



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 20.6.2007
COM(2007) 341 final

**REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND
THE COUNCIL**

Hong Kong Special Administrative Region (SAR) : Annual Report 2006

REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

Hong Kong Special Administrative Region (SAR) : Annual Report 2006

In its Communication immediately following the handover of Hong Kong to China in 1997 (1997 COM 171), the Commission made a commitment to issue an annual report on developments in the Hong Kong Special Administrative Region. This is the ninth such report.

Hong Kong is an important partner for the EU, sharing values and interests in the economic, regulatory, educational, social and cultural spheres. Relations between the EU and Hong Kong have continued to develop across these areas since 1997 and remain practical and based on mutual interest.

Political and constitutional developments

Early in January 2006, Chief Executive Donald Tsang carried out the first major government reshuffle since he had taken office in 2005. Joseph Wong was appointed as Secretary for Commerce, Industry and Technology; John Tsang as Head of the Chief Executive's Office; and Denise Yue as Head of the Civil Service.

In July, the SAR Government released a consultation document on further development of political work within the civil service. It proposed that two new political posts, Deputy Directors of Bureau and Assistants to Directors of Bureau, should be created to assist Secretaries with political work. The consultation ending November 2006 and the government is expected to announce its decision in the first half of 2007.

In early 2006, following the Government's defeat in the Legislative Council in December 2005 on its constitutional reform proposals, relations with the pro-democracy Legislative Counsellors and political parties remained tense.

In March the Article 45 concern group formed the Civic Party, composed mainly of lawyers and academics including six members of the Legislative Council - led by Audrey Eu. This new party advocates a speedy transition to universal suffrage, social justice and the introduction of minimum wage and standard working hours.

The Democratic Party (the largest of the pro-democracy parties) was dogged by reports of infighting throughout 2006. Its leader Lee Wing Tat stepped down in December 2006 in favour of another Legislative Council member Albert Ho.

Donald Tsang's second policy address covering the remainder of his term as Chief Executive (up to 30 June 2007) was delivered to the Legislative Council in October. Notably it announced measures to address increased public concern on environmental issues. Tsang did not touch upon proposals for a goods and services tax and ruled out legislating on a minimum wage in the immediate future, drawing criticism for what was portrayed as an attempt to avoid contentious issues for the remainder of his term of office.

Commentators have been unanimous in their opinion that Donald Tsang will be re-elected as Chief Executive in elections to be held in March 2007, although as of December 2006 he had yet to declare his candidature.

Following months of speculation, Anson Chan announced in September that she would not stand for election for the post of Chief Executive. The democratic parties eventually agreed on

a single common candidate, Alan Leong, a barrister and Legislative Council member for the Civic Party.

On 10 December in the election for the 800-member Chief Executive nomination committee, 134 pro-democrats obtained seats – above the required minimum of 100 nominations to successfully nominate a candidate for the Chief Executive elections, and making it likely that Leong will be nominated as a candidate.

2006 has seen no substantive progress towards the establishment of universal suffrage, though there has been sustained and prominent debate, and this has widely reflected in media coverage.

The proposals put forward by the SAR Government at the end of 2005 did not have sufficient support for approval by the Legislative Council. This had suggested a limited expansion of the Legislative Council and the election committee for the election of the Chief Executive. Following this setback, Donald Tsang made clear that the SAR Government would not make further proposals for constitutional reform before Legislative Council elections in 2008, resulting in a suspension of any formal dialogue throughout 2006. The Commission on Strategic Development is expected to publish a new report early in 2007 mapping out options and possible modus operandi for wider suffrage.

But public debate has continued. Politicians such as former Chief Secretary Anson Chan, former Secretary for Security Regina Ip as well as Hong Kong's Catholic Cardinal Joseph Zen have joined the public debate on political developments calling for universal suffrage – many mentioning the 2012 Chief Executive elections as a deadline. The pro-democracy political parties including the pro-democracy camp in LegCo now call for full universal suffrage for the direct election of the Chief Executive in 2012. During 2006, independent opinion polls continued to show around 60% of Hong Kong people supporting and seeking further progress towards democracy and universal suffrage.

