

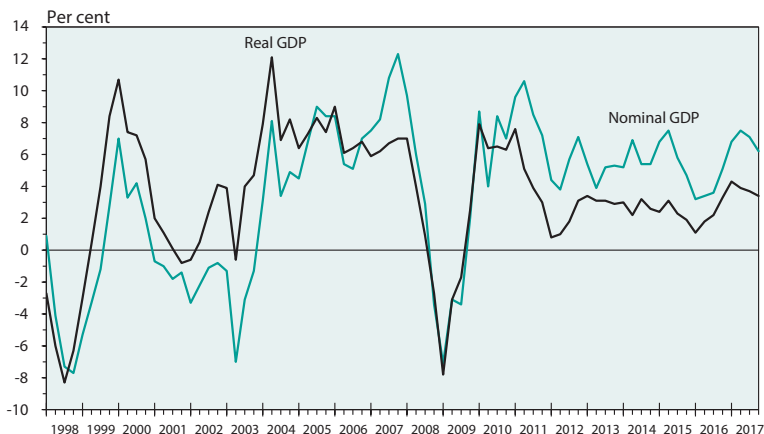
The Economy

The Hong Kong economy sustained notable expansion throughout 2017 amid a synchronised global economic upswing. External demand turned stronger and domestic demand was robust. The unemployment rate fell successively to a near 20-year low towards the year end. Inflation eased.

The Hong Kong economy expanded notably in 2017. Gross Domestic Product (GDP) grew 3.8 per cent in real terms, accelerating from 2.1 per cent growth in 2016 and markedly faster than the trend growth of 2.7 per cent in the past 10 years. In terms of the quarterly profile, the year-on-year growth rate of real GDP leaped to 4.3 per cent in the first quarter against a relatively low base of comparison in early 2016, and maintained above-trend growth at 3.9 per cent, 3.7 per cent and 3.4 per cent respectively in the second, third and fourth quarters (*chart 1*).

Chart 1

Quarterly Gross Domestic Product
(year-on-year rate of change)



The Hong Kong economy picked up to expand at an above-trend pace in 2017.

Total exports of goods grew briskly in 2017, picking up from the modest growth in 2016. The strengthening global demand gave rise to vibrant regional production and trading activities in Asia. Against this backdrop, exports to Asian markets continued to be the key propeller in 2017. Exports to the United States and European Union also reverted to growth for the year as a whole.

Exports of services likewise saw a broad-based turnaround, reverting to moderate growth from the annual decline in 2016, thanks to vibrant regional trade flows, a solid revival of inbound tourism and increasingly buoyant global financial markets.

Domestically, private consumption expenditure continued to display strength, with growth gathering pace over the course of 2017. The stellar private consumption performance was underpinned by favourable job and income situations as well as a bigger boost from positive wealth effects. Investment expenditure resumed a moderate increase for 2017 as a whole after three years of annual decline, aided by generally optimistic business sentiment and an acceleration in public-sector building and construction works.

The labour market tightened in 2017 on the back of a vibrant economy. Both unemployment and underemployment rates averaged at their respective post-1997 lows, of 3.1 per cent and 1.2 per cent, for the year as a whole. Benefiting from the broad-based tightening of the labour market, wages and earnings growth across most of the major sectors continued to be well above inflation.

The residential property market was generally buoyant in 2017, except for a temporary moderation around the middle of the year following the introduction of the eighth round of macro-prudential measures for property mortgage loans by the Hong Kong Monetary Authority (HKMA) in May. Improved global and local economic performance, the still-tight demand-supply balance of flats and sustained low local interest rates all contributed to the fervent market situation. Trading turned more active again in the latter part of 2017 and overall flat prices recorded a hefty gain of 15 per cent during the year.

The local stock market saw a strong rally, as investor sentiment turned more bullish amid the brightened global economic outlook and receding external risks. The Hang Seng Index rose almost uninterruptedly, reaching a post-crisis high of 30,003 on 22 November before closing the year at 29,919, 36 per cent higher than at end-2016.

Inflation remained moderate as local cost pressure was largely contained and imported inflation stayed low. The underlying inflation rate dropped to 1.7 per cent in 2017 from 2.3 per cent in 2016, marking the sixth consecutive year of easing.

Structure and Development of the Economy

Hong Kong is a global centre for world trade, finance, business and telecommunications, located strategically at the doorstep of the Mainland's huge and vibrant economy. According to the World Trade Organisation, Hong Kong was the world's seventh largest merchandise trading entity in 2017. It operates one of the world's busiest container ports in terms of container

throughput, as well as one of the world's busiest airports in terms of the number of international passengers and volume of international air cargo handled.

Hong Kong was also the world's sixth largest banking centre in terms of external positions as at end-2017, and the fourth largest foreign exchange trading centre according to a triennial survey conducted by the Bank for International Settlements in 2016. Its stock market is the third largest in Asia in terms of market capitalisation as at end-2017 and ranks second in Asia in terms of initial public offering equity funds raised during the same year.

As an international business hub, Hong Kong has a business-friendly environment with the rule of law, free trade and free flow of information, open and fair competition, a well-established and comprehensive financial network, superb transport and communications infrastructure, sophisticated support services, and a flexible labour market with a well-educated workforce and a pool of efficient and innovative entrepreneurs. In addition, Hong Kong has sizeable foreign exchange reserves, a fully convertible and stable currency, prudent fiscal management and a simple tax system with low tax rates. Thanks to these virtues, Hong Kong has been ranked persistently by the Heritage Foundation and the Fraser Institute as the world's freest economy.

As for competitiveness, Hong Kong was ranked the world's most competitive economy for the second consecutive year by the International Institute for Management Development in 2017, and the fifth easiest place to do business globally according to the World Bank's *Doing Business 2018* report, published in October 2017.

The Hong Kong economy nearly doubled in size over the past two decades, expanding at an average annual rate of 3.3 per cent in real terms, faster than most high-income economies. Over the same period, per capita GDP rose about 67 per cent in real terms, posting an average annual growth rate of 2.6 per cent. Hong Kong's per capita GDP at current market prices reached US\$46,200 in 2017 (*chart 2*), comparable to many advanced economies.

