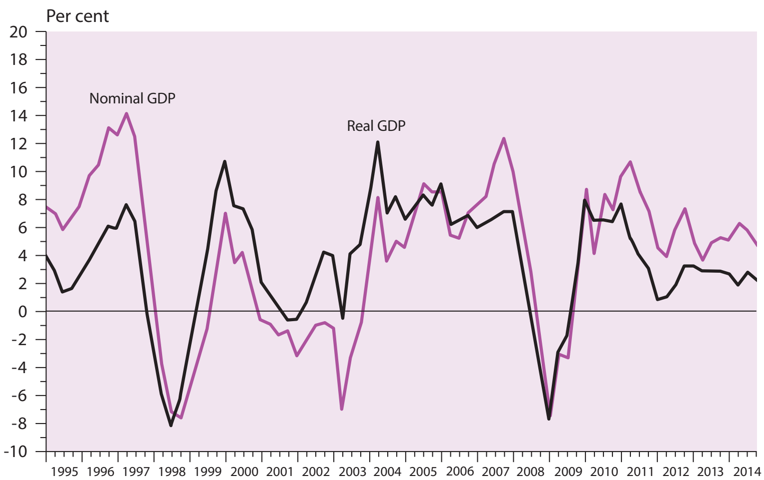
Chapter 3

The Economy

The Hong Kong economy continued to grow below-trend in 2014. The slow global economic recovery weighed on exports of goods, while tourist spending and domestic demand also weakened. The labour market was largely stable, while inflation continued to ease.

The Hong Kong economy remained on a modest expansion path in 2014, with the Gross Domestic Product (GDP) expanding modestly by 2.3 per cent in real terms, slower than the 2.9 per cent growth in 2013 and the annual average growth of 3.9 per cent in the past decade. In terms of the quarterly profile, the year-on-year growth rate of real GDP slowed to 2.6 per cent and 1.8 per cent respectively in the first and second quarters, followed by a rebound to 2.7 per cent in the third quarter, before moderating to 2.2 per cent in the fourth quarter (*Chart 1*).

Chart 1 **Quarterly Gross Domestic Product (year-on-year rate of change)**



The Hong Kong economy remained on a modest path of expansion in 2014.

Total exports of goods grew only modestly in 2014, with a relapse to a slight decline in the fourth quarter, reflecting the lacklustre external trading environment. While the US economy displayed some strengthening during the year, the eurozone economy and Japan's economy still lacked momentum. Emerging market economies also slowed down by varying degrees, with emerging Asia faring better. Besides, the divergence of monetary policy stance among major central banks, heightened geopolitical tensions in various parts of the world as well as the plunge in oil prices all added headwinds to the financial market and foreign exchange markets, exacerbating the already unsteady external environment.

Exports of services eased visibly to grow only slightly in 2014, marking the slowest growth since 2009. The main drag stemmed from a fall-off in visitor spending on big-ticket items. Meanwhile, other services exports remained generally lacklustre, also affected by subdued global demand.

The domestic sector's growth momentum also softened in 2014. Private consumption expenditure saw only moderate growth. Investment expenditure slackened to a marginal decline, mainly due to the fall in machinery and equipment acquisition, which more than offset the rebound in building and construction activity.

The labour market remained in a state of full employment in 2014. Total employment growth continued to outpace that of labour force, with the seasonally adjusted unemployment rate staying low at 3.3 per cent in the fourth quarter. Wages and earnings registered further gains.

The residential property market was relatively soft in the first quarter of 2014, but revived in April and stayed generally buoyant for the rest of the year amid the tight demand-supply balance and the continued low interest rate environment. Overall flat prices surged by 14 per cent between December 2013 and December 2014. Trading activities jumped by 26 per cent in 2014.

The local stock market continued to fluctuate during 2014. The local stock market came under pressure in early 2014, with the Hang Seng Index (HSI) reaching a low of 21,182 in March. But it gained support subsequently and rallied successively upon the signs of revival in the US economy, continued steadiness of the Mainland economy, expectations of the Shanghai-Hong Kong Stock Connect, and the continued accommodative stance by the US Federal Reserve (Fed) with the HSI hitting a six-year high of 25,318 in early September. Afterwards, the HSI lost ground again on jitters about the global economic outlook and oil price slump, closing the year at 23,605, slightly higher than at end-2013 by 1.3 per cent. The average daily turnover also rose markedly in the second half of the year, bringing an average of $69.5 billion for the whole year. Fund-raising activity continued to pick up in 2014 with total initial public offering (IPO) funds raised amounting to $233 billion in 2014, up remarkably from $169 billion in 2013. As a result, Hong Kong ranked as the world's second largest IPO centre for the second consecutive year in 2014.

Inflation eased further in 2014, as domestic cost pressures moderated, while imported inflation remained tame. In 2014, underlying inflation averaged 3.5 per cent, down from 4 per cent in 2013.

Structure and Development of the Economy

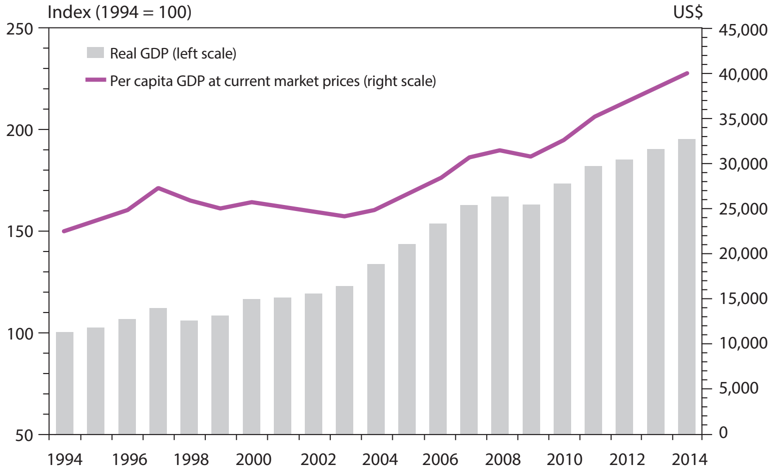
Hong Kong is a global centre for world trade, finance, business and telecommunications, strategically located at the doorstep of the Mainland's huge and vibrant economy. According to the World Trade Organisation (WTO), Hong Kong is the world's eighth largest trading entity in 2014. It operates one of 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 seventh largest banking centre in terms of external positions in 2014, and the fifth largest foreign exchange trading centre according to the triennial survey conducted by the Bank for International Settlements in 2013. Its stock market is the third largest in Asia in terms of market capitalisation as at end 2014 and ranked number one in the region in terms of equity funds raised during the same year.