On 31 March 2006, the United Nations Human Rights Committee issued its concluding observations on the second report of the Hong Kong SAR in the light of the International Covenant on Civil and Political Rights (ICCPR). It said all necessary measures should be taken whereby the Legislative Council is elected by universal and equal suffrage and asked the Hong Kong SAR to submit within one year information on the follow-up given to the Committee's recommendations.

The European Union supports democracy throughout the world as the best means of creating legitimate, stable, accountable and transparent government, protecting rights and freedoms, and upholding the rule of law. The EU supports early and substantial progress towards the ultimate goal of universal suffrage in Hong Kong as set out in the Basic Law and in line with the wishes of the people of Hong Kong. The Commission has commented at length on Hong Kong's constitutional development and interpretations by the National People's Congress of the SAR's Basic Law in previous annual reports – especially those for 2004 and 2005.

There have been indications of the interests of the Chinese Government in Beijing in this debate, and as a corollary, pressure on the SAR Government. The Chinese leadership have called for constructive debate to reach a consensus on the SAR's democratic development in accordance with the Basic Law.

However the Commission recognises that in general the 'one country, two systems' principle has been respected and is working well for the people of Hong Kong. The EU supports this principle, and in particular the respect for human rights and individual freedoms enshrined in the Basic Law, which should be enjoyed by the citizens of the Hong Kong SAR. It is important that the SAR government continues to enjoy a high degree of autonomy in

economic, trade, fiscal, financial and regulatory matters, and the people of Hong Kong benefit from their own legal systems, an independent rule of law, individual property rights, freedom of speech, and market economic systems.

Economic developments, Trade and Sectoral Issues

The Hong Kong economy continued to grow briskly for the first three quarters of 2006: the Mainland economy provided sustained growth momentum for the goods and services sectors; overall investment spending remained solid; the property market remained stable; and the labour market improved, with unemployment falling to the lowest level in five years. In tandem with strong domestic demand, there was evidence of consumer price inflation.

Hong Kong economic indicators:

	GDP growth	Inflation rate	Unemployment rate	Services as % share of GDP
2005	7.3%	1%	5.6%	90.6%
2006 (Q1-Q3)	6.8%	2.3%	4.7%	N/A

Among the various economic sectors, financial services, import and export trade and transport services were the most dynamic elements of the economy in 2006. Hong Kong maintained its position as a regional hub for finance, trading, logistics and transport services. Hong Kong also scored very highly in a number of international surveys conducted by the world's rating institutions as having a business-friendly environment.

The strong performance of the financial sector, particularly the stock market, was driven by huge levels of liquidity in the region. Capital market activities related to Mainland Chinese enterprises flourished. Hong Kong successfully listed a number of large Chinese enterprises in 2006, including the world's largest ever Initial Public Offering of shares for the Industrial and Commercial Bank of China. The total funds raised during the year reached a record high, and put Hong Kong in volume terms at a competitive level with London and New York. Reflecting the robust market outlook, the Hang Seng Index and the trading volume of the Hong Kong's stock market both reached historic highs during 2006.

Hong Kong's capital market continues to play a key role in financing the reform of China's state-owned enterprises, expansion of private enterprises, and its massive infrastructure development programme. Favourable provisions under CEPA have provided easier access for Hong Kong banking and finance service providers in Mainland China. At the end of 2006 from the initial Mainland authorities' policy declarations it appeared that China is prepared to enhance Hong Kong's leadership even more fully as an international financial centre for China – by, for example, including Hong Kong in possible measures for extending and liberalising of the markets for Yuan Renminbi-denominated financial instruments.

The trade interests of Hong Kong and China, in particular the Pearl River Delta, continue to interweave and converge. Formalised institutions have been set up to facilitate cooperation and exchange of goods, services and people between the two jurisdictions, including the successive conclusions of a Closer Economic Partnership Agreement (CEPA), the Pan Pearl River Delta Regional Cooperation Framework Agreement, and the Quality Migrant Admission Scheme. While Hong Kong needs a hinterland to support its continued growth and economic development, it is also a challenge for Hong Kong to maintain its liberal cosmopolitan outlook and free market business practices as the two economies integrate further.

