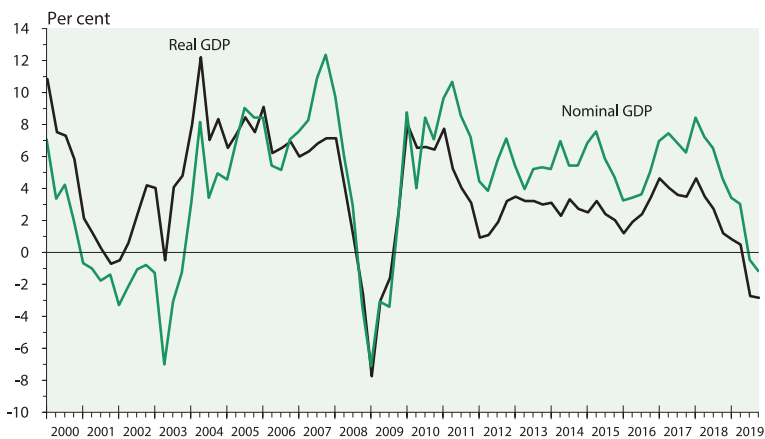


The Economy

Hong Kong's economy contracted in 2019 for the first time in a decade. It grew modestly in the first half of the year amid softening global growth and elevated Mainland-US trade tensions, and entered recession in the second half as local social incidents involving violence dealt a further heavy blow. The labour market slackened while overall inflationary pressures stayed largely moderate.

Gross Domestic Product (GDP) contracted 1.2 per cent in real terms for 2019 as a whole, the first annual decline since 2009, compared with the 2.8 per cent growth in 2018. In terms of the quarterly profile, real GDP grew modestly by 0.7 per cent year on year in the first quarter and 0.4 per cent in the second quarter, before shifting into consecutive quarterly declines of 2.8 per cent and 3.0 per cent (*chart 1*).

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



The Hong Kong economy entered recession in the second half and contracted for the year as a whole.

Total exports of goods fell in 2019, as the global economic slowdown and Mainland-US trade tensions dampened trade and investment worldwide. Exports to most major markets recorded declines of varying degrees. Exports of services worsened visibly and registered the biggest annual decline on record that was particularly drastic in the second half as social unrest caused a severe setback in inbound tourism.

Domestic demand retreated in 2019, especially in the second half when consumption-related activities and economic sentiment were severely affected by the local social incidents. Private consumption expenditure posted the first annual decline since 2003. Overall investment expenditure recorded the biggest drop in two decades, with machinery and equipment acquisition falling sharply and building and construction expenditure weakening further.

The labour market came under increasing pressure during 2019, especially in the second half when economic conditions deteriorated abruptly. The seasonally adjusted unemployment rate went up from a low of 2.8 per cent in the second quarter to 3.3 per cent in the fourth quarter, with those sectors related to consumption and tourism showing more visible increases. The underemployment rate also edged up to 1.2 per cent in the fourth quarter, after staying at a low of 1 per cent in the previous three quarters. As economic conditions worsened, growth of wages and earnings decelerated in the second half of the year.

The residential property market stayed generally active during the first five months of 2019, after which it quietened visibly from June as sentiment was dampened by the weaker global economy, Mainland-US trade tensions, local social incidents and their impacts on the local economic outlook. While flat prices had generally softened since June, on average a cumulative increase of 6 per cent was still recorded across the year.

The local stock market showed considerable volatility in 2019, as market sentiment swung along with the abrupt changes in external and local situations. The Hang Seng Index closed the year at 28,190 points, 9.1 per cent higher than in end-2018.

Overall price pressures were largely moderate. Nonetheless, underlying consumer price inflation went up from an average of 2.6 per cent in 2018 to 3.0 per cent in 2019, primarily due to a sharp increase in pork prices amid a reduced supply of fresh pork since May.

Structure and Development of the Economy

Hong Kong is a global centre for world trade, finance and business, 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 eighth largest merchandise trading entity in 2019. 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-2019, and the fourth largest foreign exchange trading centre according to a triennial survey conducted by the Bank for International Settlements in 2019. Its stock market was the third

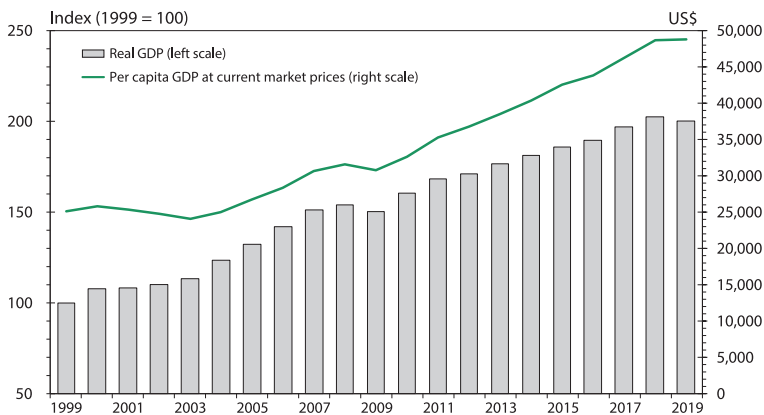
largest in Asia by market capitalisation as at end-2019 and ranked first globally in terms of initial public offering (IPO) equity funds raised during the year.

