Chapter 3

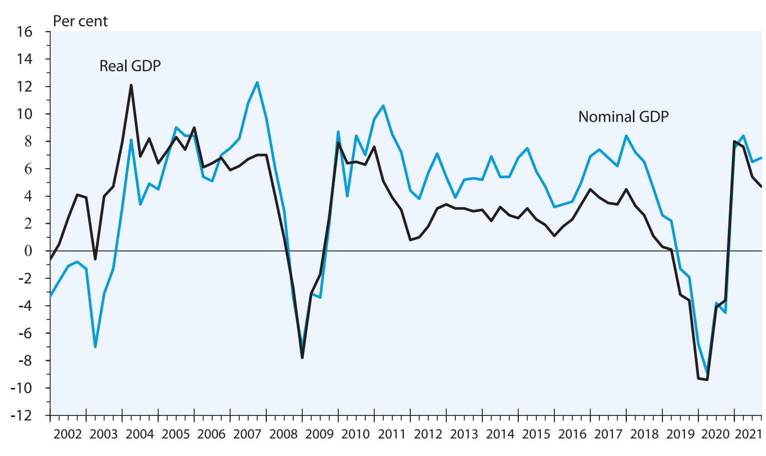
The Economy

Hong Kong's economy staged a visible recovery in 2021 after an extremely difficult 2020. It turned to a strong year-on-year expansion in the first half and posted further solid growth in the second half. Yet the recovery was uneven as inbound tourism remained frozen. The labour market improved continuously while underlying consumer price inflation went up modestly through the year.

Gross Domestic Product (GDP) expanded 6.3 per cent in real terms in 2021, the fastest pace since 2010, having declined 6.5 per cent in 2020. In terms of the quarterly profile, real GDP resumed year-on-year growth of 8.0 per cent in the first quarter after six consecutive quarters of contraction and grew further by 7.6 per cent in the second quarter, 5.4 per cent in the third quarter and 4.7 per cent in the fourth quarter *(chart 1)*.

Chart 1 **Quarterly Gross Domestic Product**

(year-on-year rate of change)



The Hong Kong economy staged a visible recovery in 2021, reversing the declines in the previous two years.

Total exports of goods surged in 2021, underpinned by the marked revival of import demand from major economies and vibrant regional trading and production activities. With frozen inbound tourism throughout the year, exports of services grew only mildly despite the revival of regional trade and cargo flows as well as increased cross-border commercial and financial services.

Domestic demand was recovering in 2021. Private consumption expenditure rose appreciably thanks to the receding local epidemic, improving labour market situation and the roll-out of the Consumption Voucher Scheme, though outbound tourism remained severely hindered. Overall investment expenditure saw a visible rebound amid improved business outlook.

The labour market was under notable pressure in early 2021, but improved continuously through the year. After reaching a 17-year high of 7.2 per cent in December 2020 to February 2021, the seasonally adjusted unemployment rate fell successively to 4.0 per cent in the fourth quarter of 2021. The underemployment rate went down from 3.9 per cent to 1.7 per cent over the same period. Nominal wages and labour earnings reversed the general trend of decelerated growth in the past two years or so. Median household income rebounded during 2021 from the low levels earlier.

The residential property market was generally active in 2021, though turned quieter in the latter part of the year. While the low interest rate environment, firm end-user demand and local economic recovery continued to provide support in the first half, sentiment weakened thereafter amid the local stock market correction and growing concerns over possible interest rate hikes in the US.

The local stock market underwent a sharp correction in 2021, dampened by the prospective tightening of the US Fed's monetary policy, regulatory requirements in the Mainland, and uncertainties surrounding the global economic outlook. The Hang Seng Index closed the year at 23,398 points, down 14.1 per cent from a year earlier.

Underlying consumer price inflation went up modestly over the course of the year alongside the economic recovery and higher import prices. Prices of some consumption items saw accelerated increases in the second half of the year, while the low bases of comparison for transport and meals out and takeaway food also contributed. Offsetting these developments were the softening of the private housing rental component and modest increase in basic food prices. For 2021 as a whole, underlying consumer price inflation averaged at 0.6 per cent, down from 1.3 per cent in 2020.

Structure and Development of the Economy

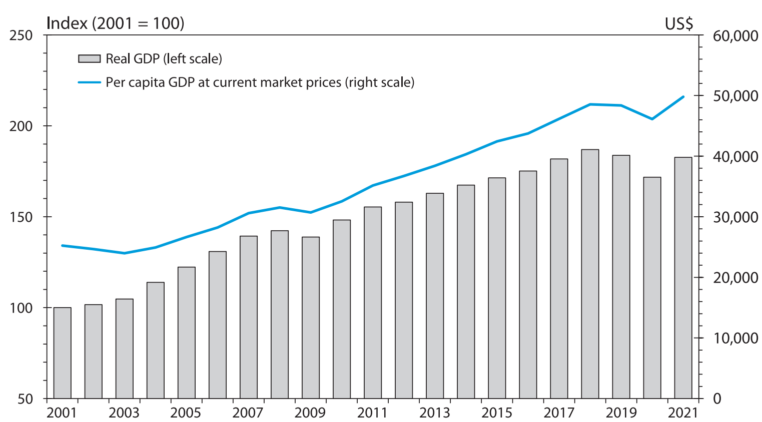
Hong Kong is a global centre for world trade, finance, transportation and business, located strategically at the doorstep of the Mainland's huge and vibrant economy. Hong Kong was the world's sixth-largest merchandise trading entity in 2021, according to the World Trade Organisation, and was home to 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-2021. Its stock market was the fourth largest in Asia by market capitalisation as at end-2021 and ranked fourth globally in terms of initial public offering 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 seventh globally and second in Asia in the *World Competitiveness Yearbook 2021* published by the International Institute for Management Development. Hong Kong has also been ranked consistently by the Fraser Institute as the world's freest economy.