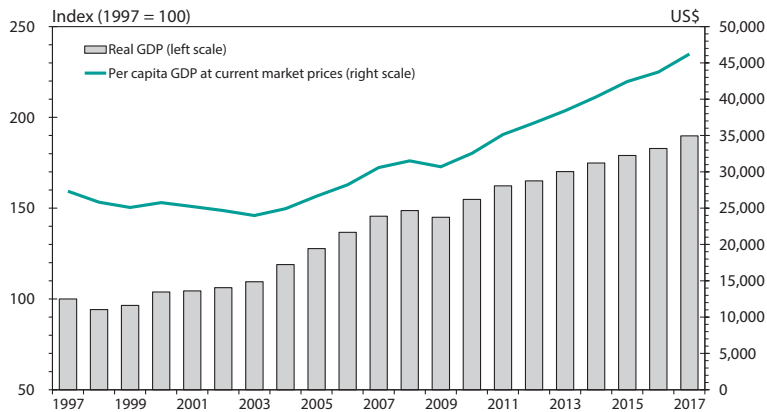
Trade links with other parts of the world have grown appreciably. Trade in goods and services almost tripled in real terms over the past two decades. The total value of goods trade, compiled under the GDP accounting framework based on the change of ownership principle and comprising re-exports, domestic exports and imports of goods, reached \$8,567 billion in 2017, equivalent to 322 per cent of GDP. This was higher than the ratio of 192 per cent in 1997 and 299 per cent in 2007. Including the value of exports and imports of services, the ratio of total trade to GDP was even higher, at 375 per cent in 2017, up from 233 per cent in 1997 and 362 per cent in 2007.

The stock of direct investment liabilities in Hong Kong was enormous, at \$14,142 billion in market value at the end of 2016, equivalent to 568 per cent of GDP. It served as another vivid manifestation of Hong Kong being one of the most preferred destinations for inward direct investment, ranked fourth in the world by the United Nations' *World Investment Report 2017*.

The corresponding figures for Hong Kong's stock of direct investment assets were likewise huge, at \$13,527 billion, or 543 per cent of GDP. As an international financial centre with huge cross-territory fund flows, Hong Kong's external financial assets and liabilities were also

substantial, at \$42,735 billion and \$31,841 billion respectively at the end of 2017. The corresponding ratios to GDP in 2017 were 1,605 per cent and 1,196 per cent. Reflecting Hong Kong's robust international investment position, its net external financial assets amounted to \$10,894 billion at the end of 2017, equivalent to 409 per cent of GDP.

Chart 2 Gross Domestic Product



Over the past two decades, the Hong Kong economy grew an average of 3.3 per cent in real terms, faster than most high-income economies.

The Gross National Income (GNI), comprising GDP and net external primary income flow, stood at \$2,773 billion in 2017. This was higher than the corresponding GDP by 4.2 per cent. The difference represented a net inflow of external primary income. In gross terms, inflows and outflows of external primary income were both substantial in 2017, at \$1,401 billion and \$1,290 billion respectively, equivalent to 53 per cent and 48 per cent of GDP respectively. This was attributable to the huge volumes of Hong Kong's inward and outward investment.

Contributions of Various Economic Sectors

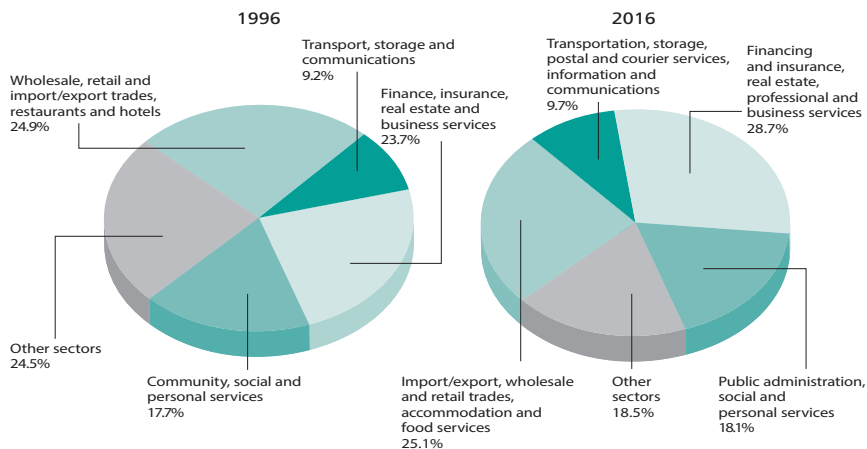
Primary production, including agriculture, fisheries, mining and quarrying, is insignificant in terms of both value-added contribution to GDP and share in total employment, as Hong Kong is a predominantly city economy.

Secondary production comprises manufacturing, construction, and supply of electricity, gas and water. In 2016, the value-added contribution from manufacturing accounted for only 1 per cent of GDP, while those of the construction sector and electricity, gas and water stood at 5 per cent and 1 per cent respectively.

The services sector is the mainstay of the Hong Kong economy. The further opening up of the Mainland and its deepening reforms have unleashed ample business opportunities for a wide range of service providers. With its geographical proximity and cultural ties with the Mainland as well as its strong market institutions, Hong Kong has leveraged its competitive strengths in services in its continuous move towards high value-added activities.

In 2016, the services sector contributed 92 per cent to GDP. Financing and insurance, real estate, professional and business services remained the largest services sector, accounting for 29 per cent of GDP. This was followed by import/export, wholesale and retail trades, accommodation and food services (25 per cent), public administration, social and personal services (18 per cent), transportation, storage, postal and courier services, and information and communications (10 per cent) (chart 3).

Chart 3 Gross Domestic Product by Major Service Sector



The financing and insurance, real estate, professional and business services sector and the import/export, wholesale and retail trades, accommodation and food services sector remained the two largest service sectors in terms of net output in 2016.

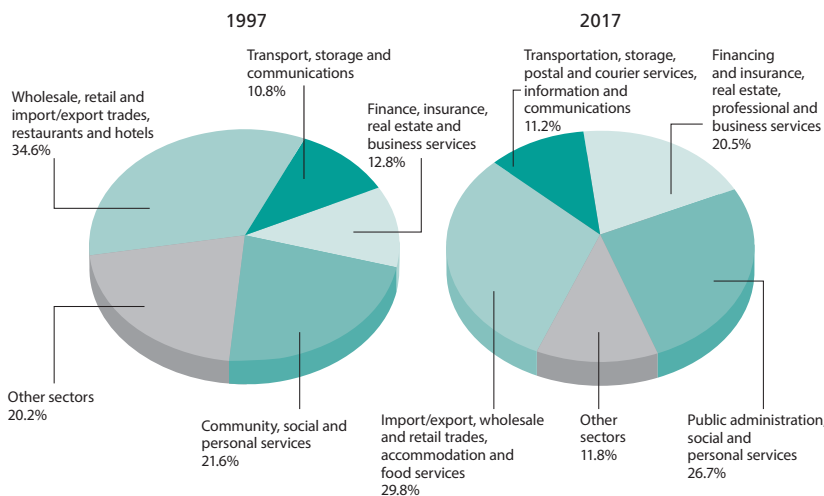
Note: Due to the adoption of the Hong Kong Standard Industrial Classification Version 2.0, the series from 2000 onwards are not strictly comparable with those of the earlier years.

