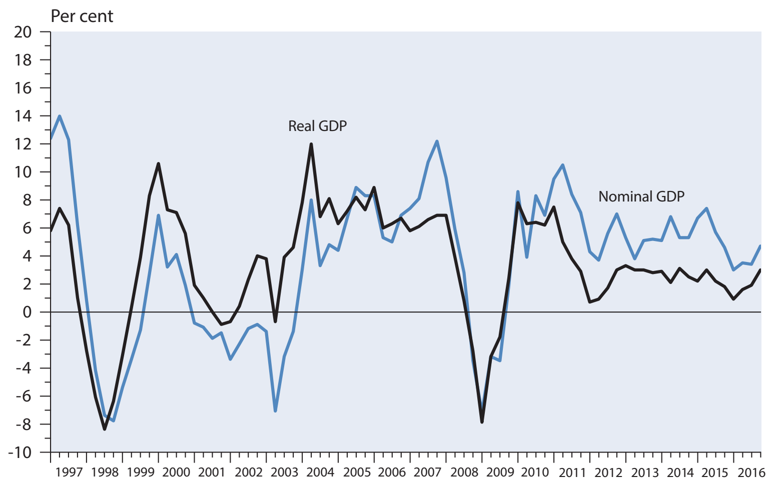
Chapter 3

The Economy

The Hong Kong economy grew moderately in 2016. Economic growth picked up during the year, upon improvement in exports and resilience in domestic demand. The unemployment rate stayed low and inflation eased slightly further.

The Hong Kong economy made moderate growth in 2016, with Gross Domestic Product (GDP) expanding 1.9 per cent in real terms, slower than the 2.4 per cent growth in 2015 and the annual average growth of 2.9 per cent in the past decade. In terms of the quarterly profile, the year-on-year growth rate of real GDP picked up successively, from 1.0 per cent in the first quarter to 1.7 per cent and 2.0 per cent respectively in the second and third quarters, and reached 3.1 per cent in the fourth quarter on the back of an improving external sector and strengthening domestic demand *(chart 1)*.

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



The Hong Kong economy continued to grow moderately in 2016.

Total exports of goods grew slightly in 2016, reversing a modest decline in 2015. The external trading environment was particularly difficult early in the year but staged some improvement subsequently, led by stronger economic growth in the United States and steady growth in the Mainland economy. The United Kingdom's vote in June to leave the European Union caught the markets by surprise, but the contagion impact remained largely contained till end-2016. Along with a general recuperation of Asia's trade flows, Hong Kong's total exports of goods revived after falling in the first quarter, with a particularly impressive growth in the fourth quarter.

Exports of services slackened, dragged down mainly by a notable fall in inbound tourism. As the global economic environment turned more benign and visitor arrivals bottomed out, exports of services generally improved during the year, reverting to growth in the fourth quarter.

The domestic sector stayed resilient despite the various external uncertainties. Private consumption expenditure registered further growth, buttressed by continued favourable employment and labour income conditions. Investment expenditure rose again in the second half of 2016 on the back of the improved business sentiment and sustained expansion of building and construction activity, though it still registered a slight decline for the whole year.

The labour market was in a state of full employment throughout the year, notwithstanding the slowdown in inbound tourism and weakness in retail sales. Total employment for 2016 as a whole rose to a new annual high. The seasonally adjusted unemployment rate edged down to 3.3 per cent in the fourth quarter. Against this background, wages and earnings attained another year of real improvements.

Following a brief consolidation in late 2015 and early 2016, the residential property market rebounded in the second quarter of 2016 and turned exuberant in the third quarter amid a still tight demand-supply situation. Yet the market cooled visibly after the government introduced a new demand-side management measure in early November and the US raised interest rates in December, with trading activities turning very quiet and the upward momentum in flat prices moderating noticeably. Overall flat prices rose 8 per cent during the full year of 2016.

The local stock market remained volatile. Local stock prices came under pressure at the beginning of the year, but rallied during the second and third quarters, supported by such developments as the smaller-than-expected contagion effect of Brexit, delays in US interest rate hikes and the approval of the Shenzhen-Hong Kong Stock Connect implementation plan. Towards the year end, the Hang Seng Index (HSI) again consolidated, finishing 2016 almost flat from a year earlier amid renewed market wariness over imminent US interest rate hikes.

Inflation eased slightly further in 2016, thanks to generally soft domestic and external price pressures. The underlying inflation rate edged down to 2.3 per cent in 2016 from 2.5 per cent in 2015, marking the fifth consecutive year of easing.

Structure and Development of the Economy

Hong Kong is a global centre for world trade, finance, business and telecommunications, located strategically at the doorstep of the Mainland's huge and vibrant economy. According to the World Trade Organisation, Hong Kong is the world's seventh largest merchandise trading entity in 2016. 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 sixth largest banking centre in terms of external positions in 2016, and the fourth largest foreign exchange trading centre according to a triennial survey conducted by the Bank for International Settlements in 2016. Its stock market is the fourth largest in Asia in terms of market capitalisation as at end-2016 and ranks first globally in terms of initial public offering equity funds raised during the same year.

