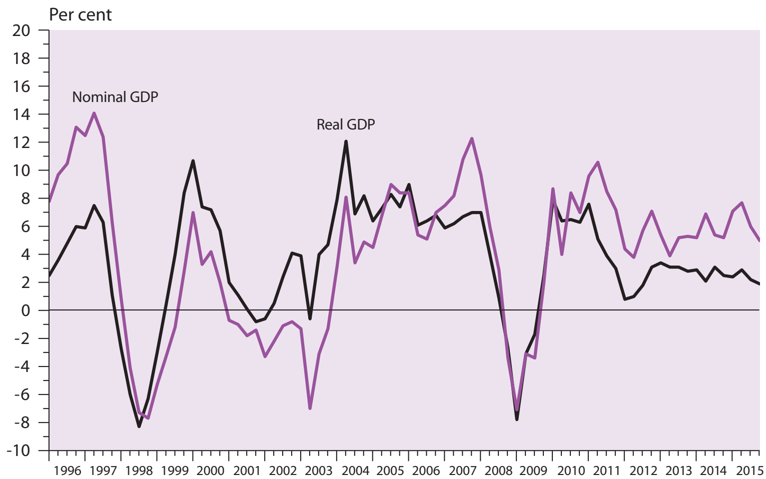
Chapter 3

The Economy

The Hong Kong economy grew modestly in 2015, confined mainly by sluggish trade flows amid a slow-growing global economy. Domestic demand remained resilient, keeping the labour market largely stable. In tandem with softer import prices and tamed domestic cost pressures, inflation continued to subside.

The Hong Kong economy remained on a modest growth path in 2015, with Gross Domestic Product (GDP) expanding 2.4 per cent in real terms, slower than the 2.6 per cent growth in 2014 and the annual average growth of 3.4 per cent in the past decade. In terms of the quarterly profile, the year-on-year growth rate of real GDP picked up from 2.4 per cent in the first quarter to 2.9 per cent in the second quarter, before moderating to 2.2 per cent and 1.9 per cent respectively in the third and fourth quarters *(chart 1)*.

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



The Hong Kong economy continued to grow modestly in 2015.

Total exports of goods fell slightly in 2015 amid a challenging external environment. The global economy decelerated during the year and grew at its slowest pace since the global financial crisis, marked by a slow and uneven recovery of advanced economies, notable downward pressures on emerging market economies and sharp declines in commodity prices. Moreover, uncertainties associated with US interest rate normalisation and diverging monetary policies among major central banks provoked global financial volatility, which further deterred international trade flow. The slack in global demand dealt a serious blow to exports in Asia, with many witnessing the worst falls since 2009.

Exports of services also slackened and showed a marginal decline, as exports of travel services weakened distinctly due to a slowdown in inbound tourism. Exports of both trade-related and transportation services remained sluggish, while exports of financial and other business services showed solid growth.

The domestic sector expanded further in 2015, though it slowed somewhat in the second half of the year. Private consumption expenditure grew solidly for the year as a whole. However, investment expenditure dropped for the second consecutive year, reflecting more cautious investment sentiment.

The overall labour market remained largely stable, with the unemployment rate staying low at 3.3 per cent in 2015. Wages and earnings attained real improvements. Thanks to the upward adjustment of the statutory minimum wage rate in May 2015, low-paid workers enjoyed more appreciable wage growth.

The residential property market was generally buoyant in the first half of 2015, but quietened down in the second half as sentiment was dented by a downslide in the local stock market during the summer months, and as concerns over a US interest rate hike grew. Trading activities slowed down visibly from July. Flat prices showed a decline in the fourth quarter, though these were still up by 2 per cent for 2015 as a whole.

The local stock market fluctuated sharply over the course of 2015. The Hang Seng Index (HSI) went successively higher in the first few months of the year alongside Mainland and other major markets worldwide, reaching a seven-year high of 28,443 on 28 April. The HSI then slipped towards the end of the second quarter in tandem with the global stock market rout. It fell to a low of 20,557 on 29 September, before recovering some lost ground to finish the year at 21,914, 7 per cent lower than at end-2014. Average daily turnover rose markedly to $105.6 billion from $69.5 billion in 2014. Despite escalated financial market volatility, total initial public offering (IPO) funds raised still reached $261.3 billion, up from $232.5 billion in 2014. With such stellar performance, Hong Kong regained its position as the world's largest IPO centre in 2015, having ranked second in the preceding two years.

Inflation subsided further, thanks to softer import prices and tamed domestic cost pressures. For 2015 as a whole, underlying inflation averaged 2.5 per cent, marking the fourth consecutive year of easing.

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, Hong Kong is the world's eighth largest trading entity in 2015. 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 the 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 2015, and the fifth largest foreign exchange trading centre according to a triennial survey conducted by the Bank for International Settlements in 2013. Its stock market is the fourth largest in Asia in terms of market capitalisation as at end-2015 and ranked number one globally in terms of equity funds raised during the same year.