The Hong Kong economy expanded at an average annual rate of 3.1 per cent over the past two decades, faster than many other advanced economies. Over the same period, per capita GDP rose about 65 per cent in real terms, posting an average annual growth rate of 2.5 per cent. Per capita GDP at current market prices was US$49,800 in 2021 *(chart 2)*, exceeding many advanced economies.

Chart 2 **Gross Domestic Product**



Over the past two decades, the Hong Kong economy grew an average of 3.1 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 $10,466 billion in 2021, equivalent to 365 per cent of GDP, far higher than the ratio of 196 per cent in 2001. Including the value of exports and imports of services, the ratio of total trade to GDP was even higher, at 402 per cent in 2021, up from 241 per cent in 2001.

As an international financial centre with huge cross-territory fund flows, Hong Kong has substantial external financial assets and liabilities, of $50,127 billion and $33,553 billion respectively at the end of 2021. The corresponding ratios to GDP were 1,747 per cent and 1,169 per cent. Reflecting the city's robust international investment position, its net external financial assets amounted to $16,574 billion at the end of 2021, equivalent to 578 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 $16,837 billion in market value at the end of 2021, equivalent to 587 per cent of GDP. The corresponding figures for Hong Kong's stock of direct investment assets were likewise huge, at $17,305 billion, or 603 per cent of GDP.

Gross National Income, comprising GDP and net external primary income flow, stood at $3,075 billion in 2021, higher than the corresponding GDP by 7.1 per cent. The difference represented a net inflow of external primary income. Owing to the huge stocks of Hong Kong's outward and inward investment, inflows and outflows of external primary income were both substantial, at $1,640 billion and $1,435 billion respectively, equivalent to 57 per cent and 50 per cent of GDP respectively.

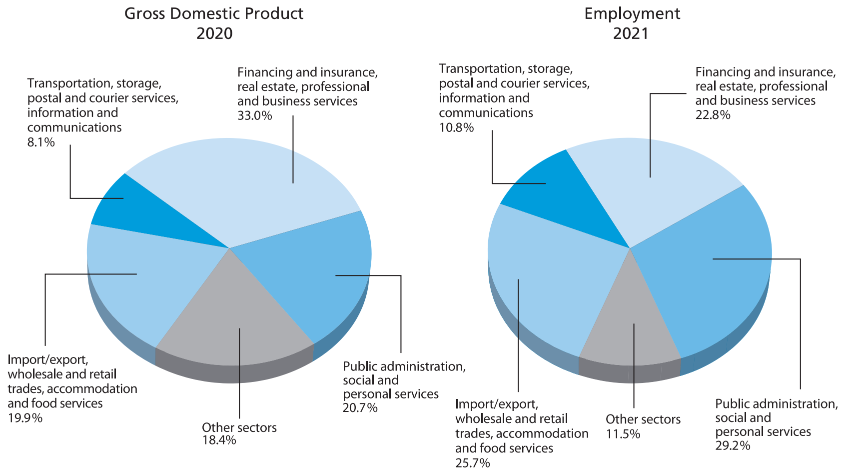
Contributions of Various Economic Sectors

Primary production, including agriculture, fisheries, mining and quarrying, is tiny 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 electricity, gas and water supply. In 2020, 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 2021, manufacturing constituted only 2 per cent, and electricity, gas and water supply 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 2020. The largest services sector continued to be financing and insurance, real estate, professional and business services, accounting for 33 per cent of GDP. This was followed by public administration, social and personal services (21 per cent); import/export, wholesale and retail trades, accommodation and food services (20 per cent); and transportation, storage, postal and courier services, and information and communications (8 per cent). In terms of total employment, services accounted for 89 per cent in 2021. 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 mainstay 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 increasingly sophisticated 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.