As an international business hub, Hong Kong offers a business-friendly environment with a fine tradition of the rule of law and judicial independence, an unfettered flow of capital, people, goods and 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 was ranked the world's second most competitive economy by the International Institute for Management Development and the third by the World Economic Forum in 2019, and was the third easiest place to do business globally according to the World Bank's *Doing Business 2020* report published in October 2019. Hong Kong has also been ranked consistently by the Heritage Foundation and the Fraser Institute as one of the world's freest economies.

The Hong Kong economy has doubled in size over the past two decades, expanding at an average annual rate of 3.5 per cent, faster than most high-income economies. Over the same period, per capita GDP rose about 76 per cent in real terms, posting an average annual growth rate of 2.9 per cent. Per capita GDP at current market prices reached US\$48,700 in 2019 (*chart 2*), comparable to many advanced economies.

Chart 2

Gross Domestic Product



Over the past two decades, the Hong Kong economy grew an average of 3.5 per cent annually, faster than most high-income economies.

Trade links with other parts of the world have grown extensively. Trade in goods and services has almost tripled in real terms over the past two decades. The total value of the goods trade compiled under the GDP accounting framework reached \$8,711 billion in 2019, equivalent to 304 per cent of GDP, far higher than the ratio of 178 per cent in 1999. Including the value of

exports and imports of services, the ratio of total trade to GDP was even higher, at 353 per cent in 2019, up from 220 per cent in 1999.

As an international financial centre with huge cross-territory fund flows, Hong Kong has substantial external financial assets and liabilities, of \$43,760 billion and \$31,588 billion respectively at the end of 2019. The corresponding ratios to GDP were 1,527 per cent and 1,102 per cent. Reflecting the city's robust international investment position, its net external financial assets amounted to \$12,172 billion at the end of 2019, equivalent to 425 per cent of GDP.

Hong Kong is also one of the most preferred destinations for external direct investment. The stock of direct investment liabilities is enormous, at \$16,173 billion in market value at the end of 2019, equivalent to 564 per cent of GDP. The corresponding figures for Hong Kong's stock of direct investment assets were likewise huge, at \$15,598 billion, or 544 per cent of GDP.

Gross National Income, comprising GDP and net external primary income flow, stood at \$3,014 billion in 2019, higher than the corresponding GDP by 5.2 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 \$1,671 billion and \$1,522 billion respectively, equivalent to 58 per cent and 53 per cent of GDP respectively. This was attributable to the huge stocks of Hong Kong's outward and inward investment.

Contributions of Various Economic Sectors

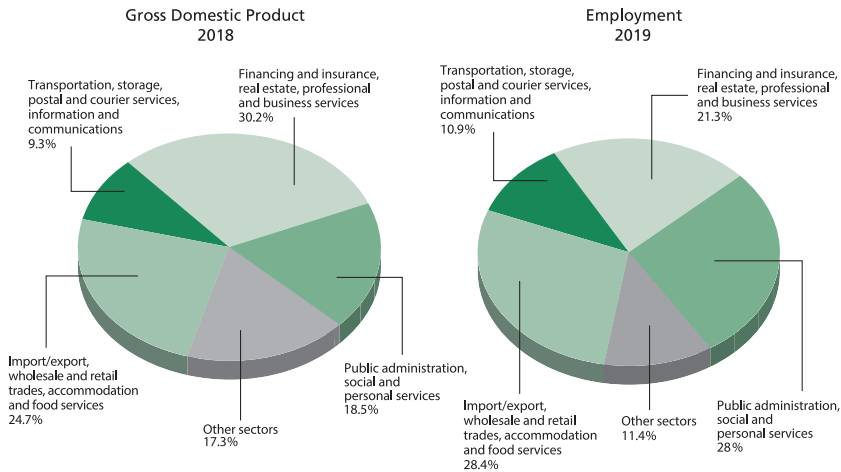
Primary production, including agriculture, fisheries, mining and quarrying, is insignificant in terms of both value-added contribution to GDP and share in total employment, as Hong Kong is predominantly a city economy.

Secondary production comprises manufacturing, construction and the supply of electricity, gas and water. In 2018, the value-added contributions of manufacturing and of electricity, gas and water each accounted for only 1 per cent of GDP, while the construction sector contributed 4 per cent. As for the share in total employment in 2019, manufacturing constituted only 2 per cent, and electricity, gas and water less than 1 per cent. Construction took up 9 per cent.

The services sector is the mainstay of the Hong Kong economy, making up 93 per cent of GDP in 2018. The largest services sector continued to be 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 accounted for 89 per cent in 2019. In particular, import/export, wholesale and retail trades, accommodation and food services accounted for 28 per cent of total employment, followed by public administration, social and personal services (28 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 accounts for only a small share of 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 over the years, thanks to increased supply-chain arrangements involving the Mainland and other neighbouring economies and continued enhancement of innovation and technology (I&T). The well-established links between Hong Kong's offshore productive capacity and the local economy underpin the growth of its services sector, especially the rapid development of trading, financial and other support services.

Notwithstanding the local social incidents in the second half of 2019, Hong Kong continues to hold its own as an international financial centre and one of the world's best places to do business. Given its strong competitive edge, the services sector is well positioned to benefit from the vibrant development of emerging Asian economies, particularly the Mainland, which is set to remain the global growth engine in the years to come.