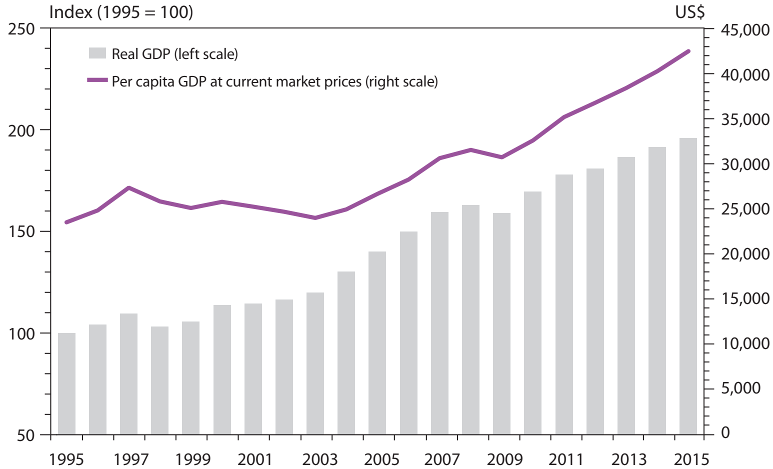
As an international business hub, Hong Kong has a business-friendly environment with the rule of law, free trade and free flow of information, open and fair competition, a well-established and comprehensive financial network, superb transport and communications infrastructure, sophisticated support services, 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 second most competitive economy by the International Institute for Management Development in 2015 and the fifth easiest place to do business globally according to the World Bank's *Doing Business 2016* report published in October 2015. 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, per capita GDP rose about 65 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$42,400 in 2015, 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 almost tripled in real terms over the past two decades. In 2015, the total value of goods trade, comprising re-exports, domestic exports and imports of goods, reached $8,069 billion, equivalent to 336 per cent of GDP. This was higher than the ratios of 251 per cent in 1995 and 323 per cent in 2005. Including the value of exports and imports of services, the ratio of total trade to GDP was even higher, at 400 per cent in 2015, up from 290 per cent in 1995 and 377 per cent in 2005.

Chart 2 **Gross Domestic Product**



Over the past two decades, the Hong Kong economy grew 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 $12,715 billion in market value at the end of 2014, equivalent to 564 per cent of GDP. It served as another vivid manifestation of Hong Kong's increasing international focus. The territory is among the most preferred destinations for inward direct investment, ranked second in the world after only the Mainland by the United Nations' *World Investment Report 2015*.

The corresponding figures for Hong Kong's stock of direct investment assets were likewise huge, at $12,359 billion, or 548 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 $33,436 billion and $25,848 billion respectively at the end of 2015. The corresponding ratios to GDP in 2015 were 1,392 per cent and 1,076 per cent. Reflecting Hong Kong's robust international investment position, its net external financial assets amounted to $7,588 billion at the end of 2015, equivalent to 316 per cent of GDP.

The Gross National Income (GNI), comprising GDP and net external primary income flow, stood at $2,442 billion in 2015. 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 2015, at $1,272 billion and $1,232 billion respectively, equivalent to 53 per cent and 51 per cent of GDP respectively. This was attributable to the huge volumes of Hong Kong's inward and outward investment.

Contributions of Various Economic Sectors

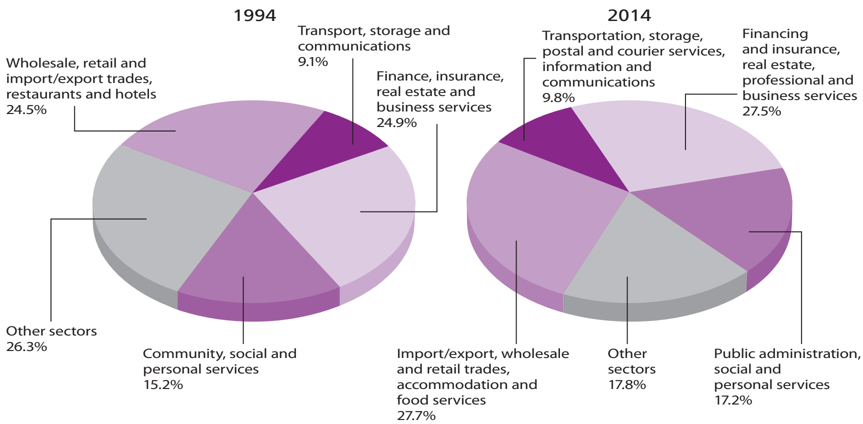
Primary production, including agriculture, fisheries, mining and quarrying, is insignificant in terms of both value-added contribution to GDP and share in total employment, as Hong Kong is a predominantly city economy.

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 2014, while those of the construction sector and electricity, gas and water stood at 4 per cent and 2 per cent respectively.

Hong Kong has become increasingly service-oriented since the '80s. 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 reorientated itself towards service activities and moved up the value chain.

In 2014, the services sector contributed 93 per cent directly to GDP. Import/export, wholesale and retail trades, and accommodation and food services remained the largest service sector, accounting for 28 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**



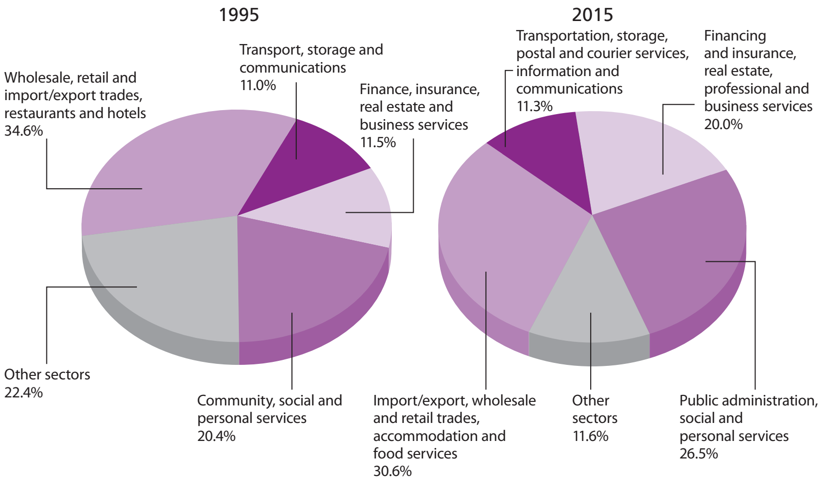
The import/export, wholesale and retail trades, accommodation and food services sector, and the financing and insurance, real estate, professional and business services sector remained the two largest service sectors in terms of net output in 2014.

Note: Due to the 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 increased supply-chain arrangements involving the Mainland and other neighbouring economies, Hong Kong's productive capacity has 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 78 per cent in 1995 to 87 per cent in 2005 and 88 per cent in 2015. As for individual service segments, import/export trade and wholesale, retail, accommodation and food services accounted for 31 per cent of the total in 2015. 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 2015.

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.

