Chapter 3

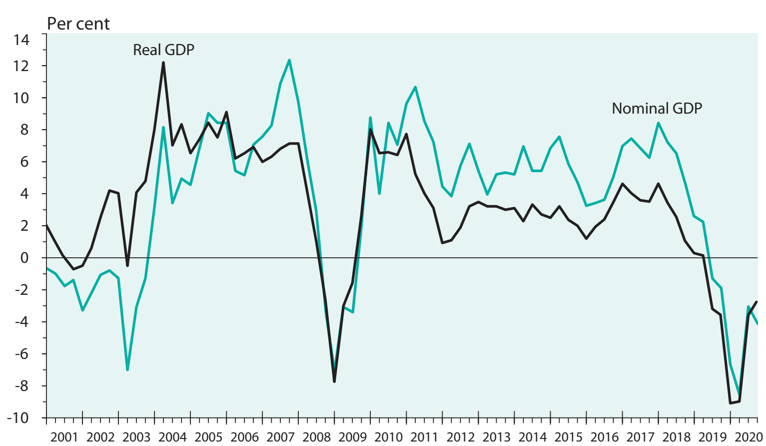
The Economy

Hong Kong's economy registered the sharpest annual decline on record in 2020 as the COVID-19 pandemic dealt a heavy blow to global and local economic activities. It saw a substantial year-on-year contraction in the first half of the year, before improving somewhat in the second half partly thanks to a revival in goods exports and active financial markets. The labour market deteriorated while overall inflationary pressures receded.

Gross Domestic Product (GDP) contracted 6.1 per cent in real terms for 2020 as a whole, the sharpest annual decline on record, following the 1.7 per cent decline in 2019. In terms of the quarterly profile, real GDP fell sharply by 9.1 per cent year on year in the first quarter and 9.0 per cent in the second quarter, before showing narrowed declines of 3.6 per cent in the third quarter and 2.8 per cent in the fourth quarter *(chart 1)*.

Chart 1 **Quarterly Gross Domestic Product**

(year-on-year rate of change)



The Hong Kong economy saw the sharpest annual contraction on record in 2020.

Total exports of goods picked up over the course of 2020 but still fell mildly for the year as a whole. The fall in the first half of the year, amid significant disruptions to the regional supply chains and plunging global demand, was followed by a visible revival in the second half alongside the recovery of the global economy. Exports of services posted a record annual decline, dragged down by frozen inbound tourism from February and generally weak cross-boundary transport and business services.

Domestic demand was badly hit in 2020. Private consumption expenditure recorded the steepest ever annual decline, as local consumption activities were severely disrupted by the COVID-19 epidemic, job and income conditions worsened and outbound tourism virtually ground to a halt. Overall investment expenditure declined noticeably amid an austere business environment and weak construction activity.

The labour market deteriorated sharply in 2020 as the economy experienced the most severe contraction on record due to the COVID-19 pandemic. The seasonally adjusted unemployment rate surged to 6.6 per cent in the fourth quarter, the highest in 16 years. The underemployment rate also soared, to a post-SARS high of 3.8 per cent in the third quarter and stayed elevated at 3.4 per cent in the fourth quarter. For 2020 as a whole, the unemployment rate and underemployment rate averaged 5.8 per cent and 3.3 per cent respectively, 2.9 and 2.2 percentage points respectively higher than in 2019. Labour market conditions in all major sectors deteriorated. Overall wages and labour earnings continued to increase in nominal terms in 2020, but at a decelerated pace. Median household income fell markedly in 2020.

The residential property market was broadly steady in 2020, notwithstanding some moderate fluctuations in individual months. While the COVID-19 pandemic took a heavy toll on the overall economy and market sentiment was swayed by the local epidemic situation from time to time, the market was supported by the low local interest rate environment resulting from massive monetary stimulus around the world and firm end-user demand.

The local stock market exhibited considerable volatility in 2020, as market sentiment was swayed by concerns over the global economic outlook amid the COVID-19 pandemic and the development of China-US relations. The Hang Seng Index closed the year at 27,231 points, 3.4 per cent lower than end-2019.

Overall price pressures receded visibly. Underlying consumer price inflation eased from an average of 3.0 per cent in 2019 to 1.3 per cent in 2020, as price pressures on most goods and services eased amid austere global and local economic conditions. The moderated year-on-year increase in prices of basic foodstuffs in the second half of the year against a high base of comparison also contributed.

Structure and Development of the Economy

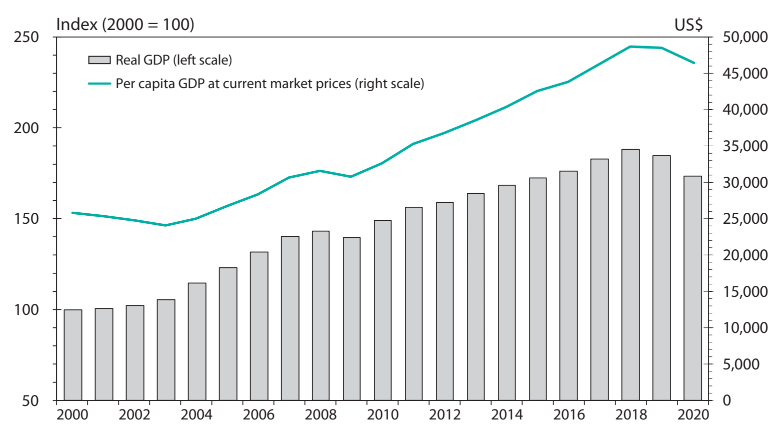
Hong Kong is a global centre for world trade, finance, transportation and business, located strategically at the doorstep of the Mainland's huge and vibrant economy. Hong Kong was the world's sixth largest merchandise trading entity in 2020 according to the World Trade Organisation, and was home to one of the world's busiest airports in terms of the 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-2020, 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-2020 and ranked second 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 has been ranked consistently by the Fraser Institute as the world's freest economy.

