

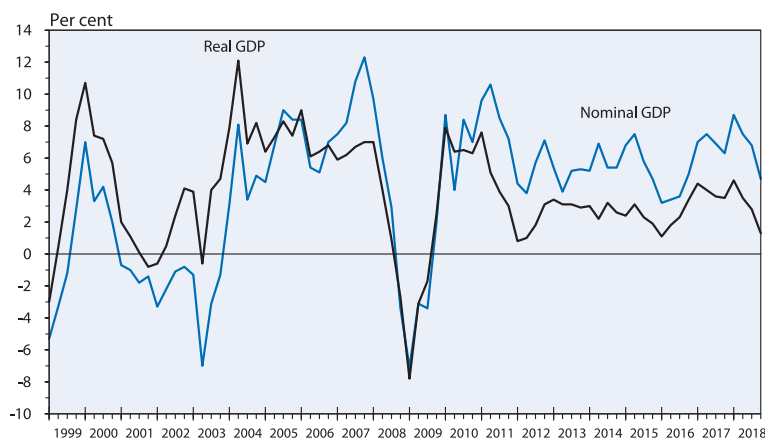
Chapter 3

The Economy

The Hong Kong economy recorded another year of above-trend growth for 2018 as a whole. Strong growth was sustained in the first half of the year. In the face of easing global economic growth, the Mainland-US trade conflict and successive US interest rate hikes, growth decelerated visibly in the second half. Despite the external challenges, the labour market tightened further. Inflation rose but remained at a moderate level.

Gross Domestic Product (GDP) grew 3.0 per cent in real terms. While faster than the trend growth of 2.8 per cent over the past 10 years for the second year running, this was slower than the 3.8 per cent growth in 2017. In terms of the quarterly profile, real GDP grew visibly on a year-on-year basis by 4.6 per cent in the first quarter and 3.6 per cent in the second quarter, but the pace of growth moderated to 2.8 per cent in the third quarter and further to 1.2 per cent in the fourth quarter (*chart 1*).

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



The Hong Kong economy recorded above-trend growth for the second year running in 2018, notwithstanding the deceleration in the second half.

Total exports of goods grew moderately for 2018 as a whole following the strong growth in 2017. However, the notable growth in the first three quarters was followed by a virtual halt in the fourth quarter, as the global economic growth momentum eased and the elevated Mainland-US trade conflict took its toll. Exports to many major markets recorded decelerated growth or even declines in the fourth quarter.

Exports of services grew solidly for 2018 as a whole, faster than the moderate growth in 2017. Growth picked up in the first half of 2018, before slowing noticeably in the second half. Underpinned by a surge in visitor arrivals, exports of travel services registered the strongest annual growth since 2013 despite the visible deceleration in the second half due to softer per capita visitor spending. Exports of financial services grew notably, thanks to the particularly strong growth in the first half amid buoyant cross-border financial activities. Exports of transport services and business and other services saw only modest growth.

Domestic demand was broadly resilient. Private consumption expenditure maintained notable growth for 2018 as a whole on the back of solid gains in wages and earnings, but the growth rate eased successively through the year amid asset market corrections. Investment expenditure grew modestly for another year, within which machinery and equipment acquisition expanded visibly while building and construction expenditure recorded a marginal decline.

The labour market showed further tightening in 2018 on the back of another year of above-trend economic growth. The unemployment rate for 2018 as a whole declined to 2.8 per cent, while the underemployment rate edged down to 1.1 per cent, both being the lowest in more than 20 years. Under the tight labour market conditions, wages and earnings continued to post solid growth, translating into real gains across most of the major sectors.

The residential property market remained buoyant in the first half of 2018, but underwent a consolidation in the second half. While the tight demand-supply balance of flats continued to render support, market sentiment was dampened by various uncertainties, including the Mainland-US trade tensions, continued US interest rate hikes and subsequent increase in local Best Lending Rates in September, and volatility in the global stock markets. Trading activities quietened down in the second half of 2018. Flat prices registered a decline from August, though still recording a gain of 2 per cent for the whole year.

Local stock prices underwent a sharp correction from early 2018 in the face of concerns about the US interest rate hikes, Mainland-US trade tensions and, later, the moderating global economic growth. The Hang Seng Index closed the year at 25,846, 22 per cent lower than its peak of 33,154 in January.

Consumer price inflation went up amid the above-trend growth. Underlying consumer price inflation accelerated from 1.7 per cent in 2017 to 2.6 per cent in 2018, remaining at a moderate level.

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 was the world's seventh largest merchandise trading entity in 2018. It operates one of the world's busiest airports in terms of the number of international passengers and volume of international air cargo handled, as well as one of the busiest container ports by container throughput.

Hong Kong was also the world's sixth largest banking centre in terms of external positions as at end-2018, 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 was the third largest in Asia by market capitalisation as at end-2018 and ranked first globally in terms of initial public offering (IPO) equity funds raised during the year.

As an international business hub, Hong Kong offers 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. The city 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 the world's freest economy.

Hong Kong was also ranked the world's second most competitive economy by the International Institute for Management Development and seventh by the World Economic Forum in 2018, and the fourth easiest place to do business globally according to the World Bank's *Doing Business 2019* report, published in October 2018.