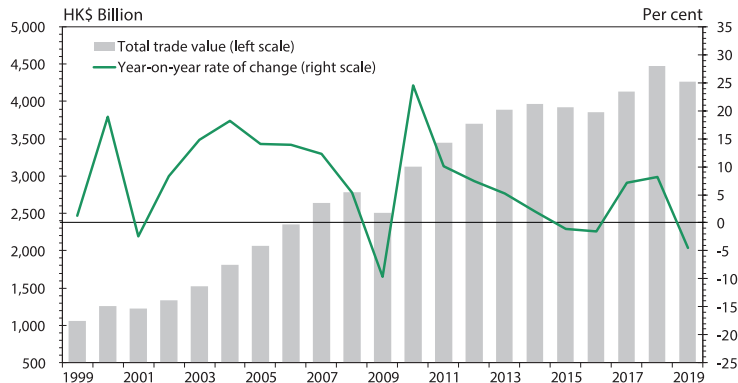
Economic Links with Mainland

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 of the Mainland. The vibrant activities have brought significant mutual benefits to both Hong Kong and the Mainland.

With its total merchandise trade surging from US\$361 billion in 1999 to US\$4.6 trillion in 2019, the Mainland plays a prominent role in driving global economic growth. Hong Kong has benefited substantially from the Mainland's phenomenal external trade growth. In 2019, visible

trade between Hong Kong and the Mainland was more than four times that of 20 years ago, representing growth of 7 per cent per annum in value terms (*chart 4*). The Mainland was the world's largest merchandise trading entity while Hong Kong ranked eighth.

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 the city's total merchandise trade value in 2019. At the same time, Hong Kong was the Mainland's third largest trading partner in 2019 after the United States and Japan, accounting for about 6 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 the Mainland's role as a production hinterland and the highly integrated production network within Asia.

Meanwhile, the Mainland economy's increasing emphasis on high-quality development and greater roles for domestic consumption and services in driving economic growth have 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 2008 and 2018. The Mainland was the largest market for Hong Kong's exports of services in 2018, accounting for more than 40 per cent of the total. The Agreement Concerning Amendment to the Mainland and Hong Kong Closer Economic Partnership Arrangement Agreement on Trade in Services was signed in November 2019 for implementation from 1 June 2020. It further liberalises the Mainland market for Hong Kong's service suppliers in a number of important sectors, including financial services, legal services, construction, testing and certification, television, motion pictures and tourism.

Hong Kong also serves as a principal gateway to and from the Mainland for tourism, business and capital. In 2019, foreign visitors made 2.7 million trips through Hong Kong to the Mainland, while Mainland residents made 44 million trips to or through Hong Kong. Hong Kong remains the largest external investor in the Mainland. According to the Mainland's statistics,

the cumulative value of realised direct investment in the Mainland from Hong Kong exceeds US\$1 trillion, 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 56 per cent of its total outward direct investment position as at end-2018, 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 position as at end-2018. Mainland companies maintain a strong presence in Hong Kong as well. As at mid-2019, Mainland companies were operating 1,799 regional headquarters and regional or local offices in Hong Kong, up from 750 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 realised direct investment in Guangdong from Hong Kong reached US\$304 billion as at end-2019, accounting for 65 per cent of the province's total inward direct investment position.

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. The Leading Group for the Development of the Greater Bay Area, chaired by Vice Premier Han Zheng and with members comprising the Chief Executives of the Hong Kong and Macao Special Administrative Regions, Heads of the Guangdong Provincial Government and representatives of relevant ministries, held two meetings in 2019, after which policy measures were announced. The measures could be broadly grouped under three categories, namely benefiting members of the public; facilitating the development of professional services, including financial and legal services, in the Mainland cities of the Greater Bay Area; and supporting Hong Kong's development into an international I&T hub.

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 Hong Kong's position as an international financial centre. As a major funding centre for Mainland enterprises, Hong Kong had 1,241 Mainland enterprises listed on its stock market as at end-2019. Of these, 114 were listed in 2019, raising more than \$250 billion in equity funds. IPOs and secondary market financing combined raised more than \$350 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-2019. RMB bank lending and outstanding RMB bonds stood at about RMB154 billion and RMB169 billion respectively. RMB trade settlements handled by banks in Hong Kong reached RMB5.4 trillion in 2019.

Hong Kong is also the largest offshore RMB investment product market. As at end-2019, there were 42 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 RMB7.7 billion, and 25 SFC-authorised, RMB-denominated exchange traded funds primarily investing onshore via the same channels with an aggregate NAV of RMB57.3 billion.