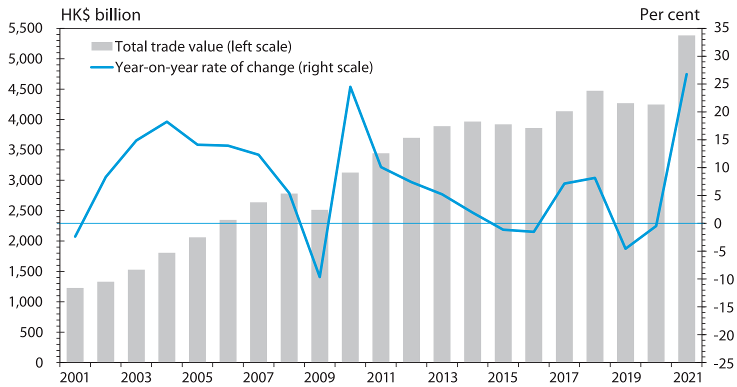
With its unique advantages under 'one country, two systems' and strong competitive edge, Hong Kong's services sector is well positioned to take advantage of the opportunities presented by national development and the eastward shift of global economic gravity. The government continues to enhance institutional strengths, promote innovation and technology and other areas of growth potentials, address major bottlenecks of land and manpower supply, and stress the importance of acting as a 'facilitator' and 'promoter' to keep connecting with the world to open up markets and explore business opportunities for enterprises.

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$510 billion in 2001 to US$6.1 trillion in 2021, the Mainland plays a prominent role in driving global economic growth. Hong Kong has benefited substantially from the Mainland's remarkable external trade growth. In 2021, visible trade between Hong Kong and the Mainland was more than four times that of 20 years ago, representing growth of 8 per cent per annum in value terms *(chart 4)*. The Mainland was the world's largest merchandise trading entity while Hong Kong ranked sixth in 2021.

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 2021. At the same time, Hong Kong was the Mainland's fourth-largest trading partner in 2021 after the United States, Japan and Korea, accounting for about 6 per cent of the Mainland's total trade value. More than 60 per cent 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 rise of the Mainland as the world's second-largest economy with increasing emphasis on high-quality development has brought about an ever-growing market, providing enormous opportunities for various services. Hong Kong, being highly competitive in many high-end services, has risen with the tide. The Plan for Comprehensive Deepening Reform and Opening Up of the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone was promulgated by the Central Government on 6 September. The area of the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone will be expanded significantly from 14.92 square kilometres to 120.56 sq km. Hong Kong will capitalise on its own advantages to assist in promoting full liberalisation of trade in services in Qianhai, greater mutual access of financial markets, and a higher level of opening up in legal matters, thereby expanding the room for development for enterprises and professionals in different sectors.

Hong Kong has always been a principal gateway to and from the Mainland. While the flow of people between Hong Kong and the Mainland was severely disrupted by the pandemic, capital flow continued to thrive. In 2021, foreign visitors made around 3,000 trips through Hong Kong to the Mainland, and Mainland residents made only 66,000 trips to or through Hong Kong, both figures representing less than 1 per cent of their pre-pandemic levels. Meanwhile, 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 exceeded US$1 trillion as at end-2020, 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-2020, 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 external direct investment, accounting for 27 per cent of Hong Kong's total inward direct investment stock as at end-2020. Mainland companies maintain a strong presence in Hong Kong as well. As at mid-2021, Mainland companies were operating 2,080 regional headquarters and regional or local offices in Hong Kong, up from 805 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$22.2 billion in 2021, accounting for 78 per cent of the province's total inward direct investment in the year.

The Outline of the 14th Five-Year Plan for National Economic and Social Development of the People's Republic of China and the Long-Range Objectives Through the Year 2035, approved by the National People's Congress in March, supports Hong Kong to enhance its competitiveness as eight international centres or hubs[1], with a view to better integrating Hong Kong into the overall development of the country. The Chief Executive's 2021 Policy Address highlighted how Hong Kong could leverage the Central Government's support for each centre or hub and provided measures in taking forward the development of the Guangdong-Hong Kong-Macao Greater Bay Area (GBA).

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 Government's policy to enhance Hong Kong's position as an international financial centre,

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1 Support regarding the 'eight international centres or hubs' includes supporting Hong Kong's development as an international innovation and technology hub, an international legal and dispute resolution services centre in the Asia-Pacific region, an East-meets-West centre for international cultural exchange, and a regional intellectual property trading centre; and enhancing its status as an international financial centre, an international transportation centre, an international trade centre and an international aviation hub.

including the launch of Southbound Bond Connect and Cross-boundary Wealth Management Connect in the GBA in September. As a major funding centre for Mainland enterprises, Hong Kong had 1,368 Mainland enterprises listed on its stock market as at end-2021. Of these, 87 were listed in 2021, raising more than $320 billion of funds through initial public offerings (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 RMB945 billion of RMB customer deposits and outstanding RMB certificates of deposit issued as at end-2021. RMB bank lending and outstanding RMB bonds stood at about RMB164 billion and RMB311 billion respectively. RMB trade settlements handled by banks in Hong Kong were about RMB7.1 trillion in 2021.

Hong Kong is also the largest offshore RMB investment product market. As at end-2021, there were 37 Securities and Futures Commission (SFC)-authorised, RMB-denominated unlisted funds primarily investing onshore via the Qualified Foreign Investor scheme, Stock Connect, Bond Connect and the China Interbank Bond Market, with an aggregate net asset value of RMB34 billion, and 39 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 net asset value of RMB71.3 billion.

