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**REPORT FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN
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ANNUAL REPORT HONG KONG 2009

Foreword to 12th Annual Report on Hong Kong from the Commission to the Council and the European Parliament

Catherine Ashton, High Representative of the Union for Foreign Affairs and Security Policy,
Vice-President of the European Commission

I am delighted to be able to provide the foreword to the European Commission's 12th Annual Report on Hong Kong, focusing on developments in 2009. Relations and cooperation between the European Union and Hong Kong have continued to move forward on a very positive track, in terms of our trade, investment and dialogue on issues of common interest.

The European Commission has continued to keep a close watch on political, institutional, economic and social developments in Hong Kong. The implementation of the 'one country, two systems' principle remains satisfactory, as the rights and fundamental freedoms of the people of Hong Kong have been respected, the rule of law protected and the market economy and positive business environment maintained.

In this period of economic downturn, the strong financial and economic ties between the European Union and Hong Kong have been very valuable. Hong Kong's economy has emerged from the global financial crisis without any major systemic problems. With one of the biggest European business communities in Asia and as a financial and economic hub for the region, it will continue to be of strategic importance as a trade and investment partner for Europe as we kick-start our own growth.

The Hong Kong SAR government has also now published a set of proposals for the 2012 legislative and leadership elections, following a public consultation on the matter. The European Union continues to strongly support early and substantial progress towards the goal of genuine universal suffrage, in accordance with the Basic Law of Hong Kong and the wishes of its people.

Hong Kong continues to be an important player in the region, and the European Union under the new Lisbon Treaty arrangements will be able to further intensify ties, especially through our Office there.

Catherine Ashton

Hong Kong Special Administrative Region: Annual Report 2009

Introduction

Since the handover of Hong Kong to Mainland China more than twelve years ago, the European Commission has been closely monitoring 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 twelfth such report covering 2009.

During this period 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. 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 preserved.

In 2009 bilateral relations and cooperation between the European Union and Hong Kong continued to expand. The European Union maintained its position as Hong Kong’s second largest trading partner, despite a decrease in bilateral trade. It is Hong Kong’s biggest source of foreign direct investment (after Mainland China and the British Virgin Islands). Home to one of the biggest European business communities in Asia, Hong Kong is therefore a strategic trading and investment partner for the European Union..

The European Union attaches great importance to Hong Kong’s stability, prosperity, democratic development and progress towards the ultimate 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. Hence, the EU will continue to support timely and substantial progress towards this goal.

Political developments

In 2009 the European Commission continued to keep a close watch on Hong Kong’s political, institutional and social developments in accordance with its 1997 commitment to the European Parliament. In 2009 this process was the subject of Hong Kong Government proposals to reform the electoral methods for the 2012 Chief Executive election and the selection of the Legislative Council in 2012.

On 15 January 2009 Hong Kong’s Chief Executive Donald Tsang announced the postponement of the Hong Kong Government’s public consultation on reforming electoral methods for the 2012 elections, initially foreseen for the first half of 2009, to allow his government to focus on tackling ‘economic and livelihood concerns’ in the wake of the financial crisis.

On 18 November the Hong Kong Special Administrative Region Government released its consultation paper on the 2012 electoral arrangements for its legislature and leader. This will have a significant influence on the city’s progress towards universal suffrage. The Consultation Document on the Methods for Selecting the Chief Executive and for Forming the Legislative Council in 2012 (‘Consultation Document’) was the subject of a three-month consultation inviting members of the public to comment on the proposals put forward by the government. This consultation period came to an end on 19 February 2010.

Henry Tang, the Chief Secretary for Administration, announced the consultation in the Legislative Council and stressed that having a more democratic electoral system in Hong Kong in 2012 would be a crucial step towards direct elections in 2017. The Hong Kong Government underlined that the proposals were in line with the National People's Congress Standing Committee's Decision on Issues Relating to the Methods for Selecting the Chief Executive and for Forming the Legislative Council.

The Consultation Document proposes that in 2012 the number of legislative seats should be increased from 60 to 70. Five of these seats would be directly elected through geographical constituencies and the other five would be allocated to functional constituencies, thus retaining the current ratio of directly elected and functional seats. The Consultation Document raised the possibility of having these five new seats returned by election among elected District Council members.

As regards the method for electing Hong Kong's Chief Executive, the Consultation Document proposes enlarging the Election Committee which chooses the city's leader from 800 to 1 200 members, 'so as to meet the requirement of gradual and orderly progress, providing more room for members of the community to participate in the election, and to further enhance the representativeness of the Election Committee'. This could be done by adding 100 members to each of the four sectors represented in the Election Committee. The nomination threshold within the Election Committee would be maintained at its current ratio of one-eighth of the total membership of this Electoral College (that is, 150 votes out of the increased membership of 1 200). The Consultation Document also proposed maintaining the existing requirement that the Chief Executive should not have any political affiliation.

