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EUROPEAN COMMISSION

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JOINT REPORT TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

ANNUAL REPORT HONG KONG 2010

Hong Kong Special Administrative Region: Annual Report 2010

INTRODUCTION

Since the handover of Hong Kong to Mainland China more than thirteen years ago, the European Union has closely monitored economic and political developments in the Hong Kong Special Administrative Region (SAR), in order to fulfil its 1997 commitment to the European Parliament to issue an annual report on developments in Hong Kong. This is the thirteenth such report covering developments in 2010.

During 2010, the principle of ‘one country, two systems’, as established in the Sino-British Declaration and the Basic Law of Hong Kong, has continued to work well, as the rights and fundamental freedoms of the people of Hong Kong have been respected, the rule of law protected and the market economic system and business environment maintained.

Bilateral relations and cooperation between the EU and Hong Kong have continued to move forward on a very positive track, in terms of trade, investment and dialogue on issues of common interest. The EU continued to be Hong Kong’s second largest trading partner. It is Hong Kong’s biggest source of foreign direct investment (FDI) after Mainland China and the British Virgin Islands. With one of the biggest European business communities in Asia and as a financial and economic hub for the region, Hong Kong maintains its strategic importance as a trading and investment partner for the EU.

The EU continues to strongly support early and substantial progress towards the goal of genuine universal suffrage, in accordance with the Basic Law of the Hong Kong SAR and the wishes of the people of Hong Kong.

POLITICAL DEVELOPMENTS

2010 was a crucial year for Hong Kong's constitutional development, dominated by intense political debate on electoral reform.

In June, Hong Kong took an important step forward with the approval by the Legislative Council of the Proposals for the Methods of Selecting the Chief Executive and for Forming the Legislative Council in 2012. Under this legislation, in 2012 the committee which elects the chief executive will be expanded from 800 to 1200 members and the number of seats in the Legislative Council from 60 to 70 members. The 50:50 ratio of legislative seats directly elected by the public and those elected via members of functional constituencies (as set out by the National People's Congress Standing Committee decision of 2007) remains.

Of the ten new seats added to the Legislative Council, five have been allocated to directly-elected geographical constituencies and the other five to functional constituencies. The five new functional constituency seats will be filled by directly-elected members of District Councils, which are local government bodies. This means that the 3.2 million registered voters who currently do not have the right to elect any functional constituency lawmakers will be eligible to vote for the five new functional constituency seats.

On 25 June, Chief Executive Donald Tsang said that it was "a triumph of the one country, two systems arrangements". Later in his October policy address, he stressed that Hong Kong had taken a decisive step towards universal suffrage when the 2012 constitutional package was passed by the Legislative Council, and that the community's aspiration to roll forward with constitutional development has been realised.

On 25 June 2010, the spokesperson of the EU High Representative for Foreign Affairs and Security Policy, Catherine Ashton, issued a statement which took note of the Legislative Council's approval of the 2012 electoral reforms and stressed that the EU continued to strongly support early and substantial progress towards the goal of genuine universal suffrage in accordance with the Basic Law of Hong Kong and international standards. It concluded that this was the best guarantee of stability and prosperity for the Hong Kong people.

The legislative process was difficult. The Government's proposals were initially opposed by all pan-democratic parties. By-elections were held in May triggered by the resignation in January of five pan-democratic legislators who argued that by-elections would constitute a "de facto-referendum" on the pace of democratic development. All five legislators regained their seats in a by-election with a very low (17%) turnout and the non-participation of the pro-government parties. In an effort to find a compromise that would avoid a second rejection by the legislature of the electoral reform package, mainland officials and Hong Kong pan-democratic leaders met for the first time since the Tiananmen events in 1989. The Central government accepted the Democratic Party proposal to allow all registered voters (rather than just elected district councilors) in Hong Kong to vote for the five new functional constituency seats and eventually the new proposal was approved by the legislature with the necessary two-thirds majority. The EU warmly welcomes the dialogue, which made the passage of this proposal possible.