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. In addition, Hong Kong has sizeable foreign exchange reserves, a fully convertible and stable currency, prudent fiscal management and a simple tax system with low tax rates. Thanks to these virtues, Hong Kong has been persistently ranked by the Heritage Foundation and the Fraser Institute as number one in the world in terms of economic freedom. As for competitiveness, Hong Kong was ranked the world's fourth most competitive economy by the International Institute for Management Development in 2014 and the third easiest place to do business globally according to the World Bank's Doing Business 2015 Report published in October 2014. Hong Kong's economic vitality is also well-recognised internationally, as reflected in the top triple-A credit rating conferred by Standard and Poor's.

The Hong Kong economy nearly doubled in size over the past two decades, expanding at an average annual rate of 3.4 per cent in real terms, and consistently faster than most high-income economies. Over the same period, Hong Kong's per capita GDP rose by about 60 per cent in real terms, posting an average annual growth rate of 2.5 per cent. Hong Kong's per capita GDP at current market prices reached US$40,000 in 2014, one of the highest in the region and the world (*Chart 2*).

Thanks to continued globalisation, the further deepening of regional trade integration and the government's sustained efforts in exploring new markets, 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 2014, the total value of goods trade (comprising re-exports, domestic exports and imports of goods) reached $8,350 billion, equivalent to 372 per cent of GDP. This was considerably higher than the ratios of 229 per cent in 1994 and 313 per cent in 2004. Including the value of exports and imports of services, the ratio of total trade to GDP was even higher, at 441 per cent in 2014, up significantly from 267 per cent in 1994 and 365 per cent in 2004.

Chart 2 Gross Domestic Product



Over the past two decades, the Hong Kong economy grew by an average of 3.4 per cent in real terms, consistently faster than most high-income economies.

The stock of direct investment liabilities in Hong Kong was enormous, at $11,347 billion in market value at the end of 2013, equivalent to 532 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, ranked fourth in the world and second in Asia, only after the Mainland, by the United Nations' World Investment Report 2014.

The corresponding figures for Hong Kong's stock of direct investment assets were likewise huge, at $10,483 billion or 492 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 $29,125 billion and $23,248 billion respectively at the end of 2013. The corresponding ratios to GDP in 2013 were 1,366 per cent and 1,091 per cent. Reflecting Hong Kong's robust international investment position, its net external financial assets amounted to $5,877 billion at the end of 2013, equivalent to 276 per cent of GDP.

The Gross National Income (GNI), comprising GDP and net external primary income flows, stood at $2,307 billion in 2014. This was higher than the corresponding GDP by 3 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 2014, at $1,284 billion and $1,223 billion respectively, equivalent to 57 per cent and 54 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 in Hong Kong

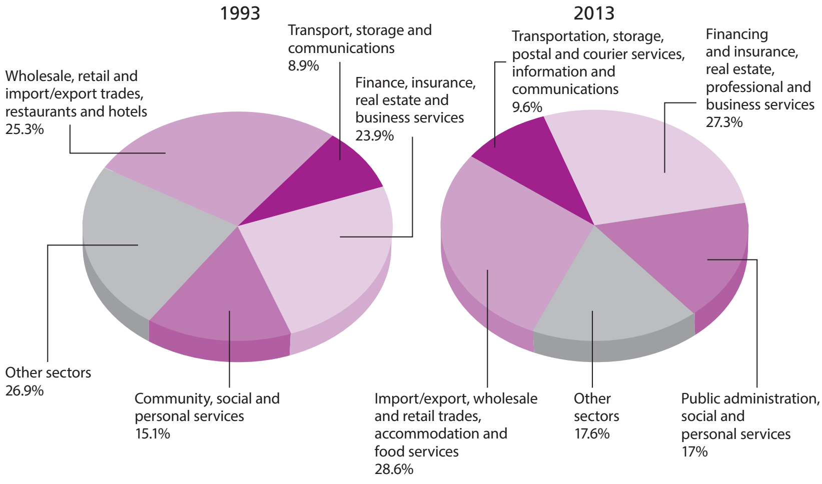
Primary production (including agriculture, fisheries, mining and quarrying) is insignificant in terms of both value-added contribution to GDP and share in total employment, as Hong Kong is a predominantly city economy.

Secondary production comprises manufacturing, construction, and supply of electricity, gas and water. The value-added contribution from manufacturing, which has diminished in relative importance since the early 1980s, was only 1 per cent in 2013, while those of the construction sector and electricity, gas and water stood at 4 per cent and 2 per cent respectively.

The Hong Kong economy has become increasingly service-oriented since the 1980s. The Mainland's open-door policy and economic reforms have unleashed ample business opportunities for a wide range of service providers. Leveraging its geographical proximity and cultural ties with the Mainland as well as its strong market institutions, Hong Kong has re-orientated itself towards service activities and moved up the value chain.

In 2013, 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 sector, 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 (17 per cent), transportation, storage, postal and courier services, and information and communications (10 per cent) (*Chart 3*).

Chart 3 **Gross Domestic Product by Major Service Sector**



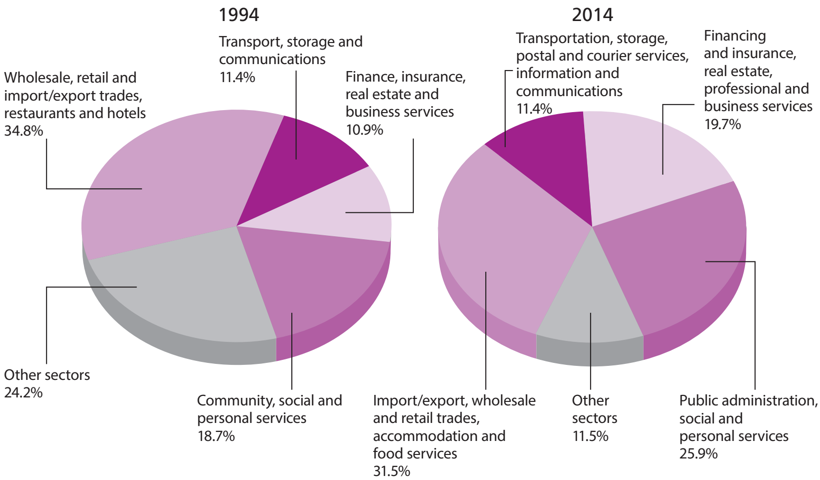
The import/export, wholesale and retail trades, accommodation and food services sector, and the financing and insurance, real estate, professional and business services sector remained the two largest service sectors in terms of net output in 2013.