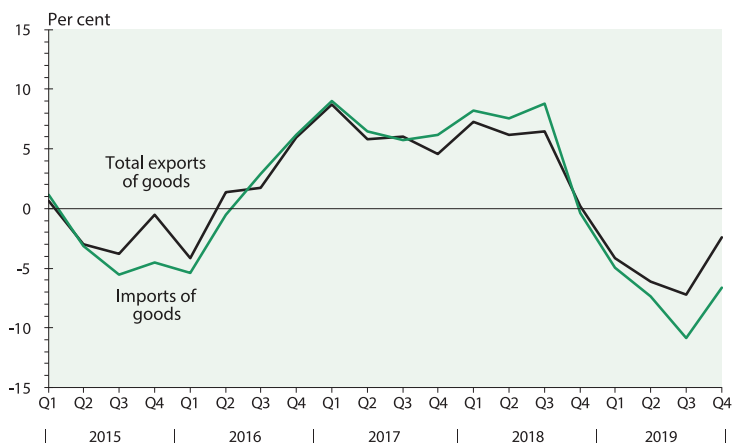
The Economy in 2019

External Trade

Total exports of goods, based on external merchandise trade statistics, fell 5 per cent in real terms in 2019 after 4.9 per cent growth in the preceding year, as the global economic slowdown and Mainland-US trade tensions dampened trading and investment activities worldwide. The year-on-year decline in merchandise exports widened from 4.2 per cent in the first quarter to 6.1 per cent and 7.2 per cent in the second and third quarters respectively, and then narrowed to 2.4 per cent in the fourth quarter due to a low base of comparison (*chart 5*). Analysed by major market, exports to the US recorded a double-digit decrease, weighed down by the US' additional tariffs on a wide range of Mainland products and weakened import demand from the US. Exports to the European Union likewise changed course and went into a decline amid modest economic growth in the EU. Exports to many Asian markets, including the Mainland, also worsened.

Chart 5

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



Merchandise exports went into a decline in 2019.

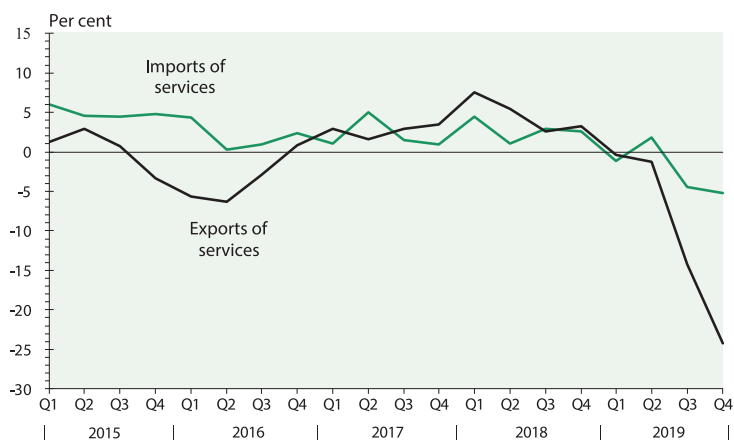
Imports of goods fell markedly by 7.6 per cent in real terms in 2019, having grown 5.9 per cent in 2018. Retained imports, which refer to imports for domestic use and accounted for around one-quarter of total imports, plummeted 14.7 per cent, reflecting the significant fall-offs in

domestic demand. Imports for subsequent re-export also fell noticeably in tandem with the enlarged decline in merchandise exports.

Exports of services deteriorated sharply and slumped 10.2 per cent in real terms in 2019, the largest annual decline on record. This followed a solid expansion of 4.6 per cent in 2018. The downward spiral was particularly drastic in the second half of the year, as the social unrest dealt a severe blow to inbound tourism (*chart 6*). Exports of travel services plunged and recorded the largest annual decline on record. Other services exports were also dragged down by mounting external headwinds. Specifically, exports of transport services went into a visible decline, reflecting subdued cargo and passenger flows. Exports of financial, business and other services also fell, as cross-border financial and commercial activities weakened amid softening global economic growth.

Chart 6

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



Exports of services deteriorated sharply in 2019.

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

Imports of services switched to a decline of 2.4 per cent in real terms in 2019, after recording 2.8 per cent growth in 2018. Of the various services, imports of travel services decelerated in the second half and registered only modest growth for the year as a whole, as worsened economic sentiment increasingly weighed on the spending of residents travelling abroad. Imports of transport services fell, noticeably in the second half, due to subdued cargo and passenger flows. Imports of manufacturing services recorded a double-digit drop, reflecting weakness in outward processing activities amid sagging global demand and heightened Mainland-US trade tensions. Imports of business and other services also slackened in the face of the difficult external environment, recording a modest decline for the year as a whole.

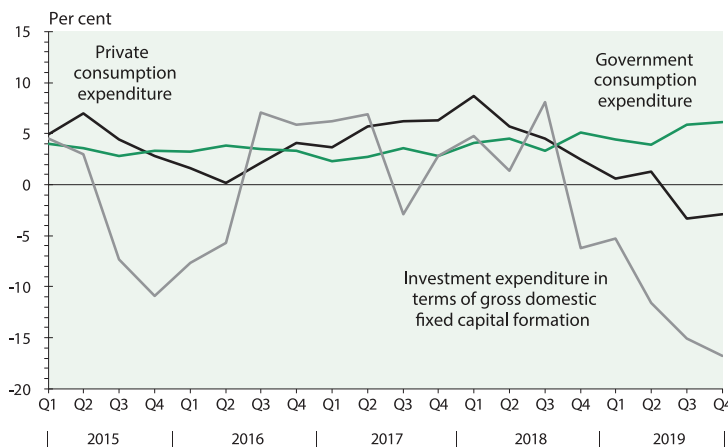
Compiled based on the change of ownership principle, the goods deficit narrowed markedly in 2019, as imports fell more than exports. Over the same period, the services surplus shrank. As the reduced services surplus was still larger than the goods deficit, the combined goods and services account registered a surplus of \$49 billion in 2019, in contrast to the deficit of \$6 billion in 2018.

