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**COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE
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**The European Union, Hong Kong and Macao:
possibilities for cooperation 2007-2013**

Executive summary

The European Union's relations with the Hong Kong and Macao Special Administrative Regions (SARs) have continued to develop since they returned to Chinese sovereignty.

The EU has a strong interest in the continued autonomy and freedoms enjoyed by the two SARs, and supports early and substantial progress towards universal suffrage. The Commission has issued annual reports on the constitutional, political, trade, economic and bilateral developments in the two SARs and will continue to do so.

Relations are above all practical and based on mutual interest. There is substantial and growing cooperation, both direct and indirect, as Hong Kong and Macao continue to provide a platform for deepening cooperation with mainland China.

The EU should continue to build on the strong base of existing cooperation and dialogue. There should be a regular structured dialogue between the Commission and the Hong Kong SAR on matters under its competence, and the annual Joint Committee meetings between the Commission and the Macao SAR should continue.

Following agreement of a new financing instrument for industrialised countries, there should be a review and new agenda for cooperation between the two sides. This Communication sets a number of challenging objectives for moving forward cooperation in seven key areas: trade and customs; finance; people-to-people links (including academia); transport; the environment; health; and food safety.

THE EUROPEAN UNION, HONG KONG AND MACAO: POSSIBILITIES FOR COOPERATION 2007-2013

The Commission's policy towards the Hong Kong Special Administrative Region (SAR) was set out in a 1997 Communication to the European Council. That Communication, which was issued in the context of Hong Kong's handover to Chinese sovereignty, underlined the importance of smooth implementation of the 'one country, two systems' principle and set out ways in which the EU could contribute to Hong Kong's political and economic development. The Commission has since issued annual reports on developments in the Hong Kong SAR, most recently with the eighth annual report on developments in 2005. The Commission has also engaged with the SAR Government on a number of policy dialogues, notably on trade and economic policy, signed important bilateral agreements in areas such as customs cooperation and the readmission of illegal immigrants, and, when the need has arisen, made declarations on political developments in Hong Kong.

Policy towards the Macao Special Administrative Region was set out in a Communication to the European Council in 1999. The Commission has issued annual reports on developments in the Macao SAR and held annual meetings of the Joint Committee with the SAR authorities.

The European Union's relations with both Hong Kong and Macao have developed considerably since they returned to Chinese sovereignty. During his visit to Macao and Hong Kong on 18 July 2005, President Barroso agreed with the Chief Executives of both SAR Governments that "the European Commission should develop, broaden and deepen cooperation" with the two Special Administrative Regions in areas of mutual interest. Accordingly, this Communication evaluates the current relationships and makes a number of recommendations for improving and deepening the EU's cooperation with the two SARs.

1. POLITICAL AND CONSTITUTIONAL DEVELOPMENTS

Since the transfer of Hong Kong and Macao to Chinese sovereignty, both Special Administrative Regions have been governed according to the principle of ‘one country, two systems’, set out in detail in a separate Basic Law for each.

In general the ‘one country, two systems’ principle has been respected and is working well for the people of Hong Kong and Macao. The EU supports this principle, and in particular the respect for human rights and individual freedoms enshrined in the Basic Laws, which should be enjoyed by the citizens of both SARs. Both SAR governments continue to enjoy a high degree of autonomy in economic, trade, fiscal, financial and regulatory matters, and the people of Hong Kong and Macao benefit from their own legal systems, an independent rule of law, individual property rights, freedom of speech, and market economic systems.

In both SARs, the specific constitutional development measures envisaged in their Basic Laws have been implemented fully and on schedule.

However, the Basic Law of Hong Kong also states: “The ultimate aim is the selection of the Chief Executive by universal suffrage upon nomination by a broadly representative nominating committee in accordance with democratic procedures”¹. (There is no analogous article in Macao’s Basic Law².) Neither Hong Kong nor Macao has yet achieved universal suffrage nor defined a road map towards full democracy.