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.

It is also worth noting that although the manufacturing sector's direct value-added contribution to the economy is not large, Hong Kong's manufacturers continue to be versatile and resilient in coping with the changing global and regional economic landscapes. Thanks to the increased supply-chain arrangements involving the Mainland and other neighbouring economies, Hong Kong's productive capacity has been effectively expanded. Its well-established linkages with the Mainland economy have underpinned the growth of Hong Kong's services sector, especially the rapid development of trading, financial and other supporting services.

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 76 per cent in 1994 to 86 per cent in 2004 and 88 per cent in 2014. As for individual service segments, import/export trade and wholesale, retail, accommodation and food services accounted for 32 per cent of the total in 2014. 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, 20 per cent; and transportation, storage, postal and courier services, information and communications, 11 per cent (*Chart 4*).

Chart 4 **Employment by Major Service Sector**



Import/export trade and wholesale, retail, accommodation and food services employed the most people in 2014.

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.

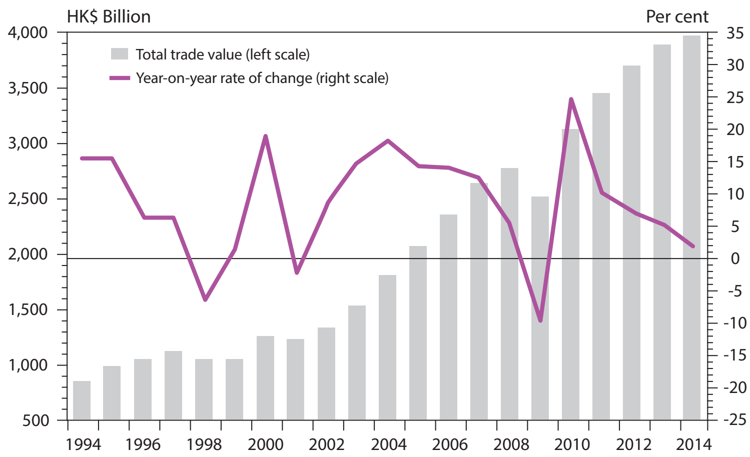
Starting from the first quarter of 2009, industrial classification of employment has adopted the Hong Kong Standard Industrial Classification Version 2.0 while that in the previous years is based on Version 1.1.

Economic Links between Hong Kong and the Mainland

Following several decades of reform and opening-up in the Mainland, the economic ties between the Mainland and Hong Kong has been stronger than ever. Throughout the period, the flows of goods, services, people and capital between Hong Kong and the Mainland and between the Mainland and the world through Hong Kong have flourished and brought significant mutual benefits in the two places.

With its total trade surging from US$237 billion in 1994 to US$4.3 trillion in 2014, the Mainland plays an increasingly prominent role in the global economy and Hong Kong has benefited substantially from the Mainland's phenomenal trade growth. Visible trade between Hong Kong and the Mainland in 2014 was about five times that of 20 years ago, representing growth of 8 per cent per annum in value terms (*Chart 5*). In 2014, the Mainland was ranked the world's largest trading entity and Hong Kong was ranked the eighth.

Chart 5 **Goods 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. Bilateral trade with the Mainland accounted for more than half of Hong Kong's total trade value in 2014. On the other hand, Hong Kong is the Mainland's second largest trading partner only after the US, accounting for about 8.7 per cent of the Mainland's total trade value in 2014. Nearly half of Hong Kong's exports to the Mainland (mainly re-exports) in 2014 involved raw materials, reflecting the latter's role as a production hinterland and the highly integrated production network within Asia. Also, Hong Kong's exports of consumer goods (mainly re-exports) to the Mainland increased by nearly 70 per cent over the past decade. With a population of close to 1.4 billion (over 100 million in Guangdong Province alone) and the Central People's Government's goal to restructure economic growth towards domestic consumption, the Mainland market represents a huge business opportunity for Hong Kong's exporters.

Hong Kong also serves as a principal gateway to and from the Mainland for business and tourism. In 2014, foreign visitors to the Mainland made 3.7 million trips through Hong Kong. The number of trips made by Mainland residents to or through Hong Kong grew by 16 per cent to 47.2 million over the same period.

Hong Kong remains 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$747 billion as at the end of 2014, accounting for as much as half of the total.

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 57 per cent of its total outward direct investment as at the end of 2013, reflecting Hong Kong's role as a platform for Mainland companies to reach out and go global. Meanwhile, based on Hong Kong's statistics, the Mainland is Hong Kong's second largest source of foreign direct investment, accounting for about one-third of Hong Kong's total inward direct investment. Mainland companies have also maintained a strong presence in Hong Kong. As at mid-2014, Mainland companies had established a total of 957 regional headquarters, or regional or local offices in Hong Kong, up from 635 a decade ago.

Due to proximity, Guangdong's economic links with Hong Kong are understandably the closest amongst all provinces in the Mainland. Based on the Mainland's statistics, the cumulative value of Hong Kong's realised direct investment in Guangdong was US$218 billion as at end 2014, accounting for 62 per cent of its total inward direct investment. The substantial direct investment from Hong Kong did not only contribute to the Mainland's rapid industrialisation in the past decades, but also facilitated the structural transformation of the Hong Kong economy.

Thanks to the increasing cross-boundary economic activities and the Central People's Government's policy to enhance the position of Hong Kong as an international financial centre, financial links between Hong Kong and the Mainland have strengthened substantially over the years. As a major funding centre for Mainland enterprises, 876 Mainland enterprises were listed on the Hong Kong stock market as at the end of 2014 (84 of these listing in 2014, raising $199.8 billion in equity funds), with $700.5 billion in aggregate funds raised from IPOs and secondary financing. In addition, the Shanghai-Hong Kong Stock Connect scheme, launched in November 2014, supports mutual stock market access between the Shanghai Stock Exchange and the Stock Exchange of Hong Kong, signifying a breakthrough in the opening up of Mainland China's capital markets and marking an important step in the internationalisation of Renminbi (RMB).