The Hong Kong economy expanded at an average annual rate of 2.8 per cent over the past two decades, faster than many other advanced economies. Over the same period, per capita GDP rose about 55 per cent in real terms, posting an average annual growth rate of 2.2 per cent. Like many other economies, the growth figures would have been more impressive if the especially weak performance in 2020 were excluded. Per capita GDP at current market prices was US$46,300 in 2020 *(chart 2)*, exceeding many advanced economies.

Chart 2 **Gross Domestic Product**



Over the past two decades, the Hong Kong economy grew an average of 2.8 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 more than doubled in real terms over the past two decades. The total value of the goods trade compiled under the GDP accounting framework reached $8,532 billion in 2020, equivalent to 317 per cent of GDP, far higher than the ratio of 203 per cent in 2000. Including the value of exports and imports of services, the ratio of total trade to GDP was even higher, at 352 per cent in 2020, up from 248 per cent in 2000.

As an international financial centre with huge cross-territory fund flows, Hong Kong has substantial external financial assets and liabilities, of $48,768 billion and $32,077 billion respectively at the end of 2020. The corresponding ratios to GDP were 1,814 per cent and 1,193 per cent. Reflecting the city's robust international investment position, its net external financial assets amounted to $16,690 billion at the end of 2020, equivalent to 621 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 $15,665 billion in market value at the end of 2020, equivalent to 583 per cent of GDP. The corresponding figures for Hong Kong's stock of direct investment assets were likewise huge, at $16,200 billion, or 603 per cent of GDP.

Gross National Income, comprising GDP and net external primary income flow, stood at $2,837 billion in 2020, higher than the corresponding GDP by 5.5 per cent. The difference represented a net inflow of external primary income. Measured at current market prices, inflows and outflows of external primary income were both substantial, at $1,539 billion and $1,390 billion respectively, equivalent to 57 per cent and 52 per cent of GDP respectively. This was attributable to the huge stocks of Hong Kong's outward and inward investment.

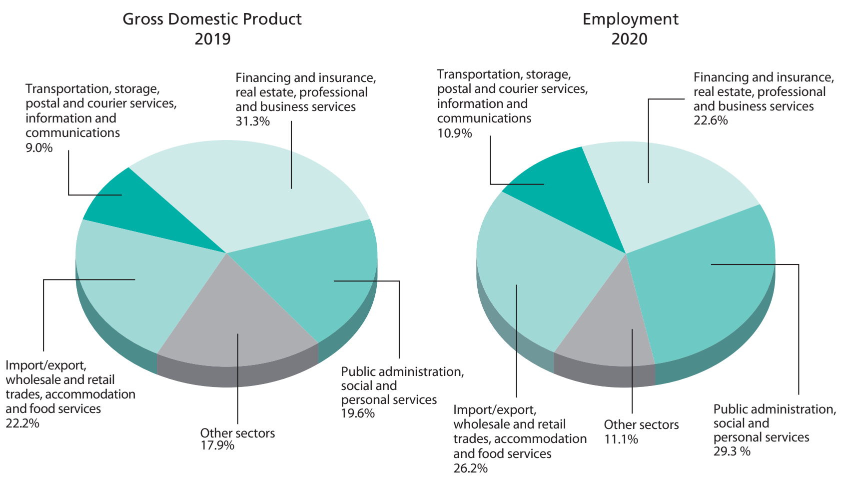
Contributions of Various Economic Sectors

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 2019, the value-added contributions of manufacturing and of electricity, gas and water supply 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 2020, manufacturing constituted only 2 per cent, and electricity, gas and water supply less than 1 per cent. Construction took up 8 per cent.

The services sector is the mainstay of the Hong Kong economy, making up 93 per cent of GDP in 2019. The largest services sector continued to be financing and insurance, real estate, professional and business services, accounting for 31 per cent of GDP. This was followed by import/export, wholesale and retail trades, accommodation and food services (22 per cent); public administration, social and personal services (20 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 2020. In particular, public administration, social and personal services accounted for 29 per cent of total employment, followed by import/export, wholesale and retail trades, accommodation and food services (26 per cent); financing and insurance, real estate, professional and business services (23 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. 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.