Chief Executive Donald Tsang made clear in his October policy address that his government will not legislate on the issue of national security in accordance with Article 23 of the Basic Law during his term. Tsang said that although it was a constitutional duty, he will focus his energy on more pressing issues such as implementing legislation that will put into place the changes for electoral reform in time for 2012 and resolving livelihood issues.

Hong Kong's new Chief Justice, Geoffrey Ma, took office in September 2010 vowing to defend the rule of law in the Special Administrative Region and promising to vigorously protect the integrity of the city's courts.

Hong Kong lawmakers from across the political spectrum voiced support for jailed Chinese activist Zhao Lianhai, who organised a parents' group to seek compensation for children affected by melamine-tainted milk in the Mainland. Some of them had also signed a petition to the Supreme People's Court calling for the activist's release. A joint petition by 28 Hong Kong deputies to the National People's Congress was also presented to the Court, urging a more lenient judgement on the case. Zhao Lianhai was released on medical parole in December 2010.

23 August 2010 witnessed the tragic events that unfolded in the Philippines where a Hong Kong tourist bus was taken hostage in Manila resulting in the death of eight people from Hong Kong and others injured. The EU expressed its condolences and support to the Hong Kong people.

Ties between Hong Kong and Taiwan continued to expand in 2010 with the visit of Hong Kong Financial Secretary, John Tsang, to Taiwan in August. The Taiwan – Hong Kong Economic and Cultural Cooperation Council was established in May in Hong Kong. Both sides agreed to strengthen exchanges and cooperation on trade, finance, investment promotion and tourism.

In general terms, the EU believes that during 2010 the implementation of the "one country, two systems" principle in Hong Kong SAR remained satisfactory and the rights and freedoms of Hong Kong's people, guaranteed in the Sino-British Declaration and the Basic Law, continued to be respected.

ECONOMIC AND TRADE DEVELOPMENTS

Hong Kong's economy recovered well from the global financial crisis upon entering 2010. GDP increased by 7.1% in real terms during the first three quarters of 2010, after a 2.7% contraction in 2009. Government measures introduced during the crisis period proved able to cushion external risks and maintain confidence. The post-crisis growth was supported by the robust Mainland Chinese economy, a strong rebound in exports to the Asian markets, abundant liquidity inflows as well as rising consumer and business confidence. The labour market was stable and the unemployment rate dropped to a two-year low at 4.1% in the three months to November 2010¹. However, inflationary pressure became distinct along with the sustained economic recovery and rising import prices. Consumer price inflation for 2010 was 2.3%² and the uptrend seems likely to continue into 2011.

In 2010, Hong Kong attracted abundant inflows of international liquidity to the asset markets under a relaxed global monetary environment. Given the Hong Kong-US dollar peg, there was no possibility for the use of monetary policies to address asset price pressure. Consequently, mitigating the risk of an asset bubble became a major challenge for the Hong Kong SAR Government during 2010. Despite the negative impact of the currency link on asset price movements and inflation, Hong Kong authorities publicly reiterated their stance of maintaining the Linked Exchange Rate System (HKD-USD peg) which has been in place since 1983.

Hong Kong expanded its role in the internationalisation of the Mainland currency, the Renminbi (RMB). With the support of the Central Government, along with the financial expertise and infrastructure Hong Kong has to offer, Hong Kong has, for now, successfully positioned itself to be the leading offshore centre for RMB business and products. During 2010, China progressively relaxed its rules on RMB capital transfers, cross-border settlement, corporate bond issuances and access to its onshore inter-bond market, aiming to improve circulation of offshore RMB funds. At the same time, RMB business in Hong Kong took off in a serious and sustained manner, witnessing growing and record levels of RMB deposits, cross-border trade settlement transactions and a burgeoning of RMB-denominated financing and investment products. Hong Kong also maintained its leading position as the largest IPO market globally in 2010.

¹ Source: Hong Kong Census and Statistics Department.