Domestic Demand

Domestic demand retreated in 2019. Private consumption expenditure fell 1.1 per cent in real terms for 2019 as a whole after growing 5.3 per cent in 2018, marking its first annual decline since 2003. Following modest growth in the first half, private consumption expenditure deteriorated sharply to record a year-on-year slump in the second half (*chart 7*), as the local social incidents with violence caused severe disruptions to consumption-related activities and dampened consumer sentiment already weakened by the subdued economic conditions. Meanwhile, government consumption expenditure grew solidly by 5.1 per cent in real terms in 2019, after expanding 4.2 per cent in 2018.

Chart 7

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



Private consumption expenditure deteriorated abruptly in the second half of 2019. Overall investment spending also plummeted.

Overall investment spending in terms of gross domestic fixed capital formation plummeted 12.3 per cent in real terms in 2019 after a 1.7 per cent growth in 2018, the biggest annual drop since 1999. Expenditure on acquisitions of machinery, equipment and intellectual property products plunged 20 per cent, as business sentiment became very pessimistic amid the heightened Mainland-US trade tensions and increasingly violent local social incidents. Building and construction expenditure fell 6.2 per cent. Private-sector building and construction activities went into a decline alongside worsening economic conditions. Public-sector building

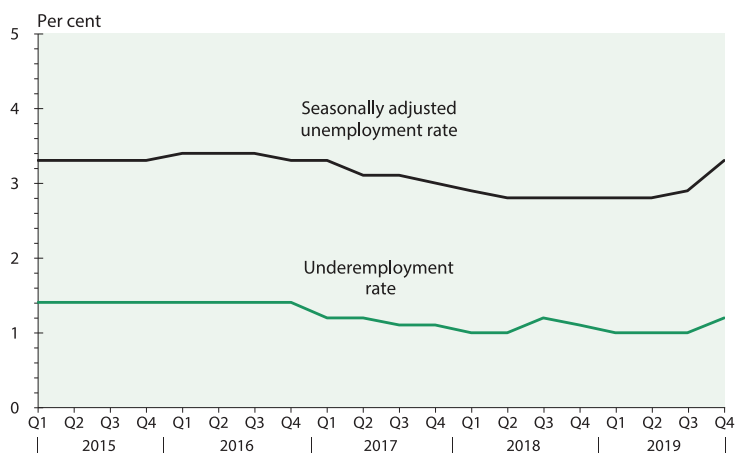
and construction works shrank further, as new projects had yet to generate sufficient output to offset the completion of some major infrastructure projects. The costs of ownership transfer fell amid declining property transactions, especially in the non-residential segments.

Labour Market

The labour market came under increasing pressure during 2019. Having stayed at a low of 2.8 per cent in the first two quarters, the seasonally adjusted unemployment rate went up successively to 2.9 per cent in the third quarter and 3.3 per cent in the fourth quarter when the economy fell into recession. The unemployment rates of the retail, accommodation and food services sectors increased more visibly, particularly in the second half of the year as business was hit hard by the local social incidents involving violence. The underemployment rate also edged up in the fourth quarter after staying low in the first three quarters. For 2019 as a whole, the unemployment rate averaged 2.9 per cent, up 0.1 percentage points from 2018, while the underemployment rate averaged 1.1 per cent, the same as in the preceding year (*chart 8*).

Chart 8

Unemployment and Underemployment Rates

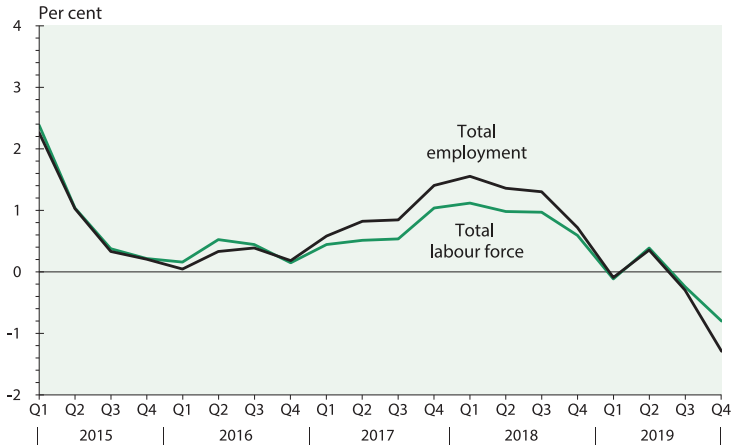


The labour market came under increasing pressure during 2019, with the seasonally adjusted unemployment rate rising steadily in the second half.

The labour force and total employment decreased 0.3 per cent and 0.4 per cent respectively in 2019, in contrast to the corresponding growth of 0.8 per cent and 1.1 per cent in 2018 (*chart 9*). Data collected from private-sector establishments showed some signs of easing in labour demand in the first half of 2019, with the situation deteriorating further in the second half as the decline in employment widened and the number of vacancies continued to dive. The number of private-sector vacancies plunged 13.5 per cent to 67,630 in 2019. Reflecting a slackening in the overall manpower balance, the ratio of job vacancies per 100 job-seekers decreased visibly from 70 in 2018 to 58 in 2019. The slackening in labour demand was particularly notable in construction, import/export trade and wholesale, food and beverage services, and retail.