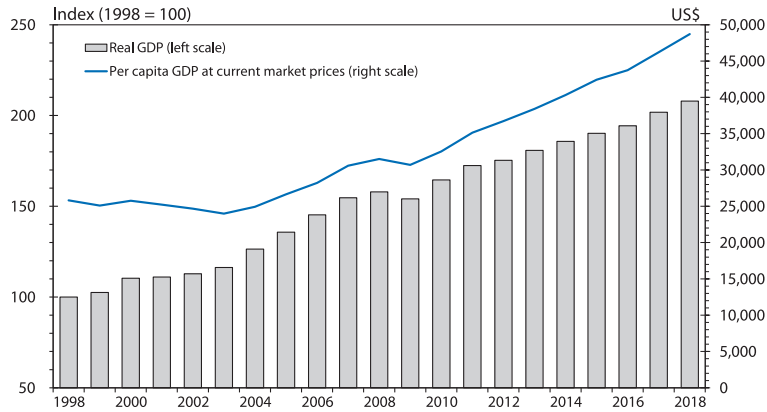
The Hong Kong economy has doubled in size over the past two decades, expanding at an average annual rate of 3.7 per cent, faster than most high-income economies. Over the same period, per capita GDP rose about 83 per cent in real terms, posting an average annual growth rate of 3.1 per cent. Per capita GDP at current market prices reached US\$48,700 in 2018 (*chart 2*), comparable to many advanced economies.

Trade links with other parts of the world have grown appreciably. Trade in goods and services has more than tripled in real terms over the past two decades. The total value of the 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 \$9,177 billion in 2018, equivalent to 323 per cent of GDP. This was higher than the ratio of 180 per cent in 1998. Including the value of exports and imports of services, the ratio of total trade to GDP was even higher, at 377 per cent in 2018, up from 221 per cent in 1998.

The stock of direct investment liabilities in Hong Kong was enormous, at \$17,465 billion in market value at the end of 2018, equivalent to 614 per cent of GDP. It served as another manifestation of Hong Kong being one of the most preferred destinations for inward direct investment, ranked second in the world by the United Nations' *World Investment Report 2019* based on inward stock.

Chart 2

Gross Domestic Product



Over the past two decades, the Hong Kong economy grew an average of 3.7 per cent annually, faster than most high-income economies.

The corresponding figures for Hong Kong's stock of direct investment assets were likewise huge, at \$16,469 billion, or 579 per cent of GDP. As an international financial centre with huge cross-territory fund flows, its external financial assets and liabilities were also substantial, at \$42,933 billion and \$32,794 billion respectively at the end of 2018. The corresponding ratios to GDP were 1,510 per cent and 1,154 per cent. Reflecting the city's robust international investment position, its net external financial assets amounted to \$10,140 billion at the end of 2018, equivalent to 357 per cent of GDP.

Gross National Income (GNI), comprising GDP and net external primary income flow, stood at \$2,985 billion in 2018, higher than the corresponding GDP by 5 per cent. The difference represented a net inflow of external primary income. In gross terms, inflows and outflows of external primary income were both substantial, at \$1,628 billion and \$1,486 billion respectively, equivalent to 57 per cent and 52 per cent of GDP respectively. This was attributable to the huge volumes of Hong Kong's outward and inward investment.

Contributions of Various Economic Sectors

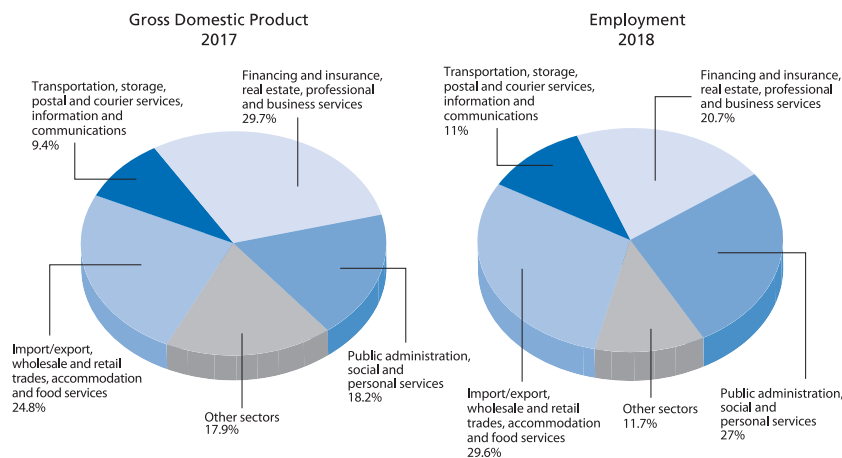
Primary production, including agriculture, fisheries, mining and quarrying, is insignificant in terms of both value-added contribution to GDP and share in total employment, as Hong Kong is predominantly a city economy.

Secondary production comprises manufacturing, construction and the supply of electricity, gas and water. In 2017, the value-added contribution of manufacturing accounted for only 1 per cent of GDP, while the construction sector and electricity, gas and water contributed 5 per cent and 1 per cent respectively. As for the share in total employment, manufacturing constituted only 2 per cent in 2018. The construction sector and electricity, gas and water took up 9 per cent and less than 1 per cent respectively.

The services sector is the mainstay of the Hong Kong economy. As the Mainland economy rebalances towards services- and consumption-led growth and opens up further, ample opportunities have become available for service providers in Hong Kong. With its geographical proximity, cultural ties with the Mainland and strong market institutions, Hong Kong has leveraged its competitive strengths in services in the Mainland's continuous move towards high value-added activities.

Services' contribution to GDP made up 92 per cent in 2017. The largest services sector was still financing and insurance, real estate, professional and business services, accounting for 30 per cent of GDP. This was followed by import/export, wholesale and retail trades, accommodation and food services (25 per cent); public administration, social and personal services (18 per cent); and transportation, storage, postal and courier services, and information and communications (9 per cent). In terms of total employment, services took up 88 per cent in 2018. In particular, import/export, wholesale and retail trades, accommodation and food services accounted for 30 per cent of total employment, followed by public administration, social and personal services with a share of 27 per cent; financing and insurance, real estate, professional and business services (21 per cent); and transportation, storage, postal and courier services, information and communications (11 per cent) (*chart 3*).

