



**COUNCIL OF
THE EUROPEAN UNION**

Brussels, 19 June 2013

11155/13

**COASI 91
ASIE 24
RELEX 536
COMEM 160
COLAT 19
COEST 149
DEVGEM 154
PE 297
CADREFIN 148
PESC 729
CODEC 1514
PARLNAT 143**

COVER NOTE

from: Secretary-General of the European Commission,
signed by Mr Jordi AYET PUIGARNAU, Director

date of receipt: 18 June 2013

to: Mr Uwe CORSEPIUS, Secretary-General of the Council of the European
Union

No Cion doc.: JOIN(2013) 13 final

Subject: Joint Report to the European Parliament and the Council
Hong Kong Special Administrative Region: Annual Report 2012

Delegations will find attached Commission document JOIN(2013) 13 final.

Encl.: JOIN(2013) 13 final



HIGH REPRESENTATIVE OF
THE EUROPEAN UNION
FOR FOREIGN AFFAIRS
AND SECURITY POLICY

Brussels, 17.6.2013
JOIN(2013) 13 final

JOINT REPORT TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

Hong Kong Special Administrative Region: Annual Report 2012

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Hong Kong Special Administrative Region: Annual Report 2012

INTRODUCTION

Since the handover of Hong Kong to the People's Republic of China in 1997, the European Union and its Member States have closely followed political and economic developments in the Hong Kong Special Administrative Region (SAR). In order to fulfil the 1997 commitment to the European Parliament, an annual report is issued on developments in Hong Kong. This is the 15th such report, covering developments in 2012.

In 2012, the principle of 'one country, two systems', enshrined in the Sino-British Declaration and the Basic Law of Hong Kong, continued to work well, as the rights and fundamental freedoms of the people of Hong Kong continued to be respected, the rule of law protected and the market economic system and business environment maintained.

Bilateral relations between the EU and Hong Kong continued to deepen, marked by a visit to Hong Kong in July by the EU High Representative/Vice President Catherine Ashton, when she met the Chief Executive of the Hong Kong SAR Government, Chun-ying Leung.

The European Union attaches great importance to Hong Kong's stability, economic prosperity and democratic development. The EU continues to strongly support early and substantial progress towards the goal of universal suffrage, in accordance with the Basic Law of the Hong Kong SAR and the wishes of the people of Hong Kong.

POLITICAL DEVELOPMENTS

2012 saw important political events in Hong Kong, with the election of a new Chief Executive of the Government on 25 March, the inauguration of the new Government on 1 July and the election of a new Legislative Council on 9 September. For the first time in its history, Hong Kong witnessed a change of government and of legislature in the same year.

The election of the Chief Executive was conducted through the Election Committee with members selected from business, the professions, civil society and politicians at District and Legislative Council level. For this election, the membership of the Committee had gone up from 800 to 1200 members. Three candidates for the chief executive post passed the threshold to run for office. The election campaign was livelier than ever before, with proper campaigning and intense media coverage, including two live election debates, and with a very high level of public engagement despite the limited role the public can play in the election as such.

The election campaign was characterised by some controversy, including allegations involving the main contenders. Scandals led to a shift of public opinion, which hurt the initial front runner, Henry Tang.

In the election, Chun-ying Leung received 689 votes (60.9%) of the 1132 votes cast, Henry Tang received 285 votes (25.2%) and Albert Ho received 76 votes (6.7%). The Electoral

Affairs Commission recorded 82 invalid votes, of which 75 were blank. On the occasion of the election of Chun-ying Leung as Hong Kong Special Administrative Region's fourth term Chief Executive, EU High Representative/Vice-President Catherine Ashton issued a statement congratulating the new Chief Executive and expressing her desire to further deepen EU - Hong Kong relations during his term in office. Chinese Premier Wen Jiabao appointed Chun-ying Leung as the fourth term Chief Executive on 28 March.

Chinese President Hu Jintao presided over the swearing in of the Chief Executive on 1 July, which also marked the 15th anniversary of the handover. In his inauguration speech, Chief Executive Leung pledged 'to uphold justice, the rights of the people, safeguard the rule of law, clean government, freedom and democracy which are among the core values of Hong Kong.' He also said he would 'promote the development of a democratic political system in accordance with the provisions of the Basic Law and the relevant decisions of the Standing Committee of the National People's Congress.' The EU welcomes these commitments.