Chart 9

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



The total labour force and total employment contracted in 2019.

Wages and earnings stayed on the rise in 2019, but the pace of increase decelerated in the second half. Labour earnings, as measured by the index of payroll per person engaged for all selected industry sections, registered a decelerated year-on-year increase of 2.7 per cent in the second half of the year, compared with 4.1 per cent in the first half. While the economic slowdown played a part, the delay in pay adjustment in some subvented organisations also contributed to the slower growth. For 2019 as a whole, labour earnings rose 3.4 per cent, slower than the gain of 3.9 per cent in the preceding year.

Separately, the General Household Survey, though not strictly comparable to surveys on businesses, suggested that earnings of low-income workers continued to increase in 2019. The average monthly employment earnings of full-time employees in the lowest three decile groups combined, excluding foreign domestic helpers, increased 3.6 per cent in nominal terms, slightly above the inflation rate of 3.3 per cent as measured by the Consumer Price Index (A), which was driven up by a sharp increase in pork prices since May 2019. As to the overall income situation, median monthly household income, excluding foreign domestic helpers, went up slightly by 1.7 per cent from \$28,000 in 2018 to \$28,500 in 2019.

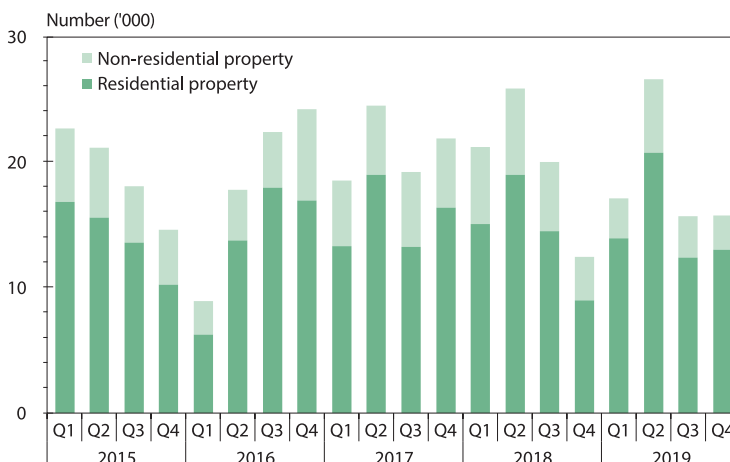
Property Market

Having stayed generally active during the first five months of 2019, the residential property market quietened visibly from June, as sentiment was dampened by the weaker global economy, the Mainland-US trade tensions, the local social incidents and their impacts on the local economic outlook. Flat prices generally softened from June onwards, reversing the rebound in the preceding five months.

For 2019 as a whole, the Land Registry received 59,800 sale and purchase agreements for residential property, up 4 per cent, mainly reflecting the buoyant trading situation in the first five months. Even so, this was still far below the long-term average of 81,200 from 1999 to 2018 (*chart 10*). Total consideration declined 2 per cent to \$548.8 billion.

Chart 10

Sale and Purchase Agreements by Broad Type of Property



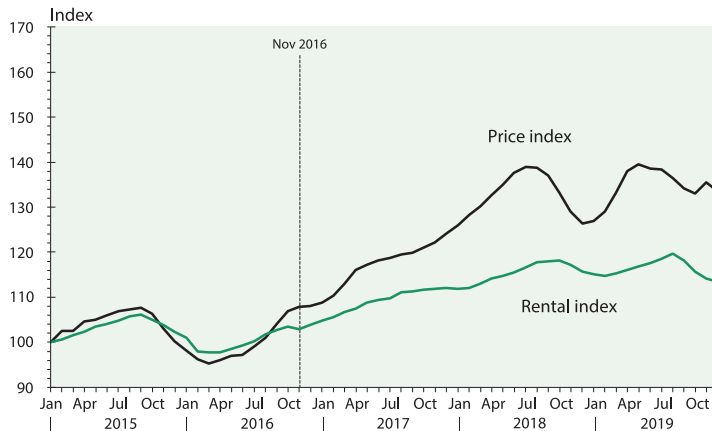
Trading activities were buoyant in the first five months of 2019 before becoming quieter in the rest of the year.

Flat prices in December 2019 on average retreated 4 per cent from the recent peak in May. Nonetheless, given the hefty gains in the first few months of 2019, there was still an increase of 6 per cent over December 2018. Analysed by size, prices of small and medium-sized flats and large flats went up 6 per cent and 1 per cent respectively during the year. The leasing market also cooled off, with flat rentals shifting to a decline in the latter part of the third quarter. As a result, flat rentals in December 2019 on average retreated 5 per cent from the recent peak in August and were 2 per cent lower than in December 2018. Analysed by size, rentals of small and medium-sized flats and large flats declined 2 per cent and 4 per cent respectively during the year (*chart 11*).

Chart 11

Prices and Rentals of Residential Property

(Jan 2015=100)



Flat prices generally softened from June 2019 onwards, and rentals also shifted to a decline in the latter part of the third quarter.

Mainly reflecting the rally in the past few years, flat prices in December 2019 exceeded the 1997 peak by 119 per cent. The index of home purchase affordability¹ stayed elevated at around 72 per cent in the fourth quarter, significantly above the long-term average of 44 per cent over 1999-2018². Should interest rates rise three percentage points to a more normal level, the ratio would soar to 93 per cent.