Meanwhile, offshore RMB business in Hong Kong grew strongly in 2014. The value of RMB trade settlement handled by banks in Hong Kong surged by 63 per cent in 2014 to another record high of RMB6,258 billion. The total amount of RMB customer deposits and outstanding RMB certificates of deposit issued increased 10 per cent over the previous year to RMB1,158 billion as at the end of 2014 and the outstanding amount of RMB loans also leapt to RMB188 billion over the same period. Outstanding RMB bonds rose by 23 per cent to RMB381 billion as at the end of the year. In November 2014, the RMB conversion limit for Hong Kong residents of RMB20,000 per day was removed, making it more convenient for Hong Kong residents to participate in RMB financial transactions and facilitating the development of RMB investment products in Hong Kong.

Hong Kong remained the largest offshore RMB investment product market in 2014. At the end of 2014, there were 65 SFC-authorised RMB Qualified Foreign Institutional Investor Scheme (RQFII) unlisted funds with an aggregate net asset value of RMB30 billion, and 18 SFC-authorised

RQFII exchange traded funds (ETFs) adopted dual counter trading arrangements (ie RMB and HKD trading counters) with an aggregate net asset value of RMB53 billion. A wide range of RMB investment products, including listed and unlisted investment funds, insurance products, currency futures, real estate investment trusts, shares and derivative products, are available in the market. During the year, Hong Kong's market infrastructure for offshore RMB business development was further enhanced. First, the Hong Kong Monetary Authority (HKMA) designated seven banks in October as Primary Liquidity Providers. With access to a dedicated repurchase ('repo') facility provided by the HKMA, the Primary Liquidity Providers pledged to expand their market-making activities in Hong Kong for various offshore market instruments, and use the Hong Kong platform in promoting their global offshore RMB business. In addition, the HKMA launched the intraday repo under the RMB liquidity facility in November to assist banks in managing their RMB liquidity and to promote efficient payment flows in Hong Kong.

Economic co-operation with the Mainland has also been continuously enhanced through the broadening of the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA). In December 2014, the 'Agreement between the Mainland and Hong Kong on Achieving Basic Liberalisation of Trade in Services in Guangdong' was signed under the CEPA framework, opening up 153 services sub-sectors in Guangdong to the Hong Kong service industry, accounting for 95.6 per cent of all services sub-sectors according to the WTO's classification. The forthcoming establishment of the Guangdong Pilot Free Trade Zone (covering new areas of Nansha, Qianhai and Hengqin), as announced by the Central People's Government in December 2014, will also promote in-depth co-operation between Guangdong and Hong Kong.

The construction of the Hong Kong-Zhuhai-Macao Bridge (HZMB) and related local projects continued in 2014. When completed, the HZMB 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. Construction of the Hong Kong Section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link also progressed. Upon completion, it will reduce the journey time between Guangzhou and Hong Kong to 48 minutes, and give passengers easy access to the Mainland's 16,000 kilometres high-speed railway network to all the major cities.

The Economy in 2014

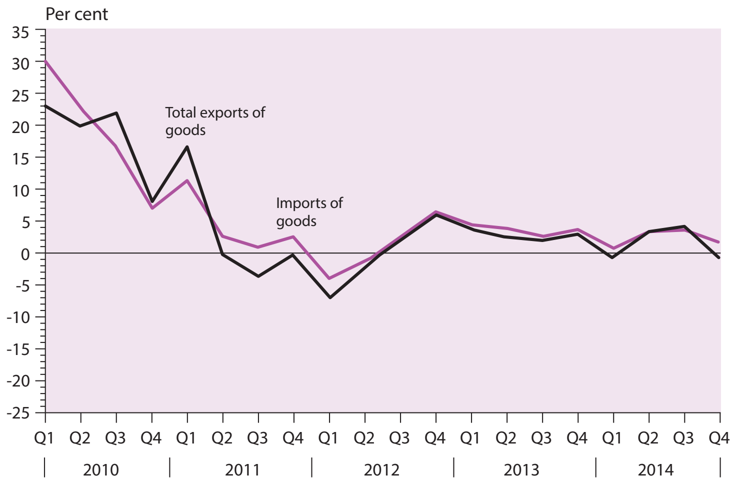
External Trade

The subdued global demand conditions continued to constrain Hong Kong's external trade performance in 2014. Total exports of goods, compiled under the GDP accounts, grew by a meagre 1 per cent in real terms in 2014. On the basis of external merchandise trade statistics[1], after excluding the distortions by the fluctuations in exports of non-monetary gold, export growth of merchandise goods stayed modest at 1.5 per cent in real terms. While the US market improved, exports to the EU and Japan faltered, a reflection of the marked growth divergence among these advanced economies. Meanwhile, exports to Asia also exhibited a mixed

[1] The real growth rates of merchandise trade are based on the new series of trade index numbers compiled using the chain linking approach released in March 2015.

performance, with the Indian and ASEAN markets faring visibly better. In terms of the quarterly profile, merchandise exports reverted from a 0.7 per cent year-on-year decline in the first quarter to growth of 3.4 per cent and 4.1 per cent respectively in the second and third quarters, before relapsing to a 0.8 per cent decline in the fourth quarter (*Chart 6*).

Chart 6 **Hong Kong's Goods Trade (year-on-year rate of change in volume terms)**



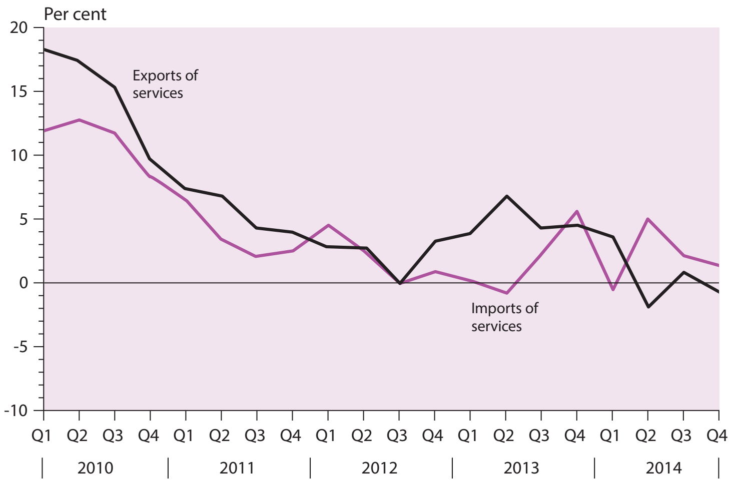
Merchandise exports were still constrained by a slow-growing global economy in 2014.