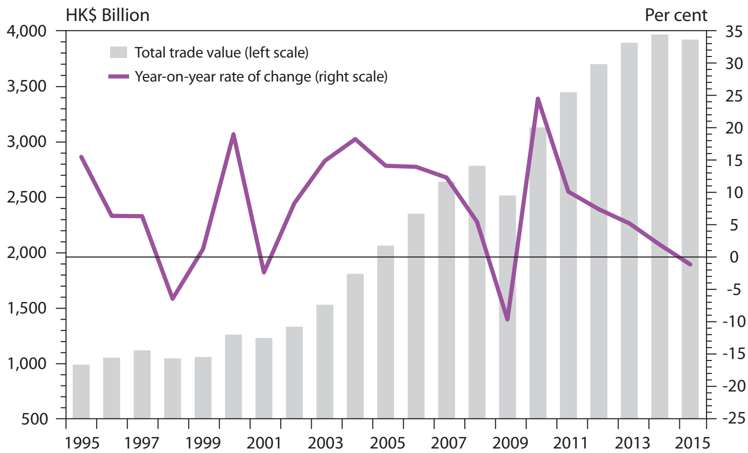
Starting from the first quarter of 2009, industrial classification of employment has adopted the Hong Kong Standard Industrial Classification Version 2.0 while that in the previous years is based on Version 1.1.

Economic Links between Hong Kong and Mainland

Following several decades of reform and opening up on the Mainland, cross-boundary economic ties have been stronger than ever. Throughout the period, the flow 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$281 billion in 1995 to US$4.0 trillion in 2015, 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 2015 was about four times that of 20 years ago, representing growth of 7 per cent per annum in value terms *(chart 5)*. In 2015, the Mainland was ranked the world's largest trading entity and Hong Kong was ranked 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. Cross-boundary trade accounted for more than half of Hong Kong's total trade value in 2015. On the other hand, Hong Kong is the Mainland's second largest trading partner after the United States, accounting for about 9 per cent of the Mainland's total trade value in 2015. More than half of Hong Kong's exports to the Mainland in 2015, which were mainly re-exports, 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 nearly 50 per cent over the past decade. The Mainland has a population of close to 1.4 billion, with 100 million in Guangdong Province alone. That, coupled with the

Central People's Government's goal to restructure economic growth towards domestic consumption, makes the Mainland market 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 2015, foreign visitors to the Mainland made 3.6 million trips through Hong Kong, while Mainland residents made 45.8 million trips to or through Hong Kong.

Hong Kong remains the largest external investor on the Mainland. According to the Mainland's statistics, the cumulative value of Hong Kong's realised direct investment in the Mainland reached US$833 billion as at the end of 2015, accounting for more than 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 58 per cent of its total outward direct investment as at the end of 2014, reflecting Hong Kong's role as a platform for Mainland companies to explore other markets 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 nearly one-third of Hong Kong's total inward direct investment. Mainland companies have also maintained a strong presence in Hong Kong. As at mid-2015, Mainland companies had established a total of 1,091 regional headquarters and regional or local offices in Hong Kong, up from 710 a decade ago.

Due to proximity, Guangdong's economic links with Hong Kong are understandably the closest among all the provinces. Based on the Mainland's statistics, the cumulative value of Hong Kong's realised direct investment in Guangdong was US$239 billion as at end-2015, accounting for 63 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, Hong Kong saw 951 Mainland enterprises listed on its stock market as at the end of 2015. Of these, 75 were listed in 2015, raising $242.8 billion in equity funds, with $658.1 billion in aggregate funds raised from IPOs and secondary financing.

Separately, the amount of outstanding RMB bonds issued in Hong Kong was largely steady at RMB368 billion as at the end of the year. The territory continued to possess the world's largest offshore pool of RMB liquidity, with the total amount of RMB customer deposits and outstanding RMB certificates of deposit issued standing at RMB1,010 billion as at the end of 2015. Many aspects of offshore RMB business in Hong Kong attained progress in 2015. The value of RMB trade settlement handled by banks in Hong Kong increased further by 9 per cent to RMB6,833 billion, while the outstanding amount of RMB loans jumped 58 per cent to RMB297 billion as at the year end, both attaining their respective record highs.

Hong Kong remained the largest offshore RMB investment product market in 2015. At the end of the year, there were 71 Securities and Futures Commission-authorised RMB Qualified Foreign Institutional Investor Scheme (RQFII) and RMB Stock Connect unlisted funds with an aggregate net asset value of RMB20.8 billion, and 24 SFC-authorised RQFII exchange traded funds (ETFs) adopted dual RMB and HKD counter trading arrangements with an aggregate net asset value of RMB32.7 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 enhanced further. After the Shanghai-Hong Kong Stock Connect was launched in November 2014, the Mainland-Hong Kong Mutual Recognition of Funds was introduced in July 2015, signifying another breakthrough in the opening up of the Mainland's capital account and marking an important step in the internationalisation of RMB. The mutual recognition would enrich the types of fund products offered in the two places and deepen the mutual access between the Hong Kong and Mainland financial markets.

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). On the basis of the Agreement between the Mainland and Hong Kong on Achieving Basic Liberalisation of Trade in Services in Guangdong, signed in 2014, both sides signed the Agreement on Trade in Services in November 2015, extending the geographical coverage of basic liberalisation of trade in services to the whole Mainland to help Hong Kong enterprises capitalise on the enormous Mainland market.