The government's Consultation Document on electoral reforms for 2012 was not supported by the members of Hong Kong's pan-democratic camp, who would like to see full and genuine universal suffrage in place as soon as possible. They believe the Consultation Document does not go far enough. In addressing these concerns, Chief Secretary for Administration Henry Tang said that 'the NPCSC decision sets no precondition that democratic progress must be made for the 2012 elections before universal suffrage for the Chief Executive and the Legislative Council could be implemented. However, if progress could be made for constitutional development in 2012, this would be conducive to a steady transition of Hong Kong's electoral system to universal suffrage'.

The Consultation Document does not address the long-term existence of functional constituencies. During a Legislative Council question-and-answer session on 15 October 2009, Chief Executive Donald Tsang admitted that functional constituency seats 'are not totally compatible' with the principles of equal and universal suffrage and that functional constituencies cannot survive in their present form. Hong Kong's pan-democratic legislators have called for functional constituencies to be completely abolished.

On 28 December 2009, Chief Executive Donald Tsang met Chinese President Hu Jintao and Premier Wen Jiabao in Beijing in the course of his annual duty visit. According to media reports, President Hu called on Donald Tsang to deal appropriately and effectively with political developments to maintain Hong Kong's harmony and stability. Premier Wen Jiabao also called on Donald Tsang to find a more effective solution to Hong Kong's 'deep-rooted conflicts'. The Hong Kong Government is expected to present its proposals for changing the 2012 electoral methods later in 2010. A two-thirds majority of legislators must vote in favour.

The European Commission continues to take a close interest in political developments in Hong Kong and notes the Hong Kong SAR Government's proposals for electoral reform in 2012 as well as the ongoing public debate on the constitutional evolution of Hong Kong. According to the European Commission, the best guarantee of stability and prosperity for Hong Kong lies in a shift to a system of genuine universal suffrage, in accordance with the Basic Law and as set out by the National People's Congress Standing Committee decision of 2007. Therefore, the Hong Kong Government and all the parties concerned are encouraged to enter into a dialogue which will facilitate and accelerate this process.

Residents in Hong Kong hold an annual candlelight vigil to mark the 20th anniversary of the Chinese Government's confrontation with the student-led movement in Tiananmen Square on 4th June 1989.

The turnout at the 2009 candlelight vigil exceeded expectations (organisers estimated 150 000 people; police estimated 62 800), making it probably the largest turnout since the 1990 candlelight vigil. Chief Executive Donald Tsang told the Legislative Council that he understood the feelings of the Hong Kong people about 4 June. 'But the incident happened a long time ago. The country's development has achieved tremendous results and brought economic prosperity to Hong Kong. I believe the Hong Kong people will make an objective assessment of the nation's development.'

Events such as this, including the annual first of July demonstrations, illustrate that the 'one country, two systems' principle is functioning well in Hong Kong. It also shows that rights and freedoms guaranteed under the Basic Law of the Hong Kong SAR, such as freedom of speech and assembly, are generally respected. However, various associations of journalists in Hong Kong have expressed rising concerns regarding press freedom, particularly incidents where Mainland Chinese police have acted against Hong Kong journalists reporting on Mainland stories (such as events in Mainland China's Xinjiang Autonomous Region). On 9 September 2009 Chief Executive Donald Tsang said his government had forwarded Hong Kong journalists' views to the State Council's Hong Kong and Macao Affairs Office and Xinjiang authorities.

The European Commission also noted serious concerns over border and immigration incidents that could lead to repatriation decisions and other arrangements involving restrictions of basic rights and freedoms, such as the case of the Chinese dissident Zhou Yongjun or the Lo Wu border protest on 27 December 2009 in support of Mainland activist and Charter 08 author Liu Xiaobo.

On 28 August 2009 the United Nations Committee on the Elimination of Racial Discrimination (UN CERD) issued its periodic report on China, including Hong Kong and Macao. It recommended that Hong Kong should adopt a law on refugees 'with a view to establishing a comprehensive procedure for the screening of individual asylum claims.' In response to these observations the Hong Kong Government stated in a press release that 'the asylum claims lodged in Hong Kong were being administered by the UNHCR directly, which makes decisions on the screening of genuine refugees and their resettlement afterwards.' Regarding the Race Discrimination Ordinance adopted in 2008, the UN CERD expressed concerns about the definition of racial discrimination contained in the Hong Kong legislation, 'which is not completely consistent with Article 1 of the Convention as it does not clearly define indirect discrimination with regard to language, and it does not include immigration status and nationality among the prohibited grounds of discrimination.'