The European Union supports democracy throughout the world as the best means of creating legitimate, stable, accountable and transparent government, protecting rights and freedoms, and upholding the rule of law. The EU supports early and substantial progress towards the ultimate goal of universal suffrage in Hong Kong as set out in the Basic Law, and also in Macao, in line with the wishes of the people of Hong Kong and Macao.

The Commission has commented at length on Hong Kong's constitutional development and interpretations by the National People's Congress of the SAR's Basic Law in its previous annual reports (see the 2004 and 2005 annual reports in particular)³. It has also commented on developments in Macao in its previous annual reports on the Macao SAR⁴.

On the international stage, both the Hong Kong and Macao SAR Governments have quickly become accepted as, and remain, autonomous international partners on economic, trade, fiscal, financial, sports, research, educational, cultural, and people-to-people matters, for which they retain legal competence under their Basic Laws. They continue to be active members of international organisations such as the World Trade Organisation (WTO) and the World Customs Organisation and are parties to a number of international treaties. As recently as December 2005, Hong Kong successfully hosted the Sixth WTO Ministerial meeting, and in the same month Macao hosted the 2005 East Asian Games.

¹ Article 45.

² For Macao, the Basic Law stipulates that "if there is a need to change the method for forming the Legislative Assembly of the Macao SAR in and after 2009, such amendments must be made with the endorsement of two-thirds majority of all the members of the Assembly and the consent of the Chief Executive”, and there is no reference to universal suffrage.

³ The Commission’s annual reports on Hong Kong are available on the internet website: <http://www.delhkg.cec.eu.int/en/index.htm> and are listed in annex to this Communication.

⁴ The Commission’s annual reports on Macao are available on the internet website: <http://www.delhkg.cec.eu.int/en/index.htm> and are listed in annex to this Communication.

2. ECONOMIC DEVELOPMENTS

Mainland China's rapid growth and increasing economic prosperity has created new opportunities for Hong Kong and Macao. The SARs' close relationships with south China, and Guangdong province in particular, have become key to their economic success. Hong Kong and Macao are benefiting as liberal, open gateways to and from China. The Closer Economic Partnership Arrangements with mainland China and the Individual Visit Schemes, which relax travelling restrictions for mainland residents wishing to visit, have made significant contributions to economic growth.

Hong Kong

In the period immediately following handover, the Hong Kong SAR Government was faced with unprecedented challenges in financial, economic and fiscal management. It is to the credit of the SAR Government that Hong Kong has now recovered from the recession that followed the negative economic impacts of the Asian financial crisis in 1997-98 and the outbreak of SARS (Severe Acute Respiratory Syndrome) in 2003.

Hong Kong's 2005 economic and financial figures have now regained their 1997 levels. GDP grew in 2005 at 7.3 % (and the government's forecast for 2006 is for 4 to 5% growth). Unemployment in December 2005 was at a four-year low of 5.2%. Fiscal balance was finally restored for 2005-06, the first time in eight years after the handover, as the economy picked up and public expenditure was restrained.

Helped by the financing needs of mainland China, Hong Kong is consolidating its position as the international financial centre for East Asia. Mainland Chinese enterprises are using Hong Kong as a fund-raising and investing centre, creating a growing demand for Hong Kong's financial, legal and business services. China-related companies accounted for over 80% of the IPO (initial public offering) funds raised in Hong Kong, helping to make Hong Kong the fourth largest equity fund raising centre in the world in 2005 and a globally important funds trading and asset management centre. Hong Kong's success as an international financial centre hinges on its ability to play an increasing role in intermediating Mainland China's large domestic savings. Given the competition from other regional financial centres, Hong Kong will need to continue to increase competitiveness by maintaining flexible labour and product markets, strong institutions and sound macroeconomic policies.

Hong Kong's businesses and people have also demonstrated a remarkable capacity to adjust to competitive and external challenges. They have been able to move up the value-added chain to higher-price and higher-margin activities in financial services, business services, trade, high-value manufacturing, tourism, retail and other services. But Hong Kong still faces the challenges of increasing cost and supply-side constraints resulting from the challenges of congestion and environmental pollution. Its ambition to remain "Asia's World City" will depend on meeting these challenges.