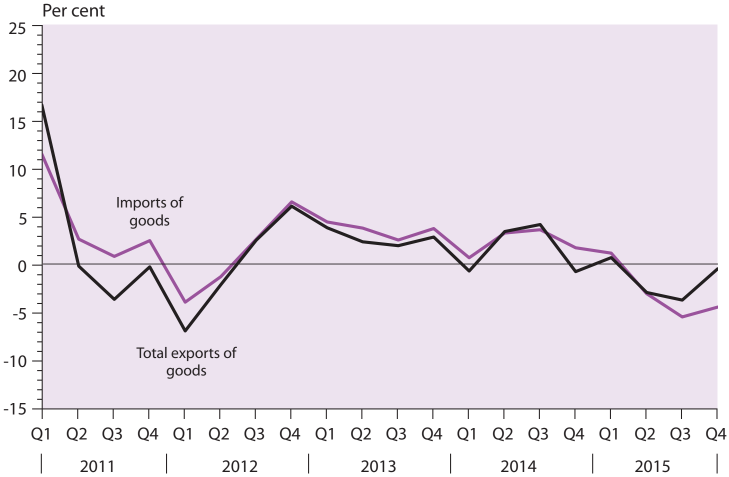
Meanwhile, the construction of several major cross-boundary infrastructure projects continued in 2015, including the Hong Kong-Zhuhai-Macao Bridge and the Hong Kong section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link. Upon completion, these infrastructures will facilitate the flow of people and goods, thereby further deepening the economic and trade relations between Hong Kong and the Mainland.

The Economy in 2015

External Trade

External demand deteriorated visibly in 2015, with the slowdown of the global economy making a serious dent in regional trade flow and manufacturing activity. Total exports of goods, on a merchandise trade statistics basis, fell 1.7 per cent in real terms after 1.5 per cent growth in 2014. This was the worst performance since 2009. Exports to the European Union and Japan remained lacklustre alongside subdued economic activity in both places. Exports to the US, though faring better, registered only slight growth as the market weakened in the second half of the year amid softer economic growth and sagging industrial production in that country. With global demand sluggish, exports to the Mainland and many other Asian markets worsened. Exports to India and Vietnam were the major exceptions, posting notable growth in 2015 as a whole. In terms of the quarterly profile, except for a modest year-on-year growth of 0.7 per cent in the first quarter, merchandise exports declined in the rest of the year, by 3.0 per cent, 3.8 per cent and 0.5 per cent respectively in the second, third and fourth quarters *(chart 6)*.

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



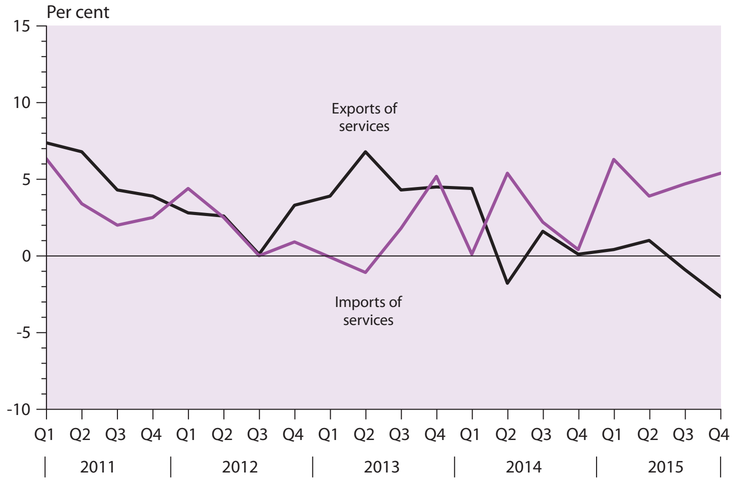
Merchandise exports suffered a setback in 2015 amid protracted sluggishness in global demand.

Imports of goods likewise fell 3.2 per cent in real terms in 2015, following a 2.3 per cent growth in the preceding year. Apart from the slide in those imports for subsequent re-exporting, retained imports also weakened considerably. Retained imports, referring to imports for domestic use, accounted for about a quarter of total imports and relapsed to a 7.4 per cent decline in real terms in 2015 after a moderate increase of 4.5 per cent in 2014. The decline partly reflected a fall-off in retained imports of raw materials and semi-manufactures amid sluggish region-wide trading and production activities, and partly reflected reduced intake of the relevant retained imports upon setbacks in the retail market as well as a fall-off in machinery and equipment acquisition during the year.

Exports of services slackened to a slight decline of 0.6 per cent in real terms in 2015 as a whole, compared with 1.1 per cent growth in 2014. The fall in exports of travel services widened and remained the main drag, as visitor arrivals decelerated further to record Hong Kong's first annual decline since 2003, while tourist spending on big-ticket items continued to retreat. Exports of trade-related and transportation services remained lacklustre amid sluggish trade and cargo flow. However, hectic fund-raising and cross-border financing activities drove solid growth in exports of financial and other business services, thereby rendering some cushioning to overall services exports.

Imports of services grew moderately by 5.1 per cent in real terms in 2015, after 2.0 per cent growth in 2014. The pick-up in growth was buttressed mainly by notable growth in the imports of travel services throughout the year, reflecting strong interest among local residents in travelling. Apart from stable local job and income conditions, the higher purchasing power of residents following depreciations of many currencies against the US dollar conceivably also fostered interest in overseas travel. Meanwhile, imports of financial and other business services grew moderately. On the other hand, imports of trade-related services weakened to show only a meagre increase in the midst of an austere external trading environment, while imports of transportation services likewise relapsed into a decline *(chart 7)*.

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



Exports of services slackened in 2015.

The goods deficit narrowed in 2015, thanks to an improvement in terms of trade and reduced intake of retained imports as the economy slowed. With the services surplus more than offsetting the goods deficit, the combined goods and services account registered a surplus of $57 billion in 2015, equivalent to 1.2 per cent of total import value and considerably larger than the surplus of only $3 billion in 2014.

