997, and overall flat rentals were also 8 per cent above the peak (Chart 14).

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

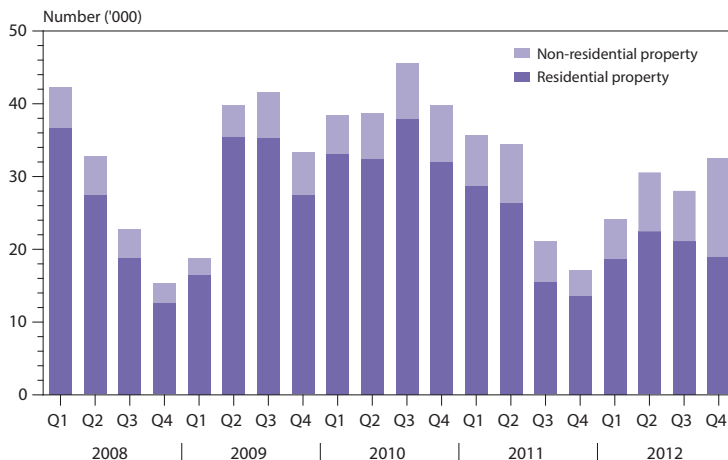


Both flat prices and rentals surged further.

Residential property transactions gradually gathered momentum from February, before plummeting to very subdued levels in November and December. There were 81,333 sale and

purchase agreements for residential property received by the Land Registry in 2012, 4 per cent lower than in 2011, but total consideration edged up by 2 per cent to \$452.3 billion due to rising property prices (*Chart 15*).

Chart 15 **Sale and Purchase Agreements by Broad Type of Property**



Overall trading in the property market gathered momentum over the course of the year before plunging in November and December.

As a result of the faster increase in flat prices than in 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 to 52 per cent in the fourth quarter, surpassing the long-term average of 49 per cent over 1992-2011.

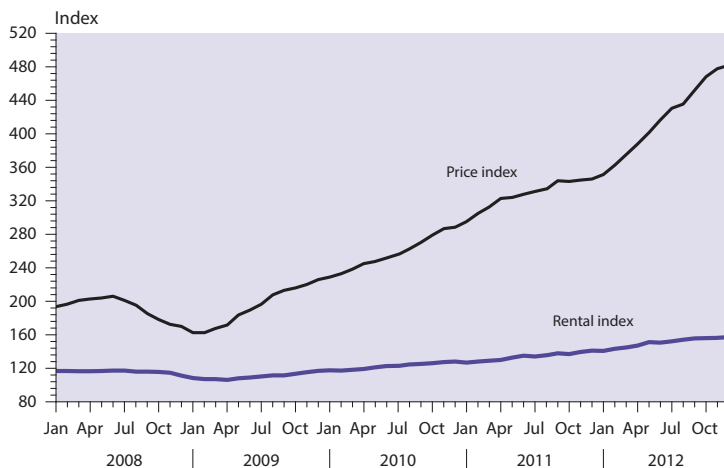
Raising flat supply through increasing land supply is the Government's top policy priority in ensuring a healthy and stable development of the property market. To step up efforts in this direction, in August and September the Government introduced a series of measures to increase land and flat supply, such as changing the use of various sites to residential use.

Before the supply side measures can fully redress the tight demand-supply balance of flats, the Government also puts strong emphasis on managing demand and reducing the possible risks to financial stability arising from an exuberant property market. In September, the Hong Kong Monetary Authority introduced the fifth round of macro-prudential measures to strengthen the risk management of the banking sector's mortgage lending business. In October, the Government announced an enhancement of the Special Stamp Duty to further curb speculative activities and the introduction of a Buyer's Stamp Duty to give priority to the housing needs of Hong Kong permanent residents. The Government has also made efforts to improve transparency of the residential property market, with the Residential Properties (First-hand Sales) Ordinance enacted in July 2012.

Completion of private residential flats was at a modest 10,100 units in 2012, though it was already 7 per cent higher than in 2011. Completion net of demolition, at 7,600 units, was similar to a take-up of 7,600 units. As a result, the vacancy rate stayed at a low 4.3 per cent at the end of 2012, the same as a year earlier. Completions are forecast to increase by 34 per cent to 13,600 units in 2013. In the coming three to four years, the total supply of flats (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 62,000 units as estimated at the end of 2011 to 67,000 units as estimated at the end of 2012, the highest since September 2007.

The non-residential property markets were generally buoyant in 2012. Underpinned by vibrant inbound tourism and ongoing strength in the local consumption market, prices of retail shop space in the fourth quarter of 2012 surged by 38 per cent over a year earlier, and rentals also rose by 13 per cent (*Chart 16*).