² Source: Figure represents the Composite CPI growth rate for the first eleven months of 2010, Hong Kong Census and Statistics Department.

Hong Kong and China continued to forge stronger economic and trade ties through the Closer Economic Partnership Arrangement (CEPA). The seventh supplement to CEPA was signed in May 2010, under which China introduced more liberalisation measures in services to Hong Kong service suppliers, bringing the total number of liberalised service sectors under CEPA to 44. The EU continued its cooperation with the Hong Kong Government to disseminate information on CEPA to the European business community.

On regional integration, Hong Kong and the Chinese province of Guangdong took further steps to institutionalise their cooperation and exchanges through a framework agreement endorsed by the State Council of the People's Republic of China and signed on 7 April 2010. It aims to promote joint socio-economic development in Hong Kong and Guangdong and to capitalise on the competitiveness of Hong Kong's service industries and Guangdong's manufacturing industries to build an advanced global manufacturing and modern services base.

While maintaining its strong support for multilateralism in the area of trade liberalisation, Hong Kong has recently become more active in negotiating and concluding free trade agreements (FTAs). Apart from the CEPA with Mainland China, Hong Kong signed a Closer Economic Partnership Agreement with New Zealand on 29 March 2010, its first FTA with a foreign country. FTA negotiations with the European Free Trade Association (EFTA) started in January 2010 and are reported to be nearing completion. Exploratory talks were initiated by Hong Kong with Chile, Peru and Malaysia. A WTO trade policy review of Hong Kong, China was conducted in December 2010. As with previous WTO trade policy reviews, this one stated that Hong Kong remains one of the most liberal and transparent foreign investment regimes, and one of the most market-oriented and open economies globally.

Several milestone economic legislative proposals were either introduced or passed in 2010. In July, Hong Kong passed its first minimum wage law. The Legislative Council adopted the proposal of the government-appointed task group to set a minimum wage level of HK\$28 per hour (approximately €2.80). The minimum wage law will take effect on 1 May 2011.

Another milestone was the introduction of a draft competition bill. The draft bill (if adopted) would see the establishment of a Competition Commission with responsibility for investigating and prosecuting anti-competitive practices falling under the scope of the competition bill, while the current broadcasting and telecommunications authorities would enjoy concurrent jurisdiction for matters relating to either of those distinct areas. The bill would also see the establishment of a Competition Tribunal. The EU welcomes the introduction of competition law in Hong Kong as we believe competition policy is an important attribute of a well-functioning market economy. It would create a level playing field for firms, enhance economic efficiency and protect free trade to the benefit of consumers.

On 3 March 2010 Hong Kong completed the legislative process for the enactment of the law and provisions on exchange of information in accordance with the 2004 version of the OECD Model Tax Convention. The tax law provides for exchange of information upon request only. In response to public demand, Hong Kong has included safeguards in individual comprehensive Double Taxation Agreements ("CDTAs") providing for additional statutory procedural safeguards in handling an Exchange of Information request by foreign jurisdictions. During 2010, Hong Kong signed 14 of these CDTAs tax treaties (7 with EU

Member States). The growing network of bilateral tax treaties is expected to bring about new business and trade and investment opportunities for all parties.

EUROPEAN UNION – HONG KONG RELATIONS AND COOPERATION

In 2010, the European Union and Hong Kong bilateral relations and cooperation have continued to expand. Hong Kong is an important player in the region and an intermediation platform for trade and investment flows between the EU and Mainland China.

In 2010, the EU maintained its position as Hong Kong's second-largest trading partner after Mainland China. Conversely, in the same year Hong Kong was the 16th largest trading partner of the EU. Bilateral trade between the EU and Hong Kong recovered robustly and increased by 29.9% during the first nine months of 2010, reaching €37.9bn.

Next to Mainland China and the British Virgin Islands, the EU was the biggest foreign investor in Hong Kong, contributing to 9.9% of the total FDI stock in 2009. Hong Kong investment in Europe has been developing steadily, as one of the major sources of direct investment from Asia.