Chart 3 Gross Domestic Product and Employment by Major Service Sector



The services sector continued to be the key driver of the economy.

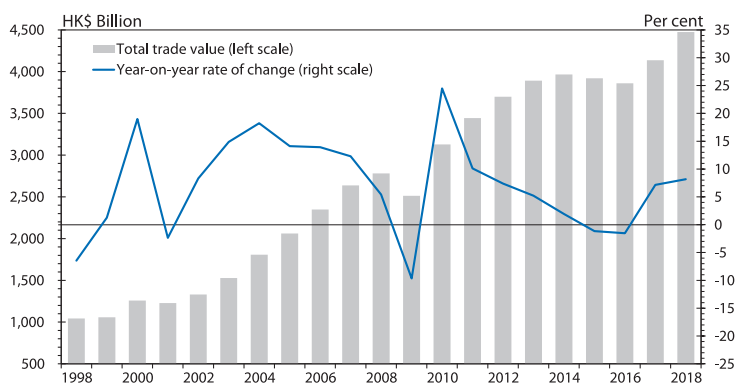
It is worth noting that although the manufacturing sector does not make large direct contributions to the economy in terms of value added and employment, Hong Kong's manufacturers are versatile and resilient in coping with the changing global and regional economic landscapes. The city's productive capacity has effectively expanded, thanks to increased supply-chain arrangements involving the Mainland and other neighbouring economies. The well-established links between the offshore productive capacity and the local economy underpin the growth of Hong Kong's services, especially the rapid development of trading, financial and other support services.

Economic Links between Hong Kong and Mainland

Cross-boundary economic ties between Hong Kong and the Mainland are stronger than ever. The flow of goods, services, people and capital between the two places, and between the Mainland and the world through Hong Kong, have been flourishing alongside the continued reform and opening up in the Mainland. The vibrant activities have brought significant mutual benefits to both Hong Kong and the Mainland.

With its total trade surging from US\$324 billion in 1998 to US\$4.6 trillion in 2018, the Mainland plays a prominent role in driving global economic growth. Hong Kong has benefited substantially from the Mainland's phenomenal trade growth. In 2018, visible trade between Hong Kong and the Mainland was more than four times that of 20 years ago, representing growth of 8 per cent per annum in value terms (*chart 4*). The Mainland was the world's largest merchandise trading entity while Hong Kong ranked seventh.

Chart 4 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, contributing to more than half of Hong Kong's total merchandise trade value. At the same time, Hong Kong was the Mainland's fourth largest trading partner in 2018 after the United States, Japan and Korea, accounting for about 7 per cent of the Mainland's total trade value. More than half of Hong Kong's exports to the Mainland, which were mainly re-exports, involved raw materials and semi-manufactures, reflecting both the latter's role as a production hinterland and the highly integrated production network within Asia. Goods of Hong Kong origin exported to the Mainland can fully enjoy zero tariffs through an enhanced arrangement for rules of origin from 1 January 2019, thanks to the Agreement on Trade in Goods signed in December 2018 under the framework of the Mainland and Hong Kong Closer Economic Partnership Arrangement.

Meanwhile, the Mainland economy's increasing emphasis on high-quality development and greater roles for domestic consumption and services in driving economic growth has unleashed enormous demand for various services. Hong Kong, being highly competitive in many high-end services, has risen with the tide. Indeed, its exports of services to the

Mainland had grown rapidly and almost tripled between 2007 and 2017. The Mainland was the largest market for Hong Kong's exports of services in 2017, accounting for some 40 per cent of the total.

Hong Kong also serves as a principal gateway to and from the Mainland for tourism, business and capital. In 2018, foreign visitors to the Mainland made 3.1 million trips through Hong Kong, while Mainland residents made 51 million trips to or through Hong Kong, up 14.8 per cent. Hong Kong remains the largest external investor in the Mainland. According to the Mainland's statistics, the cumulative value of Hong Kong's realised direct investment in the Mainland exceeded US\$1 trillion as at end-2018, more than half of the total.

Reciprocally, Hong Kong is the largest destination 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 54 per cent of its total outward direct investment as at end-2017, 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 25 per cent of Hong Kong's total inward direct investment. Mainland companies maintain a strong presence in Hong Kong as well. As at mid-2018, Mainland companies were operating 1,591 regional headquarters and regional or local offices in Hong Kong, up from 722 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 has exceeded US\$270 billion, consistently remaining at above 60 per cent of the province's total inward direct investment.

Building further on the solid ties with Guangdong, Hong Kong works closely with central ministries and the governments of Guangdong and Macao to foster interconnectivity in the flow of people, goods, capital and information within the Guangdong-Hong Kong-Macao Greater Bay Area, so as to bring Hong Kong new areas of economic growth and the opportunity for Hong Kong residents to expand their space for living and development. A high-level Steering Committee for the Development of the Greater Bay Area was established in late 2018 to facilitate overall coordination of matters regarding Hong Kong's participation in the Greater Bay Area development.

Over the years, financial links between Hong Kong and the Mainland have strengthened substantially, thanks to the increasing cross-boundary economic activities and the Central People Government's policy to enhance the city's position as an international financial centre. As a major funding centre for Mainland enterprises, Hong Kong had 1,146 Mainland enterprises listed on its stock market as at end-2018. Of these, 101 were listed in 2018, raising more than \$270 billion in equity funds. IPOs and secondary market financing combined raised about \$470 billion in aggregate funds.