On the fiscal side, the Hong Kong Government launched a consultation exercise on a broad-based goods and services tax (GST) in July 2006, attempting to broaden the narrow tax base to smooth government revenues. In view of the long term financial burden of a rapidly ageing population and the volatility of its present major revenue sources, the Hong Kong Government saw the need to introduce tax reforms to ensure a more sustainable financial base. But the GST proposal was not received favourably, by political parties, business, or the general public. In December, in the face of widespread and vocal opposition, the government suspended its GST proposal. Hong Kong is one of the few high income, developed economies which does not have a broad-based value added tax.

Bilateral trade and economic relations between the EU and Hong Kong are mature and characterised by a very limited incidence of trade irritants. Hong Kong authorities maintain frequent and regular contacts with business associations, both foreign and local, and are responsive to their concerns. The near-absence of problems at the micro level was underscored by the general praise of WTO members at Hong Kong's trade policy regime during the Trade Policy Review that took place in Geneva on 15 December.

EU-Hong Kong bilateral trade recorded strong growth in 2006. The EU became the second largest trading partner of Hong Kong in 2006, after Mainland China. The key growth items were office machines and textiles.

EU Trade with Hong Kong						
Year	EU Imports from HK (€billion)	Yearly change %	EU Exports to HK (€billion)	Yearly change %	EU trade surplus (€billion)	Total trade (€billion)
2006	14.2	33.9	21.5	5.3	7.2	35.8

Source: Eurostat

Intellectual Property Rights. The European Commission appreciates Hong Kong's sustained efforts in IPR protection. The measures of the Hong Kong Government – strengthening partnership with industry, raising awareness of the importance of IPR for the public, introducing new legislation, and increasing enforcement efforts - have led to notable improvements in IPR protection. However, the Commission considers that IPR problems have not been completely resolved in some areas. The Commission remains concerned that Hong Kong continues to allow companies to register under names identical to or closely resembling well known EU brand names, which then infringe the rights of the EU companies through operation in mainland China. The Commission is also concerned that owners of patent rights to pharmaceutical products are not adequately protected under the current system of registration.

Competition law. The European Commission welcomes the SAR Government's consideration of new comprehensive legislation on competition. The Competition Policy Review Committee concluded in its report in June that Hong Kong needed a cross-sector competition law targeting specific types of anti-competitive conduct which should be enforced by an independent Competition Commission. The Hong Kong Government has launched a public consultation exercise on this which ends in February 2007. The Commission continues to monitor developments in this area with great interest.

Civil Aviation. The Commission has proposed a dialogue with the SAR Government on the need for amending existing bilateral air services agreements between Hong Kong and EU Member States in order to bring these into conformity with Community law. The Commission has invited the SAR Government to restore, in mutual interest, legal certainty to these agreements as a matter of priority. To this effect, the Commission has proposed a "horizontal agreement" between the two sides that would provide a sound legal basis for all existing agreements. The Commission has taken note of concerns expressed by the SAR Government and welcomes its agreement to begin dialogue with the Commission.

Wine tax. The European Commission was disappointed that the Hong Kong Government did not revise downward the very high excise duty on wine in the 2006-07 fiscal year, which was maintained at 80%.

The EU Savings Taxation Directive. In 2006, the Commission expressed its interest in starting exploratory talks with the SAR Government with a view to promoting the introduction of measures equivalent to the EC Directive on taxation of savings. In line with its stated tax policy of promoting internationally accepted good governance principles as widely as possible, the Commission proposes to work with Hong Kong to improve transparency and the exchange of information, strengthening enforcement measures to prevent the avoidance or evasion of taxes, and in particular promoting application of measures equivalent to those applied within the EU on taxation of income from savings. The Commission welcomes the SAR Government's agreement to working-level exploratory dialogue on this issue.

Closer Economic Partnership Arrangement (CEPA). The first free trade agreement between Hong Kong and Mainland China that was signed in 2003 has entered into its fourth phase. Supplement III (CEPA IV) was signed on 27 June 2006. Mainland China and Hong Kong continued to cooperate to improve market access for both sides and agreed on further liberalisation measures covering both goods and services, as well as facilitation measures in the area of intellectual property protection. Effective from 1 January 2006, all products of Hong Kong origin (except for some prohibited articles) enjoy tariff free treatment for import into Mainland China upon fulfillment of the CEPA rules of origin. A total of 27 service sectors have been liberalised under CEPA since its full implementation in 2004. The free trade arrangement provides earlier and wider market access to Hong Kong service providers while some sectors even enjoy WTO plus treatment including tourism, legal services, audiovisual services, transport services and distribution services. The preferential provisions granted to the services sectors have further consolidated the position of Hong Kong as a service centre.