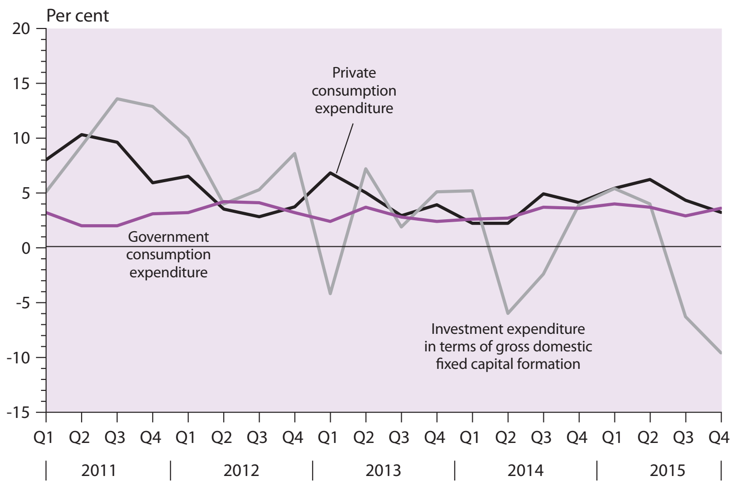
Domestic Demand

Domestic demand grew further in 2015, rendering key impetus to overall economic growth. Supported by the stable labour market conditions, private consumption expenditure grew a solid 4.8 per cent in real terms after 3.3 per cent growth in 2014. The growth momentum eased somewhat in the second half of 2015, however, conceivably reflecting negative repercussions on local consumer sentiment from local asset price corrections and increased uncertainties over the economic outlook. Government consumption expenditure grew steadily by 3.4 per cent in real terms, slightly faster than the 3.0 per cent growth in 2014.

Overall investment spending in terms of gross domestic fixed capital formation remained weak, down 2.2 per cent in real terms in 2015, representing the second year of decline after a 0.1 per cent dip in 2014. Machinery and equipment acquisition was the key drag, down further by 5.8 per cent in 2015, with more visible declines in the second half of the year, conceivably reflecting increasing worry over the dimmer global economic outlook and impending interest rate lift-off.

On the other hand, overall building and construction expenditure posted moderate growth of 2.8 per cent, driven by a steady expansion of private-sector building and construction activity *(chart 8)*.

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

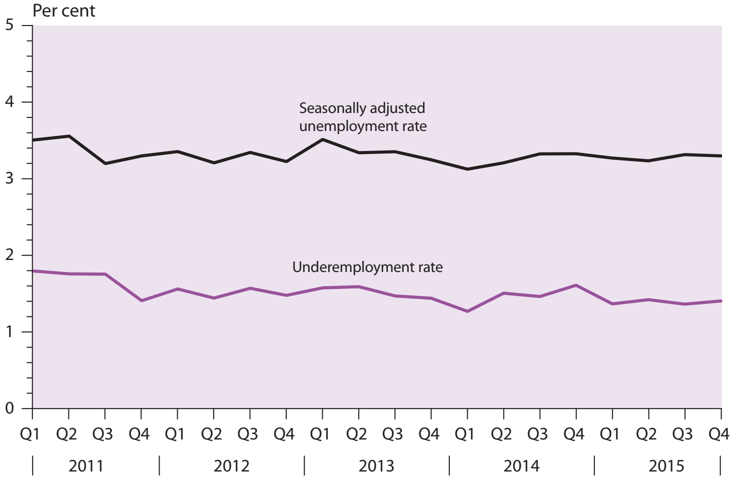


Private consumption expenditure expanded solidly in 2015, but investment expenditure declined.

Labour Market

The labour market remained largely stable in overall terms, with the unemployment rate averaging 3.3 per cent for the year as a whole. Both total employment and the labour force grew further at a largely similar pace, with the former reaching a new annual high of 3,780,900 in 2015. The underemployment situation improved, with the underemployment rate falling slightly by 0.1 percentage point to 1.4 per cent, the lowest annual level since 1997 *(chart 9)*.

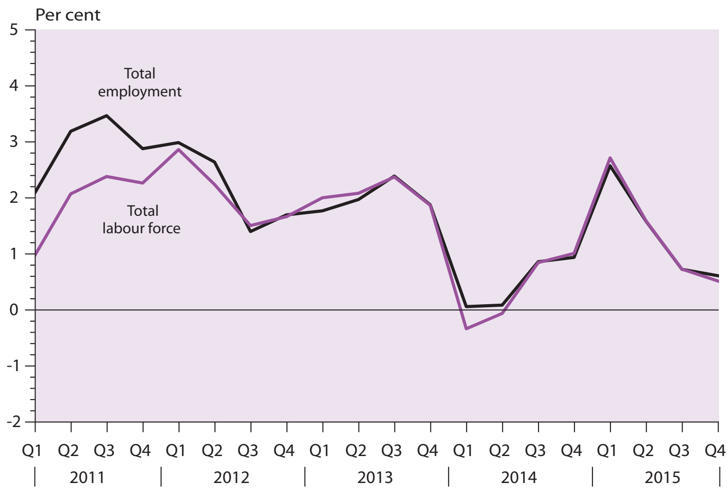
Chart 9 **The Unemployment and Underemployment Rates**



The seasonally adjusted unemployment rate hovered at a low level of 3.2-3.3 per cent during the year, signifying another year of full employment.

Total employment and the labour force expanded moderately by 0.8 per cent and 0.9 per cent in 2015 respectively *(chart 10)*. However, data collected from private-sector establishments pointed to weaker labour demand, particularly in the trade and tourism-related sectors. In 2015, private-sector employment in the import/export trade and wholesale, accommodation services, and retail industries declined amid the lacklustre external trade and sustained weakness in inbound tourism.

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



Total employment and the labour force grew moderately in 2015.

The vacancy situation likewise showed signs of easing labour demand. In 2015, the number of private-sector vacancies declined further by 1.3 per cent to 75,590.

Analysed by economic sector, more noticeable decreases in vacancies were observed in construction sites covering manual workers only (down 42.6 per cent year on year), manufacturing (down 10.6 per cent), food and beverage services (down 10.5 per cent), retail (down 8.6 per cent), and import/export trade and wholesale (down 7.7 per cent). More apparent increases in vacancies were seen in human health services (up 22.0 per cent), arts, entertainment and recreation (up 15.3 per cent), and financing and insurance (up 12.4 per cent). Alongside the dip in vacancy number was a decrease in the ratio of job vacancies per 100 job-seekers from 60 in 2014 to 59 in 2015, after recording increases for five years in a row.