It is worth noting that although the manufacturing sector's direct value-added contribution to the economy is not large, Hong Kong's manufacturers continue to be versatile and resilient in coping with the changing global and regional economic landscapes. Hong Kong's productive capacity has effectively expanded, thanks to increased supply-chain arrangements involving the Mainland and other neighbouring economies. Its well-established links with the Mainland economy have underpinned the growth of Hong Kong's services sector, especially the rapid development of trading, financial and other supporting services.

The increasing service orientation of the economy was also borne out by a shift in the sectoral composition of employment. Over the past two decades, the share of the services sector in total employment increased from 80 per cent in 1997 to 87 per cent in 2007 and 88 per cent in 2017. As for individual service segments, import/export, wholesale and retail trades, accommodation and food services accounted for 30 per cent of the total in 2017. This was followed by public administration, social and personal services with a share of 27 per cent; financing and insurance, real estate, professional and business services (20 per cent); and

transportation, storage, postal and courier services, information and communications (11 per cent) (chart 4).

Chart 4 Employment by Major Service Sector



Import/export, wholesale and retail trades, accommodation and food services employed the most people in 2017.

Note: Starting from the first quarter of 2009, industrial classification of employment has adopted the Hong Kong Standard Industrial Classification Version 2.0 while that in the previous years is based on Version 1.1.

Economic Links between Hong Kong and Mainland

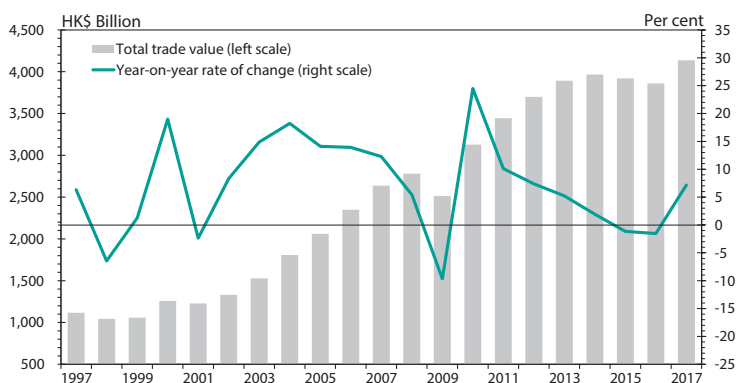
Following several decades of reform and opening up on the Mainland, cross-boundary economic ties are stronger than ever. The flow of goods, services, people and capital between Hong Kong and the Mainland, and between the Mainland and the world through Hong Kong, have flourished and brought about significant mutual benefits to the two places.

With its total trade surging from US\$325 billion in 1997 to US\$4.1 trillion in 2017, the Mainland plays a prominent role in driving global economic growth. Hong Kong has benefited substantially from the Mainland's phenomenal trade growth. Visible trade between Hong Kong and the Mainland in 2017 was about four times that of 20 years ago, representing growth of 7 per cent per annum in value terms (chart 5). In 2017, the Mainland was ranked the world's largest merchandise trading entity and Hong Kong was ranked seventh.

The Mainland has long been Hong Kong's largest trading partner. Cross-boundary trade accounted for more than half of Hong Kong's total trade value in 2017. At the same time, Hong Kong is the Mainland's third largest trading partner after the US and Japan, accounting for about 7 per cent of the Mainland's total trade value. More than half of Hong Kong's exports to the Mainland, which were mainly re-exports, involved raw materials and semi-manufactures,

reflecting the latter's role as a production hinterland and the highly integrated production network within Asia. On the other hand, as the Mainland economy evolves from high-speed to high-quality development with domestic consumption and services playing greater roles in driving economic growth, enormous demand has been unleashed for various services. Hong Kong, being highly competitive in various high-end services, rose with the tide. Indeed, Hong Kong's exports of services to the Mainland have seen rapid growth, more than tripling from 2007 to 2016. By 2016, the Mainland was the largest market for Hong Kong's exports of services, accounting for some 40 per cent of the total value.

Chart 5 Goods Trade between Hong Kong and Mainland



Merchandise trade between Hong Kong and the Mainland grew notably in the past two decades.

Hong Kong also serves as a principal gateway to and from the Mainland for business and tourism. In 2017, foreign visitors to the Mainland made 3.3 million trips through Hong Kong, while the number of trips made by Mainland residents to or through Hong Kong grew 3.9 per cent to 44.4 million. Hong Kong remains the largest external investor on the Mainland. According to the Mainland's statistics, the cumulative value of Hong Kong's realised direct investment on the Mainland exceeded US\$1 trillion as at end-2017, accounting for more than half of the total.

Reciprocally, Hong Kong is the first port of call for the Mainland's outward direct investment. Based on the Mainland's statistics, the Mainland's stock of outward direct investment to Hong Kong accounted for 58 per cent of its total outward direct investment as at end-2016, reflecting Hong Kong's role as a platform for Mainland companies to explore other markets and go global. Based on Hong Kong's statistics, the Mainland is Hong Kong's second largest source of foreign direct investment, accounting for 26 per cent of Hong Kong's total inward direct investment. Mainland companies also maintain a strong presence in Hong Kong. As at mid-2017, Mainland companies had established 1,264 regional headquarters and regional or local offices in Hong Kong, up from 725 a decade ago.

Due to proximity, Guangdong's economic links with Hong Kong are understandably the closest among all the provinces. Based on the Mainland's statistics, the cumulative value of Hong

Kong's realised direct investment in Guangdong exceeded US\$200 billion in the past couple of years, consistently remaining at above 60 per cent of its total inward direct investment. The substantial direct investment from Hong Kong not only contributed to the Mainland's rapid industrialisation in the past decades, but also facilitated the structural transformation of the Hong Kong economy.

Financial links between Hong Kong and the Mainland have strengthened substantially over the years, thanks to the increasing cross-boundary economic activities and the Central People Government's policy to enhance Hong Kong's position as an international financial centre. As a major funding centre for Mainland enterprises, Hong Kong saw 1,051 Mainland enterprises listed on its stock market as at end-2017. Of these, 55 were listed in 2017, raising \$98.5 billion in equity funds, with \$365.8 billion in aggregate funds raised from IPOs and secondary financing.

Hong Kong continued to possess the world's largest offshore pool of RMB liquidity, with the total amount of RMB customer deposits and outstanding RMB certificates of deposit issued standing at about RMB618 billion as at end-2017. RMB bank lending and outstanding RMB bonds stood at RMB145 billion and RMB212 billion respectively. The value of RMB trade settlements handled by banks in Hong Kong reached RMB3.9 trillion in 2017.