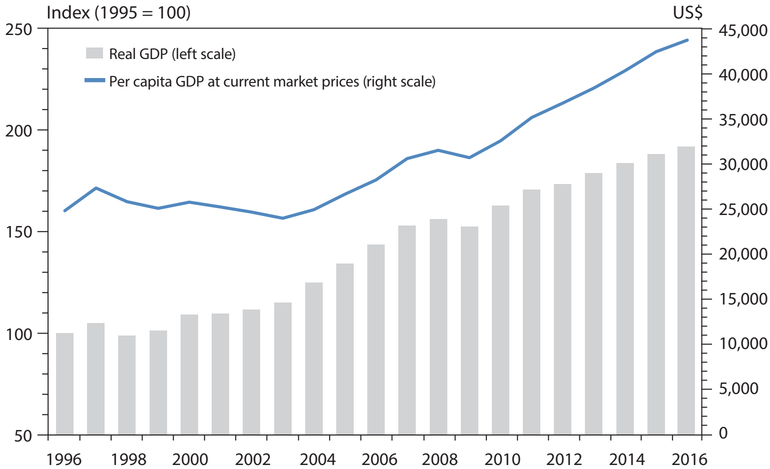
As an international business hub, Hong Kong has a business-friendly environment with the rule of law, free trade and free flow of information, open and fair competition, a well-established and comprehensive financial network, superb transport and communications infrastructure, sophisticated support services, 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 ranked persistently 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 most competitive economy by the International Institute for Management Development in 2016 and the fourth easiest place to do business globally according to the World Bank's *Doing Business 2017* report, published in October 2016. 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 3.3 per cent in real terms and consistently faster than most high-income economies. Over the same period, per capita GDP rose about 68 per cent in real terms, posting an average annual growth rate of 2.6 per cent. Hong Kong's per capita GDP at current market prices reached US$43,700 in 2016 *(chart 2)*, comparable to many advanced economies.

Trade links with other parts of the world have grown appreciably, thanks to continued globalisation, the further deepening of regional trade integration and the government's sustained efforts in exploring new markets. Trade in goods and services almost tripled in real terms over the past two decades. The total value of goods trade, compiled under the GDP accounting framework based on the change of ownership principle and comprising re-exports, domestic exports and imports of goods, reached $7,936 billion in 2016, equivalent to 319 per cent of GDP. This was higher than the ratio of 199 per cent in 1996 and 298 per cent in 2006. Including the value of exports and imports of services, the ratio of total trade to GDP was even higher, at 373 per cent in 2016, up from 245 per cent in 1996 and 359 per cent in 2006.

Chart 2 **Gross Domestic Product**



Over the past two decades, the Hong Kong economy grew an average of 3.3 per cent in real terms, consistently faster than most high-income economies.

The stock of direct investment liabilities in Hong Kong was enormous, at $13,697 billion in market value at the end of 2015, equivalent to 571 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 US by the United Nations' *World Investment Report 2016*.

The corresponding figures for Hong Kong's stock of direct investment assets were likewise huge, at $13,231 billion, or 552 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 $35,497 billion and $26,342 billion respectively at the end of 2016. The corresponding ratios to GDP in 2016 were 1,426 per cent and 1,058 per cent. Reflecting Hong Kong's robust international investment position, its net external financial assets amounted to $9,155 billion at the end of 2016, equivalent to 368 per cent of GDP.

The Gross National Income (GNI), comprising GDP and net external primary income flow, stood at $2,573 billion in 2016. This was higher than the corresponding GDP by 3.4 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 2016, at $1,264 billion and $1,180 billion respectively, equivalent to 51 per cent and 47 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

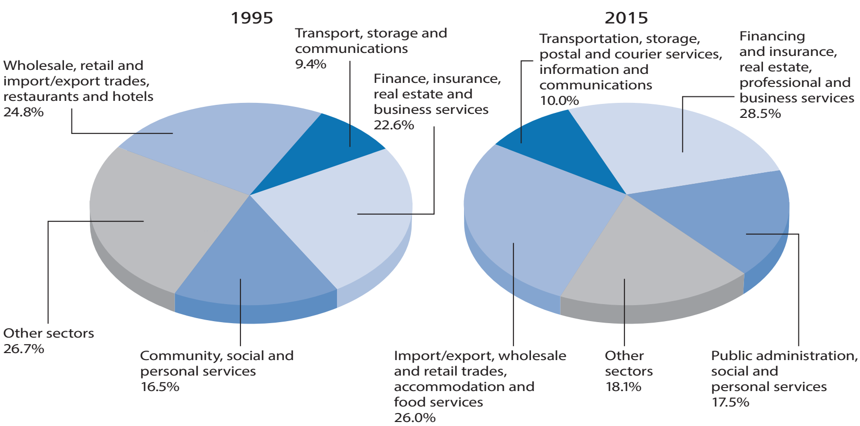
Primary production, including agriculture, fisheries, mining and quarrying, is insignificant in terms of both value-added contribution to GDP and share in total employment, as Hong Kong is a predominantly city economy.

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, accounted for only 1 per cent of GDP in 2015, while those of the construction sector and electricity, gas and water stood at 5 per cent and 1 per cent respectively.

Hong Kong 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 reorientated itself towards service activities and moved up the value chain.

In 2015, the services sector contributed 93 per cent directly to GDP. Financing and insurance, real estate, professional and business services became the largest services sector, accounting for 28 per cent of GDP. This was followed by import/export, wholesale and retail trades, and accommodation and food services (26 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**



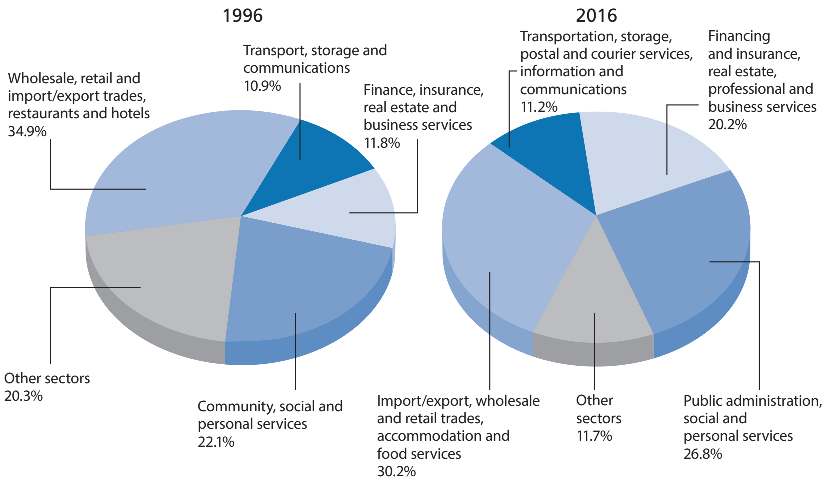
The financing and insurance, real estate, professional and business services sector and the import/export, wholesale and retail trades, accommodation and food services sector remained the two largest service sectors in terms of net output in 2015.