For its election, the Legislative Council (LegCo) was enlarged from 60 to 70 members, with seats evenly divided between the geographical constituencies and functional constituencies. Geographical constituency seats are elected under proportional representation rules. Five additional members were elected as new geographical constituencies and five so-called 'Super Legislators' were selected from District Councillors by universal suffrage in a new District Council (second) functional constituency. This was the first time that more than half of the Legislative Council seats were elected directly, giving the current legislature more democratic legitimacy than its predecessors.

Some 287 candidates representing 17 parties or interest groups ran for the 70 seats. Voter turnout in the five geographical constituencies on 9 September was 53%, higher than in the 2008 Legislative Council election (45%) but lower than in the 2004 election (55,6%). Voting statistics revealed the following: Geographical Constituency (35 seats): 53% of 3.47m registered voted, the District Council (second) functional constituency (commonly known as the 'super seats') (5 seats): 51.9% of 3.22m registered voted and the 14 contested traditional functional constituencies (30 seats): 69.6% of 216 979 registered voted. The election process was generally seen as having been well-managed. There were media and other reports of involvement in the election campaign of the Central Government Liaison Office, through public statements and lobbying for candidates.

Pro-establishment parties won 43 seats (17 geographical, 2 super-seats and 24 functional), falling short of a two-thirds majority. Among these, the Democratic Alliance for the Betterment and Progress of Hong Kong (DAB) remained Hong Kong's biggest party in the legislature, with 13 seats in the Legislative Council. Its former chairman, Jasper Tsang Yok-sing was re-elected President of the Legislative Council. The opposition pan-democratic grouping won 27 seats (18 geographic, 3 super-seats and 6 functional) of the 70 seats in the legislature, giving it a sufficiently large minority to block constitutional changes.

The Independent Commission Against Corruption (ICAC) received 2,281 complaints relating to district council elections held in November 2011. Of those complaints, 1,614 alleged vote-rigging, with 1,604 pursuable. By November 2012, 45 persons had been prosecuted for vote-rigging offences, resulting in 38 convictions. A special taskforce set up by the ICAC concluded investigations into those vote-rigging complaints, which had not revealed evidence to suggest rampant or systematic vote-rigging. In his first policy speech to the Legislative Council, Chief Executive Leung emphasised affordable housing, poverty, the elderly and Hong Kong's ageing population and the environment as his top priorities. The Chief

Executive also said he would work towards building consensus for introducing a proposal for universal suffrage for the 2017 chief executive election. The Chief Executive's priority areas met with a very critical reaction by some Legislative Council members, who on occasion used filibustering to block decision-making. The Chief Executive also regularly came under criticism from the media, partly due to allegations of unauthorised refurbishments to his home. The Government faced major opposition to a plan, announced on 30 April under the previous administration, to introduce Moral and National Education in the school curriculum. On 7 July, a Parents' Concern Group on National Education was launched to oppose the introduction of the National Education curriculum. The Group claimed that on 29 July over 90 000 people took part in a rally urging the Government to withdraw the plan. Eventually, on 8 September the Government announced that the National Education curriculum would not be mandatory and that schools could exercise their professional discretion on whether or not to implement it. A month later the Government made a further announcement that Moral and National Education curriculum guide would be formally shelved and that the Government would not request schools to adopt the curriculum guide, nor would it use the guide as the basis for school inspection.

The maintenance of the rule of law and the independence of the judiciary continued to be a subject of public debate. The Chief Executive and the Justice Secretary stressed on many occasions its importance in protecting Hong Kong's core values and in keeping the region attractive for investment. A controversy broke out when the former Justice Secretary made a statement which, according to members of the Legislative Council and the media, called into doubt the independence of the judiciary from the Central Government. The current Justice Secretary was criticised when he suggested that the Court of Final Appeal, prior to ruling on an appeal case, should ask the National People's Congress Standing Committee to interpret the legal effect of an earlier interpretation of the Committee.

Nevertheless, the overall impression remains that the principle of judicial independence and the rule of law is supported and adhered to by all stakeholders. Foreign firms continue to cite the independence of Hong Kong's judicial system as one of the key reasons for setting up business in Hong Kong. The legal profession, including judges, lawyers and barristers, have often taken steps to safeguard and develop the quality of Hong Kong's judicial system and the rule of law in general.

The Mediation Ordinance was enacted in June 2012 and came into operation on 1 January 2013. This Ordinance provides the legislative framework for carrying out mediation in Hong Kong, with an emphasis on protecting confidentiality.