Hong Kong also remained the largest offshore RMB investment product market. At the end of 2017, there were 59 Securities and Futures Commission (SFC)-authorised unlisted funds investing onshore via the RMB Qualified Foreign Institutional Investor (RQFII) Scheme, Stock Connect, Bond Connect and/or Mainland's Interbank Bond Market, with an aggregate net asset value (NAV) of RMB6.8 billion, and 29 SFC-authorised exchange traded funds investing onshore via the same channels with an aggregate NAV of RMB34.1 billion. Financial cooperation between the two places was extended to the bond market through the launch of the Bond Connect in July, enabling Hong Kong to serve as the gateway for overseas investors to enter the Mainland's bond market.

Economic cooperation between the two places has continued to deepen. Two subsidiary agreements under the framework of the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA) were signed in June. The National Development and Reform Commission (NDRC) and the governments of Guangdong, Hong Kong and Macao jointly signed the Framework Agreement on Deepening Guangdong-Hong Kong-Macao Cooperation in the Development of the Bay Area in July, establishing such key cooperation areas as promoting infrastructure connectivity, enhancing market integration, building a global technology and innovation hub, building a system of modern industries through coordinated development, jointly building a quality living circle to provide an ideal place for living, working and travelling, cultivating new strengths in international cooperation, and supporting the establishment of major cooperation platforms. This agreement allows for Hong Kong's active participation in the Guangdong-Hong Kong-Macao Bay Area development in the years to come.

To tap the vast opportunities arising from the nation's Belt and Road Initiative, Hong Kong also signed an arrangement with the NDRC in December, focusing on six key areas: finance and investment; infrastructure and maritime services; economic and trade facilitation; people-to-

people bonds; taking forward the Guangdong-Hong Kong-Macao Bay Area development; and enhancing collaboration in project interfacing and dispute resolution services.

During the year, the construction of major cross-boundary infrastructure projects continued, including the Hong Kong Boundary Crossing Facilities and Hong Kong Link Road under the Hong Kong-Zhuhai-Macao Bridge project, the Hong Kong section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link, and the Liantang/Heung Yuen Wai Boundary Control Point. Upon completion, these infrastructures will further facilitate the flow of people and goods, thereby deepening the economic and trade relations between Hong Kong and the Mainland.

The Economy in 2017

External Trade

The global trading environment was sanguine in 2017. Total exports of goods, on the external merchandise trade statistics basis, grew markedly by 6.2 per cent in real terms, accelerating notably from the 1.4 per cent increase in 2016 and representing the fastest growth in seven years. Merchandise exports sustained solid growth on a year-on-year basis throughout 2017, being subject to a higher base of comparison over the course of the year notwithstanding (*chart 6*). Analysed by major market, exports to Asian markets remained the key growth propeller, attaining high single-digit growth for the region as a whole, reflecting the vibrant intra-regional trade flows. In particular, exports to the Mainland sustained solid growth throughout the four quarters, and those to Japan staged a double-digit rebound after four years of decline. Exports to India and Taiwan saw another year of double-digit growth, while those to Singapore and South Korea saw modest to moderate growth. Exports to the US and Europe also improved, providing more visible growth impetus to the overall export performance in the latter part of the year.

Imports of goods grew 6.8 per cent in real terms in 2017, as re-export trade blossomed amid the notable improvement in global trading. The robust local consumption demand also supported visible growth in retained imports, meaning imports for domestic use, which accounted for about one-quarter of total imports. In particular, retained imports grew 8.3 per cent in real terms for 2017 as a whole, a strong rebound from an annual decline of 0.6 per cent in 2016. Retained imports sustained solid expansion throughout 2017, mirroring the brisk growth in domestic demand and progressive improvement in the local retail market over the course of the year.

Benefiting from the more favourable external developments, exports of services reverted to a moderate growth of 3.5 per cent in real terms in 2017, from a 3.4 per cent decline in 2016. The improvement was broad-based. Among the key components, exports of transport services continued to outperform, registering the fastest growth since 2010. Reflecting the buoyant global financial markets and active cross-border financing activities, exports of financial services gathered pace over the course of the year, attaining high single-digit year-on-year growth in the fourth quarter, in stark contrast to the relapse seen in 2016. Exports of travel services recovered from more than three years of decline and resumed modest growth in 2017, with the growth pace picking up somewhat towards the year end. Exports of business and other services also saw modest growth.

Chart 6

Hong Kong's Goods Trade (year-on-year rate of change in volume terms)



Merchandise exports grew markedly in 2017.

Imports of services grew steadily by 1.8 per cent in real terms in 2017, similar to the 2.1 per cent growth in 2016 (*chart 7*). Within this, imports of travel services were supported by residents' keen travel interest, given the favourable job and income conditions as well as positive wealth effects arising from increasing asset prices. Imports of transport services reverted to moderate annual growth amid the pick-up in regional trade and cargo flows. The generally sanguine global economic environment also rendered slightly faster growth impetus to imports of business and other services. On the other hand, imports of manufacturing services continued their downtrend in 2017.

Compiled based on the change of ownership principle, the goods deficit widened somewhat in 2017, as imports of goods under firm domestic demand slightly outpaced exports of goods. Nonetheless, with the services surplus more than offsetting the goods deficit, the combined goods and services account registered a surplus of \$21 billion in 2017, equivalent to 0.4 per cent of total import value, smaller than the \$57 billion surplus in 2016.

Domestic Demand

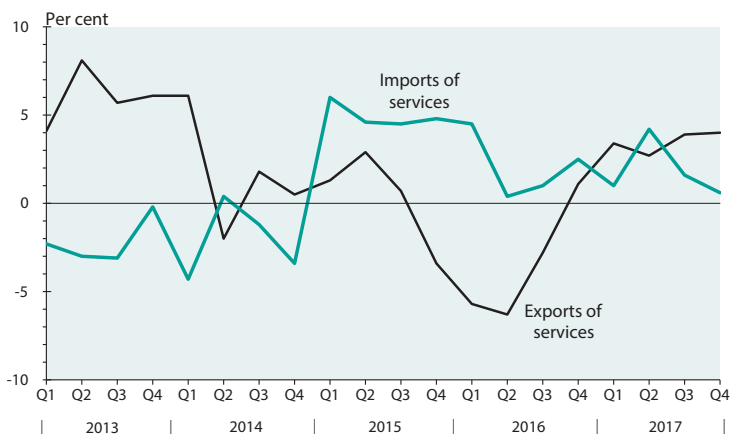
Domestic demand was robust in 2017. Private consumption expenditure displayed much strength, expanding 5.4 per cent in real terms, notably faster than its 1.9 per cent growth in 2016 (*chart 8*). Such visible growth was underpinned by sanguine consumer sentiment, thanks to the favourable employment and income conditions as well as a bigger boost from wealth effects alongside buoyant asset markets. Government consumption expenditure grew steadily by 3.4 per cent in real terms in 2017, broadly similar to its 3.3 per cent growth in 2016.