The Economy in 2021

External Trade

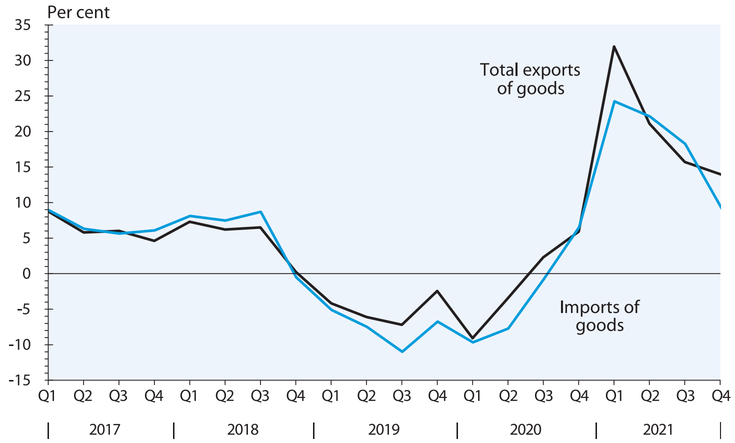
Total exports of goods, based on external merchandise trade statistics, surged 19.9 per cent in real terms in 2021, after declining slightly by 0.8 per cent in the preceding year. The strong performance was underpinned by the marked revival of import demand from major economies and vibrant regional trading and production activities. Merchandise exports posted an exceptionally strong year-on-year growth of 32.0 per cent in the first quarter, and sustained notable increases of 21.1 per cent, 15.7 per cent and 14.0 per cent in the remaining three quarters despite a progressively higher base of comparison. Merchandise exports in 2021 surpassed the high recorded in 2018 by 13.1 per cent in real terms *(chart 5)*. Analysed by major market, exports to the Mainland, the US and the European Union rose sharply, and those to other Asian markets also showed increases of varying degrees.

Imports of goods increased visibly by 18.1 per cent in real terms in 2021, after a decline of 2.6 per cent in 2020. Imports for subsequent re-export, which accounted for around four-fifths of total imports in 2021, rebounded notably by 19.6 per cent in 2021 in tandem with robust export performance. Retained imports, which refer to imports for domestic use, also rose 12.6 per cent in 2021, as domestic demand revived alongside the improving economic and labour market conditions.

Exports of services grew mildly by 1.5 per cent in real terms in 2021, after plummeting by a record 34.8 per cent in 2020 *(chart 6)*. Exports of transport services rebounded thanks to vibrant regional cargo flows, though scant cross-border passenger flows constrained the extent of revival. Exports of business and other services grew moderately alongside the global economic recovery. Exports of financial services increased further, supported by active cross-border financial and fund-raising activities. However, as inbound tourism remained frozen throughout 2021, exports of travel services remained at a very low level and plunged further by 41.1 per cent for the year as a whole.

Chart 5

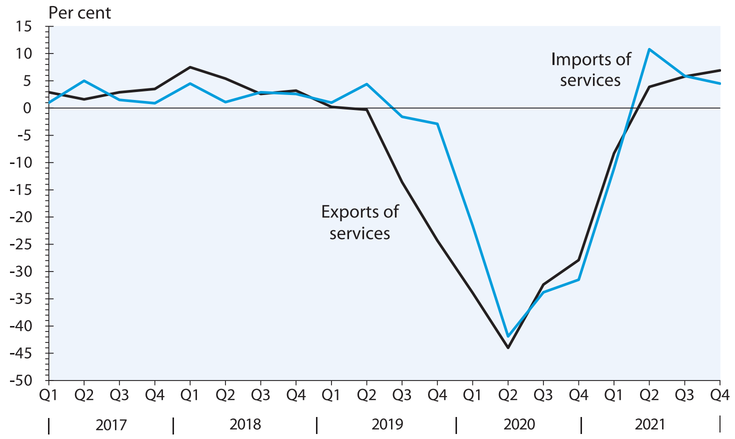
Hong Kong's Goods Trade
(year-on-year rate of change in volume terms)



Merchandise exports in 2021 surpassed the high recorded in 2018 by 13.1 per cent in real terms.

Chart 6

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



Exports of services grew mildly in 2021.

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

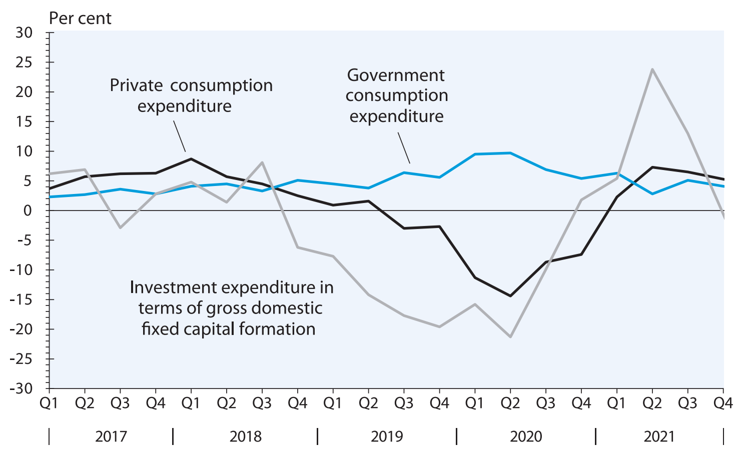
Imports of services increased moderately by 1.7 per cent in real terms in 2021, following a plunge of 32.2 per cent in 2020. Imports of travel services dived further by 42.3 per cent in 2021 as outbound tourism remained heavily constrained by the pandemic and various travel restrictions. Imports of transport services bounced back thanks to buoyant trading activities and cargo flows in the region. Imports of manufacturing services also picked up in the year, reflecting the improvement in outward processing activities. Imports of business and other services increased moderately amid the revival of the global economy.