Imports of goods, on merchandise trade statistics basis, rose moderately by 2.3 per cent in real terms in 2014, slightly down from the 3.6 per cent in 2013, as a result of the slower increases in both retained imports and import intake related to re-exports. Retained imports, which accounted for over one-quarter of total imports, grew by 4.5 per cent in real terms in 2014, lower than the 5.4 per cent increase in the preceding year. Analysed by end-use category, the deceleration in retained imports in 2014 was mainly driven by the notable declines in capital goods, reflecting the subdued investment expenditure during most of the year. Retained imports of fuels also fell, partly due to the weak demand from cargo transportation. On the other hand, retained imports of consumer goods and foodstuffs attained solid growth, as local consumption expanded further, though inventory replenishment might also have helped. Retained imports of raw materials and semi-manufactures reversed three consecutive years of declines and reported a notable gain.

Exports of services registered only modest growth, at a mere 0.5 per cent in real terms in 2014, visibly down from the 4.9 per cent growth in 2013. The main drag was the distinct slackening of exports of travel services, as visitor spending on luxury items fell from a high base of comparison. Exports of trade-related services grew modestly during most of 2014 amid tepid regional trade flows. Deterred by continued uncertainties in the global economy, exports of financial and other business services attained only mild growth. Transportation services fared slightly better, thanks largely to the vibrant passenger flows which offset the weakness in cargo throughput.

Imports of services grew by 1.9 per cent in real terms in 2014, further to a 1.8 per cent growth in 2013. Imports of travel services outpaced other major services imports and grew moderately, underpinned largely by local residents' avid interest in travel abroad for recreation and other purposes amid stable labour market conditions. The weakening of major currencies against the US dollar also raised the appetite for overseas travel. Imports of transportation services and trade-related services grew only mildly in 2014, broadly in line with the sluggish trading environment. Meanwhile, imports of financial and other business services also grew modestly in 2014 (*Chart 7*).

Chart 7 **Hong Kong's Services Trade (year-on-year rate of change in real terms)**



Exports of services attained modest growth in 2014.

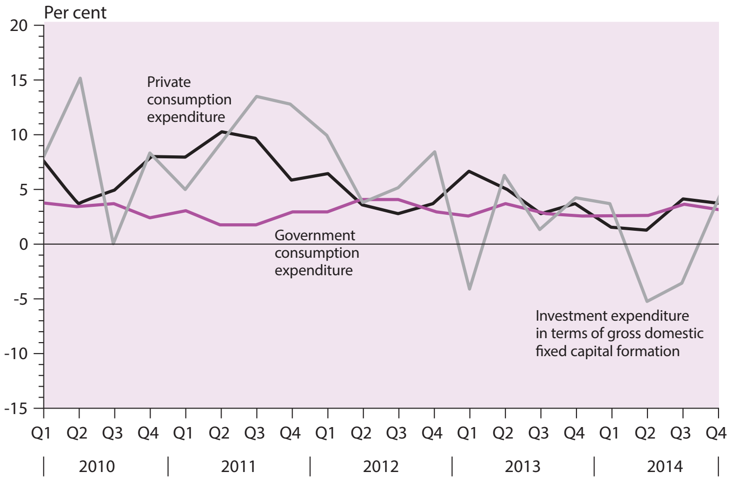
Given the sluggish merchandise export performance and the steady expansion of import demand, the goods deficit widened slightly in 2014. Nevertheless, the services surplus also increased marginally. As a result, the goods and services account was largely in balance, showing a small surplus of $3 billion (equivalent to 0.1 per cent of the total value of imports of goods and services). The respective figures for 2013 were $13 billion and 0.3 per cent.

Domestic Demand

Domestic demand slowed somewhat in 2014. Private consumption expenditure (PCE) grew modestly by 2.7 per cent in real terms in 2014, down from the 4.6 per cent growth in the preceding year, with the moderation concentrated in the first half in tandem with the slower economic growth. PCE saw some relative improvement in the second half of the year, underpinned by the faster employment growth, while such incidental factors as positive wealth effects and the launch of new smartphone models also provided support. Separately, government consumption expenditure grew at a steady pace of 3.1 per cent in real terms in 2014.

Overall investment spending, in terms of gross domestic fixed capital formation, dipped by 0.3 per cent in real terms in 2014, the first decline since 2009. The decline was due to subdued machinery and equipment acquisition, which fell by 5.2 per cent in real terms. While a high base of comparison after brisk growth in the preceding three years was to blame, its weak performance to a certain extent might have also been associated with the subpar growth of the economy. Nevertheless, overall building and construction activity staged a solid rebound of 6.5 per cent in real terms in 2014, as public infrastructure works re-accelerated to show notable growth, and private sector building and construction activity also picked up from the lull in the previous year (*Chart 8*).

Chart 8 **Main Components of Domestic Demand (year-on-year rate of change in real terms)**

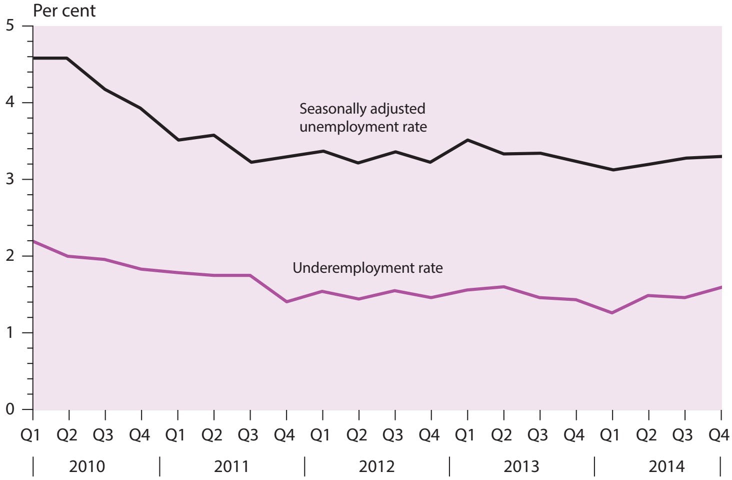


Domestic demand slowed somewhat in 2014.

The Labour Market

The labour market stayed generally tight and resilient in 2014, with the unemployment rate staying at a low level of 3.3 per cent for the year as a whole, down by 0.1 percentage point over 2013. Both total employment and the labour force attained further growth, with the former reaching a new annual high of 3,749,200 in 2014. Meanwhile, the underemployment situation held broadly stable, with the underemployment rate remaining low at 1.5 per cent for the third consecutive year (*Chart 9*). Nevertheless, the demonstrations associated with the 'Occupy Movement' from late September to mid-December 2014 caused temporary disturbances to certain sectors, including retail, accommodation and food services, and transportation, resulting in some worsening in underemployment.