Overall investment spending in terms of gross domestic fixed capital formation resumed moderate growth of 4.2 per cent in real terms in 2017 despite some volatility in individual quarters, after dipping 0.1 per cent in 2016. In particular, overall building and construction grew solidly by 3.0 per cent in real terms in 2017. Within this, private-sector activities saw further

growth in 2017 after a surge in the previous year, while public-sector works picked up notably. A surge in the costs of ownership transfer amid a more active property market also contributed to the annual increase in overall investment spending. Expenditure on acquisitions of machinery, equipment and intellectual property products increased 1.9 per cent in real terms, arresting a trend of annual declines since 2014, as business sentiment stayed generally positive throughout 2017 along with the improved global economic outlook.

Chart 7

Hong Kong's Services Trade (year-on-year rate of change in real terms)

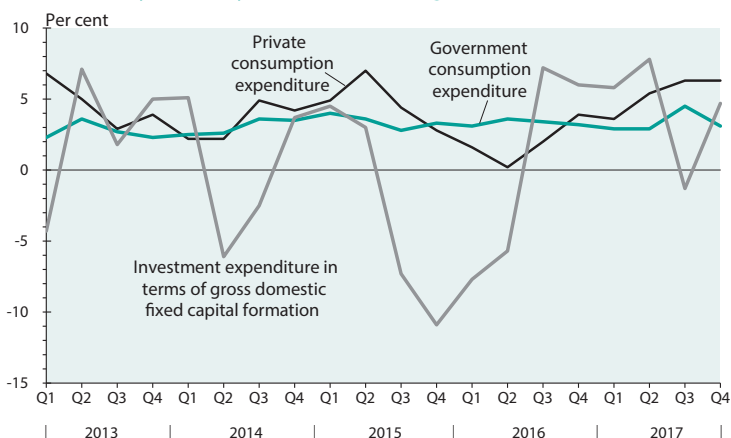


Exports of services improved visibly in 2017, reverting to a moderate annual growth.

Note: Exports and imports of services are compiled based on the change of ownership principle.

Chart 8

Main Components of Domestic Demand (year-on-year rate of change in real terms)



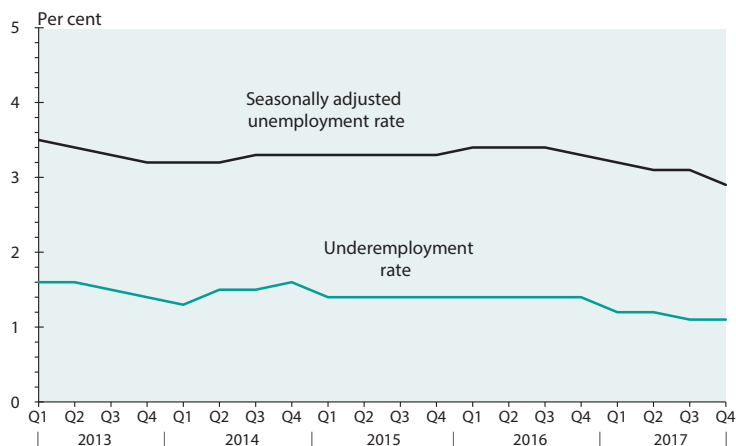
Private consumption expenditure grew strongly in 2017.

Investment expenditure resumed moderate growth.

Labour Market

The labour market showed a broad-based tightening during 2017 amid a buoyant local economy. Both the labour force and total employment picked up notably in growth, with the latter reaching a new record annual high of 3.82 million. Unemployment and underemployment rates went lower progressively over the course of 2017, averaging at post-1997 lows of 3.1 per cent and 1.2 per cent respectively for the year as a whole (*chart 9*).

Chart 9 Unemployment and Underemployment Rates



The labour market tightened in 2017 on the back of a buoyant local economy.

Total employment and the labour force expanded 1 per cent and 0.7 per cent respectively in 2017, after the 0.4 per cent gains in 2016 for both (*chart 10*). Data collected from private-sector establishments likewise pointed to solid employment growth throughout the year amid the vibrant local consumption and recovery of inbound tourism. Specifically, more visible job gains were observed in construction sites (covering manual workers only), human health services, professional and business services excluding cleaning and similar services, education, financing and insurance, and real estate.

The number of private-sector vacancies increased 3.7 per cent over 2016 to 71,310, with the growth pace picking up towards the latter part of the year.

Analysed by economic sector, most of the sectors saw more vacancies, with notable increases observed in construction sites (covering manual workers only), human health services, accommodation services, transportation, storage, postal and courier services, cleaning and similar services, and financing and insurance. Fewer vacancies were recorded in arts, entertainment, recreation and other services. As a combined result of the rebound in vacancies and falling unemployment, the ratio of job vacancies per 100 job-seekers increased from 52 in 2016 to 58 in 2017.

Chart 10

Total Labour Force and Total Employment (year-on-year rate of change)



Growth in both the labour force and total employment picked up notably in 2017.

On the back of a tight labour market, overall wages and earnings witnessed solid increases in both nominal and real terms. Labour earnings in the private sector rose further by 3.7 per cent for 2017 as a whole, translating into a 2.3 per cent real growth after discounting inflation. More notable increases were seen in accommodation and food services, real estate, and professional and business services.

Separately, the General Household Survey, though not strictly comparable to surveys on the business establishment, suggested the average monthly employment earnings of full-time employees in the lowest three decile groups combined, excluding foreign domestic helpers, grew markedly by 6.1 per cent in nominal terms and 4.5 per cent in real terms in 2017. Apart from the tight manpower situation, the uprating of the statutory minimum wage in May provided further growth impetus to earnings for grass-roots workers.

For the overall income situation, median monthly household income, excluding foreign domestic helpers, picked up through the year and rose 5 per cent to \$26,250 in 2017 from \$25,000 in 2016.

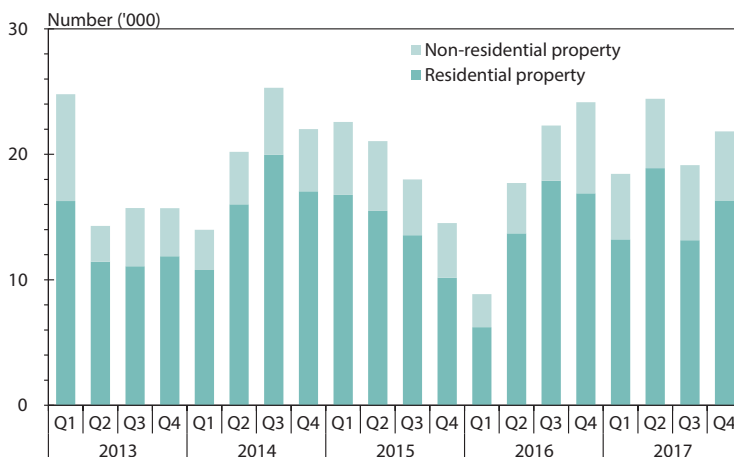
Property Market

The residential property market was generally buoyant in 2017, except for a temporary moderation around the middle of the year following the introduction of the eighth round of macro-prudential measures for property mortgage loans by the HKMA in May. Improved global and local economic performance, the still-tight demand-supply balance of flats and sustained low local interest rates all contributed to the fervent market situation.

