REPORT FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

ANNUAL REPORT HONG KONG 2008
Executive summary

11 years after the handover, implementation of the “one country/two systems” concept continues to be satisfactory, upholding Hong Kong’s way of life, the rule of law and fundamental freedoms. In 2008 cooperation with the EU, fostered by a mutually pragmatic approach, progressed well, further reinforced by the EU Business Information Program. After a decline in the late 1990’s, Hong Kong’s economy was revived notably through China providing a boost to local tourism and giving Hong Kong privileged access to the mainland’s markets. The economy is now severely affected by the global financial crisis which hit the service sector very hard. The pace of reforms preparing for the introduction of universal suffrage for the designation of the Chief Executive in 2017 and the legislators in 2020 remains a cause for concern.

Introduction

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

Eleven years have now passed since Hong Kong became a Special Administrative Region of the People's Republic of China (SAR), based on the concept of “one country, two systems”, as established in the Sino-British Declaration and the Basic Law of Hong Kong. The Basic Law, which took effect on the 1st July 1997, guarantees Hong Kong's market economy system, business environment, protection of the rule of law and fundamental rights and freedoms for the next 50 years. Over these eleven years, this principle has worked well.

Hong Kong is an important partner for the European Union, sharing values and interests in the economic, trade, regulatory, social and cultural areas. Relations between the EU and Hong Kong have continued to develop across these areas since 1997. EU-Hong Kong relations have widened over the past year and new areas of cooperation have been opened in fields such as the environment, aviation, competition and education. The EU has a strong interest in the continued autonomy and freedoms enjoyed by Hong Kong people and supports steps for an early and substantial progress towards universal suffrage, as envisaged in the Basic Law.

Economic developments

Hong Kong, as an open economy and an international financial centre, increasingly integrated with the economy of Mainland China and dependent on exports to the US and EU markets, could not avoid the impact of the global financial and economic crisis. Its economy experienced a rapid deceleration in 2008, though it managed to attain good growth of around 5.7% in the first half of the year. The Hong Kong stock market experienced massive fluctuations along with it. Inflationary pressure eased towards the end of the year, with the Consumer Price Index at 3.1% in November (from over 6% in mid-2008). Fiscal reserves remained strong and have enabled the government to launch more fiscal stimulus measures to cope with the crisis.
As underlined by the Chief Executive Donald Tsang in his October Policy Address, Hong Kong's challenges are to cope with the severe external financial environment and to reinforce Hong Kong as an international financial centre. Hong Kong reacted to the financial crisis with measures to enhance the regulatory framework, provide liquidity to the financial system and guarantee all bank deposits. However, credit tightening has exacerbated the difficulties of many highly-leveraged companies, especially small and medium-sized enterprises (SMEs) and cross-border manufacturers in the Pearl River Delta, where the operating environment has become difficult due to rising production costs and weakened external demand. Funding schemes to assist them have been provided by the Hong Kong SAR government.

The Hong Kong SAR government has identified four sectors of the economy which are particularly vulnerable to the global financial crisis – financial services, trade and logistics, tourism and consumption-related services, and real estate and construction. The Taskforce on Economic Challenges chaired by the Chief Executive will formulate specific options for the government and business community to address these challenges. However, as the effects of the financial crisis continue to spread, corporate streamlining and large-scale layoffs are making unemployment one of the biggest challenges for Hong Kong.

Premier Wen Jiabao reiterated in October 2008 that China would assist Hong Kong in coming out the global financial crisis and laid down detailed directions of the support measures – working with Hong Kong financial regulators on contingency plans, implementing fast track infrastructure projects, in particular the Hong Kong-Macao-Zhuhai Bridge, extending the individual travellers scheme, providing support to SMEs and guaranteeing stable supplies of food to ease inflation.

Hong Kong continues to pursue closer integration with Mainland China regarding flows of people, knowledge, services and resources, notably through the Closer Economic Partnership Arrangement (CEPA). Hong Kong and Mainland China signed the main text of their first free trade agreement (CEPA I) in 2003. After five rounds of supplements, CEPA has become a substantially “WTO-plus” trade agreement on services liberalisation. Hong Kong-based EU service suppliers are benefitting from preferential market access to the Mainland market. As of mid-2008, a total of 1,232 companies were registered as Hong Kong services suppliers under CEPA, of which 144 were Hong Kong-based EU companies.

On monetary matters, Hong Kong repeated that it would maintain its peg with the US dollar, which has been in place for the past 25 years. It is also noted that the development of Renminbi (RMB) business in Hong Kong will be further expanded under Mainland China's support to help Hong Kong with the financial and economic crisis. Hong Kong will continue to be a testing ground to run pilot projects on RMB liberalisation.