Chart 9 The Unemployment and Underemployment Rates



The unemployment rate stayed low throughout 2014, signifying another year of full employment.

The labour force expanded only modestly by 0.5 per cent for 2014 as a whole, after recording visible growth for three consecutive years. Though constrained by labour supply, total employment grew at a slightly faster pace of 0.6 per cent (*Chart 10*). Employment growth was almost across the board, with more visible job gains in construction sites (covering manual workers only) as well as social and personal services sectors.

Chart 10 Total Labour Force and Total Employment (year-on-year rate of change)

Total employment and the labour force grew further in 2014, with the former slightly outpacing the latter.

Job vacancies eased back somewhat in 2014, after recording several years of double-digit increases. For the year as a whole, the number of private sector vacancies, though stood high at 76,600, decreased slightly by 0.7 per cent over 2013. Analysed by economic sector, except for a further sizable gain in construction sites (covering manual workers only) (up 32.4 per cent year-on-year), job vacancies saw some noticeable easing in major sectors like import/export trade and wholesale (down 13.7 per cent), social and personal services (down 12.9 per cent), and financing and insurance (down 9.4 per cent) in 2014. Vacancy growth in some domestically-oriented sectors, most notably retail (up 4 per cent), also decelerated alongside the weaker consumption market during the year. However, manpower shortages remained apparent in 2014. The ratio of job vacancies rose slightly further from 59 per 100 job-seekers in 2013 to 60 in 2014, with the ratio of the lower-skilled segment increasing from 64 to 66 while that of the higher-skilled segment staying at 81.

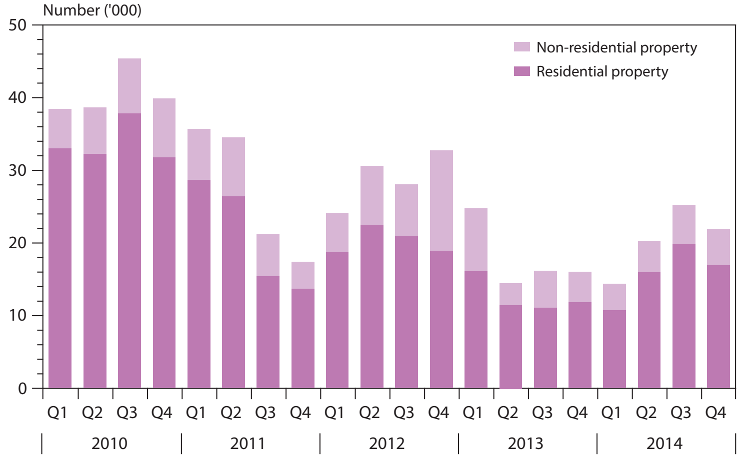
In tandem with generally tight labour market conditions, wages and earnings remained on the rise in 2014. Labour earnings in the private sector posted a further broad-based improvement of 4.3 per cent for 2014 as a whole, with more notable increases seen in professional and business services and financial and insurance activities. Separately, statistics compiled from the General Household Survey, though not strictly comparable to those from the business establishment surveys, suggested that the average employment earnings of full-time employees engaged in elementary occupations (excluding foreign domestic helpers) rose appreciably further by around 7 per cent in nominal terms and 1 per cent in real terms, indicating that labour market conditions remained largely favourable for grassroots workers. For the overall income situation, the median monthly household income (excluding foreign domestic helpers) sustained further year-on-year growth in all quarters of 2014, and rose by 4.1 per cent to $23,100 in 2014 from $22,200 in 2013.

The Property Market

The residential property market was relatively soft in the first quarter, but revived in April and stayed generally buoyant for the rest of the year. While the government's strategy of providing more land for residential development has helped increase the supply of flats in the medium term, the demand-supply balance remained tight. Coupled with the continued low interest rate environment, this rendered support to the market expectation that flat prices would remain firm, and saw many end-users rushing to buy in both the primary and secondary markets.

Transactions showed a sharp rebound in the second quarter and then stayed at a relatively high level (*Chart 11*). For 2014 as a whole, the total number of sale and purchase agreements for residential property received by the Land Registry surged by 26 per cent over the low base in 2013 to 63,800, though still below the long-term average of 94,400 over 1994 to 2013. Meanwhile, total consideration soared by 45 per cent to $433.4 billion.

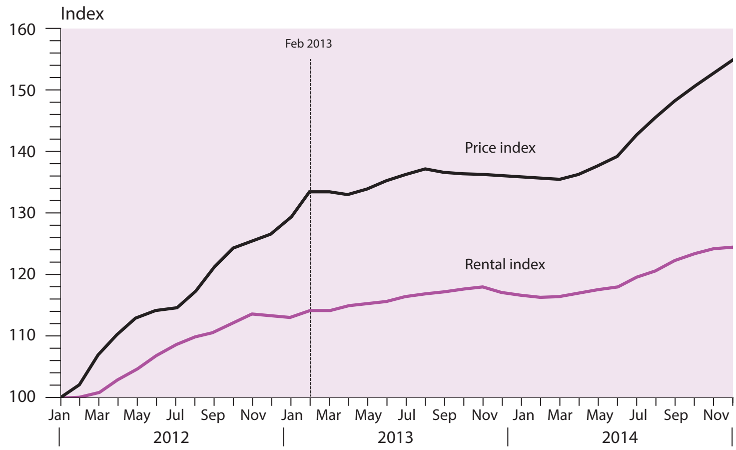
Chart 11 **Sale and Purchase Agreements by Broad Type of Property**



Trading activities rebounded in April and stayed generally active for the rest of 2014.

In tandem with the rebound in trading activities, flat prices have also reverted from a modest decline in the first quarter to sustained increases since the second quarter. Comparing December 2014 with a year earlier, overall flat prices surged by 14 per cent, with most of the gains occurring during the second half. The increase was led by small/medium-sized flats, the prices of which soared by 14 per cent. By comparison, prices of large flats went up by a less rapid 6 per cent. Similarly, overall flat rentals rose by 6 per cent, with rentals of small/medium-sized and large flats increasing by 7 per cent and 2 per cent respectively (*Chart 12*).