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. Hong Kong's productive capacity has effectively expanded, thanks to increased supply-chain arrangements involving the Mainland and other neighbouring economies. Its well-established links 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 80 per cent in 1996 to 87 per cent in 2006 and 88 per cent in 2016. As for individual service segments, import/export trade and wholesale, retail, accommodation and food services accounted for 30 per cent of the total in 2016. This was followed by public administration, social and personal services with a share of 27 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 2016.

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.

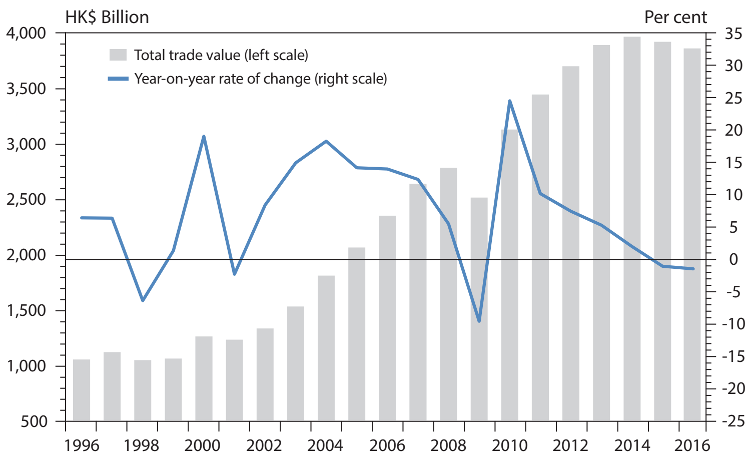
Starting from the first quarter of 2009, industrial classification of employment has adopted the Hong Kong Standard Industrial Classification Version 2.0 while that in the previous years is based on Version 1.1.

Economic Links between Hong Kong and Mainland

Following several decades of reform and opening up on the Mainland, cross-boundary economic ties are stronger than ever. 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 to the two places.

With its total trade surging from US$290 billion in 1996 to US$3.7 trillion in 2016, 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 2016 was about four times that of 20 years ago, representing growth of 7 per cent per annum in value terms *(chart 5)*. In 2016, the Mainland was ranked the world's second largest merchandise trading entity and Hong Kong was ranked seventh.

Chart 5 **Goods Trade between Hong Kong and Mainland**



Merchandise trade between Hong Kong and the Mainland grew notably 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 2016. On the other hand, Hong Kong is the Mainland's second largest trading partner after the US, accounting for about 8 per cent of the Mainland's total trade value in 2016. More than half of Hong Kong's exports to the Mainland in 2016, which were mainly re-exports, involved raw materials and semi-manufactures, 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 30 per cent over the past decade. The Mainland has a population of close to 1.4 billion, with over 100 million in Guangdong Province alone. That, coupled with the Central People's Government's (CPG) 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 2016, foreign visitors to the Mainland made 3.5 million trips through Hong Kong, while Mainland residents made 42.8 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 on the Mainland reached US$915 billion as at the end of 2016, 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 60 per cent of its total outward direct investment as at the end of 2015, reflecting Hong Kong's role as a platform for Mainland companies to explore other markets and go global. Based on Hong Kong's statistics, the Mainland is Hong Kong's second largest source of foreign direct investment, accounting for 27 per cent of Hong Kong's total inward direct investment. Mainland companies also maintain a strong presence in Hong Kong. As at mid-2016, Mainland companies had established 1,123 regional headquarters and regional or local offices in Hong Kong, up from 717 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$256 billion as at end-2016, accounting for 64 per cent of its total inward direct investment. The substantial direct investment from Hong Kong not only contributed to the Mainland's rapid industrialisation in the past decades, but also facilitated the structural transformation of the Hong Kong economy.

Financial links between Hong Kong and the Mainland have strengthened substantially over the years, thanks to the increasing cross-boundary economic activities and the CPG's policy to enhance Hong Kong's position as an international financial centre. As a major funding centre for Mainland enterprises, Hong Kong saw 1,002 Mainland enterprises listed on its stock market as at the end of 2016. Of these, 57 were listed in 2016, raising $182.9 billion in equity funds, with $348.4 billion in aggregate funds raised from IPOs and secondary financing.

Hong Kong 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 RMB625 billion as at the end of 2016. During the year, RMB bank lending held largely steady at RMB295 billion while RMB bond issuance moderated to RMB52.8 billion. The value of RMB trade settlements handled by banks in Hong Kong reached RMB4,542 billion.

Hong Kong also remained the largest offshore RMB investment product market. At the end of 2016, there were 68 Securities and Futures Commission (SFC)-authorised unlisted funds investing onshore via the RMB Qualified Foreign Institutional Investor (RQFII) Scheme, Stock Connect and/or China's Interbank Bond Market, with an aggregate net asset value (NAV) of RMB10 billion, and 26 SFC-authorised RQFII/Stock Connect exchange traded funds adopted dual trading counters in RMB and HKD with an aggregate NAV of RMB28.9 billion. Following the launch of the Shanghai-Hong Kong Stock Connect in November 2014, the launch of the

Shenzhen-Hong Kong Stock Connect in December 2016 opened up another major corridor for global investors to access the A-share markets through the platform in Hong Kong.