EU-Hong Kong cooperation

Relations between the EU and Hong Kong have continued to grow since 1997 on the basis of shared interests and mutual concerns. Hong Kong is a strategic trading and investment partner of the EU and a platform for trade and investment intermediation between the EU and China. There is substantial and pragmatic bilateral cooperation, which has been enhanced during 2008 in new areas of mutual interest.

In 2007, the EU was Hong Kong's second largest trading partner, only after Mainland China. On the other hand, Hong Kong was the 15th largest export market for the EU in 2007. Total bilateral trade between the EU and Hong Kong amounted to €31.5 billion in 2007 and grew by 3.9% to €35.4 billion in the first nine months of 2008. As European businesses
increasingly deal directly with China, the relative importance of trade via Hong Kong has declined. EU-China trade via Hong Kong as a percentage of the total EU-China trade has fallen steadily from one-third in 2002 to around 13% in the first 8 months of 2008.

The EU was the biggest foreign investor in Hong Kong in 2006 (according to the latest available data), well ahead of the US and Japan, excluding Mainland China and British Virgin Islands. On the other hand, Hong Kong was the most popular direct investment destination for the EU in Asia. Hong Kong investment in Europe has been steadily developing, and became the second largest source of foreign direct investment from Asia after Japan.

Hong Kong has attracted a large number of European citizens residing and working in the territory, totalling 31,000 as of June 2008 (Hong Kong Immigration official figures). This represents the biggest concentration of EU citizens in Asia and thus continues to be a motivating factor for the EU's involvement in Hong Kong. The EU's business presence in Hong Kong continues to increase and covers a large variety of sectors, notably financial and business services, trading, retail and transportation. As of June 2008 there were 1,298 regional headquarters and 2,584 regional offices in Hong Kong representing their parent companies located outside Hong Kong. EU companies continue to be the largest investor in the territory with 1,142 regional headquarters and regional offices based in Hong Kong.

The European Commission's Communication, "The EU, Hong Kong and Macao: possibilities for cooperation 2007-2013", remains the guiding policy framework for the European Union's relations with Hong Kong. It sets a number of challenging objectives to move EU-Hong Kong relations forward by deepening and broadening cooperation in seven key areas: trade and customs, finance, people to people links, transport, the environment, health and food safety.

The implementation of the agreed policy and regulatory cooperation measures in the seven sectors should now be further reinforced with the recently-launched "European Union Business Information Programme" for Hong Kong and Macao (EUBIP) that will run a programme of content driven events until 2011. EUBIP will serve as a vehicle to promote better understanding and share knowledge between Hong Kong and the European Union with a range of bilateral cooperation activities in areas such as trade and investment, financial services, transport and logistics, the environment, health, food and product safety. A call for proposals was launched in August 2008 and the contract was awarded to a consortium formed by the European Chamber of Commerce in Hong Kong, Macao Trade and Investment Promotion Institute, and the Institute of European Studies of Macau. EUBIP is expected to be fully operational in early 2009.

The second EU-Hong Kong Structured Dialogue was held in Brussels on 11 December, moving forward bilateral dialogue and cooperation in the fields of trade, standards, intellectual property protection, investment, customs, competition, food safety, aviation, the environment, education and culture. Research is a possible area of cooperation and Hong Kong organisations can participate in the ICT/FP7 programme.

The Structured Dialogue has become an effective high-level platform for officials from both sides to discuss issues of common interest. This year's meeting devoted substantial discussions to the global financial crisis and both sides appreciated the response by their respective governments. Both sides agreed to enhance bilateral cooperation through the EU Business Information Programme, the Hong Kong/Macao Seminar package on IPR and standardisation issues as well as initiatives on environment, creative industries and people to people exchanges.
Several bilateral high-level visits during 2008 have contributed to enhancing EU-Hong Kong relations and push forward cooperation initiatives. Commissioner Kovacs visited Hong Kong in January with a view to deepen customs cooperation and initiated an exploratory dialogue with the Hong Kong SAR government on the issue of EU Savings Taxation Directive. In June, Commissioner Kuneva came to Hong Kong to address the business community on EU policies on the global governance of product safety. There were also numerous visits by Commission officials to Hong Kong to explore cooperation in policy areas such as the environment, economic affairs, information and communications technology and trade. In April, the Chief Secretary, Mr Henry Tang, visited Brussels and met with Commissioner Mandelson. He called for closer ties between the EU and Hong Kong.