Chart 12 **Prices and Rentals of Residential Property (Jan 2012=100)**



Flat prices and rentals reverted to sustained increases after a modest decline in the first quarter of 2014.

Raising flat supply through increasing land supply is the government's top policy priority in facilitating the property market's healthy development. Combining the various sources (including government land sale, railway property development projects, the Urban Renewal Authority's projects and private re-development/development projects), the aggregate private housing land supply in the financial year 2014-15 is estimated to have the capacity to provide about 20,000 flats, exceeding the annual target of 18,800 flats. This is a record high since the government introduced the private housing land supply target in 2010.

Reflecting the government's sustained efforts, the total supply of flats in the coming three to four years (comprising unsold flats of completed projects, flats under construction but not yet sold and flats on disposed sites where construction can start any time) rose from 71,000 units as estimated at end-2013 to a record high of 74,000 units as estimated at end-2014. Yet the demand-supply balance of the property market remained tight in the year. The vacancy rate for private flats fell further from 4.1 per cent at end-2013 to 3.8 per cent at end-2014, well below the long-term average of 5 per cent over 1994-2013.

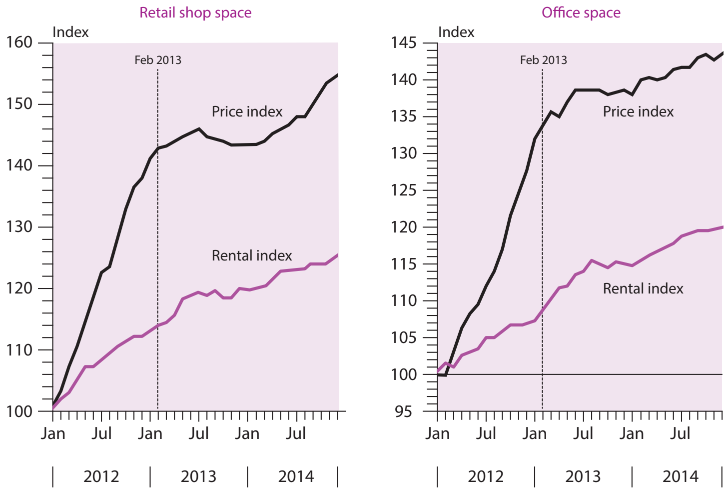
As it takes time to increase supply, the government has also put in significant efforts to manage demand and reduce the possible risks to financial stability arising from an exuberant property market. These measures have yielded notable results, but with the current revival of the market, the risks of a housing market bubble are still prominent. Following the almost uninterrupted rally in the past few years, overall flat prices in December 2014 have surpassed the 1997 peak by 61 per cent. Home purchase affordability (ie the ratio of mortgage payments for a 45-square metre flat to median household income, excluding those living in public housing) worsened to around [58] per cent in the fourth quarter, exceeding the long-term average of 47 per cent over 1994-2013. Should interest rates rise by three percentage points to a more normal level, the ratio would soar to 76 per cent.

Likewise, the non-residential property market has also turned more active since the second quarter. For the year as a whole, prices and rentals recorded moderate gains in general. Trading activities showed some pick-up from the lows in the first quarter, though they were still at subdued levels by historical standards. Taking 2014 as a whole, the number of sale and purchase agreements for non-residential property dropped by 11 per cent to 17,700, and total consideration by 28 per cent to $114 billion.

Sale prices of retail shop space rose by 8 per cent and rentals by a modest 5 per cent between December 2013 and December 2014 (Chart 13).

For office space, overall prices recorded a moderate gain of 3 per cent. Prices of Grade A, B and C office space went up by 1 per cent, 4 per cent and 1 per cent respectively. Overall office rentals rose by 5 per cent, with Grade A, B and C office space increasing by 3 per cent, 6 per cent and 8 per cent respectively (*Chart 13*). Meanwhile, prices and rentals of flatted factory space rose by 5 per cent and 9 per cent respectively.

Chart 13 **Prices and Rentals of Retail Shop Space and Office Space (Jan 2012=100)**



Prices and rentals of retail shop and office spaces recorded moderate gains during 2014.

As to demand-supply balance, the vacancy rate for retail shop space edged up from 7.2 per cent at end-2013 to 7.3 per cent at end-2014, while that for office space and flatted factory space declined from 7 per cent to 6.3 per cent and from 5.8 per cent to 5.6 per cent respectively. These were well below their respective long-term averages of 8.7 per cent, 10.2 per cent and 8.2 per cent over 1994-2013.

Price Movements

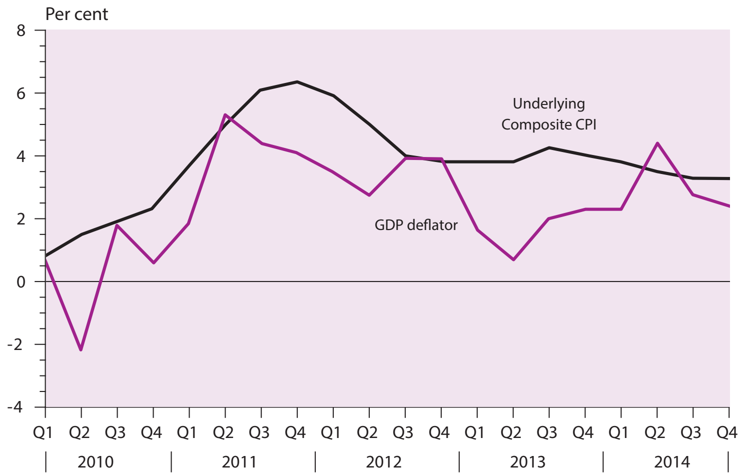
Inflation followed an easing trend in 2014. Underlying consumer price inflation, which nets out the effects of the government's one-off relief measures, retreated to 3.5 per cent in 2014, down successively from 5.3 per cent in 2011, 4.7 per cent in 2012 and 4 per cent in 2013. In terms of the quarterly profile, underlying inflation receded gradually over the course of 2014, from 3.8 per cent in the first quarter to 3.5 per cent in the second quarter, and slightly further to 3.3 per cent in both the third and fourth quarters.

The moderation in underlying inflation mainly reflected the milder imported inflation and receding local cost pressures during the year. Externally, import prices rose at a modest pace in 2014, thanks to softer international energy and raw material prices. Locally, the year-on-year increases in the private residential rental component narrowed further, while the rise in commercial rents was also rather moderate.