Economic cooperation has also been enhanced continuously through the broadening of the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA). The Agreement on Trade in Services under CEPA came into effect in June 2016, extending the geographical coverage of basic liberalisation of trade in services to the whole Mainland. There are now 153 sectors which the Mainland has fully or partially opened up to the Hong Kong services industry, accounting for 95.6 per cent of all the 160 services trade sectors.

During the year, the construction of several major cross-boundary infrastructure projects continued, including the Hong Kong Boundary Crossing Facilities and Hong Kong Link Road under the Hong Kong-Zhuhai-Macao Bridge project, 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.

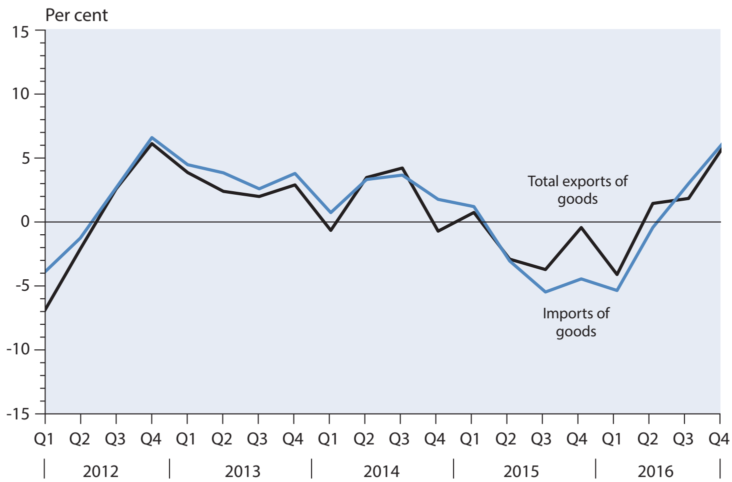
The Economy in 2016

External Trade

The global trading environment showed improvement during the course of 2016. Total exports of goods, on the external merchandise trade statistics basis, reverted to a slight growth of 1.4 per cent in real terms in 2016 from a 1.7 per cent decline in 2015. With the more acute risks waning and global demand reviving modestly, merchandise exports reverted from a 4.2 per cent year-on-year decline in the first quarter of 2016 to growth of 1.4 per cent and 1.8 per cent respectively in the second and third quarters. The growth accelerated to 5.9 per cent in the fourth quarter amid broad-based improvement in regional trade flows *(chart 6)*. Analysed by major market, exports to Asian markets generally picked up over the course of 2016, as the relative stabilisation in global demand during the year led to increased intake of raw materials and semi-manufactures in the region. Exports to the Mainland rebounded modestly. Exports to Taiwan surged, those to Singapore grew solidly and exports to South Korea reverted to a slight growth. The Indian market displayed notable growth for the fourth consecutive year. In stark contrast, exports to major advanced economies remained subdued amid low economic growth there, with exports to the US, EU and Japan all registering declines.

Imports of goods grew marginally by 1 per cent in real terms in 2016, reversing the 3.2 per cent decline in 2015 on the back of an improved re-export trade and a much smaller overall decline in retained imports. Retained imports, meaning imports for domestic use, accounted for about one-quarter of total imports. Such imports fell in the first half of 2016 from a year earlier amid the weakness in local investment spending and retail sales, which reduced the related intake in imports. In the second half of the year, retained imports bounced back visibly, leading to only a marginal decline of 0.6 per cent in real terms for 2016 as a whole, much smaller than the 7.4 per cent in 2015. The upturn went in tandem with the visible pick-up in domestic demand and the relative improvement in the retail market.

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

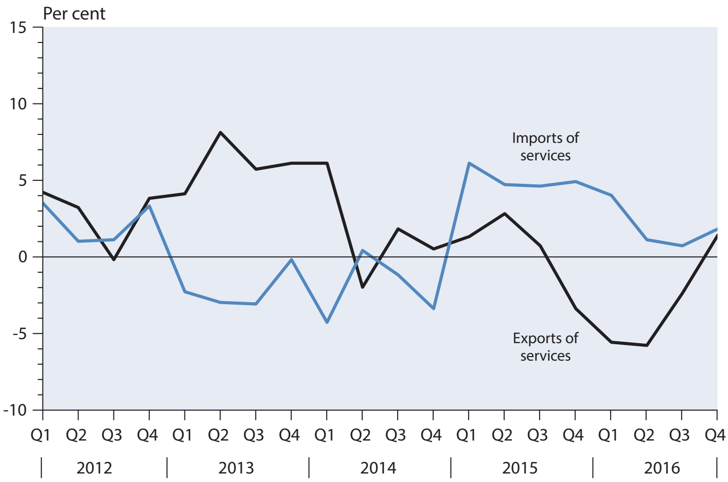


Merchandise exports showed successive improvements after a setback in the first quarter of 2016.

Exports of services slackened and fell 3.1 per cent in real terms in 2016, posting the first annual decline in real terms since 1998, dragged down mainly by a notable fall-off in inbound tourism. Yet, as the global economic environment turned more benign and visitor arrivals bottomed out, exports of services generally improved during the year, reverting to growth in the fourth quarter. Among the key components, the fall in exports of travel services posed a significant drag, being affected by subpar regional growth, a strong currency and the effect of the 'one trip per week' Individual Visit Endorsements. Exports of financial services and of business and other services were likewise sluggish, though these fared better towards the year end. Exports of transport services were a bright spot, benefiting from improved regional trade flows during the year.

