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**REPORT FROM THE COMMISSION
TO THE COUNCIL AND THE EUROPEAN PARLIAMENT**

Hong Kong Special Administrative Region (SAR) : Annual Report 2005

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2005 was an important year for Hong Kong:

- Hong Kong continued to enjoy a high degree of autonomy as set out under the Basic Law and the principle of “one country two systems”. However, the two most significant political and constitutional developments of 2005 raised some concerns;
- Hong Kong’s economy showed strong economic growth, restoring fiscal balance for the first time since 1997;
- 2005 also signalled a strengthening and deepening of Hong Kong’s bilateral relationship with the EU. President Barroso visited Hong Kong in July.

Political and constitutional developments

On 10 March 2005, CH Tung tendered his resignation from the position of Chief Executive of the SAR Government and was replaced by the former Chief Secretary, Donald Tsang. Mr Tung played an important role as Hong Kong’s first Chief Executive. The European Commission enjoyed a good working relationship with him and his administration and expresses its thanks. Mr Tsang was elected as Hong Kong’s second Chief Executive on 21 June. The Commission congratulates Mr Tsang and looks forward to working with him to continue and strengthen the cooperation between the EU and Hong Kong.

There was significant debate in Hong Kong as to whether the new Chief Executive should serve a full five-year mandate or the remainder of the previous Chief Executive’s term. Mr Tsang announced – contradicting the SAR Government’s previous position – that the new Chief Executive would serve a term of only 2 years, the remainder of Mr Tung’s term. Mr Tsang subsequently requested an interpretation by the Standing Committee of the National People’s Congress (NPC), which confirmed this position. There were significant objections to Mr Tsang’s initial decision, and the recourse to an NPC interpretation, which a number of pan-democrats and legal associations regarded as an erosion of the “one country two systems” principle and Hong Kong’s high degree of autonomy.

The Commission recognises the power of the NPC’s Standing Committee to interpret the Basic Law. But the Commission believes this power should be exercised carefully and in a balanced manner consistent with Hong Kong’s high degree of autonomy and judicial independence.

The second important constitutional development of 2005 was the Legislative Council’s rejection of proposals (based on the final report of the Constitutional Development Task Force) for new procedures for the selection of the Chief Executive in 2007 and the Legislative Council in 2008. The proposals were widely and publicly debated in the latter months of 2005. Pan-democrat legislators and others criticised the absence of a timetable for universal suffrage; the increase in the number of appointed District Councillors; and the participation of appointed Councillors in the election of the Chief Executive. As a result, the proposals did not secure the 40 positive votes necessary for adoption by the Legislative Council.

The Commission followed this debate closely. The Commission expresses its hope that the SAR Government and the members of the pro-democracy camp will maintain and reinforce their dialogue, and will continue their efforts to find a solution for progress towards universal suffrage. The Commission continues to support early and substantial progress towards the ultimate goal of universal suffrage in Hong Kong, as set out in the Basic Law and in line with the wishes of the people of Hong Kong.

Trade and the economy

Hong Kong's accelerating growth throughout 2005 was higher than forecast, with real GDP growth reaching 7.3 percent. Taken cumulatively, Hong Kong has now enjoyed sustained momentum in its economic expansion for ten consecutive quarters. As a result, fiscal balance was restored for the first time since the handover, with a small surplus recorded for operating and consolidated accounts. The EU and Hong Kong remain important and growing trade partners: total bilateral trade rose by 6.8 percent in 2005 to reach 31 billion euros (Eurostat figures).

The process of Hong Kong's economic integration with mainland China continued to intensify. The third phase of the Closer Economic Partnership Agreement (CEPA III) between the two sides was signed in October 2005. CEPA III expanded tariff-free treatment to cover products currently classed as having Hong Kong origin, and agreed further liberalisation of trade in services. However, trade volume under CEPA remained fairly small (at around five percent of Hong Kong's total exports to China). Hong Kong's economic prospects depend increasingly on effective positioning and engagement in the region, with mainland China and in particular with South China and the Pearl River Delta.

The Commission welcomes the SAR Government's establishment of a Competition Policy Review Committee (which is expected to complete its work by mid-2006). The Commission continues to urge the SAR Government to consider a general competition law supported by an independent competition authority, which would help to ensure equality of access for existing and new entrants to Hong Kong markets. The Commission also welcomes the SAR Government's commitment to the protection of intellectual property rights. Recent measures to combat local pirated production have been effective. But the Commission remains concerned by transshipment of pirate and counterfeit goods through Hong Kong to the EU, the inadequate protection of pharmaceutical patents under the current registration system, and the practice of Chinese companies registering in Hong Kong under names which are identical or similar to those of foreign companies.

EU / Hong Kong relations

There were a number of key official and high-level contacts in 2005, demonstrating the Commission's clear support and commitment to strengthening bilateral relations. Commissioners Mandelson and Kovacs visited Hong Kong for bilateral meetings (in April and November respectively), and Commissioners Mandelson and Fischer-Boel led a 150-strong EU delegation, including European Parliament officials, to participate in the sixth WTO Ministerial Conference in December, which successfully carried forward the ongoing Doha Development Agenda negotiations.

President Barroso visited Hong Kong on 18 July 2005. In the joint statement which he issued with Mr Tsang, they agreed that "Hong Kong and the European Union should develop,

broaden and deepen cooperation in areas of common interest". The Commission intends to present further practical suggestions for achieving this through a Communication in 2006.

The annex to this report gives full details of the Commission's analysis, covering political events, constitutional developments, the economy, trade issues and EU / Hong Kong relations (Commission Staff Working Document SEC(2006) 1098).