The total number of sale and purchase agreements for residential property received by the Land Registry rose 13 per cent to 61,600 in 2017, though still below the long-term average of 88,100 from 1997 to 2016 (*chart 11*). Trading was generally active other than for a couple of

months when the HKMA's macro-prudential measures dented market sentiment. Total consideration soared 30 per cent to \$556 billion in parallel.

Chart 11 Sale and Purchase Agreements by Broad Type of Property



Trading turned active again in the latter part of 2017.

Overall flat prices recorded a hefty gain of 15 per cent between December 2016 and December 2017. While the rate of increase decelerated somewhat around the middle of the year, it accelerated again towards the year end along with a revival in transactions. Analysed by size, prices of small and medium-sized flats and large flats went up 15 per cent and 12 per cent respectively. Overall flat rentals also picked up to register an increase of 8 per cent between December 2016 and December 2017 amid the favourable economic environment. Rentals of small and medium-sized flats and large flats increased 8 per cent and 4 per cent respectively (*chart 12*).

As a result of the surge over the past several years, overall flat prices in December 2017 exceeded the 1997 peak by 104 per cent. Home purchase affordability¹ stayed elevated at about 67 per cent in the fourth quarter, significantly above the long-term average of 45 per cent over 1997-2016². Should interest rates rise three percentage points to a more normal level, the ratio would soar to 87 per cent.

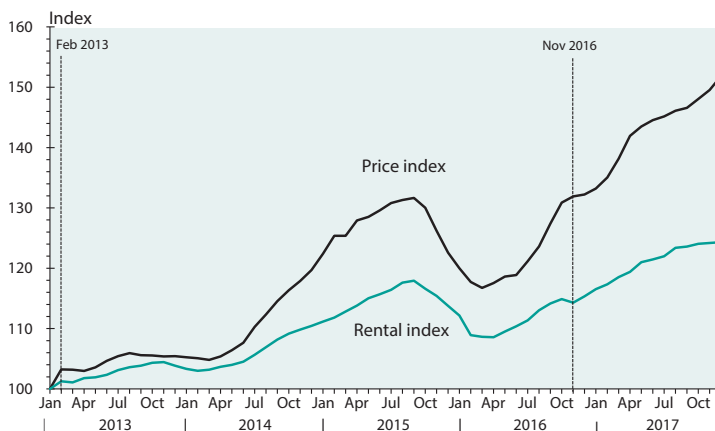
While the demand-supply balance of flats remained tight for the time being as indicated by the vacancy rate, it is set to ease in the years ahead. The vacancy rate edged down from 3.8 per cent at end-2016 to 3.7 per cent at end-2017. Nonetheless, reflecting the government's sustained efforts in land supply, the total supply of flats in the coming three to four years – comprising

¹ The ratio of mortgage payment for a 45 square metre flat to median income of households, excluding those living in public housing.

² The historical data on home purchase affordability has been revised to reflect the revision to income statistics in the General Household Survey.

unsold flats of completed projects, flats under construction but not yet sold and flats on disposed sites where construction can start any time – stayed at a high level of 97,000 units as estimated at end-December.

Chart 12 Prices and Rentals of Residential Property
(Jan 2013=100)



Flat prices recorded a hefty gain during 2017 while the increase in rentals accelerated.

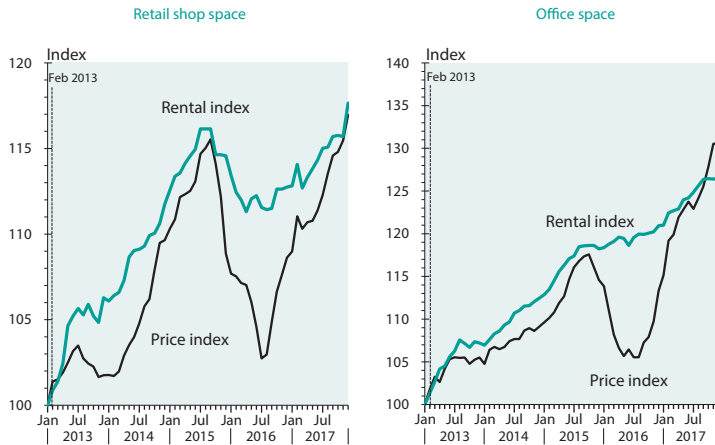
The government has also put in significant efforts to manage demand and reduce possible risks to financial stability arising from an exuberant property market. These measures have yielded notable results.

The commercial and industrial property markets generally revived in 2017. For the year as a whole, the number of sale and purchase agreements for non-residential property rose 21 per cent to 22,200, and total consideration soared 62 per cent to \$170.1 billion. Prices and rentals in individual market segments increased by varying degrees.

Sale prices of retail shop space rose 7 per cent between December 2016 and December 2017, while rentals went up 4 per cent (*chart 13*). For office space, overall prices gained 15 per cent. Prices of grade A, B and C office space went up 17 per cent, 12 per cent and 14 per cent respectively. Overall office rentals rose 5 per cent, with those of grade A, B and C office space recording a gain of 5 per cent, 3 per cent and 5 per cent respectively (*chart 13*). Prices and rentals of flatted factory space increased 13 per cent and 5 per cent respectively.

As to demand-supply balance, the vacancy rate of retail shop space stayed unchanged from a year earlier, at 9 per cent at end-2017, while those for office space and flatted factory space rose from 8.2 per cent and 5.8 per cent at end-2016 to 9.5 per cent and 6.1 per cent respectively at end-2017. Their respective long-term averages over 1997-2016 were 8.8 per cent, 9.8 per cent and 7.7 per cent.

Chart 13 Prices and Rentals of Retail Shop Space and Office Space
(Jan 2013=100)



Prices and rentals of retail shop space and office space increased by varying extents during 2017.