Hong Kong possesses the world's largest offshore pool of Renminbi (RMB) liquidity, holding about RMB658 billion of RMB customer deposits and outstanding RMB certificates of deposit issued as at end-2018. RMB bank lending and outstanding RMB bonds stood at about RMB106 billion and RMB171 billion respectively. RMB trade settlements handled by banks in Hong Kong reached RMB4.2 trillion in 2018.

Hong Kong is also the largest offshore RMB investment product market. As at end-2018, there were 47 Securities and Futures Commission (SFC)-authorised, RMB-denominated unlisted funds primarily investing onshore via the Renminbi Qualified Foreign Institutional Investor, Stock Connect, Bond Connect and China's Interbank Bond Market, with an aggregate net asset value (NAV) of RMB6.3 billion, and 33 SFC-authorised, RMB-denominated exchange traded funds primarily investing onshore via the same channels with an aggregate NAV of RMB51.4 billion.

In 2018, the Hong Kong-Zhuhai-Macao Bridge and the Hong Kong Section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link began operation. Both projects greatly shorten travel between Hong Kong and cities in the Mainland, facilitating the flow of people and goods and further deepening the cross-boundary economic and trade links.

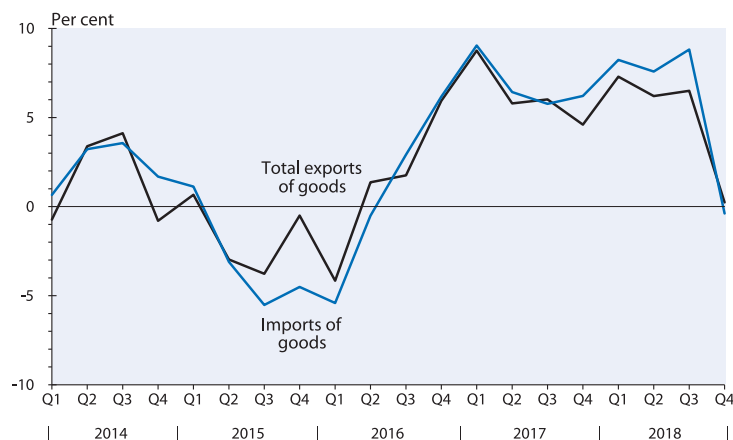
The Economy in 2018

External Trade

Total exports of goods, based on external merchandise trade statistics, grew solidly by 4.9 per cent in real terms in 2018 despite decelerating from the strong 6.2 per cent increase in 2017. Merchandise exports grew 6.6 per cent year on year in the first three quarters, but weakened visibly to a marginal growth of 0.2 per cent in the fourth quarter (*chart 5*) as global economic growth moderated and the Mainland-US trade conflict took its toll. Analysed by major market, exports to the US grew notably in 2018. However, the pace of growth moderated in the fourth quarter as re-exports affected by additional tariffs imposed by the US showed a sharp slowdown. Exports to the European Union recorded strong growth. Exports to the Mainland grew solidly for 2018 as a whole, with a year-on-year decline in the fourth quarter. Exports to other Asian markets were mixed, and many experienced decelerated growth or even declines in the fourth quarter.

Chart 5

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



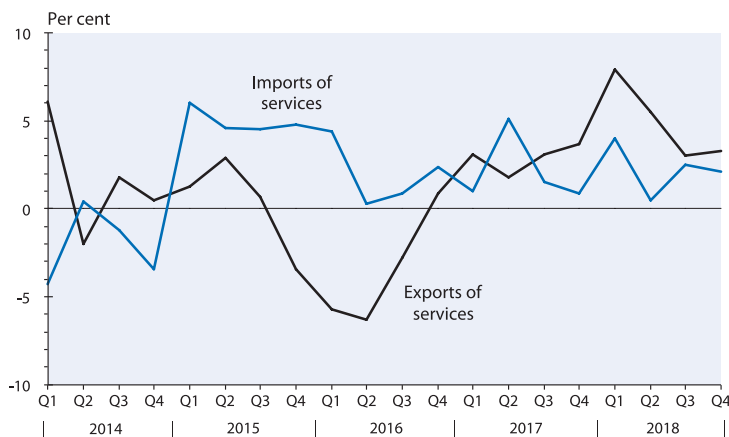
Merchandise exports grew solidly for 2018 as a whole.

Imports of goods expanded notably by 5.9 per cent in real terms on the back of rapid growth in retained imports and solid expansion in re-exports. Thanks to the robust domestic demand in the first three quarters, retained imports, which refer to imports for domestic use and accounted for about one-quarter of total imports, grew strongly by 8.7 per cent in real terms. However, imports of goods experienced a marginal fall of 0.4 per cent in the fourth quarter as both retained imports and imports for subsequent re-export weakened.

Exports of services grew solidly by 4.9 per cent in real terms. However, after the robust expansion in the first half of the year, growth moderated in the second half amid mounting external headwinds (*chart 6*). Underpinned by the surge in visitor arrivals, exports of travel services registered the strongest annual growth since 2013 despite visible deceleration in the second half due to softer per capita visitor spending. Exports of financial services grew notably, thanks to the particularly strong first-half growth amid buoyant cross-border financial activities. Exports of transport services and business and other services saw only modest growth.

Chart 6

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



Exports of services grew solidly for 2018 as a whole.

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

Imports of services grew modestly by 2.3 per cent in real terms in 2018, similar to the 2.1 per cent growth in 2017. Of the various services, imports of travel services, while fluctuating over the course of the year, grew modestly for the year as a whole. Imports of transport services and business and other services also saw modest growth amid expansion in regional trading activities. Imports of manufacturing services fell modestly, as an expansion in outward processing activities in the region in the first three quarters was more than offset by a decline in the fourth quarter.