Macao

The explosive growth of Macao's small, open economy since 2000 has been due primarily to the gaming and tourism sectors. In 2002 the gaming sector was liberalised, and the 40-year-old casino monopoly abolished. Coupled with the Individual Visit Scheme from mainland China, this has attracted a growth in visitors, which in turn has provided impetus for wider economic growth. With rising demand, Macao should continue to grow rapidly, though this

could be affected if there were problems with or a challenge to its gaming monopoly for China.

Macao is a small but dynamic urban centre, which is seeking to build itself as a strategic services hub for the Pearl River Delta. With gaming and tourism as its basic economic pillars, the SAR Government aims to diversify Macao into a regional entertainment, exhibition and conference service centre. But it will face stiff competition, squeezed between Hong Kong's highly developed services economy and the low wages of the mainland. The key challenges for Macao will be to: reinforce its legal and financial systems to support future growth and avoid erosion of the integrity of its financial and social systems; and effective training of a local labour market (or importing and integration of qualified labour).

3. CASE FOR GREATER ENGAGEMENT

Hong Kong

EU interests in Hong Kong are substantial: Hong Kong is the EU's sixteenth bilateral trading partner by volume, and if the huge transit trade via Hong Kong to China is taken into account, ranks as high as sixth. Two-way trade, although declining slightly in recent years (due primarily to a number of Hong Kong industries moving to the mainland) remains close to €30 billion. Hong Kong continues to play a 'gateway' function for a number of EU newcomers looking for access to the mainland Chinese market. Increasingly, mainland Chinese companies are using Hong Kong as a base and a source of knowledge — a gateway for business opportunities in Europe. The EU is Hong Kong's third largest supplier after the mainland and Japan, and the third largest investor.

Thousands of EU companies maintain regional HQs or offices in the SAR and over 45 000 EU citizens are resident there. EU financial services institutions continue to have a leading stake in Hong Kong. In 2005, 34 of the 132 licensed banks in Hong Kong were incorporated in the EU; and of the 175 insurance companies authorised in Hong Kong 30 are incorporated in the EU, putting them top of the list in terms of the number of overseas insurers operating in Hong Kong.

European business activity within Hong Kong accounts for the largest foreign non-Chinese presence. EU companies constitute the largest number of foreign companies with regional headquarters and regional offices based in Hong Kong (1083 or 28% of the total, as at June 2005). In addition to a European Chamber of Commerce, there are 14 EU Member State bilateral Chambers of Commerce in Hong Kong. The EU/Hong Kong Business Council also meets annually to provide a forum for a strategic dialogue between Hong Kong and EU business leaders.

Hong Kong is a key East Asian transportation hub for European Union traders, service providers and individuals. Hong Kong's container port remains the largest in the world in terms of the number of containers passing through. The EU also has strong civil aviation relations with Hong Kong: most Member States have bilateral air services agreements. Hong Kong is a major airfreight and passenger hub for onwards traffic to the wider Asia-Pacific region as well as an important gateway to the Chinese mainland. Hong Kong's open English-speaking environment means it is also a key tourism, education and conference destination.

Overall, our bilateral relationship with Hong Kong is good across the board, with highlights including:

- the strength of trade relations and shared priorities for multilateral trade engagement through the WTO process;
- our Customs Cooperation Agreement, signed in 1999, which facilitates co-operation to combat fraud, piracy and other forms of illegality, and the exchange of information and coordination between the customs authorities of Hong Kong and the EU's Member States.
- and our agreement on 'readmission of persons residing without authorisation', which entered into force in 2004, and which provides a good basis to take forward co-operation on wider immigration issues.

But there are also areas where we would like to see improvements. Two key areas are:

- competition policy, where European companies often complain about the lack of a level playing field in certain key sectors;
- and IPR violations, where Hong Kong has worked hard in recent years, but nonetheless remains the source of some 8 % of all recorded violations in the EU.