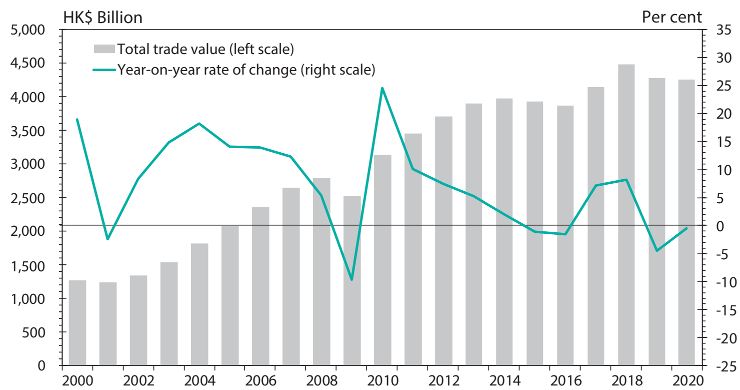
With its unique advantages under 'one country, two systems' and strong competitive edge, Hong Kong's services sector is well positioned to take advantage of the opportunities presented by national development and the eastward shift of the global centre of economic gravity. Apart from promoting free trade and enhancing Hong Kong's institutional strengths, the government continues to act as a 'facilitator' and 'promoter' in developing the economy. The government works with the private sector to explore new market opportunities and assist citizens and professional service providers to go beyond Hong Kong.

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$474 billion in 2000 to US$4.7 trillion in 2020, 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 2020, visible trade between Hong Kong and the Mainland was more than three times that of 20 years ago, representing growth of 6 per cent per annum in value terms *(chart 4)*. The Mainland was the world's largest merchandise trading entity while Hong Kong ranked sixth.

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 2020. At the same time, Hong Kong was the Mainland's fourth largest trading partner in 2020 after the United States, Japan and Korea, 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 more than doubled between 2009 and 2019. The Mainland was the largest market for Hong Kong's exports of services in 2019, accounting for around 38 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 implemented 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 has always been a principal gateway to and from the Mainland for tourism. However, COVID-19 severely disrupted the flow of people between Hong Kong and the Mainland. In 2020, foreign visitors only made 0.2 million trips through Hong Kong to the Mainland, and the number of trips by Mainland residents to or through Hong Kong also dropped markedly to only 2.7 million. However, Hong Kong still 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 58 per cent of its total outward direct investment position as at end-2019, 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 28 per cent of Hong Kong's total inward direct investment position as at end-2019. Mainland companies maintain a strong presence in Hong Kong as well. As at mid-2020, Mainland companies were operating 1,986 regional headquarters and regional or local offices in Hong Kong, up from 789 a decade ago.

Due to proximity, Guangdong's economic links with Hong Kong are understandably the closest of all the provinces. Based on the Mainland's statistics, the value of realised direct investment in Guangdong from Hong Kong was US$17.2 billion in 2020, accounting for 73 per cent of the province's total inward direct investment in the year.

In 2020, the Hong Kong continued to maintain close liaison with the central ministries and the governments of Guangdong and Macao in taking forward the development of the Guangdong-Hong Kong-Macao Greater Bay Area (GBA). The Chief Executive led a government delegation to Beijing, Guangzhou and Shenzhen in November for in-depth discussions with the relevant Mainland authorities about policy initiatives that would support Hong Kong's development and enhance the community's confidence in the future. To press ahead with GBA development, the Chief Executive's 2020 Policy Address included measures in areas such as cross-boundary infrastructure development and clearance facilitation, joint development of an international innovation and technology hub, cooperation in modern service industries, education and youth exchanges.

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 1,319 Mainland enterprises listed on its stock market as at end-2020. Of these, 112 were listed in 2020, raising more than $390 billion of funds through IPOs. IPOs and secondary market financing combined raised more than $650 billion in aggregate funds.

Hong Kong possesses the world's largest offshore pool of Renminbi (RMB) liquidity, holding about RMB757 billion of RMB customer deposits and outstanding RMB certificates of deposit issued as at end-2020. RMB bank lending and outstanding RMB bonds stood at about RMB152 billion and RMB182 billion respectively. RMB trade settlements handled by banks in Hong Kong were about RMB6.3 trillion in 2020.

Hong Kong is also the largest offshore RMB investment product market. As at end-2020, there were 36 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 RMB16.8 billion, and 29 SFC-authorised, RMB-denominated exchange traded funds listed on the Stock Exchange of Hong Kong, primarily investing onshore via the same channels with an aggregate NAV of RMB55.4 billion.

The Economy in 2020

External Trade

Total exports of goods, based on external merchandise trade statistics, picked up over the course of 2020, but still fell 0.8 per cent in real terms for 2020 as a whole after a decline of 5.0 per cent in the preceding year. The fallout from the COVID-19 pandemic, including disruptions to the regional supply chains and global demand, was particularly evident in the first half of the year. Merchandise exports volume saw a visibly enlarged year-on-year decline of 9.1 per cent in the first quarter and continued to fall 3.5 per cent in the second quarter, before resuming growth of 2.3 per cent and 5.9 per cent respectively in the third and fourth quarters alongside the gradual recovery of the global economy led by the Mainland *(chart 5)*. Analysed by major market, exports to the US and the European Union fell sharply for the year as a whole, while those to the Mainland rose notably. Exports to other Asian markets saw mixed performances.