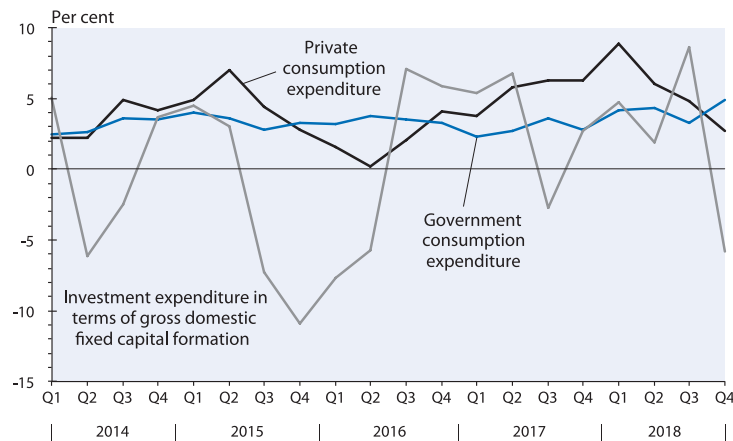
Compiled based on the change of ownership principle, the goods deficit widened somewhat in 2018 as imports of goods outpaced exports. As the services surplus was larger than the goods deficit, the combined goods and services account registered a slight surplus of \$2 billion in 2018, compared with the surplus of \$29 billion in 2017.

Domestic Demand

Domestic demand was broadly resilient in 2018. Private consumption expenditure grew notably by 5.5 per cent in real terms, slightly slower than the 5.6 per cent in 2017 (*chart 7*). The solid growth in wages and earnings continued to underpin local consumer sentiment. Nevertheless, the wealth effect from asset prices seemed to have turned from a boost to a drag over the course of the year along with the corrections in the local stock and property markets, and led to some moderation in the growth of private consumption expenditure in the second half. Government consumption expenditure grew 4.2 per cent in real terms in 2018, higher than its 2.8 per cent growth in 2017.

Chart 7

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



Private consumption expenditure maintained notable growth for 2018 as a whole, but the growth rate eased successively through the year. Investment expenditure recorded modest expansion.

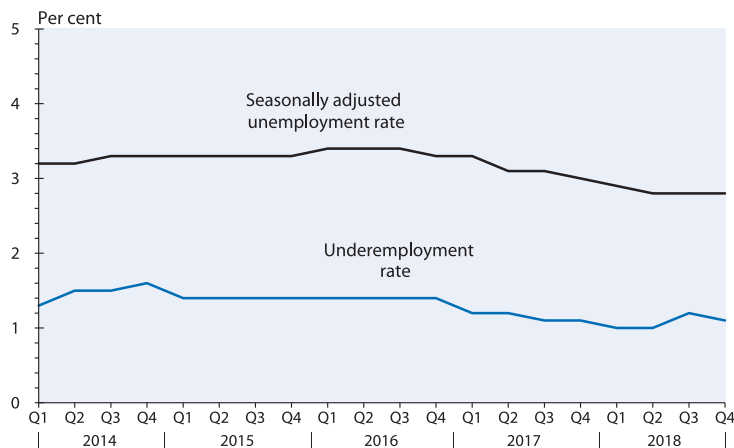
Overall investment spending in terms of gross domestic fixed capital formation grew modestly by 2 per cent in real terms in 2018, following 2.9 per cent in 2017. Specifically, expenditure on acquisitions of machinery, equipment and intellectual property products picked up to grow 8.9 per cent, whereas building and construction expenditure contracted marginally by 0.6 per cent. Within the latter, private-sector activities recorded marginal growth while public-sector works fell modestly, albeit to a level that was still high. Separately, the costs of ownership transfer declined as trading activities in the property market quietened down, especially in the second half. It is worth noting that private-sector investment slackened sharply

to a decline in the fourth quarter, conceivably reflecting weakened business sentiment amid the challenging external environment.

Labour Market

The labour market tightened further in 2018, thanks to another year of above-trend economic growth. Both the labour force and total employment expanded further, with the latter reaching a new annual high of 3.87 million. Unemployment and underemployment rates went down for the year as a whole to 2.8 per cent and 1.1 per cent respectively, both being the lowest in more than 20 years (*chart 8*).

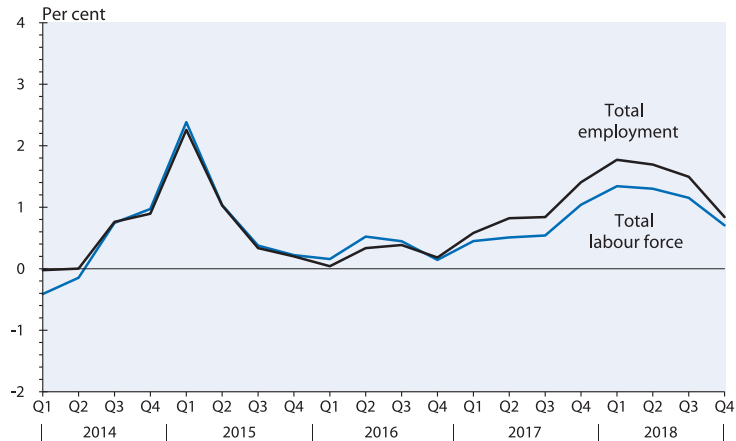
Chart 8 Unemployment and Underemployment Rates



The labour market tightened further on the back of another year of above-trend economic growth.