Compiled based on the change of ownership principle, the goods balance turned to a surplus in 2021 on the back of a larger increase in exports of goods than imports of goods. Over the same period, the services surplus widened, as surplus from trade in transport services increased visibly. The combined goods and services account registered a surplus of $138 billion in 2021, compared to the surplus of $51 billion in 2020.

Domestic Demand

Domestic demand was recovering in 2021. Private consumption expenditure rose appreciably by 5.4 per cent in real terms in 2021, after the steepest ever annual decline of 10.5 per cent in 2020 *(chart 7)*. Consumption-related activities revived steadily alongside the receding local epidemic and improving labour market situation. The roll-out of the Consumption Voucher Scheme rendered further support in the second half of the year. Yet, outbound tourism remained severely hindered amid the evolving global pandemic. Meanwhile, government consumption expenditure rose 4.6 per cent in real terms in 2021, further to the 7.9 per cent increase in 2020.

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



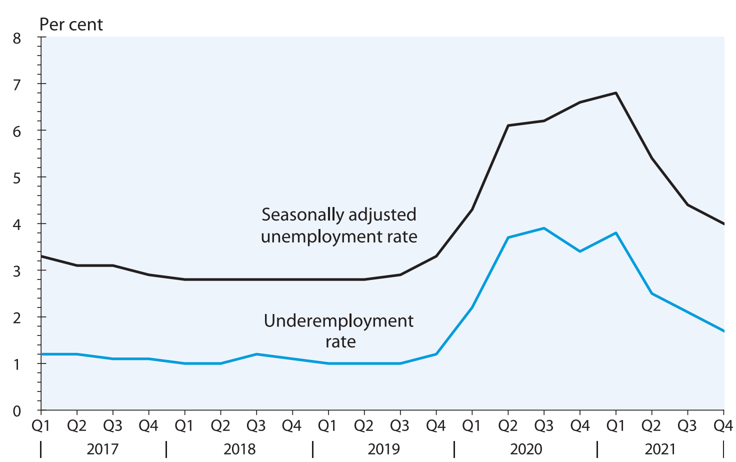
Private consumption expenditure rose appreciably in 2021.
Overall investment spending saw a visible increase.

Overall investment spending in terms of gross domestic fixed capital formation bounced back by 9.8 per cent in real terms in 2021 after an 11.5 per cent decline in 2020. Expenditure on acquisitions of machinery, equipment and intellectual property products surged 16.8 per cent, as business outlook improved during the year amid the stabilised local epidemic situation and global economic recovery. Meanwhile, expenditure on building and construction expenditure recorded a mild increase of 0.7 per cent, with the increase in public sector spending more than offsetting the slight decline in private sector spending. Separately, the costs of ownership transfer rebounded sharply in 2021, underpinned by visibly higher volumes of both residential and non-residential property transactions compared with the preceding year.

Labour Market

The labour market was under notable pressure in early 2021, but improved continuously through the year amid the sustained economic recovery and stable local epidemic situation. The seasonally adjusted unemployment rate reached a 17-year high of 7.2 per cent in December 2020 to February 2021, and then fell to 6.8 per cent in the first quarter of 2021, 5.4 per cent in the second quarter, 4.4 per cent in the third quarter and 4.0 per cent in the fourth quarter *(chart 8)*. The underemployment rate also went down from a high of 3.9 per cent to 1.7 per cent over the same period. The unemployment rates of all major sectors declined visibly in the fourth quarter of 2021 from the high levels in early 2021, particularly in retail, accommodation and food services, construction, transportation, education, and arts, entertainment and recreation.

Chart 8 **Unemployment and Underemployment Rates**



The labour market was under notable pressure in early 2021, but improved continuously through the year.

The total labour force continued to trend downwards during 2021 amid population ageing. At 3,850,300 in the fourth quarter of 2021, it was 1.3 per cent lower than a year ago *(chart 9)* or 3.6 per cent lower than the pre-recession level in the second quarter of 2019. On the other hand, total employment increased successively from its low in early 2021 amid the strengthening in labour demand. It reached 3,705,100 in the fourth quarter of 2021, which was 2.3 per cent higher than the low in December 2020 to February 2021 or 1.3 per cent higher year-on-year, though still 4.5 per cent lower than the pre-recession level in the second quarter of 2019. This phenomenon was also reflected in data collected from private-sector establishments, which showed that total private-sector employment increased successively after reaching a low in December 2020. In December 2021, it increased by 1.3 per cent over a year earlier, though it was still 4.9 per cent lower than the pre-recession level in June 2019.

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

Both total labour force and total employment declined further for 2021 as a whole, but total employment turned to year-on-year increases in the second quarter and the second half of the year.