Since 1993, the EU has maintained a permanent Office in Hong Kong (which is accredited to both Hong Kong and Macao). It is staffed and operated by the European Commission and is active in a number of areas, with the focus on economic and trade issues. 16 EU Member States are represented by resident missions accredited to Hong Kong and to Macao (the mission of Portugal is located in Macao and the other missions are located in Hong Kong).

In February 2006 the Hong Kong Government proposed to reinforce its representation offices in Europe, opening a new trade office in Berlin to serve Germany and the eastern European Member States of the EU. The existing Hong Kong Office in Brussels is to be upgraded to become the Hong Kong head office in Europe, with the London and Berlin offices reporting to Brussels.

Macao

The EU is Macao's third largest trading partner. While there are only a few EU companies based in Macao, those that are there express satisfaction with the infrastructure and communications.

Macao retains close links with Portuguese culture, and Portuguese remains one of the official languages of Macao. This contributes to the strength of the EU's relations with Macao and its attractiveness as a tourism, education and conference destination.

The EU concluded a Trade and Cooperation Agreement with Macao in 1992 and the EC-Macao Joint Committee, established under this agreement, meets annually. Since signature of the agreement, the EU has funded cooperation projects with Macao worth around 1 million euros per annum. Projects have included: training for the tourism industry (1999-2001); a European studies programme (1999-2001); a services development programme (1999-2001) advising Macao on ways to improve Macao's services sector; and the Asia-Invest programme (2001 and 2002). The EU-Macao Legal Cooperation Programme (2001-2005) is ongoing and

provides training, workshops and seminars to develop Macao's legal system and to promote the rule of law in the SAR. The European Union's interpretation service (SCIC) is providing translation and interpretation training in 2006, financed by the Government of Macao.

The EU–Macao Readmission Agreement signed in 2002 is working well, and constructive annual bilateral meetings are held to review progress.

The Macao representative in Europe, based in Lisbon, Geneva and Brussels, plays a very useful and positive role in EU-Macao relations.

4. DELIVERING CLOSER COOPERATION : OBJECTIVES

The existing policy and regulatory dialogues and cooperation between the EU and the Hong Kong and Macao SARs have provided an excellent base for relations. To move relations further forward, this base needs to be built upon and strengthened, and at the same time widened to include other sectors and take account of the much greater EU cooperation with mainland China. Hong Kong and Macao are indeed platforms for deepening cooperation with mainland China. The EU should now widen and deepen the scope for greater EU involvement in the ongoing trilateral cooperation between Hong Kong, Macao and mainland China.

Accordingly, this section sets a number of challenging new objectives for moving forward cooperation in seven key areas: trade and customs; finance; people-to-people links (including academia); transport; the environment; health; and food safety.

Trade and customs cooperation

Trade and customs cooperation remains the cornerstone for a strong bilateral relationship between the EU and both partners. This should be built upon by:

- Improving informal consultation and coordination on multilateral trade and economic regulation, particularly within the framework of the WTO as and where appropriate;
- Continuing close consultation on bilateral trade issues, in particular on trade facilitation, and strengthening customs cooperation on IPR. The EU should consider programmes to disseminate and explain measures on regulations, standards, customs procedures, phyto-sanitary requirements and other regulations that may affect the trade in goods and services between the EU, Hong Kong, Macao and China;
- Building on the framework of the Customs Cooperation Agreement to strengthen action against copyright infringement; combating transnational smuggling of counterfeit cigarettes by sharing information and intelligence; and working towards a more secure global shipping system by electronically scrutinizing containers, without slowing the flow of international commerce.
- Exchanging views and best practice on competition policy and public procurement procedures as appropriate;
- Greater support for business (particularly SMEs), including provision of information on greater China markets. The European Chambers of Commerce in Hong Kong and the Offices of Hong Kong and Macao in Europe could be involved and more closely integrated with the work of the EU-Hong Kong Business Council Cooperation Committees;

- Encouraging universities and business schools in the EU, Hong Kong, Macao and the Chinese mainland to cooperate on management education and training.