Total employment and the labour force expanded 1.1 per cent and 0.8 per cent respectively in 2018, slightly faster than the corresponding gains of 1 per cent and 0.7 per cent in 2017 (*chart 9*). Data collected from private-sector establishments likewise pointed to increased employment opportunities on the back of sustained economic growth. Specifically, notable increases in employment were seen in human health services, professional and business services excluding cleaning and similar services, accommodation and food services, financing and insurance, and real estate.

Chart 9 **Total Labour Force and Total Employment**
(year-on-year rate of change)



Total employment expanded at a slightly faster pace in 2018.

In 2018, the number of private-sector vacancies increased 9.6 per cent to 78,150, echoing the further tightening in manpower during the year.

Analysed by economic sector, most of the sectors saw more vacancies, with visible increases observed in arts, entertainment and recreation, human health services, transportation, storage, postal and courier services, and accommodation services. Upon the completion of some major infrastructural projects, construction sites (covering manual workers only) recorded fewer vacancies. As a combined result of gains in vacancies and falling unemployment, the ratio of job vacancies per 100 job-seekers increased markedly from 58 in 2017 to 70 in 2018.

Amid tight labour market conditions, wages and earnings recorded solid growth in both nominal and real terms. Labour earnings in the private sector went up by 3.9 per cent for 2018 as a whole, translating into real growth of 1.5 per cent after discounting inflation. Appreciable increases were seen in accommodation and food services, professional and business services, real estate, and social and personal services.

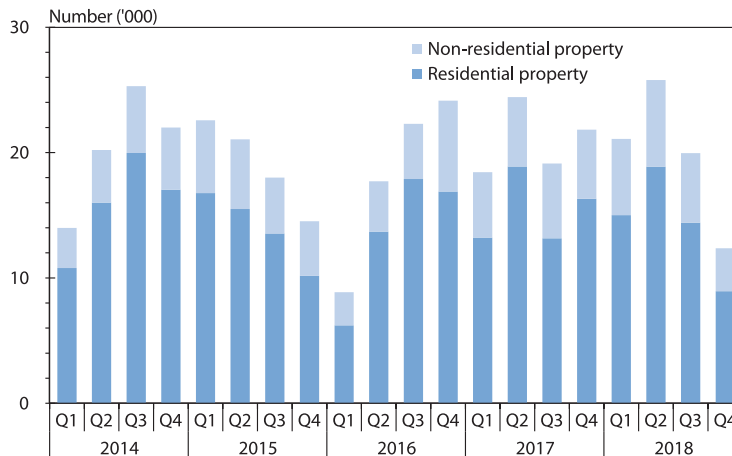
Separately, the General Household Survey, though not strictly comparable to surveys on businesses, suggested a continued rise in the earnings of grass-roots workers. The average monthly employment earnings of full-time employees in the lowest three decile groups combined, excluding foreign domestic helpers, grew solidly by 4.4 per cent in nominal terms and 1.7 per cent in real terms. As to the overall income situation, median monthly household income, excluding foreign domestic helpers, rose 6.7 per cent to \$28,000 in 2018 from \$26,250 in 2017.

Property Market

The residential property market remained buoyant in the first half of 2018, but underwent a consolidation in the second half. While the tight demand-supply balance of flats continued to render support, market sentiment was dampened by various uncertainties, including the Mainland-US trade tensions, continued US interest rate hikes and subsequent increase in local Best Lending Rates in September, and volatility in the global stock markets. Trading activities quietened down in the second half, while flat prices registered a decline from August.

Trading activities were buoyant in the first half of 2018 before turning very quiet in the second half. For the year as a whole, the total number of sale and purchase agreements for residential property received by the Land Registry fell 7 per cent to 57,200, far below the long-term average of 82,600 from 1998 to 2017 (*chart 10*). Total consideration edged up 1 per cent to \$559.3 billion.

Chart 10 Sale and Purchase Agreements by Broad Type of Property

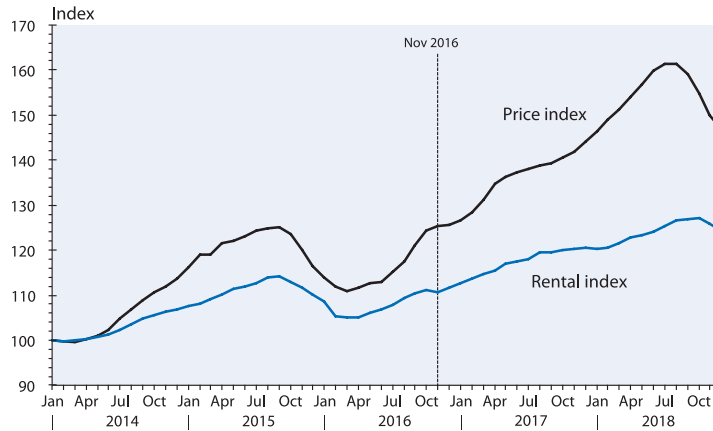


Trading activities were buoyant in the first half of 2018 before turning very quiet in the second half.

Flat prices in December on average retreated 9 per cent from the peak in July. Nevertheless, an increase of 2 per cent was recorded for the whole year, mainly reflecting hefty gains in the first half of the year. Analysed by size, prices of small and medium-sized flats rose 2 per cent during 2018, while prices of large flats edged down 1 per cent. The leasing market likewise showed signs of cooling off towards the year end. With the gains in the first three quarters partially offset by the decline in the fourth quarter, flat rentals on average rose a modest 3 per cent between December 2017 and December 2018. Rentals of small and medium-sized flats and large flats both rose 3 per cent (*chart 11*).

Chart 11

Prices and Rentals of Residential Property (Jan 2014=100)



Flat prices registered a decline from August, while rentals also fell towards the end of 2018.