Reflecting the government's sustained efforts in raising 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 level of 93,000 units as estimated at end-2019. For the time being, the demand-supply balance of private-sector flats remained tight. The vacancy rate fell from 4.3 per cent at end-2018 to 3.7 per cent at end-2019, staying below the long-term average of 5 per cent over 1999-2018.

Over the past several years, the government has also implemented demand-side management and macro-prudential measures to dampen speculative, investment and non-local demand,

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

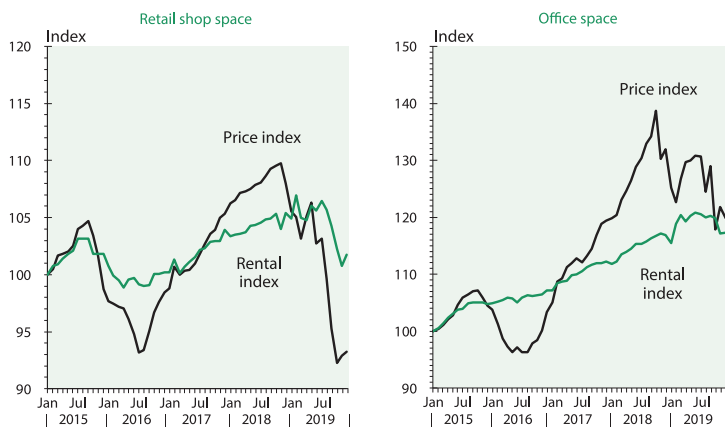
² Starting from the fourth quarter of 2019, the index of home purchase affordability is calculated based on, among other components, the mortgage rates of new loans with reference to both the best lending rate (BLR) and the Hong Kong Interbank Offered Rate. The index for the third quarter of 2019 has also been revised retrospectively based on the revised mortgage rates. As such, the third and fourth-quarter data may not be strictly comparable with those in previous quarters, which were based on the mortgage rates of new loans with reference to the BLR only.

and to reduce the possible risks to financial stability arising from an exuberant property market. These measures have yielded notable results.

Likewise, the commercial and industrial property markets became more sluggish in the second half of 2019 amid the subdued economic conditions. For the year as a whole, prices in the different market segments declined markedly, while rentals exhibited diverse movements. The number of sale and purchase agreements for non-residential property plunged 32 per cent to 15,000, while total consideration dropped 21 per cent to \$143.6 billion.

Sale prices and rentals of retail shop space fell 14 per cent and 3 per cent respectively between December 2018 and December 2019, reflecting the correction in the second half of the year amid the sharp deterioration in the retail trade. For office space, prices on average decreased 9 per cent. Prices of grade A, B and C office space dropped 14 per cent, 1 per cent and 4 per cent respectively. Office rentals on average were little changed, with rentals of grade A and B office space both rising 1 per cent, and grade C office space retreating 2 per cent (*chart 12*). Prices of flatted factory space declined 7 per cent, while rentals were little changed.

Chart 12 **Prices and Rentals of Retail Shop Space and Office Space**
(Jan 2015=100)



Prices of retail shop space and office space declined markedly during 2019, while rentals exhibited diverse movements.

As to demand-supply balance, the vacancy rate of retail shop space rose from 9.4 per cent at end-2018 to 10.1 per cent at end-2019, and that of office space from 8.6 per cent to 9 per cent. The vacancy rate of flatted factory space went down from 6.3 per cent to 5.9 per cent. The respective long-term averages for these three types of commercial property over 1999-2018 were 8.8 per cent, 9.3 per cent and 7.3 per cent.

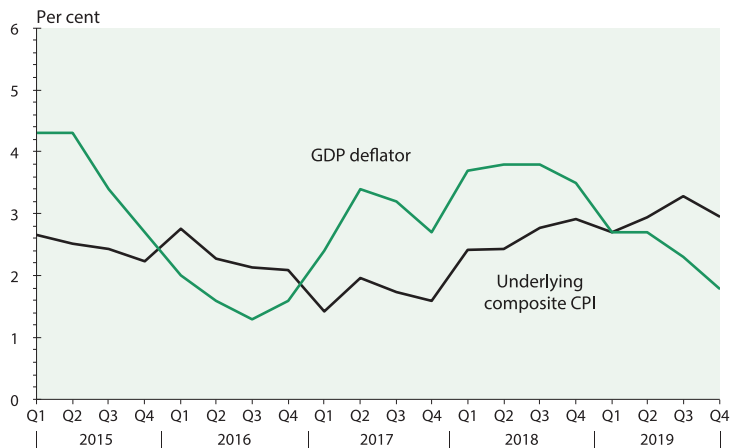
Price Movements

Overall price pressures remained largely moderate in 2019. Even so, consumer price inflation went up during the year, primarily due to the sharp increase in pork prices amid the reduced

supply of fresh pork since May. Netting out the effects of the government's one-off relief measures, underlying consumer price inflation climbed from 2.6 per cent in 2018 to 3.0 per cent in 2019. Headline consumer price inflation likewise went up from 2.4 per cent in 2018 to 2.9 per cent in 2019. Despite a downward adjustment in the quarterly ceiling of the government's rates concession in April 2019, the headline rate remained lower than the underlying rate for the year as a whole, thanks to the government's Electricity Charges Relief Scheme, which took effect in January 2019. Quarterly figures, though sometimes distorted by temporary factors, showed that underlying inflation picked up from 2.7 per cent in the first quarter to 2.9 per cent in the second quarter, then jumped to 3.3 per cent in the third quarter amid the surging pork prices before easing back to 3.0 per cent in the fourth quarter alongside the economic downturn (*chart 13*).