In September 2012, the China International Economic and Trade Arbitration Commission (CIETAC) established the CIETAC Hong Kong Arbitration Centre, the first branch outside the mainland. The Secretary for Justice, Mr Rimsky Yuen, stated that the presence of this centre, coupled with the Asia Office of the International Court of Arbitration of the International Chamber of Commerce, reinforced Hong Kong's status as an international arbitration centre. Hong Kong's position as a legal centre was further strengthened by the opening, in December 2012, of the Asia Pacific Regional Office of the Hague Conference on Private International Law.

On 28 March, the Hong Kong Government won its appeal against a lower court ruling which had given foreign domestic helpers the right to apply for Hong Kong permanent residency in Hong Kong after having legally resided in Hong Kong for seven years. Judges unanimously

rejected arguments that a provision of the immigration law that bars foreign domestic workers from the right to permanent residency was unconstitutional.

In 2012, Hong Kong residents continued to exercise their rights of freedom of speech and association, as illustrated by the annual 4 June and 1 July marches, the demonstrations against the National Education curriculum and in favour of gender equality, and countless rallies on many other topics.

According to the organisers, more than 180,000 people attended the 4 June candlelit vigil, the biggest event since 1989. On 1 July, hours after the inaugural ceremony presided over by President Hu, hundreds of thousands of Hong Kongers, making use of their right of expression, came to the streets to express grievances including anger at the slow pace of democratisation and Beijing's involvement in the Hong Kong political scene, concerns about Leung's integrity, rising housing prices, and human rights on the Mainland. Rally organisers put the turnout to around 400,000 people, while police said 63,000.

The great majority of demonstrations were peaceful and, as a rule, the police acted in a proportionate way. The media, including the digital media, continued to be free and to give voice to a variety of views. Nevertheless, there was a growing impression that both the print and the electronic media exercised self-censorship, especially when covering affairs concerning mainland China. An October 2012 opinion poll by Hong Kong University showed that 24% of respondents thought that press freedom was unsatisfactory.

ECONOMIC AND TRADE DEVELOPMENTS

Hong Kong remained well-established as one of the world's leading financial centres and a major trading hub in Asia. It continued to be a gateway for trade and investment with mainland China and remained the main testing ground for the internationalisation of the Chinese currency, the renminbi (RMB). Hong Kong continued to attract huge flows of foreign direct investment and was ranked highly on many of the global surveys measuring economic freedom and development¹.

Notwithstanding Hong Kong's economic achievements, the Government set out to broaden Hong Kong's economic base. In that regard, the Chief Executive announced a more 'proactive' approach to economic development, with more governmental, direct measures compared to previous governments. In particular, he announced measures to reduce poverty in Hong Kong, to support the elderly, and to ensure the availability of affordable housing for the lower- and middle-income groups.

On several occasions the new Chief Executive has emphasised the importance of economic integration with mainland China as a strategy for growth. While Hong Kong's economy benefited greatly from its privileged position within the larger Chinese market, 2012 also revealed a number of economic frictions resulting from integration. The tourism sector profited greatly from 35 million mainland visitors in 2012, but these visitors put its infrastructure under severe pressure. Mainland buyers were blamed for driving up property

¹ The World Economic Forum in its Financial Development Report 2012 ranked Hong Kong first among 62 of the world's leading financial systems and capital markets for the second consecutive year. Hong Kong is ranked the world's freest economy for the 19th consecutive year in the Heritage Foundation's Index of Economic Freedom. According to UNCTAD's World Investment Report 2012, FDI inflows to Hong Kong amounted to US\$83 billion in 2011, making it the fourth largest recipient in the world.

prices, exacerbating the overheated real estate market. The influx of expectant mainland mothers to give birth in Hong Kong put pressure on the city's healthcare system. Such problems posed political and policy challenges to the Government and led to popular expressions of anti-mainland sentiment.

In 2012, the Hong Kong economy grew by a modest 1.4%, as the weak external environment affected exports. Growth in mainland China and strong domestic demand cushioned the negative impact of the external factors. GDP growth in 2011 stood at 4.9%. Despite the lower growth rate, the economy boasted virtually full employment while inflationary pressure receded. The unemployment rate reached 3.3% in 2012. The consumer price index fell from 5.9% in the first quarter to 3.8% in the fourth quarter.