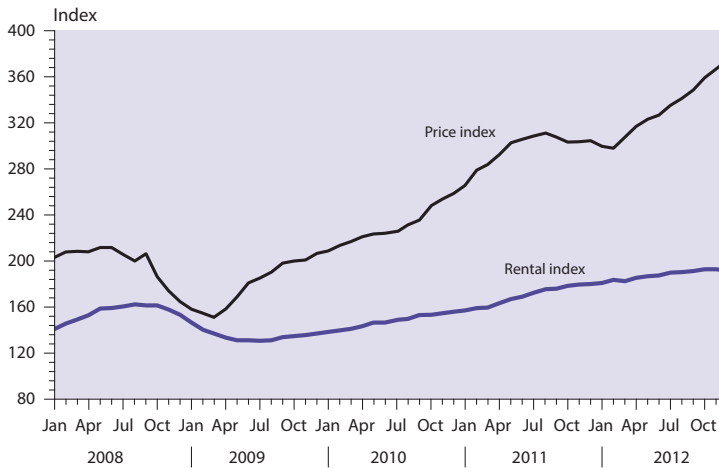
Chart 16 Prices and Rentals of Retail Shop Space
(1999=100)



Prices and rentals of retail shop space surged further.

For office space, overall prices in the fourth quarter of 2012 surged by 21 per cent over a year earlier. Prices of Grade A, B and C office space rose by 14 per cent, 23 per cent and 26 per cent respectively. Office rentals in the fourth quarter rose by 7 per cent over a year earlier, with Grade A, B and C office space registering gains of 7 per cent, 9 per cent and 9 per cent respectively. Meanwhile, prices and rentals of flatted factory space rose further by 41 per cent and 12 per cent respectively (*Chart 17*).

Chart 17 Prices and Rentals of Office Space
(1999=100)



Prices of office space soared while rentals also registered notable gains.

The number of sale and purchase agreements for non-residential property surged by 40 per cent to 34,200, and total consideration by 39 per cent to \$201.7 billion.

Reflecting the solid take-up relative to completion, vacancy rates for non-residential properties fell across the board. Specifically, the vacancy rate declined from 8 per cent to 6.9 per cent for commercial space, from 6.5 per cent to 6 per cent for office space, and from 6 per cent to 5 per cent for flatted factory space.

Price Movements

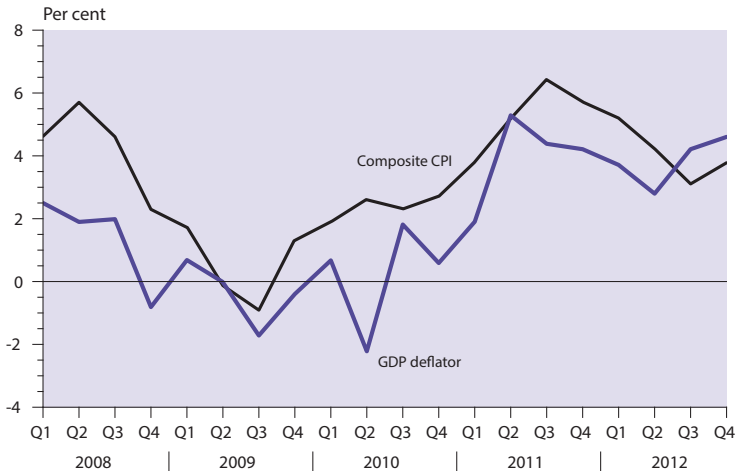
Consumer price inflation generally eased in 2012, thanks to receding external and domestic price pressures. Externally, imported inflation generally tapered over the course of 2012, thanks to global food and commodity prices peaking in early 2011 and slower inflation in Hong Kong's major trading partners. Locally, the progressive feed-through of the earlier stabilisation in fresh letting rentals in late 2011 and early 2012, the fading boost from the statutory minimum wage, and slower economic growth all helped lessen domestic cost pressures.

With price pressures on the two largest components in the household consumption basket (food prices and private housing rentals) receding, headline consumer price inflation came down to 4.1 per cent in 2012, from 5.3 per cent in 2011. Netting out the effects of the Government's relief measures, underlying consumer price inflation retreated to 4.7 per cent in 2012, from 5.3 per cent in 2011. In terms of the quarterly profile, underlying inflation eased progressively from 5.9 per cent in the first quarter to 5.1 per cent and 4 per cent respectively in the second and third quarters, and slightly further to 3.8 per cent in the fourth quarter.

The GDP deflator rose by 3.9 per cent in 2012, similar to the increase in 2011, in line with the moderate increase in domestic prices and a slight deterioration in the terms of trade (*Chart 18*).

Chart 18

Main Inflation Indicators (year-on-year rate of change)



Inflation was generally on a tapering trend in 2012, amid the slower local economic growth and moderated 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.
- The HKSAR shall practise an independent taxation system, taking the low tax policy previously pursued in Hong Kong as reference.
- The HKSAR shall follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its Gross Domestic Product.
- The Legislative Council of HKSAR shall exercise the power to approve taxation and public expenditure.