The environment is one of the key areas for enhancing EU-Hong Kong cooperation. The Commission welcomes the Hong Kong SAR government's increased interest in climate change and policy direction for a low carbon economy and that, in spite of the global financial crisis, Hong Kong's commitments to environmental protection remain unchanged. Hong Kong sees itself as having a regional role to play, especially in influencing its neighbouring province, Guangdong, in setting policy initiatives and is keen to cooperate with Mainland China to improve air quality within the region. In this regard, the EU is looking forward to stepping up cooperation initiatives with Hong Kong to protect the environment and cooperate in the global climate change agenda. With the largest financial expertise in Asia, a well regulated market and a good arbitration system, Hong Kong is also a serious candidate to become a regional trading platform for innovative green financial products, possibly benefitting from EU's experience in carbon trading with the European Trading System (ETS).

The Commission has also actively contributed to Hong Kong's consultation process on the competition bill that will be submitted to the Legislative Council in the 2008-09 legislative session. The Commission welcomes the commitment of the Hong Kong government to enact a cross-sector competition law which will help ensure a level-playing field and enhance the competitiveness of Hong Kong in the long run. In addition, the Commission welcomes future exchanges and cooperation on its implementation.

In view of strong EU–Hong Kong relations in the field of aviation, including bilateral agreements with most EU Member States, the Commission has proposed to initiate contacts with Hong Kong for a horizontal air services agreement, which would give legal certainty to the existing bilateral agreements by including a Community Designation Clause. Following exchanges between EU and Hong Kong experts in 2008, a high-level meeting is foreseen for March 2009.

EU public diplomacy in Hong Kong was a key priority in 2008, with a view to adding value to EU Member States' public diplomacy efforts in Hong Kong. Hong Kong is a centre of free press and free speech in the region, a leading media hub and a gateway for Mainland China. The Commission's efforts have been therefore concentrated on making the EU more visible in Hong Kong and on delivering prompt and substantial information on EU trade and regulatory policies, energy and climate change, intercultural dialogue and the EU's role in the world.

**Political developments**

In accordance with its 1997 commitment to the European Parliament, the Commission continued to monitor closely Hong Kong's institutional and societal developments during 2008. One of these is Hong Kong's democratic development and its process towards universal suffrage as set out in the Basic Law of the Hong Kong Special Administrative Region.
2008 started with a clear commitment by the SAR government to the implementation of universal suffrage and a concrete timetable to do it in time for direct elections for the Chief Executive in 2017 and for the Legislative Council in 2020, following the ruling issued by the Standing Committee of the National People's Congress on 29 December 2007. The European Union has consistently supported early and substantial progress towards the ultimate goal of universal suffrage in Hong Kong. Therefore on 24 January, the EU expressed its disappointment that the possibility of universal suffrage for 2012 had been ruled out when the majority of Hong Kong's people are supportive of early and greater democracy, as recognised by the Hong Kong SAR government in December 2007. We have always believed that early progress towards universal suffrage in Hong Kong in accordance with the Basic Law would be in the best interests of both Hong Kong and China. We therefore hope that all parties concerned will work towards establishing concrete proposals on wider suffrage for the 2012 Chief Executive and Legislative Council elections, which will advance Hong Kong towards full universal suffrage.

The SAR government has said that over the next four years, the focus of discussion would be on how to amend the electoral methods for the 2012 elections for the Chief Executive and Legislative Council. In February, Chief Executive Donald Tsang appointed a 30-member task group on constitutional development to study feasible options for the 2012 elections. In his annual policy address delivered on 15 October 2008, Chief Executive Donald Tsang acknowledged that the timetable for universal suffrage as given by the Standing Committee of the National People's Congress enjoys wide support in the community. The government is expected to consult the public in the first half of 2009 on the methods for electing the Chief Executive and members of the Legislative Council in 2012.

The 2008 Legislative Council election was held on 7 September under the professional supervision of the Electoral Affairs Commission. There are 60 seats in the Legislative Council, with 30 lawmakers elected by geographical constituencies through direct elections and 30 legislative councillors elected by functional constituencies. With 142 candidates running for the geographical constituency seats, this Legislative Council election became the most competitive election in Hong Kong's history. 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 elected President of the Legislative Council. The pan-democratic camp won 23 of the 60 seats in the legislature allowing a blocking minority for constitutional changes. Its share in the directly elected geographical constituencies remained unchanged, obtaining 60% of the popular vote. However, given the nature of the electoral system, pro-government parties retain a comfortable majority in the legislature.

The elections were held in a fair and orderly manner. The overall conduct of the elections was another testament to the political maturity of the people of Hong Kong and showed that there is a sound base for swift progress towards the Basic Law’s ultimate aim of universal suffrage.

This will be an important legislative period for the Legislative Council, as it will debate the government's proposal for constitutional change, in particular its suggestion to further democratise the election process in time for 2012, which will need the support of two-thirds of this Legislative Council.