Notwithstanding the recent decline, flat prices in December 2018 exceeded their 1997 peak by 108 per cent. The index of home purchase affordability¹ was around 69 per cent in the fourth quarter, still significantly above its long-term average of 44 per cent over 1998-2017². Should interest rates rise three percentage points to a more normal level, the ratio would soar to 90 per cent.

The demand-supply balance of private-sector flats remained tight for the time being despite some improvement during 2018. The vacancy rate rose from 3.7 per cent at end-2017 to 4.3 per cent at end-2018, still below the long-term average of 5 per cent over 1998-2017. Reflecting the government's sustained efforts to increase land supply, the private sector's 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 – would stay at a high of 93,000 units as estimated at end-2018.

Over the past several years, the government has also put forward demand-management and macro-prudential measures to dampen speculative, investment and non-local demand, and to reduce the possible risks to financial stability arising from an exuberant property market. These measures have yielded notable results.

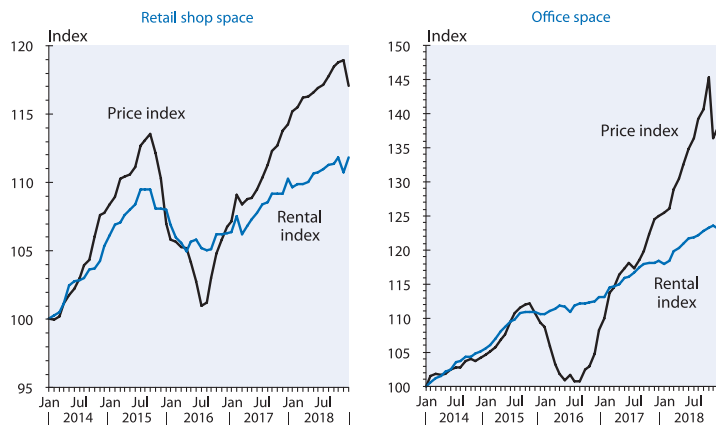
¹ The ratio of mortgage payment for a 45 square metre flat to median income of households, excluding those living in public housing.

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

The commercial and industrial property markets were generally active during most of 2018, though some cooling off was observed towards the end of the year. Prices and rentals of the different market segments recorded further gains during 2018 as a whole. The total number of sale and purchase agreements for non-residential property edged down 1 per cent to 21,900, while total consideration increased 7 per cent to \$182.1 billion.

Sale prices and rentals of retail shop space increased 3 per cent and 1 per cent respectively between December 2017 and December 2018. For office space, prices on average rose by a notable 10 per cent. Prices of grade A and B office space rose 24 per cent and 5 per cent respectively, while prices of grade C office space stayed virtually unchanged. Meanwhile, office rentals increased 4 per cent on average, rising 4 per cent, 4 per cent and 3 per cent respectively for grade A, B and C office space (chart 12). Prices and rentals of flatted factory space rose 10 per cent and 4 per cent respectively.

Chart 12 Prices and Rentals of Retail Shop Space and Office Space
(Jan 2014=100)



Prices and rentals of retail shop space and office space recorded further gains during 2018.

As to demand-supply balance, the vacancy rate of retail shop space went up from 9 per cent at end-2017 to 9.4 per cent at end-2018, and that of flatted factory space from 6.1 per cent to 6.3 per cent. Office space had a vacancy rate of 8.6 per cent, down from 9.5 per cent. The respective long-term averages over 1998-2017 were 8.8 per cent, 7.5 per cent and 9.7 per cent.

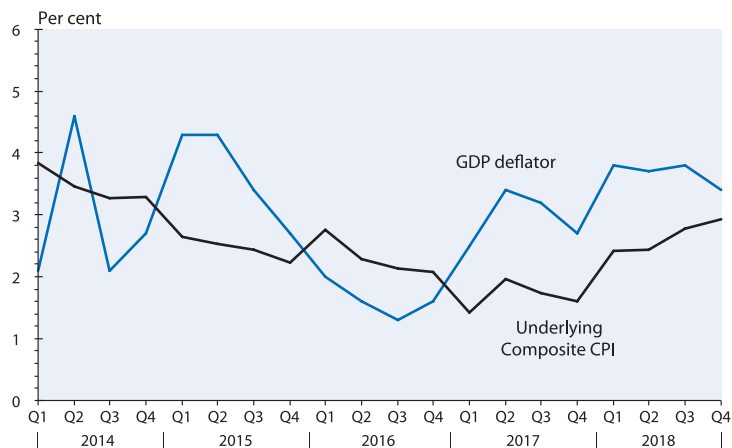
Price Movements

Consumer price inflation went up in 2018 as the local economy recorded another year of above-trend growth. Netting out the effects of the government's one-off relief measures, underlying consumer price inflation rose from 1.7 per cent in 2017 to 2.6 per cent in 2018, remaining at a moderate level. Headline consumer price inflation likewise picked up from 1.5 per cent to 2.4 per cent. The lower headline inflation rate as compared with the underlying

rate was due to an increased ceiling for the government's rates concession from the second quarter of 2018. The quarterly figures, though sometimes distorted by temporary factors, showed that underlying inflation picked up visibly to 2.4 per cent in both the first and second quarters, and further to 2.8 per cent in the third quarter before stabilising at 2.9 per cent in the fourth quarter (*chart 13*).

Chart 13

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



Underlying inflation went up in 2018 as the economy recorded another year of above-trend growth.