Imports of services grew modestly by 1.9 per cent in real terms in 2016, much decelerated from the 5.1 per cent growth in 2015 *(chart 7)*. Performance varied notably among different components. Imports of travel services held firm all through, underpinned by the keen interest of local residents in overseas travel amid resilient job and income conditions. In contrast, imports of transport services were weak. Imports of manufacturing services slackened, recording a decline. Imports of business and other services also saw weaker growth amid the bumpy global economic recovery.

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



Exports of services slackened in 2016, marking the first annual decline in real terms since 1998.

Note: Exports and imports of services are compiled based on the change of ownership principle.

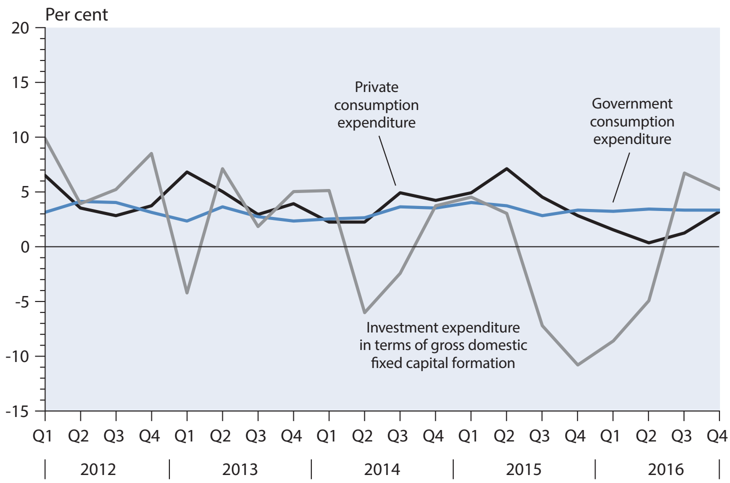
Compiled based on the change of ownership principle, the goods deficit narrowed somewhat in 2016, reflecting partly the fall in retained imports in the first half of the year amid subpar economic growth and partly the pick-up in the value of goods exports in the latter part of the year. With the services surplus more than offsetting the goods deficit, the combined goods and services account registered a surplus of $50 billion, equivalent to 1.1 per cent of total import value, slightly smaller than the surplus of $57 billion in 2015.

Domestic Demand

Domestic demand displayed much resilience in 2016, marked also by progressive strengthening during the year. Private consumption expenditure was a key growth driver, expanding 1.6 per cent in real terms in 2016 after 4.8 per cent growth in 2015 *(chart 8)*. Private consumption turned stronger gradually in the latter half of the year, as sustained rises in employment and labour earnings supported local consumption sentiment. Government consumption expenditure sustained steady growth of 3.3 per cent in real terms in 2016.

Overall investment spending in terms of gross domestic fixed capital formation showed a slight decline of 0.5 per cent in real terms in 2016, after a 3.2 per cent fall in 2015. It is worth noting the visible rebound in the second half of the year as Hong Kong's overall economy regained momentum. Overall building and construction gathered momentum over the course of the year, up 3.6 per cent in real terms in 2016. On the other hand, machinery and equipment acquisition, a typically volatile component, fell visibly in the first half of the year amid wariness over the bleak global economic outlook. While the performance of machinery and equipment acquisition improved quickly as the more acute risks in the global economy waned, for 2016 as a whole, it still registered a decline of 4.6 per cent in real terms.

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

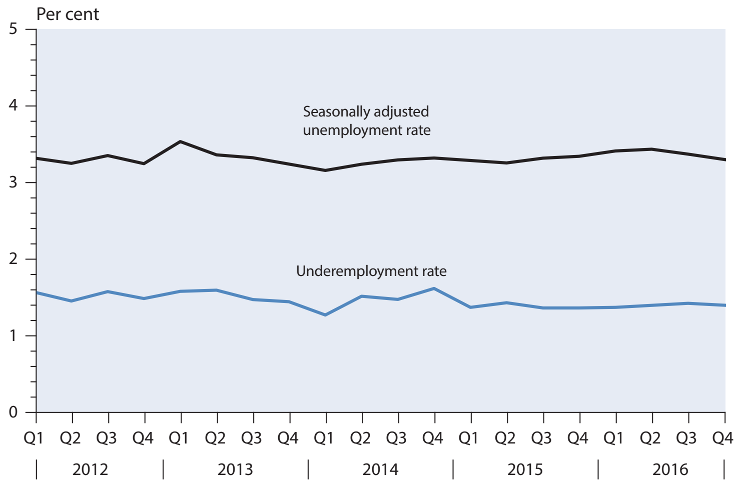


Private consumption expenditure held firm in 2016.
Investment expenditure bounced back visibly in the second half of the year.

Labour Market

The labour market was resilient and largely stable in overall terms in 2016, with the unemployment rate averaging at a low 3.4 per cent. Both total employment and the labour force grew further at a largely similar pace, with the former reaching a new annual high of 3,787,100. The annual underemployment rate held steady at 1.4 per cent *(chart 9)*.

Chart 9 The Unemployment and Underemployment Rates



The seasonally adjusted unemployment rate stayed low at 3.3-3.4 per cent during the year, signifying another year of full employment.

Both total employment and the labour force expanded modestly by 0.4 per cent *(chart 10)*. Although data collected from the private sector pointed to slower employment growth in the earlier part of 2016, the easing trend stabilised somewhat towards the year end along with the relative improvements in inbound tourism and domestic demand. In particular, employment in the retail, and accommodation and food services sectors recorded narrower declines during the second half of 2016.

In 2016, the number of private-sector vacancies declined visibly by 9.1 per cent to 68,750. Nevertheless, some relative improvements were seen in the latter part of the year.