On 2 September 2009, Chief Justice Andrew Li announced his early retirement. He would step down in September 2010 to enable his successor to appoint the successors to a number of

senior judges due to retire over the next five years. The European Commission acknowledges Chief Justice Li's contribution to preserving Hong Kong's judicial independence, a key element in preserving Hong Kong's way of life, respect for the rule of law and fundamental freedoms. As Mr Li said on 11 January 2010 at the Ceremonial Opening of the Legal Year, 'The independent judiciary has a vital constitutional role to ensure that the acts of the Executive and the Legislature comply fully with the Basic Law and that the law and our fundamental rights and freedoms, which are at the heart of Hong Kong's system, are fully safeguarded.'

The year 2009 also saw an improvement in diplomatic ties between Hong Kong and Taiwan. This is welcomed by the European Commission. The Secretary for Constitutional and Mainland Affairs, Stephen Lam, visited Taipei on 5-6 June 2009 at the invitation of Taiwan's Mainland Affairs Council to explore and discuss issues that would help further enhance cooperation between the two sides. Stephen Lam is the first Hong Kong minister to visit Taiwan in an official capacity since Hong Kong's return to Mainland China in 1997. Both Hong Kong and Taiwan agreed to set up non-governmental bodies to bolster cooperation in trade, economy, tourism, investment and other sectors. In his policy address in October 2009 the Chief Executive announced the establishment of a Hong Kong–Taiwan economic and cultural cooperation and promotion council to promote cooperation between Hong Kong and Taiwan.

On the whole, the European Commission believes that the 'one country, two systems' principle has continued to work well in the Hong Kong SAR and that the rights and freedoms of its population, guaranteed in the Sino-British Joint Declaration and the Basic Law, have been respected in general.

Economic and trade developments

Hong Kong's economy and financial system have emerged from the global financial crisis without any major systemic problems. Its economy showed progressive improvement during 2009 and gradually returned to positive growth on the back of a robust Chinese economy. For 2009 as a whole, GDP contracted in real terms by 2.7%, the first annual recession since the Asian financial crisis in 1998. The Hong Kong Government undertook to spend HK\$87.6 billion (€8.1 billion) in two years, equivalent to 5.2% of its GDP, to cushion the economy from the aftershock of the global financial crisis, which has helped maintain confidence. The unemployment rate improved to 4.9% in the fourth quarter from a peak of 5.4% in the second quarter. Inflationary pressures quickly receded with the Composite Consumer Price Index rising by 1%, a sharp fall from 5.6% in 2008.

While maintaining its competitiveness as an international financial centre, Hong Kong is increasingly turning towards servicing the Chinese market. On financial services, Hong Kong has positioned itself as the offshore centre of the Renminbi (RMB) and a testing ground for China's capital account liberalisation. With the support of the Central Government, Hong Kong began to launch new RMB products and services during 2009. The most significant development was an RMB cross-border trade settlement scheme whereby Hong Kong became the first offshore jurisdiction participating in the pilot programme for Guangdong. Hong Kong banks operating in Mainland China were given the green light to issue RMB bonds in Hong Kong. In October, the Central Government launched the first RMB sovereign bonds in Hong Kong totalling Yuan 6 billion (€659 million).

As a result of a surge in global liquidity, Hong Kong attracted an unprecedented inflow of capital in 2009. According to the Hong Kong Monetary Authority, a total of HK\$640 billion (€59 billion) of foreign capital flowed into Hong Kong's asset markets, as international investors sought safe havens for funds as well as exposure to the fast growing Chinese economy. Over half of the capital inflows were related to the fund-raising activities of Mainland Chinese companies in Hong Kong. Hence, the Hong Kong Stock Exchange became the biggest Initial Public Offering (IPO) market in the world in 2009. As for the property market, residential property prices rose by 27% on average during 2009 and luxury flat prices returned to the 1997 peak. Reportedly, speculative buying and the appetite of Mainland Chinese buyers for Hong Kong property have pushed up prices. The Financial Secretary therefore introduced a set of measures in the 2010-2011 Budget proposals to cool down the property market and reduce the risk of asset-price bubbles.