Environment. The priority the EU attaches to addressing climate change, air and water and other pollution are well known. The Commission believes that international cross-border co-operation in this regard is essential and to global benefit. The Commission welcomes the Hong Kong government's proposals for new environmental measures set out in the Chief Executive's policy address delivered in October 2006 – in particular the reference to and proposed application of EURO standards and guidelines. The Commission stands ready to co-operate with Hong Kong to assist and encourage the implementation of such measures, and to explore scope for trilateral co-operation with mainland China as appropriate.

EU-Hong Kong relations

The Commission adopted a Communication entitled "The European Union, Hong Kong and Macao: possibilities for cooperation 2007-2013" on 26 October¹, which was endorsed by Council Conclusions on 12 December. The Communication identified seven key sectors for moving forward cooperation: trade and customs; finance; people-to-people links (including academia); transport; the environment; health; and food safety. It also proposed that there should be a regular structured dialogue between the Commission and the Hong Kong SAR on matters under its competence.

On 21 December the Council adopted a financing instrument for co-operation with industrialized countries and other high income countries and territories, including Hong Kong. The Commission will discuss and agree with Hong Kong the elements of a co-operation programme which should begin by late 2007.

President Barroso received Hong Kong Chief Executive Donald Tsang in Brussels on 7 November. The two leaders agreed that "Hong Kong and the European Union should develop, broaden and deepen cooperation in areas of common interest". They agreed to establish a structured dialogue to maintain close contacts at all levels and ensure relations develop positively, recognising and responding to any challenges and opportunities quickly and effectively.

2006 saw a succession of high level meetings and missions between the European Commission and Hong Kong, strengthening relations.

- The EC-Hong Kong Readmission Committee met January in Hong Kong and reviewed implementation of the EC-Hong Kong Readmission Agreement.
- Commissioner for Health and Consumer Protection Markos Kyprianou led a large mission to Hong Kong for discussions on preparedness for a possible pandemic outbreak and visiting Hong Kong's health facilities.
- Director General for Economic and Financial Affairs Klaus Regling, and Member of the European Central Bank Executive Board Jose Manuel Gonzalez-Paramo led a major conference in Hong Kong on "The EURO: Lessons for European and Asian Financial Markets" jointly with Mr. Joseph Yam, Chief Executive of the Hong Kong Monetary Authority in February.
- Commissioner for the Internal Market Charlie McCreevy visited in May for meetings with the Secretary for Financial Services and the Treasury Frederick Ma, and with the top officials of the Hong Kong Securities and Futures Commission, Hong Kong Monetary Authority and Hong Stock Exchange
- Commissioner for Information Society and Media Viviane Reding visited in December to participate in the International Telecommunications Union Telecom World 2006 conference in Hong Kong.

The European Commission Office in Hong Kong was established in 1993, and sixteen European Union member states maintain full-time local diplomatic missions accredited to, and managing relations with Hong Kong (that of Portugal is located in nearby Macao). According to Hong Kong government statistics, as at August 2006 there were some 37,000 European Union citizens residing in Hong Kong.

¹ "The European Union, Hong Kong and Macao: possibilities for co-operation 2007-2013". Communication from the Commission to the Council and the European Parliament. COM(2006) 648 final of 26.10.2006.

The EU's public diplomacy was reinforced in Hong Kong in 2006. Throughout the year, the European Commission Office in Hong Kong has undertaken an active and expanded information and public diplomacy programme projecting through Hong Kong media and society the EU's values and policies in the economic, regulatory, social, educational and cultural spheres. In addition, to discuss and explore these matters and possibly develop and broaden future cooperation between the EU and Hong Kong in areas of mutual interest, eight consultative seminars were held in Hong Kong during 2006 by the Hong Kong Office of the European Commission involving over 200 representatives of various sectors of Hong Kong society: education and research, environment, health, food and product safety, trade, economics and finance, European chambers of commerce, and the Hong Kong-based EU business community and exporters to the EU market, as well as seminars for EU member state Heads of Mission and Trade Commissioners in Hong Kong.