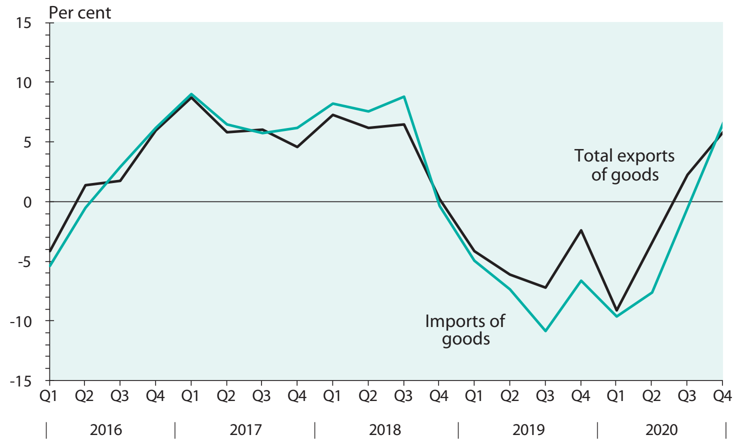
Imports of goods fell 2.6 per cent in real terms in 2020, after a decline of 7.6 per cent in 2019. Retained imports, which refer to imports for domestic use and accounted for around one-quarter of total imports in 2019, declined noticeably by 8.8 per cent in 2020, reflecting subdued domestic demand amid austere economic conditions. Imports for subsequent re-export also fell for the year as a whole, though rose moderately in the second half along with the improvement in export performance.

Exports of services plummeted a record 36.1 per cent in real terms in 2020, having contracted 9.6 per cent in 2019 *(chart 6)*. Exports of travel services fell drastically as the COVID-19 pandemic resulted in extensive travel restrictions, bringing inbound tourism to a standstill from February. Exports of transport services declined notably as passenger flows plummeted, but the pace of decline moderated somewhat in the second half of the year alongside the improvement in regional trade and cargo flows. Exports of business and other services also contracted amid the austere global economic environment. In contrast, exports of financial services expanded moderately thanks to active cross-border financial and fund-raising activities.

Chart 5

Hong Kong's Goods Trade

(year-on-year rate of change in volume terms)

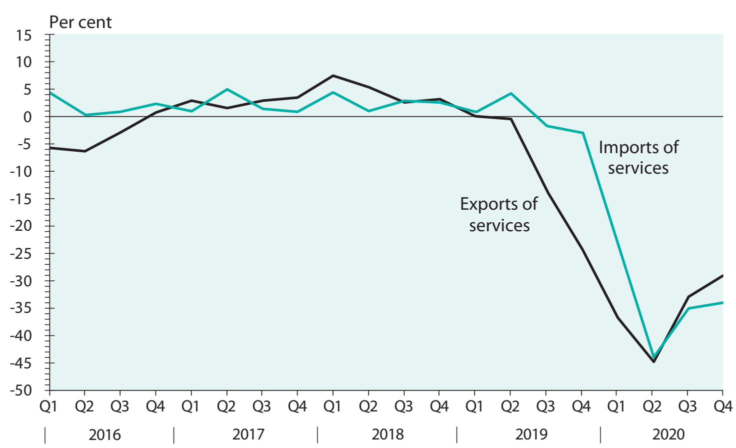


Merchandise exports picked up over the course of 2020 but still fell slightly for the year as a whole.

Chart 6

Hong Kong's Services Trade

(year-on-year rate of change in real terms)



Exports of services plummeted in 2020.

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

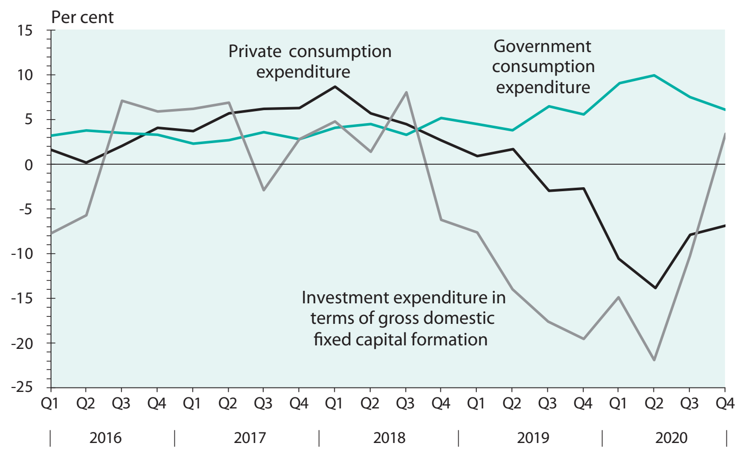
Imports of services declined markedly by 34.1 per cent in real terms in 2020, after rising 0.1 per cent in 2019. Imports of travel services dived amid stringent travel restrictions and quarantine measures worldwide during most of the year. Imports of transport services fell sharply as a result of scant passenger traffic, but the rate of decline narrowed in the second half thanks to improved regional trade and cargo flows. Imports of manufacturing services continued its down trend, reflecting the slack in outward processing activities. Imports of business and other services also fell amid the difficult global economic environment.

Compiled based on the change of ownership principle, the goods deficit narrowed further in 2020, reflecting the larger decline in imports of goods than exports of goods. Over the same period, the services surplus shrank notably, as surplus from trade in transport services was reduced and trade in travel services turned from surplus to deficit. The combined goods and services account registered a surplus of $49 billion in 2020, as compared to the surplus of $44 billion in 2019.

Domestic Demand

Domestic demand was badly hit in 2020. Private consumption expenditure recorded the steepest ever annual decline of 9.9 per cent in real terms in 2020, after falling 0.8 per cent in 2019. Local consumption activities were severely disrupted by the COVID 19 pandemic and the resultant social distancing requirements. Worsened job and income conditions also weighed on sentiment. Meanwhile, outbound tourism came to a halt with the imposition of stringent travel restrictions worldwide. In consequence, private consumption expenditure registered double-digit declines on a year-on-year basis in the first and second quarters of the year, before showing some relative improvement in the second half *(chart 7)*. Meanwhile, government consumption expenditure rose markedly by 8.1 per cent in real terms in 2020, further to a 5.1 per cent increase in 2019.