Analysed by economic sector, construction sites (covering manual workers only) recorded 7.4 per cent fewer vacancies, reflecting some previous vacancies had been filled. Apart from that, more noticeable decreases in the number of vacancies were observed in the sectors of manufacturing (down 14.2 per cent); import/export trade (down 13.1 per cent); food and beverage services (down 11.1 per cent); transportation, storage, postal and courier services (down 11 per cent); and retail (down 8.7 per cent). More apparent increases were seen in the wholesale sector (up 5.2 per cent). Alongside the dip in the number of vacancies was a further decrease in the ratio of job vacancies per 100 job-seekers from 58 in 2015 to 52 in 2016.

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

Total employment and the labour force expanded modestly in 2016.

Thanks to a broadly stable and resilient labour market, wages and earnings stayed on the rise in 2016. Labour earnings in the private sector posted a further improvement of 3.7 per cent for the year as a whole, with more notable increases seen in the sectors of accommodation and food services activities, professional and business services, and real estate activities.

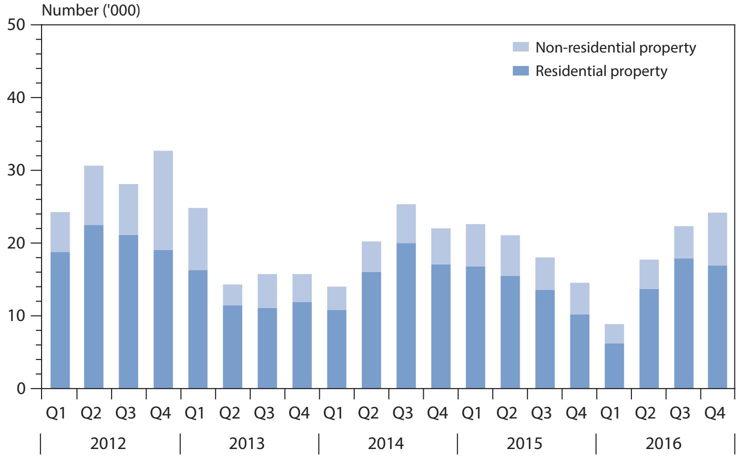
Separately, statistics compiled from the General Household Survey, though not strictly comparable to those from surveys by the business establishment, suggested the average monthly employment earnings of full-time employees in the lowest three decile groups combined, excluding foreign domestic helpers, rose appreciably by 5.5 per cent in nominal terms and 2.6 per cent in real terms in 2016.

Property Market

Following the brief consolidation in late 2015 and early 2016, the residential property market rebounded in the second quarter of 2016 and turned exuberant in the third quarter amid a still tight demand-supply balance of flats. With a view to forestalling a further build-up of housing bubble risks, the government raised ad valorem stamp duty on residential property transactions to a flat rate of 15 per cent in early November. The market cooled visibly thereafter, also aided by the US interest rate hike in mid-December. Trading activities turned very subdued, while the upward momentum in flat prices was arrested.

The total number of sale and purchase agreements for residential property received by the Land Registry fell 2 per cent to 54,700 in 2016, sharply below the long-term average of 91,900 from 1996 to 2015 *(chart 11)*. There were, however, sharp fluctuations through the year, rebounding from a low of 1,800 in February to a high of 6,700 in November before slowing down markedly to 3,600 in December, when both buyers and sellers adopted a wait-and-see attitude following the introduction of a new demand-side management measure in November. Total consideration went up slightly 3 per cent to $428 billion in 2016.

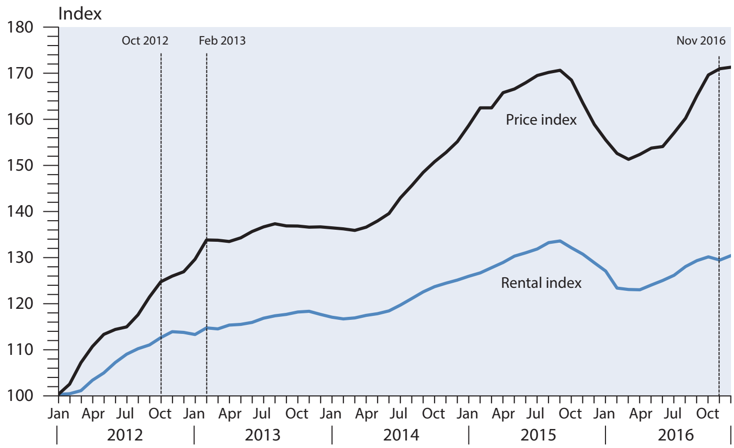
Chart 11 **Sale and Purchase Agreements by Broad Type of Property**



Trading activities picked up through most of the year before moderating after November 2016.

Flat prices also exhibited sharp volatilities over the course of the year. Overall flat prices switched from a fall of 5 per cent during the first quarter to an increase of 2 per cent during the second quarter and 7 per cent during the third quarter, but the increase moderated to 4 per cent during the fourth quarter, reflecting the sharp deceleration after the hike in ad valorem stamp duty. For the year as a whole, overall flat prices in December 2016 still went up 8 per cent over December 2015. Analysed by size, the prices of small/medium-sized flats and large flats leaped 8 per cent and 7 per cent respectively. The leasing market also revived starting from the second quarter before cooling again in the fourth quarter. Overall flat rentals in December 2016 inched up 1 per cent over December 2015. Analysed by size, the rentals of small/medium-sized flats rose 2 per cent, while rentals of large flats declined 2 per cent *(chart 12)*.

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



Flat prices and rentals showed decelerated growth in the fourth quarter of 2016.