Equities came under significant pressure amid financial and economic woes in the developed economies. Investor sentiment was also affected in the run-up to the leadership transition at the Chinese Communist Party's 18th National People's Congress. Stock prices fell and trading was subdued. In the primary market, fundraising activity was also significantly quieter. The Hong Kong Stock Exchange lost its ranking as the world's largest market for initial public offerings (IPOs) for 2012, a position which it had held for the previous three years. With the support of mainland China, Hong Kong has become the largest offshore market for RMB, as part of the Central Government's policy for the gradual internationalisation of the RMB. Hong Kong hosted the largest pool of RMB deposits outside China, with total RMB deposits and outstanding RMB certificates of deposits amounting to RMB 720 billion (as of end 2012). RMB cross-border trade settlement transactions handled by banks in Hong Kong in 2012 exceeded RMB 2.6 trillion, a 37% increase as compared to 2011. At the end of 2012, outstanding RMB bonds issued in Hong Kong exceeded RMB 230 billion - a 62% increase compared to 2011. The Hong Kong offshore RMB market has built up its infrastructure and has become dominant in terms of investment product range and liquidity. While Hong Kong has a major first-mover advantage, it anticipates that competition will increase as the Central Government gradually opens up to RMB operations in other financial centres, such as London, Singapore and Taipei.

In response to the quantitative easing measures taken by the U.S. Federal Reserve, the Hong Kong Monetary Authority (HKMA) took swift action to tighten guidelines for banks on mortgage loans. It intervened repeatedly in the money markets during the year to defend the Hong Kong-US dollar Linked Exchange Rate System during the year. The HKMA stated that it had the ability to buy an unlimited amount of US dollars to maintain currency stability. Despite monetary tightening efforts, the property market continued to heat up in 2012, with significant increases in both transaction volume and prices. Overall real estate prices went up by 25% in 2012; since their low point in 2007, property prices have doubled. The sharp increase in home prices caused social tensions, making the new Government recognise the supply of affordable housing as a key policy priority.

To reduce the risk of a property bubble, the Hong Kong government adopted fiscal measures to dampen demand, particularly from speculators and non-resident buyers. On 27 October the Government proposed to increase the Special Stamp Duty and to introduce a 15% additional Buyers Stamp Duty on corporate and non-permanent-resident buyers. Upon taking office, Chief Executive Leung announced ten measures to increase the supply of land and housing in the short and medium term. The extra short-term supply in 2012 was too small to result in any significant price corrections in an extremely low interest rate environment. Further supply measures taken in 2012 are expected to reduce prices somewhat in 2013.

On the legislative side, the Competition Ordinance was adopted in June 2012, after prolonged consultation and multiple amendments. Various provisions of the law, including the establishment of a commission, will only be implemented during 2013. The Hong Kong competition law does not contain any general merger provisions, except in the telecommunications sector, and exempts a total of 570 statutory bodies.

On the external front, Hong Kong stepped up its pursuit of free trade agreements with its trading partners. Following the successive conclusion of free trade agreements with China, New Zealand and the European Free Trade Association (EFTA), Hong Kong signed a free trade agreement with Chile on 7 September 2012. Hong Kong is also seeking to join ongoing initiatives in the region in order to maintain its status as a regional trading hub, including by forging formal trade ties with ASEAN. The Government also continues to promote investment and to seek investment protection agreements with third countries to secure better protection for its businesses and to attract foreign investment. Negotiations with Russia and New Zealand are underway, and investment negotiations with Chile will start once the FTA enters into force.

The Closer Economic Partnership Arrangement (CEPA) Supplement IX between China and Hong Kong was signed on 29 June 2012 to implement economic integration measures and facilitate cooperation between the two parties. The latest supplement introduced 43 services liberalisation and trade facilitation measures, and further liberalised restrictions on market access in 21 existing sectors. The Central Government has pledged to fully liberalise services with Hong Kong by the end of 2015. However, implementation of the CEPA on the ground in mainland China continued to be challenging in some sectors, as a result of which Hong Kong-based businesses, including EU ones, did not always reap the full benefits intended under the CEPA.

EUROPEAN UNION – HONG KONG RELATIONS AND COOPERATION

In 2012, bilateral relations and cooperation between the European Union and Hong Kong continued to deepen. Hong Kong remains an important player in the region and a key conduit for trade and investment flows between the EU and mainland China.

In 2012, the EU retained its position as Hong Kong's second-largest trading partner after mainland China. Hong Kong was the EU's 20th largest trading partner in 2012. Bilateral trade between the EU and Hong Kong recorded a steady growth of 5.9% to reach €44.2 billion in 2012.