Chart 7 **Main Components of Domestic Demand**
(year-on-year rate of change in real terms)



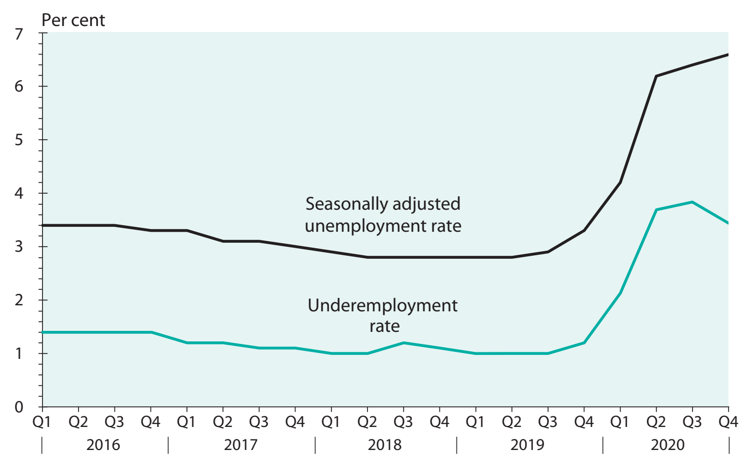
Private consumption expenditure recorded the steepest ever decline in 2020. Overall investment spending continued to fall noticeably.

Overall investment spending in terms of gross domestic fixed capital formation fell noticeably by 11.2 per cent in real terms in 2020 after a 14.9 per cent decline in 2019, notwithstanding some rebound in the fourth quarter against a low base of comparison. Expenditure on acquisitions of machinery, equipment and intellectual property products plummeted 18.0 per cent, as business sentiment worsened sharply and stayed generally weak through the year amid an exceptionally uncertain business outlook. Meanwhile, expenditure on building and construction recorded a steep fall of 7.7 per cent, as the noticeable fall in private sector spending more than offset the increase in public sector spending. Separately, the costs of ownership transfer fell for the year as a whole, despite the notable rebound in the second half amid a more active residential property market.

Labour Market

The labour market deteriorated sharply in 2020 as the economy experienced the most severe contraction on record due to the COVID-19 pandemic. The seasonally adjusted unemployment rate surged to 4.2 per cent in the first quarter of 2020 and further to 6.2 per cent in the second quarter and 6.6 per cent in the fourth quarter, the highest in 16 years. The underemployment rate also soared, to a post-SARS high of 3.8 per cent in the third quarter and stayed elevated at 3.4 per cent in the fourth quarter. For 2020 as a whole, the unemployment rate averaged 5.8 per cent, up 2.9 percentage points over 2019, while the underemployment rate averaged 3.3 per cent, up 2.2 percentage points over the preceding year *(chart 8)*. Labour market conditions deteriorated in all major sectors in 2020, particularly in retail, accommodation and food services, construction, arts, entertainment and recreation, warehousing and support activities for transportation, and transportation.

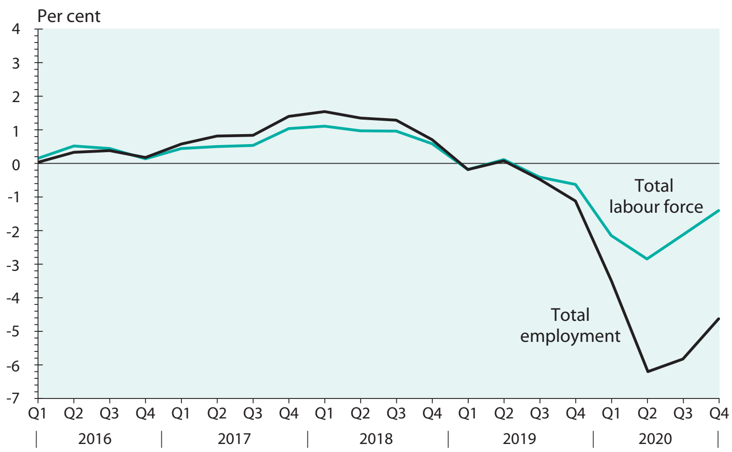
Chart 8 Unemployment and Underemployment Rates



The labour market deteriorated sharply in 2020.

The labour force and total employment declined 2.0 per cent and 4.9 per cent respectively in 2020, enlarged from the corresponding decline of 0.3 per cent and 0.4 per cent in 2019 *(chart 9)*. Data collected from private-sector establishments showed that labour demand slackened further in 2020. Having fallen 0.9 per cent in 2019, private-sector employment fell further by 4.5 per cent in 2020. Most sectors saw declines in private-sector employment, notably in accommodation and food services, import/export trade and wholesale, arts, entertainment and recreation, and retail. The number of private-sector vacancies plunged 42.6 per cent to 38,840 in 2020. Reflecting a slackened labour market, the ratio of job vacancies per 100 job-seekers dived from 58 in 2019 to 17 in 2020.

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



The total labour force and total employment both showed record annual declines in 2020.

Overall wages and labour earnings continued to rise in nominal terms in 2020, but the pace of increase decelerated. Labour earnings, as measured by the index of payroll per person engaged for all selected industry sections, saw its year-on-year increase decelerate from 3.2 per cent in the first quarter to 1.8 per cent in the fourth quarter, the slowest in over a decade. For 2020 as a whole, labour earnings rose 2.4 per cent, slower than the gain of 3.4 per cent in the preceding year.