As a result of the surge over the past several years, overall flat prices in December 2016 exceeded the 1997 peak by 78 per cent. Home purchase affordability[1] worsened to about 64 per cent in the fourth quarter, significantly above the long-term average of 46 per cent over 1996-2015[2]. Should interest rates rise 3 percentage points to a more normal level, the ratio would soar to 83 per cent.

While the demand-supply balance of flats is still tight for the time being, it is set to ease in the years ahead. The vacancy rate remained low at 3.8 per cent at end-2016, only marginally higher than the 3.7 per cent at end-2015. Nonetheless, reflecting the government's sustained efforts in raising land supply, 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 to a new record high of 94,000 units as estimated at end-2016.

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.

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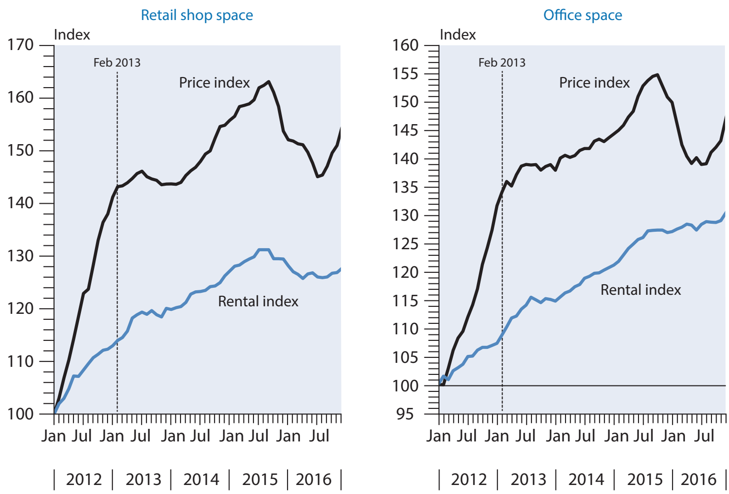
1 The ratio of mortgage payment for a 45 square metre flat to median income of households, excluding those living in public housing.

2 The historical data on home purchase affordability has been revised to reflect the revision to income statistics in the General Household Survey.

Meanwhile, the commercial and industrial property markets remained lacklustre in 2016, despite some relative firm-up in the latter part of the year. For the year as a whole, the number of sale and purchase agreements for non-residential property dropped 9 per cent to 18,300, and total consideration fell 21 per cent to $104.8 billion. Prices and rentals generally showed modest performance.

Sale prices of retail shop space were little changed between December 2015 and December 2016, while rentals fell 1 per cent *(chart 13)*. For office space, overall prices fell 2 per cent. Prices of grade A office space stayed virtually unchanged, while prices of grade B and C office space both dropped 3 per cent. Overall office rentals rose 2 per cent, with those of grade A, B and C office space all recording an increase of 2 per cent *(chart 13)*. Prices and rentals of flatted factory space increased 4 per cent and 5 per cent respectively.

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



Prices and rentals of retail shop space and office space generally showed modest performance in 2016.

As to demand-supply balance, the vacancy rates of retail shop space, office space and flatted factory space rose from 7.7 per cent, 8 per cent and 5 per cent at end-2015 to 9 per cent, 8.2 per cent and 5.8 per cent respectively at end-2016. Their respective long-term averages over 1996-2015 were 8.8 per cent, 10 per cent and 8 per cent.

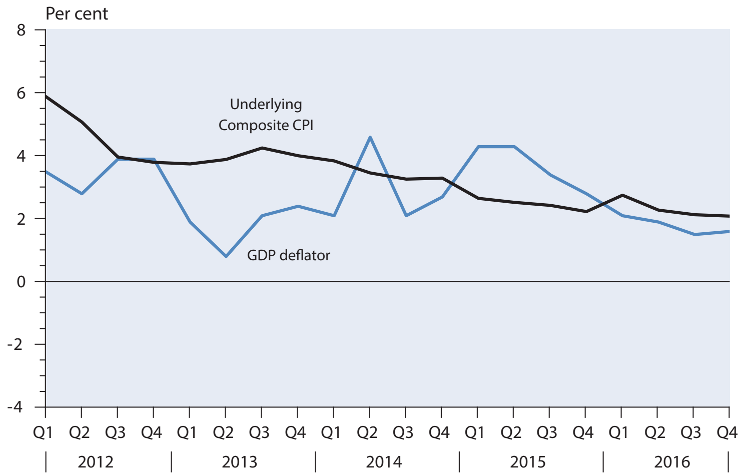
Price Movements

Consumer price inflation eased further in 2016, as domestic price pressures remained benign and imported inflation was largely absent. Headline consumer price inflation, which is under the influence of the government's one-off relief measures, moderated to 2.4 per cent in 2016 from 3 per cent in 2015. Netting out the effects of the government's one-off relief measures, underlying consumer price inflation likewise eased to 2.3 per cent in 2016 from 2.5 per cent in 2015, the lowest since 2010. In terms of the quarterly profile, underlying inflation fell from 2.8 per cent in the first quarter to 2.3 per cent in the second quarter, and slightly further to 2.1 per cent in both the third and fourth quarters.

External price pressures were muted, thanks to the relatively low inflation of Hong Kong's major import sources and to some extent the persistent strength of the US dollar. Food inflation, despite a temporary surge in the first quarter under bad weather, was moderate for the year as a whole. The moderate expansion of the local economy kept rises in domestic costs at bay. Rental inflation eased further. The price-setting power of the retailers was also constrained by the slowdown in inbound tourism and slower growth in private consumption.

The GDP deflator rose 1.8 per cent in 2016, down from the 3.7 per cent increase in 2015, mainly reflecting further moderation in the domestic demand deflator and mirroring the trend in consumer price inflation *(chart 14)*.