The Hong Kong economy relies heavily on financial services, prompting the Government to search for new growth areas to address economic challenges. Hong Kong will facilitate the development of six knowledge-based industries: testing and certification, environmental industry, innovation and technology, cultural and creative industries, medical, and educational services. The European Commission welcomes the prospect of exploring cooperation and exchanges with Hong Kong in common areas of interest, in particular testing and certification, environmental industry, innovation and technology and creative industries.

Hong Kong acted promptly to implement its commitment towards endorsing the OECD standard for the effective exchange of information in tax matters following the G20 process. An amendment to the related tax legislation was announced in early 2009 and the amendment bill was passed unanimously in January 2010. The European Commission welcomes this move. Hong Kong is now ready to sign more comprehensive double taxation agreements with third countries, including some EU Member States.

An instrument designed to facilitate economic integration between Hong Kong and China, namely Supplement VI to the Closer Economic Partnership Arrangement (CEPA), was signed in May 2009. Hong Kong and China agreed on a package of further liberalisation of trade in services as well as measures to enhance financial cooperation. Supplement VI also included measures for early and pilot implementation of liberalisation in selective services sectors in Guangdong Province. These measures were aimed at enhancing cooperation between Guangdong and Hong Kong within the service industry. The participation of European companies in the various CEPA agreements is slowly increasing, up to 151 service suppliers in 2009 out of a total of over 1 300 Hong Kong companies. Cooperation with the Hong Kong Government has been very important in spreading information on CEPA to the European business community.

In addition to CEPA, the Hong Kong Government has taken a more proactive approach to the pursuit of free trade agreements with other trading partners, trying to secure better market access for services in overseas markets. Hong Kong will continue to support the multilateral trading system while engaging in bilateral free-trade agreement discussions, provided they are WTO-consistent and can contribute to multilateral trade liberalisation. In 2009 Hong Kong concluded the FTA negotiations with New Zealand that materialised in a Closer Economic Partnership Agreement. It also initiated discussions with Chile, Peru, Malaysia and EFTA.

European Union-Hong Kong cooperation

In 2009 EU and Hong Kong bilateral relations and cooperation continued to expand, based on a shared interest in addressing mutual and global concerns. Hong Kong is a strategic trading and investment partner of the European Union. It also plays an important role as an intermediation platform for trade and investment flows between the European Union and China.

In 2009 the European Union maintained its position as Hong Kong's second largest trading partner after Mainland China. Conversely, in the same year Hong Kong was the 17th largest trading partner of the European Union. Total bilateral trade between the European Union and Hong Kong fell by 10.4% to €29.2 billion as the global financial crisis took its toll.

Next to Mainland China and the British Virgin Islands, the European Union was the biggest foreign investor in Hong Kong, contributing to around 10% of the total foreign direct investment (FDI) stock in 2008. Conversely, Hong Kong investment in Europe has been developing steadily, and has become one of the major sources of direct investment from Asia.

Despite the global economic crisis, Hong Kong has continued to attract a large number of European citizens to reside and work in the territory, totalling around 28 320 as of the end of 2009 according to official Hong Kong Immigration figures. This still represents one of the biggest concentrations of European Union citizens in Asia and continues to be a motivating factor for the European Union's involvement in Hong Kong. An investment survey conducted by the Hong Kong Census and Statistics Department showed that as of June 2009 there were 1 252 regional headquarters and 2 328 regional offices in Hong Kong representing parent companies located outside Hong Kong. Of those, the European Union continues to be the largest source of foreign companies in the territory with 419 regional headquarters and 679 regional offices. The European Union's business presence covers a large variety of sectors, mainly financial and business services, trading, logistics but now also construction and infrastructure projects.

With these substantive trade and economic flows and an important European Union presence, relations with Hong Kong are guided by the policy framework contained in the European Commission's Communication 'The EU, Hong Kong and Macao: possibilities for cooperation 2007-2013'. It fixes a number of challenging objectives designed to move European Union-Hong Kong relations forward by deepening and broadening cooperation in key areas of mutual interest.

European Union-Hong Kong cooperation was reinforced in 2009, the first year of operation of the 'European Union Business Information Programme' for Hong Kong and Macao (EUBIP). EUBIP implemented a work programme of content-driven business-related events in close partnership with relevant business and industry associations from the European Union and Hong Kong. Areas targeted in 2009 were: regulatory exchanges, financial services, the environment, intellectual property and food/product safety. A well-attended seminar on the European Union's chemical regulation (REACH), with expertise from the European Chemicals Agency and supported by the Hong Kong Government, was a case in point. EUBIP is thus proving to be an important instrument for promoting better understanding and knowledge exchange between Hong Kong and the European Union.