In December 2021, employment in most individual sectors was higher than the respective low levels a year earlier, more notably for manual workers at construction sites, employment in accommodation and food services, and real estate, though employment in some sectors was still below pre-recession levels. Meanwhile, the number of private-sector vacancies increased successively during 2021 to 60,980 in December 2021, which was 74 per cent higher than a year earlier, though still 17 per cent lower than the pre-recession level in June 2019. The ratio of job vacancies per 100 job-seekers also rebounded from the low of 14 in December 2020 to 42 in December 2021, though it was still lower than the pre-recession level of 64 in June 2019.

Nominal wages and labour earnings on average showed accelerated year-on-year increases in the second quarter and the second half of 2021, reversing the general trend of decelerated growth in the past two years or so. Labour earnings, as measured by the nominal index of payroll per person engaged for all selected industry sections, increased 0.7 per cent in the first quarter, the slowest in over 11 years. It then showed accelerated increases of 1.1 per cent in the second quarter and 1.3 per cent in the second half of the year. For 2021 as a whole, labour earnings rose 1.0 per cent, as compared with the gain of 2.4 per cent in the preceding year.

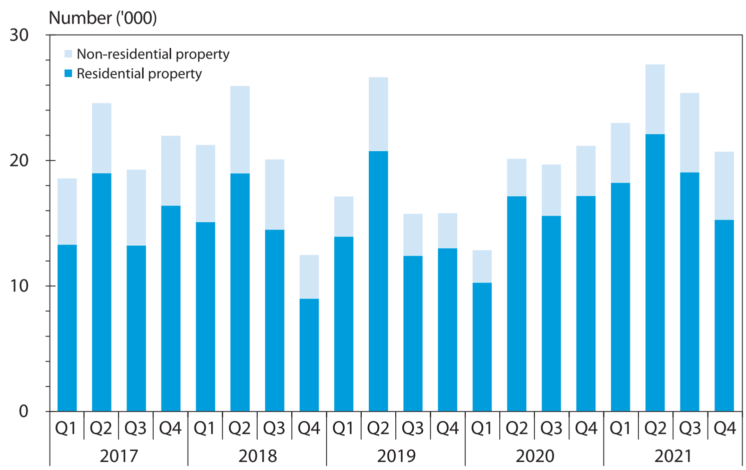
Separately, as the employment situation improved, the median monthly household income (excluding foreign domestic helpers) rebounded during 2021 from the low levels earlier, and showed a year-on-year increase of 7.3 per cent in nominal terms in the fourth quarter. Yet, for the year as whole, it still recorded a modest decrease of 0.2 per cent from 2020 to $27,100 in 2021.

Property Market

The residential property market was generally active in 2021, though turned quieter in the latter part of the year. While the low interest rate environment, firm end-user demand and local economic recovery continued to provide support in the first half, sentiment weakened thereafter amid the local stock market correction and growing concerns over possible interest rate hikes in the US. Flat prices rose for the year as a whole, notwithstanding a slight decline after reaching a peak in September.

For 2021 as a whole, the total number of sale and purchase agreements for residential property received by the Land Registry surged 24 per cent to 74,300, the highest since 2012, and was well above the five-year average of 58,600 from 2016 to 2020 *(chart 10)*. Total consideration soared 34 per cent to $733.9 billion.

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



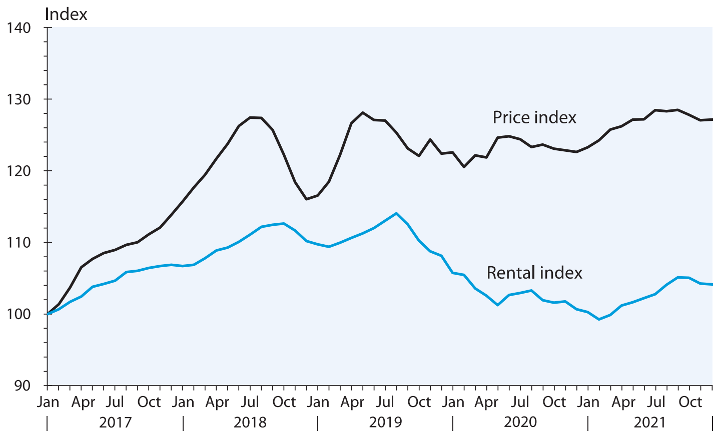
Trading activities in 2021 reached the highest level since 2012, though turned quieter in the latter part of the year.

Flat prices in December 2021 on average were 4 per cent higher than in December 2020. Following an increase of 5 per cent during the first three quarters, flat prices on average declined slightly by 1 per cent during the fourth quarter. Analysed by size, comparing December 2021 with December 2020, prices of small and medium-sized flats and large flats rose 4 per cent and 2 per cent respectively. Flat rentals have revived since the second quarter of

2021 after six consecutive quarters of decline, but weakened again during the fourth quarter. Flat rentals in December 2021 on average were 3 per cent higher than in December 2020, but still 9 per cent below the peak in August 2019. Analysed by size, rentals of small and medium-sized flats and large flats both rose 3 per cent during the year *(chart 11)*.