Price Movements

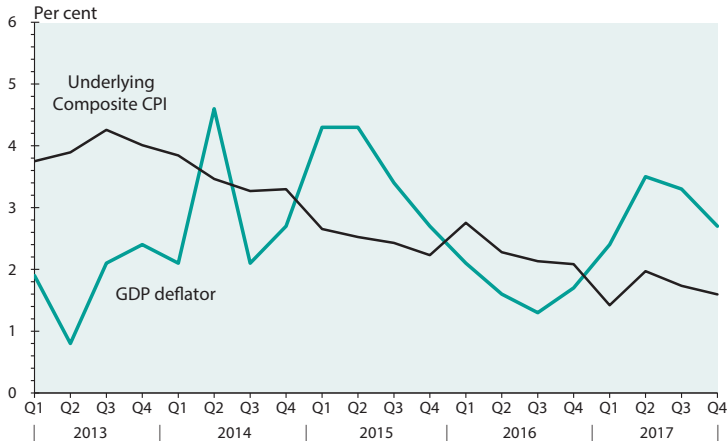
Consumer price inflation moderated in 2017, thanks to largely contained domestic and external price pressures. Headline consumer price inflation, which is under the influence of the government's one-off relief measures, moderated to 1.5 per cent in 2017 from 2.4 per cent in 2016. Netting out the effects of those one-off measures, underlying consumer price inflation likewise dropped to 1.7 per cent in 2017 from 2.3 per cent in 2016. The lower headline rate as compared with the underlying rate in 2017 was due to an extra quarter of one-off rates concession in 2017 as against 2016. The quarterly profile of underlying inflation dipped temporarily to 1.4 per cent in the first quarter due to the high base of comparison for food prices a year earlier and a late Easter holiday in April, then receded from 2.0 per cent in the second quarter to 1.7 per cent in the third quarter, and further to 1.6 per cent in the fourth quarter.

External price pressures were modest, as inflation in Hong Kong's major import partners stayed mild, notwithstanding some slightly higher import price pressure towards the latter part of the year due to the global economic upswing and depreciation of the US dollar. Locally, rental cost pressures as reflected in consumer price inflation were moderate in 2017, given that the general uptrend in fresh-letting residential rentals over the year fed through only gradually. The rise in labour costs was also in check when reckoned on a unit cost basis, as increases in labour earnings were accompanied by notable gains in labour productivity amid sustained above-trend economic growth.

The GDP deflator rose 3.0 per cent in 2017, faster than its 1.7 per cent increase in 2016. This was driven mainly by a pick-up in the domestic demand deflator, reflecting in part the surge in asset prices during the year (*chart 14*).

Chart 14

Main Inflation Indicators (year-on-year rate of change)



Underlying inflation eased for the sixth consecutive year in 2017, as domestic and external price pressures remained largely contained.

Public Finance

Management of Public Finance

The principles underlying the government's management of public finances are enshrined in the Basic Law, which stipulates that:

- The Hong Kong Special Administrative Region (HKSAR) shall have independent finances, and shall use its revenues exclusively for its own purposes.
- The HKSAR shall practise an independent taxation system, taking the low tax policy previously pursued in Hong Kong as reference.
- The HKSAR shall follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its GDP.
- The Legislative Council of the HKSAR shall exercise the power to approve taxation and public expenditure.

The government implements these constitutional provisions in its management of public finances by maintaining a low and simple tax regime and exercising fiscal prudence. Hong Kong's Public Finance Ordinance stipulates a system for the control and management of Hong Kong's public finances and defines the respective powers and functions of the legislature and the executive. Pursuant to the ordinance, the Financial Secretary submits to LegCo an annual set of estimates of revenue and expenditure. The estimates are drawn up in the context of a medium-range forecast, which is a fiscal planning tool to ensure appropriate regard is given to the longer-term trends in the economy.

A government department can incur expenditure only up to the amounts stated in the expenditure estimates and for the purposes approved by LegCo. During the financial year, which runs from 1 April to 31 March, if a department needs to change the expenditure estimates and spend more money, it must obtain LegCo's authorisation.

The government controls its finances through the General Revenue Account (GRA) and various funds established under the ordinance. The GRA is the main account for day-to-day departmental expenditure and revenue collection. Funds established under the ordinance are the Bond Fund, Capital Investment Fund, Capital Works Reserve Fund, Civil Service Pension Reserve Fund, Disaster Relief Fund, Innovation and Technology Fund, Land Fund, Loan Fund and Lotteries Fund. The total revenue and expenditure of the GRA and all these funds except the Bond Fund represent government revenue and government expenditure respectively, and the total balance of the GRA and the funds except the Bond Fund constitutes government fiscal reserves.

Financial Results

For 2016-17, the government recorded a surplus of \$111.1 billion, with revenue of \$573.1 billion and expenditure of \$462 billion. Fiscal reserves at the end of March 2017 stood at \$954 billion, equivalent to 25 months of government expenditure. Highlights of government revenue and expenditure for 2016-17 and 2017-18 (Revised Estimate) are found in table 6 of Appendix 6.

Public expenditure comprises government expenditure and expenditure by the Housing Authority and Trading Funds. In 2016-17, public expenditure increased 5.7 per cent against the previous year to \$494.8 billion, of which \$362.1 billion, or 73.2 per cent, was of a recurrent nature. Table 7 gives an analysis of public expenditure by policy area group and table 8, the growth rate of public expenditure as compared with the rate of economic growth.

Future Fund

The Future Fund was set up on 1 January 2016 with an initial endowment of \$219.7 billion for placement in longer-term investments, to secure higher returns for the fiscal reserves. As from 1 July 2016, it also includes \$4.8 billion, being one-third of the 2015-16 surplus as a top-up. This is part of fiscal measures to cope with foreseeable long-term fiscal challenges arising from an ageing population and slower economic growth.

The Future Fund is being placed with the Exchange Fund for an initial period of 10 years from 1 January 2016 to 31 December 2025. Investment returns arising from the Future Fund during the placement shall be retained by the Exchange Fund for reinvestment. Interest on the placement shall be paid to the government upon completion of the placement period or on a date as directed by the Financial Secretary.

Revenue Sources

Hong Kong's tax system is simple. Tax rates and the cost of administration are low. To protect tax revenue, the government takes vigorous measures to combat tax evasion and prevent tax avoidance. The major sources of revenue include profits tax (24 per cent), land premium (22 per cent), stamp duties (11 per cent) and salaries tax (10 per cent). All major sources of revenue are presented in chart 1 of Appendix 6.

The Inland Revenue Department collects about 51 per cent of total government revenue, including profits tax, salaries tax, property tax, stamp duties and betting and sweeps tax. Profits, salaries and property taxes, including tax under personal assessment, are levied under the Inland Revenue Ordinance and together accounted for about 36 per cent of total government revenue in 2016-17.

Profits tax is charged only on profits arising in, or derived from, Hong Kong from a trade, profession or business carried on within the territory. In 2016-17, profits of unincorporated businesses were taxed at 15 per cent and profits of corporations at 16.5 per cent. Profits tax is charged provisionally on the basis of profits made in the year preceding the year of assessment and is later adjusted according to the actual profits made in the assessment year. Generally, all expenses incurred in the production of assessable profits are deductible. There is no withholding tax on dividends paid by corporations. Interest income from deposits placed with banks or deposit-taking companies, other than that received by financial institutions, and dividends received from corporations are exempt from profits tax. In 2016-17, the profits tax collected was about \$139.2 billion, making up about 24 per cent of total government revenue.