The Government implements these constitutional provisions in its management of public finances by maintaining a low and simple tax regime and exercising fiscal prudence. Hong Kong's 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.

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 (which runs from 1 April to 31 March) 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 established under the PFO are the Bond Fund, the Capital Investment Fund, the Capital Works Reserve Fund, the Civil Service Pension Reserve Fund, the Disaster Relief Fund, the Innovation and Technology Fund, the Land Fund, the Loan Fund and the Lotteries Fund. The total revenue and expenditure of the GRA and all these funds except the Bond Fund represent government revenue and government expenditure, and the total balance of the GRA and the funds except the Bond Fund constitutes government fiscal reserves.

Financial Results

For 2011-12, the Government recorded a surplus of \$73.7 billion. Fiscal reserves at the end of March 2012 stood at \$669.1 billion. Government revenue in 2011-12 amounted to \$437.7 billion and expenditure \$364 billion. For details of revenue by source and of expenditure by component for 2011-12 and 2012-13 (Revised Estimate) see Appendix 6, Table 6.

Public expenditure comprises government expenditure and expenditure by other public bodies. In 2011-12, public expenditure totalled \$385.6 billion, an increase of 20.3 per cent over the previous year, within which some \$257.2 billion (or 66.7 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 and the cost of administration are 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 (27 per cent), land premium (19 per cent), salaries tax (12 per cent) and stamp duties (10 per cent). All major sources of revenue are presented at Appendix 6, Chart 1.

The Inland Revenue Department collects about 54 per cent of total government revenue, including profits tax, salaries tax, property tax, stamp duties and betting and sweeps tax. Profits, salaries and property taxes (including tax under personal assessment), which together accounted for about 40 per cent of the total government revenue in 2011-12, 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 2011-12, 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 2011-12, the total profits tax collected was about \$118.6 billion (about 27 per cent of total government revenue).

Salaries tax is charged on emoluments arising in, or derived from, Hong Kong. As with profits tax, a provisional tax mechanism is in place. Salaries tax is calculated at progressive rates on the net chargeable income (ie income less deductions and allowances). In 2011-12, 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 remainder 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 \$51.8 billion (about 12 per cent of total government revenue) in 2011-12. Due to the generous personal allowances under the Hong Kong tax law, only about 1.5 million people, or 43 per cent of the workforce, were liable to salaries tax for the year of assessment 2010-11.

Owners of land and buildings in Hong Kong are charged to property tax at the standard rate (15 per cent in 2011-12) 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 \$1.9 billion (about 0.4 per cent of total government revenue) in 2011-12.

Stamp duty is imposed on different classes of documents relating to transfers of immovable property, leases and transfers of shares under the Stamp Duty Ordinance. In 2011-12, the revenue from stamp duties was some \$44.4 billion, or about 10 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 administered by the Hong Kong Jockey Club. Betting duty on horse races is charged at progressive rates. In 2011-12, the rates of betting duty on horse races were 72.5 per cent on the first \$1 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 betting duty on football matches was 50 per cent of the net stake receipts. The betting duty on Mark Six lotteries was 25 per cent of the proceeds. The yield from betting duty in 2011-12 totalled some \$15.8 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 collects these duties, which totalled \$7.72 billion in 2011-12 (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 2012-13 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 1 April 2012, with rateable values reflecting the rental values on 1 October 2011. The Valuation List contained about 2.4 million assessments on 31 March 2012. The revenue from rates in 2011-12 was \$9.7 billion, accounting for about 2.2 per cent of total government revenue.

To help ease the pressure of the economic downturn on the community, the Government waived rates for 2012-13, subject to a ceiling of \$2,500 per quarter for each rateable property. As a result, about 90 per cent of properties were subject to no rates in the year, while the rates payable for the remaining 10 per cent of properties were reduced by the full concession amount of \$2,500, costing the Government about \$11.7 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 27 May 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 31 March 2012. Total Government rent collected in 2011-12 was \$6.5 billion, or about 1.5 per cent of total government revenue.

Fees and charges for services provided by government departments generated about \$13.2 billion, or about 3 per cent of total revenue, in 2011-12. It is government policy that fees should in general 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 \$3.6 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 \$37.2 billion from investments and interest income on its fiscal reserves in 2011-12, amounting to about 9 per cent of the total government revenue.

Lastly, some \$84.6 billion, or about 19 per cent of the total government revenue in 2011-12, 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.

With effect from 12 March 2010, the HKSAR Government liberalised arrangements for exchanging tax information under the CDTAs to align with international standards. Since then, Hong Kong has signed 21 CDTAs applying the new standards up to the end of 2012, including four in 2012.

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 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 2012, the GLD awarded contracts with a total value of \$5.18 billion. The goods and related services were procured from 31 different countries or territories (including Hong Kong).

To facilitate sourcing and market research, the GLD maintains 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 the case of procurement covered by the 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