On the back of broadly stable labour market conditions, wages and earnings remained on the rise in 2015. Labour earnings in the private sector posted a further improvement of 4.6 per cent for 2015 as a whole, with more notable increases seen in social and personal services, sewerage, waste management and remediation activities, accommodation and food services activities, and professional and business services.

Separately, statistics compiled from the General Household Survey, though not strictly comparable to those from surveys by the business establishment, suggested the average monthly employment earnings of full-time employees engaged in elementary occupations, excluding foreign domestic helpers, rose appreciably further by around 6.2 per cent in nominal terms and 2.2 per cent in real terms, conceivably benefiting from the statutory minimum wage uprating since May 2015. The average monthly employment earnings of full-time employees, excluding foreign domestic helpers, in the lowest three decile groups likewise grew further by a solid 6-7 per cent in 2015.

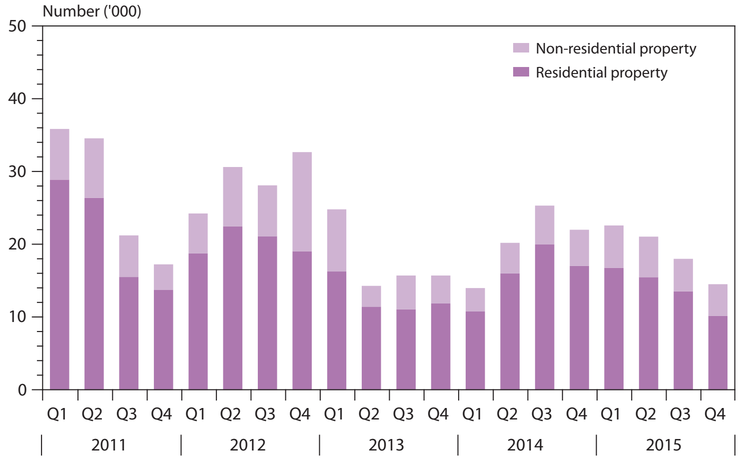
For the overall income situation, the median monthly household income, excluding foreign domestic helpers, recorded sustained growth in all quarters of 2015, rising 7.7 per cent to $24,900 in 2015 from $23,100 in 2014.

Property Market

The residential property market stayed generally buoyant in the first half of 2015, but quietened down in the second half as sentiment was dented by the stock market downslide during the summer months and as concerns over a US interest rate hike grew. With buyers adopting a more cautious attitude, trading activities quietened down visibly from July. The increase in flat prices decelerated in the third quarter and then turned into a decline in the fourth quarter amid increasing adjustment pressure facing the market.

At the Land Registry, the total number of sale and purchase agreements received for residential property fell 12 per cent to 56,000 in 2015, sharply below the long-term average of 92,900 over 1995 to 2014 *(chart 11)*. There was a noticeable moderation through the year, from a monthly average of 5,400 in the first half to 4,500 in the third quarter and sharply down to 3,400 in the fourth quarter. Total consideration declined by a more modest 4 per cent to $416.5 billion.

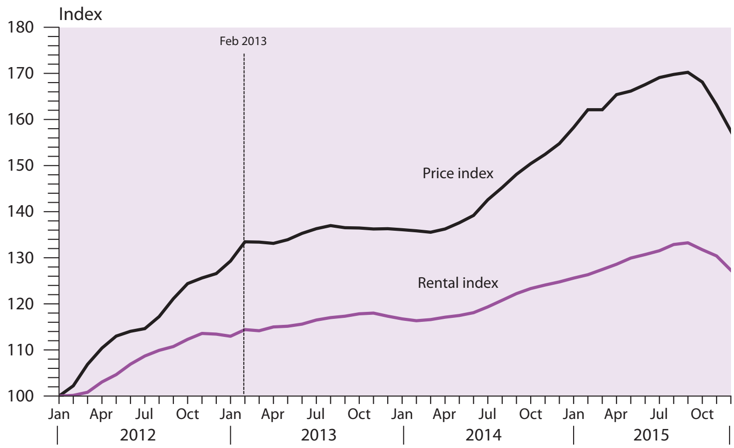
Chart 11 **Sale and Purchase Agreements by Broad Type of Property**



Trading activities quietened down visibly in the second half of 2015.

Having recorded further sharp increases during the first half of 2015, overall flat prices rose at a more modest pace during the third quarter and switched to a sharp fall of 7 per cent during the fourth quarter. For the year as a whole, overall flat prices rose 2 per cent between December 2014 and December 2015. Analysed by size, prices of large flats dropped 1 per cent during 2015, while prices of small and medium-sized flats rose 3 per cent. The leasing market also cooled off in the second half. With the drop in the fourth quarter partially offsetting the modest gains in the first three quarters, overall flat rentals rose 3 per cent during 2015. Rentals of small/ medium-sized and large flats increased 3 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 a decline in the fourth quarter.

Notwithstanding the recent consolidation, overall flat prices in December 2015 still exceeded the 1997 peak by 65 per cent. Home purchase affordability[1] was about 62 per cent in the fourth quarter, which was still significantly higher than the long-term average of 46 per cent from 1995 to 2014. Should interest rates rise 3 percentage points to a more normal level, the ratio would soar to 81 per cent.

The demand-supply balance of flats remained tight in overall terms in 2015, though the situation looks set to ease in the years ahead. With the take-up of private flats exceeding net completions[2], the vacancy rate for private flats edged down from 3.8 per cent at end-2014 to 3.7 per cent at end-2015, well below the long-term average of 5 per cent over 1995-2014. Yet, reflecting the government's sustained efforts on the supply front, 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 successively from 74,000 units as estimated at end-2014 to 87,000 units as estimated at end-2015, a record high since the statistics were published in September 2004.

As it takes time to increase supply, the government has also made significant efforts to manage demand and reduce possible risks to financial stability arising from an exuberant property market. These measures have yielded notable results.