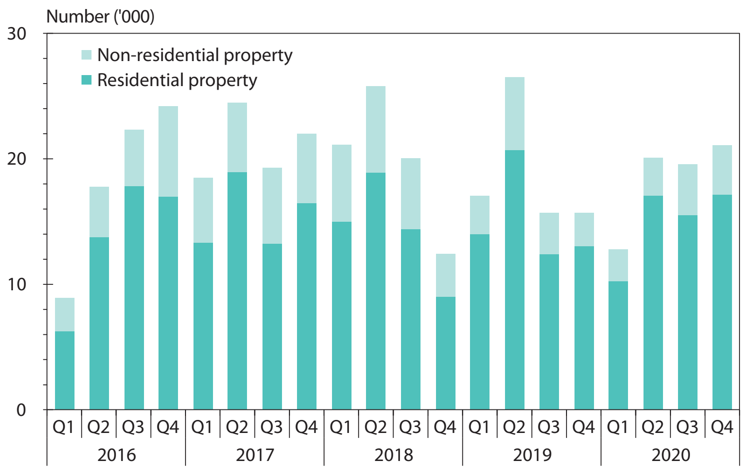
Separately, median monthly household income (excluding foreign domestic helpers) declined sharply by 5.6 per cent from $28,500 in 2019 to $26,900 in 2020, partly reflecting the decreased number of working members in households amid the notable fall in total employment.

Property Market

The residential property market was broadly steady in 2020, notwithstanding some moderate fluctuations in individual months. While the COVID-19 pandemic took a heavy toll on the overall economy and market sentiment was swayed by the local epidemic situation from time to time, the market was supported by the low local interest rate environment resulting from massive monetary stimulus around the world and firm end-user demand. Trading activities remained generally active from the second quarter, while flat prices did not show much change for the year as a whole.

After staying subdued in the first quarter, trading activities showed a sharp rebound in the second quarter and remained generally active thereafter. For 2020 as a whole, the Land Registry received 59,900 sale and purchase agreements for residential property, little changed from 2019. This was higher than the five year average of 57,900 from 2015 to 2019, though still much below the long-term average of 80,300 from 2000 to 2019 *(chart 10)*. Total consideration likewise was little changed at $548.2 billion.

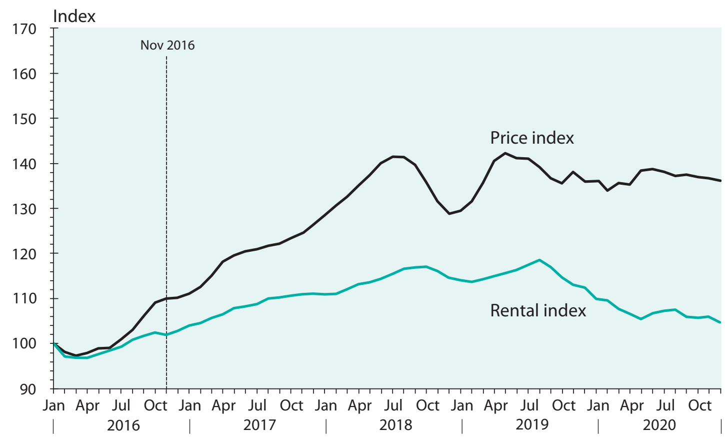
Chart 10 **Sale and Purchase Agreements by Broad Type of Property**



Trading activities remained generally active from the second quarter of 2020.

Flat prices in December 2020 were on average broadly the same as in December 2019. After staying steady during the first quarter, flat prices increased 2 per cent during the second quarter, but retreated by a similar extent during the second half of the year. Analysed by size, comparing December 2020 with December 2019, prices of small and medium-sized flats were little changed, while those of large flats rose 2 per cent. Flat prices in December 2020 were 4 per cent lower than the recent peak in May 2019. The leasing market consolidated further in 2020. Following the noticeable decline in the latter part of 2019, flat rentals on average continued to fall visibly during the first quarter of 2020 before stabilising in the ensuing three quarters. Flat rentals in December 2020 were 7 per cent lower than in December 2019, and 12 per cent below the recent peak in August 2019. Analysed by size, rentals of small and medium-sized flats and large flats declined 7 per cent and 4 per cent respectively during the year *(chart 11)*.

Chart 11 **Prices and Rentals of Residential Property**
(Jan 2016=100)



Flat prices did not show much change for 2020 as a whole, while rentals consolidated further.

Flat prices in December 2020 exceeded the 1997 peak by 120 per cent. The index of home purchase affordability[1] remained elevated at around 72 per cent in the fourth quarter, significantly above the long-term average of 45 per cent over 2000-2019[2]. Should interest rates rise three percentage points to a more normal level, the ratio would soar to 94 per cent.

Reflecting the government's sustained efforts in raising land supply, the total supply of flats in the private sector 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 92,000 units as estimated at end-2020. The demand-supply balance of private flats stayed tight despite some relative improvement during 2020. The vacancy rate rose from 3.7 per cent at end-2019 to 4.3 per cent at end-2020, yet still below the long-term average of 4.9 per cent over 2000-2019.