Salaries tax is charged on emoluments arising in or derived from Hong Kong. As with profits tax, a provisional tax mechanism is in place. Salaries tax is calculated at progressive rates on the net chargeable income, which is income less deductions and allowances. In 2016-17, the first, second and third segments of net chargeable income of \$40,000 each were taxed at 2 per cent, 7 per cent and 12 per cent respectively, and the remainder at 17 per cent. No one, however, need to pay more than the standard rate of 15 per cent of their total income after deductions.

The earnings of husbands and wives are reported and assessed separately. However, where the deductions and allowances of either spouse exceed that spouse's income, or when separate assessments would result in an increase in their total salaries tax payable, the couple may elect to be assessed jointly. Salaries tax contributed some \$59.1 billion, or about 10 per cent, of total government revenue in 2016-17. Because of generous personal allowances under the tax law, only about 1.85 million people, or 49 per cent of the workforce, were liable to salaries tax for the 2015-16 year of assessment.

Owners of land and buildings are charged property tax at the standard rate, of 15 per cent in 2016-17, on the actual rent received after an allowance of 20 per cent for repairs and maintenance. There is a system of provisional payment of tax similar to that for profits tax and salaries tax. Properties owned by a corporation carrying on a business locally are exempt from property tax, but the profits it derives from the properties are chargeable to profits tax. Property tax contributed some \$3.4 billion, or about 1 per cent, of total government revenue in 2016-17.

Stamp duty is imposed on different classes of documents relating to transfers of immovable property, leases and transfers of shares under the Stamp Duty Ordinance. In 2016-17, the revenue from stamp duties was some \$61.9 billion, or about 11 per cent of total government revenue.

Betting duty is charged on the net stake receipts from betting on horse races and football matches and on the proceeds of Mark Six lotteries, all administered by the Hong Kong Jockey

Club. The yield from betting duty in 2016-17 totalled some \$21.1 billion, about 4 per cent of total government revenue.

The Rating and Valuation Department is responsible for the billing and collection of rates, which are levied on landed properties at a specified percentage of their rateable values (5 per cent in 2017-18). The rateable value of a property is an estimate of its annual open market rent at a designated date. Rateable values are reviewed each year to better reflect prevailing market rents. The current Valuation List, containing about 2.5 million assessments, took effect on 1 April 2017, with rateable values reflecting rental values on 1 October 2016. The revenue from rates in 2016-17 was \$21.3 billion, or about 4 per cent of total government revenue.

The Rating and Valuation Department is also responsible for the billing and collection of government rent for properties held under land leases granted on or after 27 May 1985, or on the extension of non-renewable land leases. Government rent is levied at 3 per cent of the rateable value of the property and is adjusted in step with any subsequent changes in the rateable value. There were about 1.9 million assessments in the Government Rent Roll on 1 April 2017. Total government rent collected in 2016-17 was \$10.7 billion, or 2 per cent of total government revenue.

Under the Dutiable Commodities Ordinance, excise duties are levied on four commodities to be consumed locally, namely hydrocarbon oil, liquor, methyl alcohol and tobacco, irrespective of whether they are manufactured locally or imported. The Customs and Excise Department collects these duties, which totalled \$10.3 billion in 2016-17, or about 2 per cent of total government revenue, of which 58.3 per cent was from tobacco, 37.2 per cent was from hydrocarbon oil, 4.4 per cent was from liquor, and 0.1 per cent was from methyl alcohol and other alcohol products.

All motor vehicles imported for use on roads are subject to First Registration Tax under the Motor Vehicles (First Registration Tax) Ordinance. The Customs and Excise Department assesses the taxable value of vehicles to facilitate the Transport Department's collection of this tax, which totalled \$7.8 billion in 2016-17, or 1.4 per cent of total government revenue.

It is government policy that fees charged by the government should in general be set at levels adequate to recover the full cost of providing the goods or services. Certain essential services are subsidised by the government or provided free of charge. Fees and charges for goods and services provided by the government generated about \$12.7 billion, or about 2 per cent of total revenue, in 2016-17. Government-operated public utilities, the most important of which, in revenue terms, is provision of water supplies, generated about \$4.3 billion, or about 1 per cent of total revenue.

Land transactions generated some \$128 billion, or about 22 per cent of total government revenue, in 2016-17. All revenue from land transactions is credited to the Capital Works Reserve Fund to finance the Public Works Programme.

Tax Treaties and International Tax Cooperation

Comprehensive double taxation agreements (CDTAs) with major economies improve the business environment and facilitate the flow of trade, investment and talent between Hong Kong and the rest of the world. These agreements reduce tax burdens on individuals and enterprises and eliminate uncertainties over tax liabilities. Hong Kong had signed 38 CDTAs as at end-2017, as well as tax information exchange agreements with seven other jurisdictions.

Hong Kong has in place a legal framework to implement the Organisation for Economic Cooperation and Development's (OECD) new global standard on automatic exchange of financial account information on tax matters to enhance tax transparency and combat cross-border tax evasion. The first exchanges will start in 2018.

Hong Kong has committed to carrying out the Base Erosion and Profit Shifting (BEPS) package promulgated by the OECD. The government is working on an amendment bill to codify the transfer pricing principles into the Inland Revenue Ordinance and implement the minimum standards of the BEPS package.

Hong Kong is working towards executing the Multilateral Convention on Mutual Administrative Assistance in Tax Matters so as to implement international tax cooperation initiatives more effectively on a multilateral basis.

Government Procurement

Hong Kong, China is a signatory to the Agreement on Government Procurement of the World Trade Organisation (WTO GPA). Government procurement is undertaken on the principles of public accountability, value for money, transparency, and maintaining open and fair competition.

The Government Logistics Department is the government's procurement agent for many goods and related services. Open tendering is normally adopted to meet departments' procurement needs at the best value for money, with due regard to the lifetime cost, environmental considerations and stability of supply. Restricted or single tender procedures may be used under exceptional circumstances. In 2017, the department awarded contracts amounting to \$4.21 billion, procuring goods and related services from 22 countries or territories, including Hong Kong.

The department maintains supplier lists for different categories of goods and services to facilitate sourcing. It publishes tender notices online and notifies suppliers on the relevant supplier lists for open tenders. Tender notices for procurements covered by the WTO GPA are also published in the Government Gazette. Consulates and overseas trade commissions are informed where appropriate. Bidders may download tender documents and submit offers online.

Websites

Office of the Government Economist, Financial Secretary's Office: www.oge.gov.hk
Financial Services and the Treasury Bureau (The Treasury Branch): www.fstb.gov.hk/tb/en
Government Logistics Department: www.gld.gov.hk