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



Underlying inflation eased further in 2016, as domestic price pressures remained benign and imported inflation was largely absent.

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 incur expenditure only 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, Capital Investment Fund, Capital Works Reserve Fund, Civil Service Pension Reserve Fund, Disaster Relief Fund, Innovation and Technology Fund, Land Fund, Loan Fund and 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 2015-16, the government recorded a surplus of $14.4 billion, with revenue of $450 billion and expenditure of $435.6 billion. Fiscal reserves at the end of March 2016 stood at $842.9 billion, equivalent to 23 months of government expenditure. Highlights of government revenue and expenditure for 2015-16 and 2016-17 (Revised Estimate) are found in table 6 of Appendix 6.

Public expenditure comprises government expenditure and expenditure by the Housing Authority and Trading Funds. In 2015-16, public expenditure increased 10.4 per cent against the previous year to $468 billion, of which $341.5 billion, or 73 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.

Future Fund

The Future Fund was set up on 1 January 2016 with an initial endowment of $219.7 billion for placement in longer-term investments, to secure higher returns for the fiscal reserves. As from 1 July 2016, it also includes $4.8 billion, being one-third of the 2015-16 surplus as a top-up. This is part of fiscal measures to cope with foreseeable long-term fiscal challenges arising from an ageing population and slower economic growth.

The Future Fund is being placed with the Exchange Fund for an initial period of 10 years from 1 January 2016 to 31 December 2025. Investment returns arising from the Future Fund during the placement shall be retained by the Exchange Fund for reinvestment. Interest on the placement shall be paid to the government upon completion of the placement period or on a date as directed by the Financial Secretary.

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 (31 per cent), stamp duties (14 per cent), land premium (14 per cent) and salaries tax (13 per cent). All major sources of revenue are presented in chart 1 of Appendix 6.

The Inland Revenue Department collects about 65 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 46 per cent of total government revenue in 2015-16.

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 2015-16, 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 later adjusted according to the actual profits 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 2015-16, the profits tax collected was about $140.2 billion, making up about 31 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 2015-16, 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 $57.9 billion, or about 13 per cent, of total government revenue in 2015-16. Because of generous personal allowances under the tax law, only about 1.8 million people, or 48 per cent of the workforce, were liable to salaries tax for the 2014-15 year of assessment.

Owners of land and buildings are charged property tax at the standard rate, of 15 per cent in 2015-16, 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 derives from the properties are chargeable to profits tax. Property tax contributed some $3 billion, or about 1 per cent, of total government revenue in 2015-16.

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 2015-16, the revenue from stamp duties was some $62.7 billion, or about 14 per cent of total government revenue.

Betting duty is charged on the net stake receipts from betting on horse races and football matches and on the proceeds of Mark Six lotteries, all administrated by the Hong Kong Jockey Club. The yield from betting duty in 2015-16 totalled some $20.1 billion, about 5 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 2016-17). 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 2.5 million assessments, took effect on 1 April 2016, with rateable values reflecting rental values on 1 October 2015. The revenue from rates in 2015-16 was $22.7 billion, or 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 2016. Total government rent collected in 2015-16 was $10.2 billion, or 2.3 per cent of total government revenue.

Under the Dutiable Commodities Ordinance, excise duties are levied on four 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 $10.7 billion in 2015-16, or about 2 per cent of total government revenue, of which 61 per cent was from tobacco, 34.9 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.

All motor vehicles imported for use on roads are subject to First Registration Tax under the Motor Vehicles (First 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 $9.3 billion in 2015-16, or 2.1 per cent of total government revenue.

It is government policy that fees charged by the government should in general be set at levels adequate to recover the full cost of providing the goods or services. Certain essential services are subsidised by the government or provided free of charge. Fees and charges for goods and services provided by the government generated about $15.1 billion, or about 3 per cent of total revenue, in 2015-16. Government-operated public utilities, the most important of which, in revenue terms, is provision of water supplies, generated about $4 billion, or about 1 per cent of total revenue.

Land transactions generated some $60.9 billion, or about 14 per cent of total government revenue, in 2015-16. All revenue from land transactions is credited to the Capital Works Reserve Fund to finance the Public Works Programme.

Tax Treaties and International Tax Cooperation

Comprehensive double taxation agreements (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. As at end-2016, Hong Kong had signed 35 CDTAs.

The government has in place a legal framework to enter into tax information exchange agreements and had seven such agreements as at end-2016.

In June 2016, Hong Kong put in place a legal framework to implement the Organisation for Economic Cooperation and Development's (OECD) new global standard on automatic exchange of financial account information on tax matters to enhance tax transparency and combat cross-border tax evasion. The first exchanges will start in 2018.

In June 2016, Hong Kong also pledged commitment to the consistent implementation of the OECD's new package of measures to tackle base erosion and profit shifting. With the pledge, Hong Kong became an Associate in the OECD's inclusive framework for implementing the package together with 90 other jurisdictions. The Financial Services and the Treasury Bureau began a consultation exercise in October to gauge stakeholders' views on implementing the package.

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 on 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.

The Government Logistics Department is the government's procurement agent for certain goods and related services. It normally purchases through competitive tendering to meet user departments' needs at the best possible value for money, taking account of lifetime cost, reliability of supply and, where appropriate, environmental friendliness. In 2016, the department awarded contracts amounting to $2.64 billion, procuring goods and related services from 21 countries and 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 online.

Websites

Economic Analysis and Business Facilitation Unit, Financial Secretary's Office: www.eabfu.gov.hk
Financial Services and the Treasury Bureau (The Treasury Branch): www.fstb.gov.hk/tb/en
Government Logistics Department: www.gld.gov.hk