Locally, earlier increases in fresh-letting residential rentals translated into a faster rise in the private housing rental component of consumer price inflation through 2018 until the final months. As for cost pressures, while wages and earnings sustained solid growth amid tight labour market conditions, labour costs on a unit cost basis were largely contained by a concurrent improvement in labour productivity. The rental cost pressure faced by businesses, though broadly moderate, intensified slightly amid the general uptrend in retail and office rentals. External price pressures also edged up. Imported inflation rose more visibly in the first half of 2018, reflecting robust global economic conditions, the depreciation of the Hong Kong dollar along with the US dollar on a year-on-year basis and, to a lesser extent, the increase in international oil prices. Nonetheless, the strengthening of the Hong Kong dollar along with the US dollar, together with the softening in international prices of food and commodity items amid moderating global growth, reined in further acceleration of imported inflation in the second half of the year.

The GDP deflator rose 3.6 per cent in 2018, higher than its 3.0 per cent increase in 2017. The terms of trade saw marginal improvement in 2018 as export prices rose slightly faster than import prices. With external trade components excluded, the domestic demand deflator rose

3.3 per cent in 2018, up from 2.9 per cent in 2017, reflecting higher price pressures in the economy.

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 2017-18, the government recorded a surplus of \$148.9 billion, with revenue of \$619.8 billion and expenditure of \$470.9 billion. Fiscal reserves at the end of March 2018 stood at \$1,102.9 billion, equivalent to 28 months of government expenditure. Highlights of government revenue and expenditure for 2017-18 and 2018-19 (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 2017-18, public expenditure increased 2.6 per cent against the previous year to \$507.6 billion, of which \$379.8 billion, or 74.8 per cent, was of a recurrent nature. Table 7 gives an analysis of public expenditure by policy area group and table 8, the growth rate of public expenditure as compared with the rate of economic growth.

Future Fund

The Future Fund seeks to secure higher returns for Hong Kong's fiscal reserves through placement in longer-term investments. It has an endowment of \$224.5 billion. 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 land premium (27 per cent), profits tax (22 per cent), stamp duties (15 per cent) and salaries tax (10 per cent). All major sources of revenue are presented in chart 1 of Appendix 6.

The Inland Revenue Department collects about 53 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 34 per cent of total government revenue in 2017-18.

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 2017-18, 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 2017-18, the profits tax collected was about \$139.1 billion, making up about 22 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 2017-18, the first, second and third segments of net chargeable income of \$45,000 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 \$60.8 billion, or about 10 per cent, of total government revenue in 2017-18. Because of generous personal allowances under the tax law, only 1.77 million people, or 47 per cent of the workforce, were liable to salaries tax for the 2016-17 year of assessment.

Owners of land and buildings are charged property tax at the standard rate, of 15 per cent in 2017-18, 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 \$3.4 billion, or about 1 per cent, of total government revenue in 2017-18.

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 2017-18, the revenue from stamp duties was some \$95.2 billion, or about 15 per cent of total government revenue.

Betting duty is charged on the net stake receipts from betting on horse races and football matches and on the proceeds of Mark Six lotteries, all administered by the Hong Kong Jockey Club. The yield from betting duty in 2017-18 totalled some \$22 billion, or 3.5 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 2018-19). 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 2018, with rateable values reflecting rental values on 1 October 2017. The revenue from rates in 2017-18 was \$22.2 billion, or 3.6 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 two million assessments in the Government Rent Roll on 1 April 2018. Total government rent collected in 2017-18 was \$11.5 billion, or 1.9 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 2017-18, or about 1.7 per cent of total government revenue, of which 60 per cent was from tobacco, 35 per cent was from hydrocarbon oil, 4.9 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 \$8.6 billion in 2017-18, or 1.4 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 \$15.9 billion, or 2.6 per cent of total revenue, in 2017-18. Government-operated public utilities, the most important of which, in revenue terms, is the provision of water supplies, generated about \$4.4 billion, or 0.7 per cent of total revenue.

Land transactions generated some \$164.8 billion, or about 27 per cent of total government revenue, in 2017-18. 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

Hong Kong strives to expand its network of comprehensive avoidance of double taxation agreements (CDTAs) to improve the business environment and facilitate the flow of trade, investment and talent with the rest of the world. The 40 CDTAs signed by the city as at end-2018 help reduce tax burdens on taxpayers and eliminate uncertainties over tax liabilities.

Hong Kong has a legal framework in place to implement the Organisation for Economic Cooperation and Development's (OECD) global standard on the automatic exchange of financial account information in tax matters to enhance tax transparency and combat cross-border tax evasion, with the first exchanges conducted smoothly in 2018. The Convention on Mutual Administrative Assistance in Tax Matters also entered into force in Hong Kong in September, enabling the city to carry out international tax cooperation initiatives multilaterally and more effectively.

The city has committed to implement the OECD's Base Erosion and Profit Shifting package. In July, it amended the Inland Revenue Ordinance to codify the transfer pricing principles and implement the minimum standards of 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 public accountability, value for money, transparency and the maintenance of open and fair competition. The Government Logistics Department is the government's procurement agent for various goods and related services. Open tendering is normally adopted to meet departments' procurement needs at the best value for money, with due regard to the lifetime cost, environmental considerations and stability of supply. Restricted or single tendering may be used under exceptional circumstances. In 2018, the department procured goods and related services amounting to \$4.16 billion from 27 countries and territories, including Hong Kong.

The department maintains supplier lists for different categories of goods and services to facilitate sourcing. It publishes tender notices online and notifies the relevant listed suppliers about open tenders. Tender notices for procurements covered by the WTO GPA are also published in the Government Gazette and issued to consulates and overseas trade commissions where appropriate. Bidders may download tender documents and submit their offers online.

Websites

Financial Services and the Treasury Bureau (The Treasury Branch): www.fstb.gov.hk/tb/en

Government Logistics Department: www.gld.gov.hk

Office of the Government Economist, Financial Secretary's Office: www.oge.gov.hk