Chart 13

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



Underlying consumer price inflation went up in 2019, primarily due to a surge in pork prices.

Domestically, among the underlying consumer price index components, the increase in private housing rentals stayed on an easing trend in 2019. As to cost pressures, labour wages and earnings continued to rise but at a somewhat moderated pace in the latter part of the year, while pressures on commercial rent abated amid the economic downturn. External price pressures receded through 2019, thanks to a moderation in inflation rates in many of Hong Kong's major import sources and generally soft international commodity and energy prices amid the global economic slowdown. The strengthening of the Hong Kong dollar along with the US dollar against other major currencies during the year also contributed to the lower imported inflation.

The increase in GDP deflator moderated from 3.7 per cent in 2018 to 2.4 per cent in 2019. The terms of trade deteriorated slightly, as export prices rose somewhat slower than import prices.

Taking out the external trade components, the domestic demand deflator rose 2.8 per cent in 2019, 0.6 percentage points lower than the corresponding increase in 2018.

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 2018-19, the government recorded a surplus of \$68 billion, with revenue of \$599.8 billion and expenditure of \$531.8 billion. Fiscal reserves at the end of March 2019 stood at \$1,170.9 billion, equivalent to 26 months of government expenditure.

Public expenditure comprises government expenditure and expenditure by the Housing Authority and Trading Funds. In 2018-19, public expenditure increased 11.8 per cent against the previous year to \$567.6 billion, of which \$422.1 billion, or 74.4 per cent, was of a recurrent nature.

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 profits tax (28 per cent), land premium (19 per cent), stamp duties (13 per cent) and salaries tax (10 per cent).

The Inland Revenue Department collects about 56 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 39 per cent of total government revenue in 2018-19.

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 the 2018-19 year of assessment, a two-tiered profits tax rate regime was launched, lowering the profits tax rates for the first HK\$2 million of assessable profits from 16.5 per cent to 8.25 per cent for corporations and from 15 per cent to 7.5 per cent for unincorporated businesses. Assessable profits exceeding HK\$2 million are taxed at 16.5 per cent and 15 per cent respectively. 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 2018-19, the profits tax collected was about \$166.6 billion, making up about 28 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 2018-19, the first, second, third and fourth segments of net chargeable income of \$50,000 each were taxed at 2 per cent, 6 per cent, 10 per cent and 14 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 \$60.1 billion, or about 10 per cent, of total government revenue in 2018-19. Because of generous personal allowances under the tax law, only 1.87 million people, or 49 per cent of the workforce, were liable to salaries tax for the 2017-18 year of assessment.

Owners of land and buildings are charged property tax at the standard rate, of 15 per cent in 2018-19, 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 \$3.6 billion, or about 1 per cent, of total government revenue in 2018-19.

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 2018-19, the revenue from stamp duties was some \$80 billion, or about 13 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 2018-19 totalled some \$22.2 billion, or 3.7 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 2019-20). 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 2019, with rateable values reflecting rental values on 1 October 2018. The revenue from rates in 2018-19 was \$17.2 billion, or 2.9 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 2019. Total government rent collected in 2018-19 was \$12.1 billion, or 2 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 \$10.6 billion in 2018-19, or about 1.8 per cent of total government revenue, of which 59.3 per cent was from tobacco, 35.3 per cent was from hydrocarbon oil, 5.3 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 \$9.4 billion in 2018-19, or 1.6 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 \$16.2 billion, or 2.7 per cent of total revenue, in 2018-19. 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 \$116.9 billion, or about 19 per cent of total government revenue, in 2018-19. 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 43 CDTAs signed by the city as at end-2019 help reduce tax burdens on taxpayers and eliminate uncertainties over tax liabilities.

Hong Kong has always been supportive of international efforts to enhance tax transparency and combat tax evasion. The territory implements the Organisation for Economic Cooperation and Development's (OECD) global standard on the automatic exchange of financial account information in tax matters and the exchange of information on request. The legislative framework for implementing the OECD's Base Erosion and Profit Shifting package and for codifying the transfer pricing principles came into force in 2018. Hong Kong will continue to ensure its tax system complies with the prevailing international standards.

Government Procurement

The government seeks to procure stores and services at the best value for money in a publicly accountable manner. Its procurement practices are underpinned by the principles of open and fair competition, transparency, innovation and integrity. The Government Logistics Department is the government's procurement agent for the purchase of goods and related services required by departments. In 2019, the department procured goods and related services amounting to \$6.16 billion from 26 countries and territories, including Hong Kong.

Open tendering is normally adopted. The department maintains supplier lists of different categories of goods and services for sourcing. It publishes tender notices online and notifies relevant listed suppliers about open tenders. As Hong Kong, China is a signatory to the Agreement on Government Procurement of the World Trade Organisation, tender notices for procurements covered by the agreement 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 (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