Headline consumer price inflation, which is influenced by the government's one-off relief measures, edged up to 4.4 per cent in 2014 from 4.3 per cent in 2013. Higher headline inflation compared with the underlying figure was mainly caused by the lower base effect created by the government's payment of public housing rentals in September 2013, the end of the government's one-off electricity charge subsidy for households in the latter half of 2014, and the end of rates concession in October.

The GDP deflator increased by 3 per cent in 2014, following the 1.7 per cent increase in 2013 (*Chart 14*).

Chart 14 **Main Inflation Indicators (year-on-year rate of change)**



Underlying inflation trended lower in 2014, as domestic cost pressures broadly eased and imported inflation remained benign.

Public Finance

Management of Public Finance

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

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

- 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 GDP.

- The Legislative Council of the 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 drawn up in the context of a medium-range forecast which is a fiscal planning tool to ensure that appropriate 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 the Legislative Council's authorisation.

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 respectively, and the total balance of the GRA and the funds except the Bond Fund constitutes government fiscal reserves.

Financial Results

For 2013-14, the government recorded a surplus of $21.8 billion, with revenue of $455.3 billion and expenditure of $433.5 billion. Fiscal reserves at the end of March 2014 stood at $755.7 billion. For details of revenue by source and of expenditure by component for 2013-14 and 2014-15 (Revised Estimate) see Appendix 6, Table 6.

Public expenditure comprises government expenditure and expenditure by other public bodies. In 2013-14, public expenditure totalled $457.3 billion, an increase of 14.3 per cent over the previous year, of which some $300.6 billion (or 65.7 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.

Long Term Fiscal Sustainability

The Working Group on Long-Term Fiscal Planning appointed by the government released its report on the fiscal sustainability of Hong Kong's public finances in March 2014. Based on population projections up to 2041 and prevailing government policies, the working group projected economic growth, government revenue and government expenditure for the coming two to three decades, showing the pressure on public finance of an ageing population and anticipated slower economic growth. The working group recommended resolute and early action to manage Hong Kong's finances in a sustainable manner by promoting economic growth, preserving, stabilising and broadening the revenue base and containing expenditure growth. The working group also recommended that a savings scheme for Hong Kong (the 'Future Fund') be established.

The working group reconvened in July to follow up on its findings and recommendations, including options for the 'Future Fund' and how the government can improve the management of its assets.

Revenue Sources

Hong Kong's tax system is simple. 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 (9 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) are levied under the Inland Revenue Ordinance and together accounted for about 41 per cent of total government revenue in 2013-14.

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 2013-14, 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 from deposits placed with banks or deposit-taking companies, other than that received by financial institutions, and dividends received from corporations are exempt from profits tax. In 2013-14, the total profits tax collected was about $120.9 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 2013-14, 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, need pay more than the standard rate of 15 per cent of their 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 that spouse's 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 $55.6 billion (about 12 per cent of total government revenue) in 2013-14. Due to the generous personal allowances under the Hong Kong tax law, only about 1.6 million people, or 43 per cent of the workforce, were liable to salaries tax for the year of assessment 2012-13.

Owners of land and buildings in Hong Kong are charged property tax at the standard rate (15 per cent in 2013-14) 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 $2.6 billion (about 0.6 per cent of total government revenue) in 2013-14.

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 2013-14, the revenue from stamp duties was some $41.5 billion, or about 9 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. In 2013-14, the rates of betting duty for local bets on local horse races were 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 remainder. For local bets on non-local horse races, betting duty was charged at a uniform rate of 72.5 per cent on the net stake receipts. The rate of betting duty on football matches was 50 per cent on the net stake receipts. The rate of betting duty on Mark Six lotteries was 25 per cent on the proceeds. The yield from betting duty in 2013-14 totalled some $18.1 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 $9.72 billion in 2013-14 (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 (5 per cent in 2014-15). 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, containing about 2.4 million assessments, took effect on 1 April 2014, with rateable values reflecting the rental values on 1 October 2013. The revenue from rates in 2013-14 was $14.9 billion, accounting for about 3 per cent of total government revenue.

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 1.9 million assessments in the Government Rent Roll on 1 April 2014. Total government rent collected in 2013-14 was $8.6 billion, or about 1.9 per cent of total government revenue.

In a review announced in September 2014 of the property tax administrative practices of 76 jurisdictions by the USA's Council On State Taxation and Canada's International Property Tax Institute, Hong Kong (with an 'A-') was the only jurisdiction to receive an 'A' grade. The review focused on three major areas essential for fair and efficient property tax administration: transparency, simplicity and consistency, and procedural fairness.

Fees and charges for services provided by government departments generated about $12 billion, or about 3 per cent of total revenue, in 2013-14. 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 $3.9 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 billion from investments and interest income on its fiscal reserves in 2013-14, amounting to about 8 per cent of total government revenue.

Lastly, some $84.3 billion, or about 19 per cent of total government revenue in 2013-14, 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 Tax Treaties and International Tax Cooperation

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. By the end of 2014, Hong Kong had signed 32 CDTAs, including three in 2014.

In 2013, the government further enhanced the exchange of information arrangements under CDTAs and put in place a legal framework to enter into tax information exchange agreements with other jurisdictions when necessary. By the end of 2014, Hong Kong had signed seven such agreements.

In September 2014, Hong Kong indicated to the Organisation for Economic Cooperation and Development (OECD) it would implement the new global standard on automatic exchange of financial account information on tax matters to enhance tax transparency and combat cross-border tax evasion. Subject to enactment of the necessary domestic legislation by 2017, Hong Kong will commence the first automatic information exchanges by the end of 2018 (the OECD's required timeline), on a reciprocal basis with appropriate jurisdictions.

Government Procurement

Hong Kong, China is a signatory to the Agreement on Government Procurement of the World Trade Organisation (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 protection of patents.

The Government Logistics Department (GLD) is the government's central procurement agent. Purchases of goods and related services 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 environmental friendly products where available and appropriate. In 2014, the GLD awarded contracts amounting to $5.02 billion, with goods and related services procured from 27 different countries or territories (including Hong Kong).

To facilitate sourcing and market research, the GLD maintains supplier lists for different categories of goods and services. Notices for open tenders are published on the internet and suppliers on the relevant supplier lists will be notified. For procurements covered by the WTO GPA, tender notices will also be published in the Government Gazette. Consulates and overseas trade commissions will be informed where appropriate. Tender documents may be downloaded and tender offers may also be submitted through the 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