The non-residential property market also cooled off in the second half of 2015. Trading activities have quietened down since the third quarter, though for the year as a whole the number of sale and purchase agreements for non-residential property still rose 14 per cent over the low base of last year to 20,200, while total consideration increased 16 per cent to $132.1 billion. Prices and rentals likewise came under pressure towards the year end, recording only modest gains or even slight declines for 2015 as a whole.

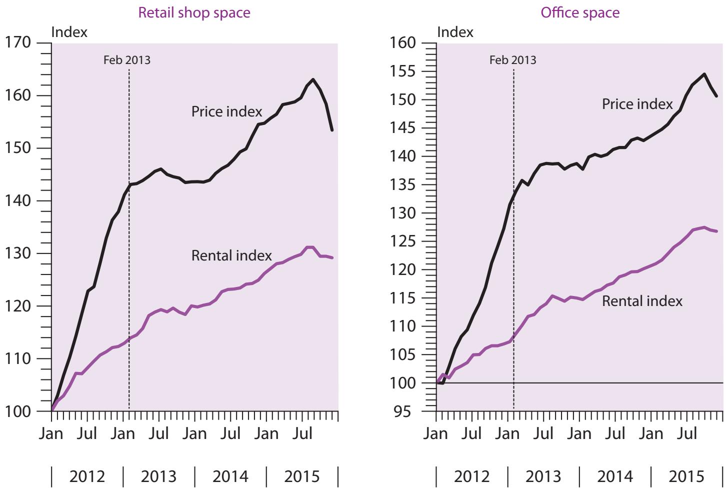
Sale prices of retail shop space dipped 1 per cent between December 2014 and December 2015, while rentals rose 2 per cent *(chart 13)*.

For office space, overall prices recorded a moderate gain of 5 per cent. Prices of Grade A, B and C office space went up 9 per cent, 7 per cent and 6 per cent respectively. Overall office rentals also rose 5 per cent, with those of Grade A, B and C office space recording a gain of 5 per cent, 6 per cent and 4 per cent respectively *(chart 13)*. Prices and rentals of flatted factory space rose 3 per cent and 5 per cent respectively.

1 The ratio of mortgage payment for a 45 square metre flat to median income of households, excluding occupants of public housing.

2 Gross completions net of demolition.

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



Prices and rentals of retail shop and office space declined in the fourth quarter.

As to demand-supply balance, the vacancy rate of retail shop space and office space rose from 7.3 per cent and 6.3 per cent at end-2014 to 7.7 per cent and 8.0 per cent at end-2015 respectively, while that for flatted factory space declined from 5.6 per cent to 5.0 per cent. These were below their respective long-term averages of 8.8 per cent, 10 per cent and 8.2 per cent over 1995-2014.

Price Movements

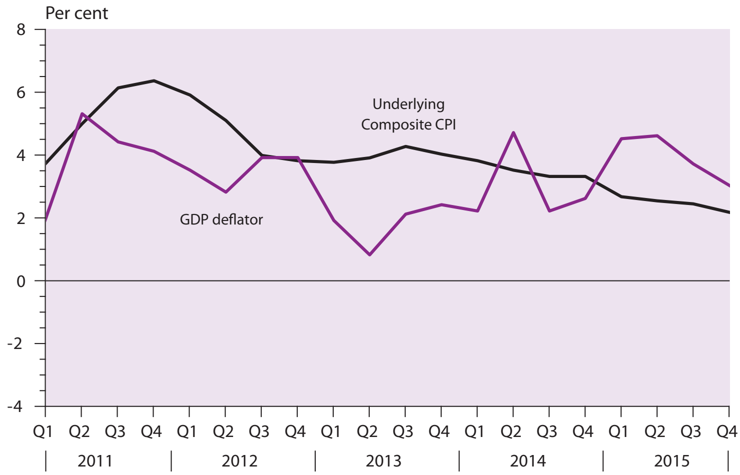
Consumer price inflation receded further in 2015. Netting out the effects of the government's one-off relief measures, underlying consumer price inflation retreated to 2.5 per cent in 2015 from 3.5 per cent in 2014, marking the fourth consecutive year of easing. In terms of the quarterly profile, underlying inflation fell from 2.7 per cent in the first quarter to 2.5 per cent in the second quarter, and slightly further to 2.4 per cent in the third quarter and 2.2 per cent (under 2014/15-based consumer price index) in the fourth quarter.

The easing trend was attributed to a further moderation in imported inflation, thanks to weak international food and commodity prices as well as the strength of the US dollar. Domestic cost pressures also remained moderate in the midst of the economic slowdown. Rises in labour costs were broadly steady. Rental inflation held generally stable during most of 2015, with some easing towards the end of the year given the setback in retail sales and consolidation of the property market. The weakness in retail sales, largely impaired by the slowdown of inbound tourism, also restrained the pricing power of retailers and other related businesses.

Headline consumer price inflation, which is under the influence of the government's one-off relief measures, likewise moderated to 3.0 per cent in 2015 from 4.4 per cent in 2014.

The GDP deflator increased 3.9 per cent in 2015, up from a 2.9 per cent increase in 2014, mainly reflecting the improvement in terms of trade *(chart 14)*.

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



Underlying inflation eased further in 2015 because of softer import prices and tamed domestic cost pressures.

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 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 ordinance, the Financial Secretary submits to LegCo 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 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 LegCo. During the financial year, which runs from 1 April to 31 March, if a department needs to change the expenditure estimates and spend more money, it must obtain LegCo's authorisation.

The government controls its finances through the General Revenue Account (GRA) and various funds established under the ordinance. The GRA is the main account for day-to-day departmental expenditure and revenue collection. Funds established under the ordinance 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 2014-15, the government recorded a surplus of $72.8 billion, with revenue of $478.7 billion, expenditure of $396.2 billion and repayment of government bonds and notes of $9.7 billion. Fiscal reserves at the end of March 2015 stood at $828.5 billion, equivalent to 25 months of government expenditure. Highlights of government revenue and expenditure for 2014-15 and 2015-16 (Revised Estimate) are in table 6 of Appendix 6.