Chart 11 **Prices and Rentals of Residential Property**

(Jan 2017=100)



Flat prices and rentals rose for 2021 as a whole, notwithstanding a slight decline during the fourth quarter.

The index of home purchase affordability[2] remained elevated at around 72 per cent in the fourth quarter, significantly above the long-term average of 47 per cent over 2001-2020[3]. Should interest rates rise three percentage points to a level closer to the historical standards, the ratio would soar to 95 per cent.

Reflecting the government's sustained efforts in raising land supply, the total supply of first-hand 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 rise to a high level of 98,000 units as estimated at end-2021. The demand-supply balance of private flats remained tight during 2021. The vacancy rate edged down from 4.3 per cent at end-2020 to 4.1 per cent at end-2021, below the long-term average of 4.8 per cent over 2001-2020.

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

3 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. Figures may be subject to revision.

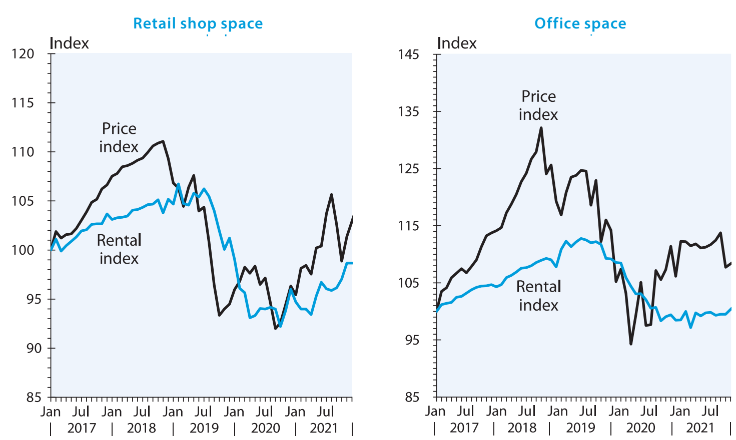
The government has implemented a number of demand-side management and macro-prudential measures during 2009 to 2017 to dampen speculative, investment and non-local demand, and to reduce the possible risks to financial stability arising from an exuberant property market. These measures have yielded notable results.

The commercial and industrial property markets improved in 2021 from the weakness in the preceding year or so alongside the local economic recovery and the abolition of the Doubled ad valorem Stamp Duty on non-residential property transactions. Trading activities for all major market segments rebounded sharply. For 2021 as a whole, the number of sale and purchase agreements for non-residential property surged 62 per cent to 21,800, while total consideration jumped 129 per cent to $183.9 billion.

While prices and rentals of office space remained relatively soft, those of retail shop space and flatted factory space saw moderate increases. Sale prices and rentals of retail shop space increased 7 per cent and 3 per cent respectively between December 2020 and December 2021. Prices and rentals in December 2021 were still 7 per cent and 8 per cent lower than their respective peaks in 2018 and 2019. For office space, prices on average declined 3 per cent between December 2020 and December 2021, as the 1 per cent increase in prices of grade A office space was more than offset by the respective declines of 3 per cent and 4 per cent in prices of grade B and C office space. Office rentals on average edged up 1 per cent, with rentals of grade A office space retreating 1 per cent, and those of grade B and C office space going up 3 per cent and 2 per cent respectively. Compared with the respective peaks in 2018 and 2019, office prices and rentals on average in December 2021 have plummeted 18 per cent and 11 per cent respectively *(chart 12)*. Prices and rentals of flatted factory space rose 9 per cent and 6 per cent respectively between December 2020 and December 2021. Prices of flatted factory space in December 2021 were 4 per cent lower than the peak in June 2019, while rentals were at similar levels as the earlier peak in August 2019.

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

(Jan 2017=100)



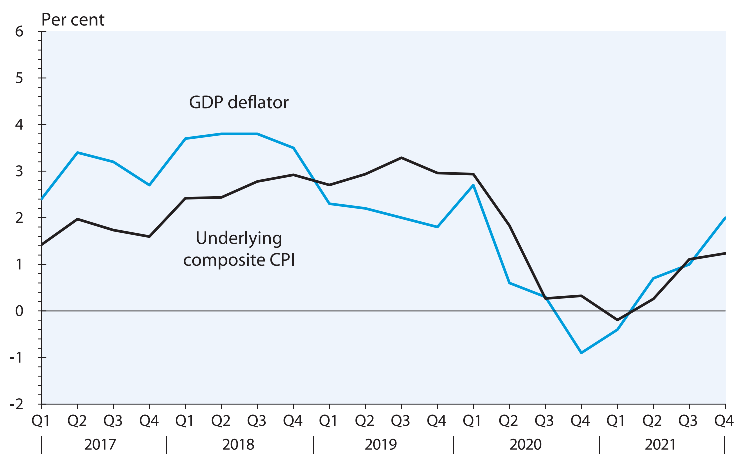
Prices and rentals of retail shop space saw moderate increases during 2021, while those of office space remained relatively soft.