With the establishment of Closer Economic Partnership Arrangements between both SARs and China (CEPAs) since July 2003, companies in the SARs are benefiting from widening access to the Mainland Chinese market. This is a positive development, but the EU will continue to monitor the CEPAs' WTO compliance and any potential negative impact on foreign invested companies.

Financial cooperation

The financial, banking and investment relationship between the EU and the SARs is already strong, but there is scope for:

- Improved regulatory dialogue and convergence on financial regulation matters, in particular on issues like anti-money laundering legislation and its implementation, investment fund regulation, corporate jurisdiction and governance issues, and accounting and financial reporting standards.
- Improved dialogue, cooperation and convergence on issues relating to good governance in tax matters, taking account of the fiscal autonomy of the Hong Kong and Macao SARs within a sovereign China. In line with its stated tax policy of promoting internationally accepted good governance principles as widely as possible, the Commission proposes work with both SARs to improve transparency and the exchange of information, strengthening enforcement measures to prevent the avoidance or evasion of taxes, and in particular promoting application of measures equivalent to those applied within the EU on taxation of income from savings. In addition the Commission will encourage both SARs to adopt the principles of the Code of conduct on business taxation which aims to develop a fair, transparent and cooperative tax environment that favours business, growth and jobs on both sides.

People-to-people and academic links

- The education and research sectors provide a rich area for possible EU/Hong Kong and EU/Macao cooperation. The Commission should consider the scope for improving relations through contacts between think tanks and journalists, parliamentary exchanges, student and teacher exchanges, institutional twinning arrangements, joint research and debate on public policy, cultural exchanges, and language training (building on the current Commission support to enhance capacity for Portuguese/Chinese interpretation in Macao); the EU should also continue to encourage civil society and non-governmental debate and dialogues.
- Both the Erasmus exchange scholarships and the Jean Monnet Programme are relevant and should be made accessible;
- A more substantial visitors programme should be built upon the existing European Union Visitors Programme (EUVP), which is successful but of limited scope at present;
- Hong Kong and Macao universities and research institutes are already bidding jointly with European institutions for access to funding from the EU Framework Programmes for Research Technology and Development. Measures should be developed to enhance this

trend and in parallel to encourage deeper cooperation — possibly through twinning and cooperation agreements (and possibly including mainland Chinese institutions) — to provide opportunities for information exchanges and networking;

- Immigration cooperation should continue. The EU and Hong Kong and Macao maintain a regular dialogue through the Joint EC-Hong Kong Readmission Committee, which last met in January 2005 in Hong Kong. This should form a basis for moving toward greater cooperation on wider immigration issues;
- The current legal cooperation and training project in Macao is a good example and should be built upon; international cross-border legal issues could form an interesting area for cooperation on the rule of law, good governance, human rights issues, civil law and commercial law;
- EU visibility should be enhanced in Hong Kong and Macao. This should be done mainly through practical actions, including through the possibility of setting up a “Europe Centre” or “Europe House”. But there is also a need to reinforce EU visibility more generally and directly. There should be a concerted public diplomacy strategy for the EU in Hong Kong and Macao and for the wider region.

Transport cooperation

- There is significant shared expertise on maritime security and regulation, and this should form the basis for further cooperation. The ongoing pilot project for the security of maritime containers, involving the Commission and ports in the UK (Felixstowe), Netherlands (Rotterdam), Shanghai and Hong Kong, provides a good example.
- The EU has strong aviation relations with Hong Kong: most Member States have bilateral air services agreements with the SAR. Hong Kong is in itself a major hub in Asia for onwards traffic to the wider Asia-Pacific region as well as an important gateway to mainland China. The EU wishes to strengthen aviation relations with Hong Kong as well as with Macao, which are key partners in the region for the EU aviation industry.
- Joint efforts are underway, and need to be reinforced, to conclude horizontal agreements at Community level with Hong Kong and Macao, which would restore legal certainty for air carriers on each side under existing bilateral agreements. This would represent an important first step in developing closer cooperation between the EU and Hong Kong and Macao in civil aviation. Broader areas of cooperation, including technical, industrial and regulatory cooperation in areas such as air traffic management, aviation safety and security as well as in other areas, should also be explored.