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

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

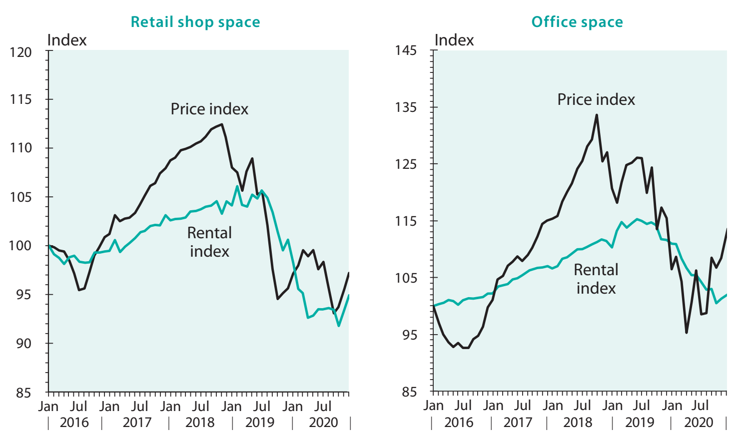
2 Starting from the third quarter of 2019, the index of home purchase affordability is calculated based on, among other components, the mortgage rates of new loans with reference to both the best lending rate (BLR) and the Hong Kong Interbank Offered Rate. As such, the data from the third quarter of 2019 onwards 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.

The commercial and industrial property markets weakened further during 2020 amid the deep economic recession and exceptionally uncertain economic outlook. Prices for major market segments exhibited diverse movements, while rentals declined. Trading activities fell to multi-year lows, but showed some rebound in the latter part of the year following the Hong Kong Monetary Authority's adjustment of the macro-prudential measures for mortgage loans on non-residential properties in August and the government's abolition of the Doubled ad valorem Stamp Duty on non-residential property transactions in late November. For 2020 as a whole, the number of sale and purchase agreements for non-residential property dropped 10 per cent to 13,400, while total consideration plunged 44 per cent to $80.2 billion.

Amid the retail trade's austere business environment, sale prices of retail shop space only went up 2 per cent between December 2019 and December 2020, while rentals declined 6 per cent. Prices in December 2020 retreated 13 per cent from the peak in 2018 and rentals were 10 per cent below the peak in 2019. For office space, prices on average dropped 2 per cent between December 2019 and December 2020. Prices of grade A and B office space declined 11 per cent and 4 per cent respectively, while prices of grade C office space edged up 1 per cent. Office rentals on average fell 9 per cent, with rentals of grade A, B and C office space retreating 10 per cent, 8 per cent and 4 per cent respectively. Compared with the respective peaks in 2018 and 2019, office prices and rentals on average in December 2020 have plummeted 16 per cent and 12 per cent respectively *(chart 12)*. Prices and rentals of flatted factory space decreased 2 per cent and 1 per cent respectively between December 2019 and December 2020. Compared with their peaks in 2019, prices and rentals of flatted factory space in December 2020 were 12 per cent and 5 per cent lower respectively.

Chart 12 **Prices and Rentals of Retail Shop Space and Office Space**

(Jan 2016=100)



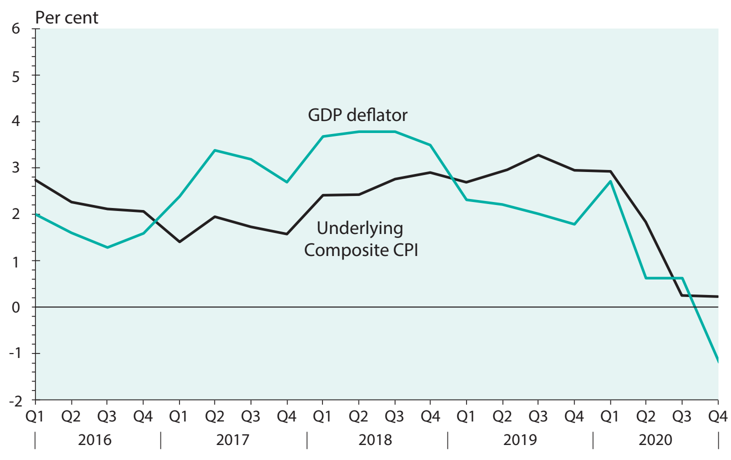
Prices of retail shop space and office space exhibited diverse movements during 2020, while rentals declined.

As to demand-supply balance, the vacancy rate of retail shop space went up from 10.1 per cent at end-2019 to 11.4 per cent at end-2020, and those of office space and flatted factory space from 9 per cent and 5.9 per cent respectively to 11.5 per cent and 6.4 per cent respectively. The vacancy rates of the respective long-term averages for these three types of non-residential property over 2000-2019 were 8.8 per cent, 9.1 per cent and 7.1 per cent.

Price Movements

Consumer price inflation receded visibly in 2020, as price pressures on most goods and services eased amid austere global and local economic conditions. The moderated year-on-year increase in prices of basic foodstuffs in the second half of the year against a high base of comparison also contributed. Netting out the effects of the government's one-off relief measures, underlying consumer price inflation eased from 3.0 per cent in 2019 to 1.3 per cent in 2020. Headline consumer price inflation likewise went down from 2.9 per cent in 2019 to 0.3 per cent in 2020, helped by the implementation of additional one-off relief measures by the government. Quarterly figures, though sometimes distorted by temporary factors, showed that underlying inflation eased from 2.9 per cent in the first quarter to 1.8 per cent in the second quarter, and further to 0.3 per cent and 0.2 per cent in the third and fourth quarter respectively *(chart 13)*.