The third European Commission-Hong Kong Structured Dialogue was held in Hong Kong on 17 December 2009. This has proven to be an effective high-level platform for officials from both sides to continue expanding bilateral relations through substantive dialogue and

cooperation. The third Dialogue focused on the incipient signs of recovery from the global financial crisis. In thoroughgoing discussions both sides agreed to continue enhancing bilateral cooperation, including through EUBIP, on financial services, information and communications technology, environment, standardisation issues and education, as well as to expand cooperation and initiatives on testing and certification, innovation and technology and creative industries. These new areas are part of the six knowledge-based industries Hong Kong wishes to develop further. Channels for information exchange on European Union regulatory and technical standards, e-passports, and financial legislation will also be strengthened.

The number of senior-level visits by the Commission to Hong Kong increased in 2009, thus contributing to the strengthening of European Union-Hong Kong bilateral relations and to the development of new cooperation initiatives in areas such as aviation, financial services, health and consumer protection, anti-corruption initiatives, education and trade as well as to the deepening of the ongoing dialogue in the field of taxation of savings. Professor K. C. Chan, Secretary for Financial Services and the Treasury, visited Brussels in May 2009 to discuss financial market regulations. A visiting group from the Economic and Social Committee met representatives of Hong Kong civil society in July 2009.

With the largest financial expertise in Asia, a well-regulated market and a good arbitration system, Hong Kong is a strong candidate to become a regional trading platform for innovative, green financial products, possibly benefitting from EU experience in carbon trading with the European Trading System (ETS). Hong Kong has also been active in Copenhagen, with Secretary for the Environment Edward Yau attending the conference as a member of the Chinese Delegation. Hong Kong's civil society was also well represented.

The European Commission regrets that European Union-Hong Kong relations in the field of aviation made little progress in 2009. The Commission maintained contacts with officials to urge Hong Kong to update bilateral air services agreements with European Union Member States and to give legal certainty to existing agreements, either by including a Community Designation Clause or by opting for a horizontal air services agreement. Exchanges between EU and Hong Kong experts will continue but have yet to bear fruit, as Hong Kong remains one of the few jurisdictions in Asia that still does not recognise EU designation.

Competition is one area of bilateral exchange. The Hong Kong Government confirmed during the 2009 Structured Dialogue that the Competition Bill, which is still at the drafting stage, would be enacted within the 2009-2010 legislative year. The European Commission urges Hong Kong to enact the Competition Bill as soon as possible.

In the region Hong Kong is a centre of free press and free speech, a leading media hub and a gateway to Mainland China. European Union public diplomacy efforts have continued to focus on making the European Union more visible in Hong Kong and on delivering prompt and substantial information on: European Union trade and regulatory policies, energy and climate change, financial regulations, intercultural dialogue, the European Parliament elections, the Treaty of Lisbon and the European Union's role in the world. These efforts were made possible thanks to the teamwork of the European Union Office in Hong Kong and the Member States officially represented in the territory.

Future Perspectives

Hong Kong's economy has been able to recover well from the impact of the global financial crisis, on the basis of sound economic and financial fundamentals and an open market economy. Maintaining a steady recovery path and Hong Kong's status as an international financial centre, based on rule of law, judicial independence and a stable legal environment, will be important factors for creating more European trade and investment in Hong Kong in 2010 and in the long-term future.

Hong Kong is also facing the dual challenge of developing further as a unique platform for trade, economic cooperation and investment with Mainland China, in particular the Pearl River Delta region, and of maintaining its role as a financial intermediary between Mainland China and the rest of the world.

Hong Kong will continue to be an important partner for the European Union in Asia, because of our bilateral trade and investment flows, extensive economic cooperation and broad European presence and interests. The European Union will maintain its substantial commitment to the Hong Kong SAR Government to step up our regulatory exchanges, facilitate trade and expand our cooperation into areas of mutual interest, including health, the environment and new technologies. Emphasis will be given to improving knowledge sharing and experience in matters related to competition, financial services, certification and immigration. People-to-people exchanges and contacts should continue to develop so that the people of Hong Kong can benefit from Europe's cultural diversity and Europeans can learn from Hong Kong's east-meets-west culture.

The entry into force of the Treaty of Lisbon in December 2009 should lead to a further consolidation of the joint efforts of the European Commission and the European Union Member States to make the European Union more visible in Hong Kong. The Treaty has been warmly welcomed by the Hong Kong authorities. Since its implementation on 1 January 2010, the Office of the European Union to Hong Kong and Macao (previously the Office of the European Commission) represents the European Union as coordinator and negotiator in this Special Administrative Region. It will continue to strive to improve European Union–Hong Kong relations.