Health, food and product safety

The EU and Hong Kong and Macao have shared interests in international health, food and product safety issues.

- On internationally transmittable diseases the informal consultations already begun between the European Commission and Hong Kong in January 2006 should form the basis for future discussions and possible co-operation with both SARs.

- Both sides should consider scope for strengthening cooperation on the Rapid Alert System for Food and Feed.
- Given the importance of Hong Kong's role in the export of consumer products and the importance of combating seriously dangerous consumer products, both sides should cooperate closely to ensure that products produced in or transited through Hong Kong are safe and are monitored against EU safety standards.

Environmental cooperation

- The Commission welcomes the deepening EU dialogue with mainland China on the environment and climate change. The Commission should also explore with Hong Kong and Macao the scope for cooperation on air and water pollution and industrial emissions to help the Hong Kong and Macao SARs better carry out their pollution control strategies, to take into account and influence cross-border issues and to work on solutions at regional and global level where relevant.
- Among other things, this should have the aim of promoting business cooperation for SMEs and dialogue on air and water pollution and industrial emissions. Hong Kong's and Macao's universities, business associations and training facilities could serve as a platform for engagement on these issues.

5. DELIVERY MECHANISMS

Consultations and transparency

In July 2005 President Barroso and the Chief Executives of Hong Kong and Macao — Donald Tsang and Edmund Ho — agreed it was important to have structured, regular dialogue between the European Commission and the two SAR governments on matters within the competence of the two governments under their respective Basic Laws.

As far as Hong Kong is concerned, this would best be achieved through regular dialogue, for which the arrangements might be as follows: (a) meetings should be held annually; (b) there should be an adequate level of representation from the European Commission and the Hong Kong government; and (c) the agenda for each meeting should cover the full range of practical issues in the relationship and be agreed in advance by both sides. These arrangements, which would complement and not replace existing sector-specific dialogue, should be implemented as soon as possible, with the first annual meeting taking place before the end of 2006.

The Commission believes that the existing EC/Macao Joint Committee mechanism works well and should continue, and positive lessons drawn from it might inform the establishment of dialogue with Hong Kong.

There should be public and transparent reporting of the annual meetings and the ongoing cooperation, which could be achieved through a combination of Joint Statements and the existing mechanism of the Commission's Annual Reports.

The Commission will continue to maximise policy coordination with all EU partners (both with Member States and the European business community) in Hong Kong, Macao, and

Europe — as well as in mainland China, as appropriate. Making available information and ensuring open communication on initiatives for future cooperation should help ensure that these actions complement and support the strategies of EU Member States, the Hong Kong and Macao governments, and private entities and individuals.

Already during 2005 and early 2006, in order to discuss and explore possible content and means to deepen, develop and broaden cooperation between the EU and Hong Kong and Macao in areas of mutual interest, a series of informal, open, brainstorming consultative seminars were arranged by the Office of the European Commission in Hong Kong and Macao with over 200 representatives of various sectors of Hong Kong and Macao society: trade and economic operators, EU Heads of Mission, environment and health professionals, and representatives of civil society, NGOs, and the academic and research community. A sixth seminar was held in November 2005 with representatives of various sectors of Macao society in Macao.

Financing cooperation

Hong Kong and Macao are important partners that share many values and institutional structures with the EU in the economic, regulatory, social and cultural spheres.

Dialogue and cooperation should therefore be backed up and reinforced by an EU financing instrument, such as the new Industrialised Countries Instrument under the future Financial Perspectives of the EU. This could provide funding for meetings, conferences, and other actions fostering economic partnerships, business collaboration and science and technology cooperation, as well as people-to-people exchanges and the development of policy dialogues in the areas detailed in this Communication. The overall aim of such action would be to promote better mutual understanding and co-operation and stimulate further development in bilateral trade, investment flows and customs cooperation between the EU and both partner SARs. The Commission should explore potential synergies for trilateral cooperation with mainland China including under the Development Cooperation Instrument.