Chart 13 **Main Inflation Indicators**
(year-on-year rate of change)



Underlying consumer price inflation receded visibly in 2020.

Domestically, among the underlying consumer price index components, private housing rentals stayed on a decelerating trend through 2020 and showed mild declines in the latter part of the year. Food inflation also eased, as the increase in prices of basic foodstuffs moderated in the second half of the year against a high base of comparison, while prices of meals bought away from home saw a narrowed increase amid the local epidemic. As to business costs, wage growth decelerated to the slowest in over a decade, while pressures on commercial rental costs softened notably. External price pressures were muted in 2020, as inflation in many of Hong Kong's major import suppliers decelerated and world energy prices recorded a visible fall. Against this backdrop, import prices saw a modest decline for the year as whole.

The increase in GDP deflator eased from 2.0 per cent in 2019 to 0.6 per cent in 2020. Within the GDP deflator, the terms of trade deteriorated slightly in 2020. Taking out the external trade components, the domestic demand deflator rose 0.8 per cent in 2020, down from the 2.4 per cent increase in 2019.

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 the Legislative Council an annual set of estimates of revenue and expenditure. The estimates are drawn up in the context of a medium-range forecast, which is a fiscal planning tool to ensure 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 the Legislative Council. 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 the council'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 2019-20, government revenue was $590.9 billion and expenditure was $607.8 billion, resulting in a deficit of $10.6 billion after receipt of net proceeds of $7.8 billion from bonds issued under the Government Green Bond Programme and repayment of notes of $1.5 billion. Fiscal reserves at 31 March 2020 stood at $1,160.3 billion, equivalent to 23 months of government expenditure.

Public expenditure comprises government expenditure and expenditure by the Housing Authority and trading funds. In 2019-20, public expenditure increased 13.2 per cent against the previous year to $642.7 billion, of which $459.8 billion, or 71.5 per cent, was of a recurrent nature.

Future Fund

The Future Fund, with an endowment of $224.5 billion, seeks to secure higher returns for Hong Kong's fiscal reserves through placement in longer-term investments to cope with foreseeable long-term fiscal challenges arising from an ageing population and slower economic growth.

The fund has been placed with the Exchange Fund. Investment returns arising from the Future Fund are retained by the Exchange Fund for reinvestment and shall be paid to the government upon completion of the placement period or on a date as directed by the Financial Secretary.

In June, in a bid to uphold Hong Kong's status as an international aviation hub, $27.3 billion was allocated from the Future Fund for investment in Cathay Pacific Airways Limited. The investment will remain part of the Future Fund.

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 (26.4 per cent), land premium (24 per cent), stamp duties (11.4 per cent) and salaries tax (8.5 per cent).

The Inland Revenue Department collects 51.3 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 36.2 per cent of total government revenue in 2019-20.

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 2019-20, the profits tax collected was about $155.9 billion, making up 26.4 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 2019-20, 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 $50.4 billion, or 8.5 per cent, of total government revenue in 2019-20. Because of generous personal allowances under the tax law, only 1.84 million people, or 48 per cent of the workforce, were liable to salaries tax for the 2018-19 year of assessment.

Owners of land and buildings are charged property tax at the standard rate, of 15 per cent in 2019-20, 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 $2.8 billion, or 0.5 per cent, of total government revenue in 2019-20.

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 2019-20, the revenue from stamp duties was some $67.2 billion, or 11.4 per cent of total government revenue.

Betting duty is charged on the net stake receipts from betting on horse races and football matches and on the proceeds of Mark Six lotteries, all administrated by the Hong Kong Jockey Club. The yield from betting duty in 2019-20 totalled some $22 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

2020-21). 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 2.6 million assessments, took effect on 1 April 2020, with rateable values reflecting rental values on 1 October 2019. The revenue from rates in 2019-20 was about $21 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 2020. Total government rent collected in 2019-20 was around $13.3 billion, or 2.3 per cent of total government revenue.

Under the Dutiable Commodities Ordinance, excise duties are levied on four commodities to be consumed locally, namely hydrocarbon oil, liquor, methyl alcohol and tobacco, irrespective of whether they are manufactured locally or imported. The Customs and Excise Department collects these duties, which totalled $11.4 billion in 2019-20, or 1.9 per cent of total government revenue, of which 61.9 per cent was from tobacco, 33.1 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 $7.2 billion in 2019-20, or 1.2 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 $12.1 billion, or 2.1 per cent of total revenue, in 2019-20. Government-operated public utilities generated about $3.9 billion, or 0.7 per cent of total revenue, the most important of which, in revenue terms, is the provision of water supplies.

Land transactions generated some $141.7 billion, or 24 per cent of total government revenue, in 2019-20. 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 45 CDTAs signed by the city as at end-2020 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, and has implemented international tax standards including the automatic exchange of financial account information in tax matters and the Base Erosion and Profit Shifting package promulgated by the Organisation for Economic Cooperation and Development.

Government Procurement

The government seeks to procure goods and services at the best value for money in a publicly accountable manner, adopting the principles of open and fair competition, transparency, innovation and integrity in its procurement practices. The Government Logistics Department is the government's procurement agent for goods and related services required by departments. In 2020, the department procured goods and related services amounting to $8.94 billion from 41 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 World Trade Organisation's Agreement on Government Procurement, tender notices 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