2008 also saw the expansion of the government's ministerial accountability system with the appointment by the Chief Executive of eight Under Secretaries and nine Political Assistants under the political appointment system to work closely with the heads of government bureaux and civil servants and to help implement the government's policies.
The Commission notes that, as in previous years, fundamental rights and freedoms, guaranteed in the Basic Law, have been protected by independent law courts and law enforcement agencies. The judiciary and the law enforcement services in Hong Kong continue to have a good track record. There were a number of judicial review cases against administrative decisions that touched on important constitutional issues in 2008. In December, the High Court ruled against the Immigration Department's procedure on reviewing torture claims filed by asylum seekers as it did not allow claimants to have legal representation with them at any stage of the review process and said it was in violation of Hong Kong’s international obligations under the United Nations Convention against Torture. In a separate judicial review case, the High Court ruled against the government's disenfranchisement which deprived all prisoners of their right to vote, regardless of their sentence. The court stressed that the ban was in contravention of a right that is constitutionally guaranteed under the Basic Law and the Hong Kong Bill of Rights. In light of these judicial review cases, Secretary for Justice Wong Yan-lung noted that Hong Kong's judiciary had provided the government with important and practical guidance in areas where the relevant legal provisions may not be free from ambiguity.

However, administrative decisions to deny foreign nationals’ entry into Hong Kong for the Olympic Torch Relay in May raised concerns as well as pending court cases for an unlicensed radio station run by pro-democracy activists. The defendants argued that Hong Kong's radio licensing regime was unconstitutional, as it granted unfettered discretion to the Chief Executive in deciding applications for a broadcaster's licence, which could undermine freedom of expression. The charges laid against them were dismissed by Magistrate Douglas Yau, based on his ruling that the licensing system breached the Basic Law's provisions on freedom of speech. That ruling was set aside by the Court of Appeal on 12 December, which ruled in favor of the Hong Kong government. The court held that a constitutional challenge to the licensing regime could not be a defence to a crime and has sent the case back to the magistrate for a re-trial.

The Commission welcomes the enactment of the Race Discrimination Bill which was passed unanimously by the Legislative Council on 10 July and which will render discrimination, harassment and vilification on the ground of race unlawful and will extend the jurisdiction of the Equal Opportunities Commission to include discrimination on racial grounds. This Bill constitutes an important step in creating a more equal society in Hong Kong. We also welcome the legislation published in 6 June 2008 to implement civil justice reforms intended to improve the cost-effectiveness of the civil procedure system and reduce complexity and delays in litigation in Hong Kong. These reforms are expected to come into effect in April 2009.

In the region, Hong Kong will seek to maintain its position as a regional centre for trade, services and the media. Hong Kong's very successful hosting of the Equestrian Olympics Games in August and the Paralympics Games in September confirms its reputation as a multicultural meeting capital in Asia, a unique place where "East meets West".

**Perspectives for the future**

Mitigating the impact of the financial crisis in the real economy will be an immediate challenge for the Hong Kong SAR government. Creating more job opportunities, boosting domestic demand and support to small and medium-sized businesses will be high on the Hong Kong SAR government's agenda while at the same time maintaining Hong Kong's role as an international finance and service centre for Asia. Chief Executive Donald Tsang said in his
policy address for 2009 that Hong Kong should look at "turning the financial crisis into an opportunity" and advocated to reinforce Hong Kong's position as an international financial centre.

The future of Hong Kong as an international financial centre is linked to its expanding economic ties with Mainland China, and in particular the Pearl River region, and its traditional connections with South East Asia, in addition to its key attributes of having a sound legal environment, rule of law, good regulatory regime and financial expertise. Hong Kong will continue to play its role in financial intermediation between Mainland China and the rest of the world.

The broad European interests in Hong Kong, as shown in this report, mean that Hong Kong will continue to be an important partner for the EU in Asia, playing a central part in the EU's relations with Mainland China. All in all, the Commission proposes to continue its effective engagement with the Hong Kong SAR government to enhance our pragmatic cooperation in order to address together global challenges such as the financial crisis, economic interdependence and environmental protection. Within the framework of the general move to improve transparency at international level as an answer to the financial crisis, the Commission and the EU Member States look forward to Hong Kong SAR willingness to establish cooperation with the EU in the area of taxation through an effective exchange of information. More emphasis should be given to increasing people-to-people contacts and exchanges that will allow Europe and Hong Kong to get to know each other better and respect the cultural diversity which is a common feature to both Hong Kong and Europe.

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. It is important that the Hong Kong SAR continues to enjoy a high degree of autonomy in economic, trade, fiscal, financial and regulatory matters. The EU is committed to Hong Kong's continued stability and prosperity. We believe that the best way to guarantee these is for Hong Kong to move towards a system for universal suffrage as envisaged in the Basic Law. Hong Kong's democratic development is important to the EU.