The EU was the largest source of foreign companies in Hong Kong with 453 regional headquarters, 740 regional offices and 697 local offices (as of June 2012). The EU's businesses are active in a wide variety of sectors, mainly financial and business services, trading, logistics, construction and retailing. Among others, EU companies are key players in Hong Kong's banking, insurance and securities sectors. As home to one of the biggest European business communities in Asia, Hong Kong continues to attract a large number of European citizens to reside and work in the territory, totalling around 31 390 at the end of 2012.

Hong Kong ranked seventh on the list of the most popular destinations for EU direct investment, taking up 2% of EU's global FDI stock in 2011 with an amount of €124 billion. On the other hand, Hong Kong investment into the EU grew rapidly in recent years. In terms of investment flows, Hong Kong was the fourth largest source of foreign direct investment in

the EU in 2011, after the United States, Switzerland and Canada. Direct inflows from Hong Kong to the EU and investment stock originating from Hong Kong amounted to €6.5 billion and €63.9 billion respectively.

Hong Kong continues to serve as a major hub for flows of foreign direct investment from the EU into mainland China and vice versa. The reasons for this include Hong Kong's proximity to and established business ties with mainland China, its tax system, the availability of high-quality service providers in areas such as finance, accountancy and law, and the presence in Hong Kong of an increasing number of EU and mainland Chinese companies. In addition, Hong Kong provides an ideal venue for raising capital for investment or expansion of business operations, through IPOs, secondary listings or bond issues (including RMB-denominated bonds).

The 6th Structured Dialogue meeting between the European Union and the Hong Kong SAR Government took place in Brussels on 3 December 2012. The Structured Dialogue is a well established platform that allows the EU and Hong Kong to discuss issues of mutual interest. The meeting covered a range of issues: economic relations, trade and investment, aviation, the environment, innovation and educational cooperation, financial services regulation, competition legislation, and customs matters.

The 9th Joint Customs Cooperation Committee in November 2012 launched expert collaboration on IPR and initiated Hong Kong's participation in the EU-China Smart and Secure Trade Lanes project. The EU continued to seek exploratory talks on possible cooperation in the area of taxation of savings, taking into account recent international developments in the field of exchange of information between tax authorities and the need for international level playing field.

2012 saw a number of high-level visits from the European Union institutions to the Hong Kong SAR including the High Representative/Vice-President Catherine Ashton in July, Internal Market and Services Commissioner Michel Barnier in January, and Trade Commissioner Karel De Gucht in February. A delegation from the European Economic and Social Committee visited Hong Kong in April. Regular visits by senior officials have also helped keep substantial exchanges in areas of common interest including financial services regulations, macro economic issues, consumer and health protection, and multilingualism. Delegations of Members of the European Parliament have also visited Hong Kong and helped to improve our cooperation.

The activities of the EU Business Information Programme for Hong Kong and Macao (EUBIP), which is run by the European Chamber of Commerce (ECC) in Hong Kong and co-funded by the EU, gave priority to activities related to the EU's response to the sovereign debt crisis, financial services regulations, the environment and climate change, CEPA and trade relations between the EU and Greater China. Business councils for sectors in which EU businesses and industries enjoy a leading position, e.g. information and communications technology (ICT), luxury and other consumer goods and financial services, provided important industry input to the government-to-government dialogue. The EUBIP programme was concluded in November 2012; its core activities will be taken on by the ECC, and a successor project will be launched in 2013.

To further intensify ties with Hong Kong, diplomatic missions of the EU and its Member States in the region increased their public diplomacy efforts, to make the EU more visible in Hong Kong and to increase knowledge and information on EU policies. These include trade

and regulatory policies, energy and climate change, financial services regulation, customs matters, gender equality policies, intercultural dialogue, academic matters, and the EU's role in the world.

The EU diplomatic missions also worked closely together to enhance people-to-people contacts and promote academic exchanges with joint activities such as the EU Higher Education Fair, the EU Film Festival and the Celebrating European Languages initiative.

On 1 September 2012, the Hong Kong EU Academic Programme commenced operations. This consortium comprises the Hong Kong Baptist University, the Chinese University of Hong Kong, the University of Hong Kong and Lingnan University. The objective of the Programme is to promote academic research, develop outreach activities to enhance the visibility of the EU and strengthen academic cooperation with EU higher education institutions.

Following a ferry accident on 1 October, the High Representative extended her profound condolences to the families and loved ones of the 39 victims. She took the opportunity to emphasise how much the EU valued Hong Kong as a friend and a partner.

The EU will continue to nurture its relationship with the Hong Kong SAR, increase economic and trade links, enhance cooperation with business and civil society, and promote mobility and exchanges with the Hong Kong people.