As to demand-supply balance, the vacancy rate of retail shop space declined from 11.4 per cent at end-2020 to 10.2 per cent at end-2021, and that of flatted factory space from 6.4 per cent to 5.7 per cent. The vacancy rate of office space rose from 11.5 per cent to 12.3 per cent. The respective long-term averages for the vacancy rates of these three types of non-residential property over 2001-2020 were 9.0 per cent, 7.0 per cent and 9.2 per cent.

Price Movements

Underlying consumer price inflation went up modestly over the course of 2021 alongside the economic recovery and higher import prices. Prices of some consumption items saw accelerated increases in the second half of the year, while the low bases of comparison for transport and meals out and takeaway food also contributed. Offsetting these developments were the softening of the private housing rental component and modest increase in basic food prices. Netting out the effects of the government's one-off relief measures, underlying consumer price inflation averaged 0.6 per cent in 2021, down from 1.3 per cent in 2020. Quarterly figures, though sometimes distorted by temporary factors, showed that underlying inflation turned from -0.2 per cent in the first quarter to 0.3 per cent in the second quarter and went up further to 1.1 per cent and 1.2 per cent in the third and fourth quarters respectively *(chart 13)*. In contrast, headline consumer price inflation rose from 0.3 per cent in 2020 to 1.6 per cent in 2021, mainly reflecting the low base of comparison caused by the government's more sizeable one-off relief measures in 2020 as compared with 2021.

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



Underlying consumer price inflation went up modestly over the course of 2021.

Domestically, among the underlying consumer price index components, private housing rentals recorded decline through the year as the earlier retreat in fresh-letting residential rentals continued to feed through. On business costs, wage growth remained modest, while commercial rentals stayed soft. External price pressures increased visibly in 2021 under the combined effects of higher inflation in some major economies amid supply bottlenecks and strong demand revival, as well as the surges in shipping costs and international commodity and energy prices. Against this background, prices of overall merchandise imports rose visibly, particularly so in the second half of the year.

GDP deflator rose by 0.9 per cent in 2021, following an increase of 0.6 per cent in 2020. Within the GDP deflator, the terms of trade improved as export prices rose faster than import prices. Taking out the external trade components, the domestic demand deflator declined 0.2 per cent in 2021.

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 2020-21, government revenue was $564.2 billion and expenditure was $816 billion, resulting in a deficit of $232.5 billion after receipt of net proceeds of $19.3 billion from bonds issued under the Government Green Bond Programme. Fiscal reserves at 31 March 2021 stood at $927.8 billion, equivalent to 14 months of government expenditure.

Public expenditure comprises government expenditure and expenditure by the Housing Authority and trading funds. In 2020-21, public expenditure increased 32.9 per cent against the previous year to $854.3 billion, of which $488.6 billion, or 57.2 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. Starting from the 2021-22 financial year, the cumulative investment returns will be brought back to and reflected in the Operating Account of the Government on a progressive basis.

Some $27.3 billion was allocated from the Future Fund for investment in Cathay Pacific Airways Limited in 2020. The investment will remain part of the Future Fund.

The government also deployed 10 per cent of the Future Fund to set up the Hong Kong Growth Portfolio which will invest in projects with a Hong Kong nexus, aiming to reinforce the city's status as a financial, commercial and innovation centre and to raise productivity and competitiveness in the long run, while seeking reasonable risk-adjusted returns.

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 (24 per cent), land premium (15.7 per cent), stamp duties (15.8 per cent) and salaries tax (13.3 per cent).

The Inland Revenue Department collects 58.6 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 39.1 per cent of total government revenue in 2020-21.

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. The two-tiered profits tax rates regime has been implemented since the 2018-19 year of assessment, 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 2020-21, the profits tax collected was about $135.5 billion, making up 24 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 2020-21, 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 $75 billion, or 13.3 per cent, of total government revenue in 2020-21. Because of generous personal allowances under the tax law, only 1.91 million people, or 50 per cent of the workforce, were liable to salaries tax for the 2019-20 year of assessment.

Owners of land and buildings are charged property tax at the standard rate, of 15 per cent in 2020-21, 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 about $4 billion, or 0.7 per cent, of total government revenue in 2020-21.

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 2020-21, the revenue from stamp duties was some $89 billion, or 15.8 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 2020-21 totalled about $20.9 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 2021-22). 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 2021, with rateable values reflecting rental values on 1 October 2020. The revenue from rates in 2020-21 was around $19 billion, or 3.4 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 around 2 million assessments in the Government Rent Roll on 1 April 2021. Total government rent collected in 2020-21 was around $12.8 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 $11.9 billion in 2020-21, or 2.1 per cent of total government revenue, of which 64.3 per cent was from tobacco, 30.9 per cent was from hydrocarbon oil, 4.7 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 $6.6 billion in 2020-21, 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 $10.5 billion, or 1.9 per cent of total revenue, in 2020-21. Government-operated public utilities generated about $3.5 billion, or 0.6 per cent of total revenue, the most important of which, in revenue terms, is the provision of water supplies.

Land transactions generated some $88.7 billion, or 15.7 per cent of total government revenue, in 2020-21. 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-2021 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 is committed to implementing the base erosion and profit shifting 2.0 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 2021, the department procured goods and related services amounting to $4.56 billion from 23 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