Public expenditure comprises government expenditure and expenditure by the Housing Authority and Trading Funds. In 2014-15, public expenditure decreased 7.3 per cent against the previous year to $424.1 billion, of which some $321.9 billion, or 75.9 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.

Injection into Housing Reserve

The government had set aside about $45 billion – the investment returns on its fiscal reserves for 2015 – for further injection into the Housing Reserve to support the 10-year public housing supply target. Together with an initial sum earmarked for the purpose last year and the interest accrued, the Housing Reserve measured about $74 billion as at 31 December 2015.

Establishment of Future Fund

In December 2015, the government announced the establishment of a Future Fund (FF) with effect from 1 January 2016 with a view to securing higher returns for its fiscal reserves. This is part of fiscal measures to cope with foreseeable long-term fiscal challenges arising from an ageing population and slower economic growth. The FF would be a long-term investment tool and would remain an integral part of the fiscal reserves. It would be placed with the Exchange Fund for an initial period of 10 years from 1 January 2016 to 31 December 2025.

The FF would comprise:

- an initial endowment of $219.7 billion, notionally held against the balance of the Land Fund;
- periodic top-ups from the government as the Financial Secretary may determine each year. This would be notionally held against the GRA; and
- interest on investment of the FF, which shall be calculated and compounded on an annual basis.

The investment returns arising from the FF during the course of the placement shall be retained by the Exchange Fund for reinvestment. Interests on the FF placement with the Exchange Fund shall be due for payment to the government upon completion of the placement period.

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 (29 per cent), land premium (16 per cent), salaries tax (12 per cent) and stamp duties (16 per cent). All major sources of revenue are presented in chart 1 of Appendix 6.

The Inland Revenue Department collects about 63 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 43 per cent of total government revenue in 2014-15.

Profits tax is charged only on profits arising in, or derived from, Hong Kong from a trade, profession or business carried on within the territory. In 2014-15, 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 adjusted subsequently 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 2014-15, the total profits tax collected was about $137.8 billion, making up about 29 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, which is income less deductions and allowances. In 2014-15, 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 to 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 $59.3 billion in 2014-15, accounting for about 12 per cent of total government revenue. Because of generous personal allowances under the Hong Kong tax law, only about 1.7 million people, or 46 per cent of the workforce, were liable to salaries tax for the year of assessment 2013-14.

Owners of land and buildings are charged property tax at the standard rate (15 per cent in 2014-15) 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 locally are exempt from property tax, but the profits it derived from the properties are chargeable to profits tax. Property tax contributed some $2.9 billion in 2014-15, constituting about 0.6 per cent of total government revenue.

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 2014-15, the revenue from stamp duties was some $74.8 billion, or about 16 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. The yield from betting duty in 2014-15 totalled some $19.5 billion, about 4 per cent of total government revenue.

Under the Dutiable Commodities Ordinance, excise duties are levied on four types of commodities to be consumed locally, namely, 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 $10.1 billion in 2014-15, or about 2 per cent of total government revenue, of which 60.6 per cent was from tobacco, 35.3 per cent was from hydrocarbon oil, 4 per cent was from liquor, and 0.1 per cent was from methyl alcohol and other alcohol products.

In addition, all motor vehicles imported for use on roads are subject to First Registration Tax under the Motor Vehicles (Frist Registration Tax) Ordinance. The Customs and Excise Department assesses the taxable value of vehicles to facilitate the Transport Department's collection of this tax, which totalled $9.55 billion in 2014-15.

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 2015-16). 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 2015, with rateable values reflecting rental values on 1 October 2014. The revenue from rates in 2014-15 was $22.3 billion, accounting for about 5 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 2015. Total government rent collected in 2014-15 was $9.3 billion, or about 1.9 per cent of total government revenue.

Fees and charges for services provided by government departments generated about $14.6 billion, or about 3 per cent of total revenue, in 2014-15. 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 $4 billion, which accounted for about 1 per cent of total revenue; the most important of these, in revenue terms, is provision of water supplies.

Lastly, some $77.8 billion, or about 16 per cent of total government revenue in 2014-15, was generated from land transactions. All revenue from land transactions is credited to the Capital Works Reserve Fund to finance the Public Works Programme.

The government set up in 2014 a Housing Reserve to support its 10-year public housing supply target. For 2014-15, the investment income in respect of the fiscal reserves for 2014 of $27.5 billion was retained within the Exchange Fund as provision for the Housing Reserve, and was not paid to the government on 31 December 2014.

Network of Tax Treaties and International Tax Co-operation

Comprehensive agreements for the avoidance of double taxation (CDTAs) with major economies improve the business environment and facilitate the flow of trade, investment and talent between Hong Kong and the rest of the world. These agreements 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 2015, Hong Kong had signed 33 CDTAs.

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 2015, Hong Kong had signed seven such agreements.

In September 2014, Hong Kong indicated to the Organisation for Economic Co-operation and Development (OECD) it would implement a 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 begin the first automatic information exchanges on a reciprocal basis with appropriate jurisdictions by the end of 2018, the OECD's required timeline. The government conducted a consultation exercise from April to June 2015 to gauge views on how to adapt the new standard to Hong Kong.

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.

The Government Logistics Department is the government's central procurement agent. It normally purchases goods and related services through competitive tendering to meet user departments' needs at the best possible prices, having regard to the lifetime cost and reliability of supply. Consideration is given to buying environmentally friendly products where available and appropriate. In 2015, the department awarded contracts amounting to $5.16 billion, with goods and related services procured from 24 different countries or territories, including Hong Kong.

To facilitate sourcing and market research, the department maintains supplier lists for different categories of goods and services. It publishes notices for open tenders on the internet and notifies suppliers on the relevant supplier lists. For procurements covered by the WTO GPA, tender notices are also published in the Government Gazette. Consulates and overseas trade commissions are informed where appropriate. Bidders may download tender documents and submit tender offers 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