Despite the global economic crisis, Hong Kong is still home to one of the biggest European business communities in Asia and continues to attract a large number of European citizens to reside and work in the territory, totalling around 31,100 as at the end of 2010 according to official Hong Kong Immigration figures. The EU is the largest source of foreign companies in Hong Kong with 423 regional headquarters, 654 regional offices and 590 local offices as of June 2010³, outnumbering those of the US and Japan. The EU's business presence covers a large variety of sectors, mainly financial and business services, trading, logistics, construction and retailing. Among others, EU companies are now key players in the banking, insurance and securities sectors of Hong Kong.

The 4th Structured Dialogue meeting between the European Commission and the Hong Kong SAR Government took place in Brussels on 22 November 2010. The meeting covered a range of issues ranging from economic relations, including trade and investment, to aviation, environment, research, technology, innovation and educational cooperation. The two sides noted with satisfaction that their trade and economic relations had continued to deepen and bilateral trade had steadily returned to the levels enjoyed prior to the financial crisis. Constructive exchanges on the regulatory reform of the financial services sector have increased as well as in the field of toy safety.

Following several years of discussions between the European Commission and Hong Kong, as well as the launch of bilateral negotiations between Germany and Hong Kong in 2008, the European Commission and Hong Kong reached agreement in 2010 on how to restore legal certainty to the EU – Hong Kong bilateral air services agreements.

2010 saw a number of high-level visits from Brussels to Hong Kong. In January, Commissioner Kuneva (Health and Consumer Protection) visited Hong Kong to attend the APEC Toy Safety Initiative Open Dialogue. In August 2010, Commissioner Semeta (Taxation and Customs Union, Audit and Anti-Fraud) met with relevant Hong Kong counterparts for

³ Source: Hong Kong Census and Statistics Department

discussions on matters relating to taxation and customs; while congratulating the Hong Kong Authorities for the steps forward made in the implementation of the OECD standards for assistance in tax matters, he stressed the continuing interest of the EU and its Member States in establishing specific cooperation on income from savings with Hong Kong in order to ensure taxation of EU investors in accordance with the rules of their Member State of residence, as provided for by the EU Directive on Taxation of Savings Income and the accompanying agreements. In September, Director-General Deffaa (Taxation and Customs Union) headed a delegation of customs officials for the 8th meeting of the EU-Hong Kong Joint Customs and Cooperation Committee.

The activities of the EU Business Information Programme for Hong Kong and Macao (EUBIP), co-funded by the European Commission and under the management of the European Chamber of Commerce (ECC) in Hong Kong, have increased in number and have become more diverse. During 2010, priority was given to financial services regulations, CEPA, environment, telecommunications, customs and taxation. Various business councils have been established for a number of sectors in which European business and industry enjoy a leading position, e.g. information and communications technology (ICT) and financial services. They have provided important industry input to our government-to-government dialogue. EUBIP has proved to be a successful channel for a better understanding between the business communities of the EU and Hong Kong.

Hong Kong continues to be a centre of free press and free speech, a leading regional media hub. EU public diplomacy efforts have focused on making the EU more active and visible in Hong Kong under the new Treaty of Lisbon setting. Since 1 January 2010, the Office of the European Union to Hong Kong represents the EU as coordinator and negotiator in the Hong Kong Special Administrative Region. The Treaty of Lisbon offers an opportunity for the EU to further intensify ties with Hong Kong. Working closely with the EU Member States officially represented in the territory, the EU Office has delivered prompt and substantial information on EU trade and regulatory policies, energy and climate change, financial regulation, intercultural dialogue, and the EU's role in the world.

Hong Kong has emerged from the global crisis without any major systemic problems. Its sound economic and financial fundamentals, its open economy and its stable legal environment based on the respect for the rule of law and judiciary independence, are noteworthy elements for increasing trade and investment flows with the EU as well as serving as a gateway for Mainland China and the region.