China's Economy

REVIEW OF 2000

After the slowdown in 1999, China's economy rebounded significantly from the trough. Real GDP increased by 8% for the whole year, which was far better than the 7.1% recorded in 1999. This represented that China's GDP had reached US$1 trillion for the first time. The Chinese government continued to focus on restructuring of SOEs and China's economic growth has entered into a steady growth phase. Fixed asset investments were up 9.3% as compared with 6.1% in 1999. Industrial output and retail sales improved substantially in 2000, as year-on-year growth of 11.4% and 9.7% respectively were recorded. Chinese government's economic stimulus package and the development of consumer credit have successfully boosted domestic consumption, thus easing the pressure of a possible deflation. The consumer price index ("CPI") turned into a positive level of 0.4% and the retail price index ("RPI"), albeit still in negative territory, showed signs of turning around. Foreign direct investments ("FDI") surged in the wake of China's accession into the WTO. Actual and contracted FDI rose by 0.93% and 50.8% year-on-year respectively. On the foreign trade front, export growth continued its strength throughout the whole year, despite economic slowdown in the US which hindered growth in the fourth quarter. Imports experienced an even stronger growth during the period due to several factors, including anti-smuggling measures and interest income tax imposed by the government during 2000. Exports and imports grew by 27.8% and 35.8% respectively. Trade surplus contracted to US$24.1 billion. Foreign exchange reserve stood at US$165.6 billion at the end of 2000 as compared to US$154.68 billion in 1999, showing a continuous healthy growing trend.

SOE restructuring was the main theme of economic reform in year 2000, and the process was faster than ever. This was viewed as a necessary step for China for two main reasons. Firstly, the financial burdens of SOEs were significantly reduced and their efficiencies were greatly improved, as evidenced by many of the SOEs that had become profitable after making losses for three or more years. The second reason was that WTO negotiations between China and other WTO members had entered into a higher level of exchange. In order to compete with multi-national corporations, corporate restructuring is a must for Chinese firms. This involved a series of IPO, debt-to-equity swap, mergers and acquisitions actions throughout the year. The only burden remaining was the international trust and investment company ("ITIC") issue. Several ITICs were unable to service their debt repayments and their bonds were technically in default. The central government had already announced that the number of ITICs will be greatly reduced and ITICs will try their best to service their debts. Banking sector reform was another hot topic during the year. NPLs of state banks were lowered significantly. Improvement in SOEs' profitability and the clearance of NPLs by the four state-established asset management companies ("AMCs") were the main reasons behind this scenario. The NPL and capital adequacy levels of state banks were approaching international standards. Apart from cleaning up their balance sheets, Chinese banks were trying to modify their cost structures in order to maintain their competitiveness.

CHINA'S ECONOMY *(Cont'd)*

The technology sector has undergone a roller-coaster ride in year 2000. Similar to what happened in the US, the Chinese technology sector received a boost during the first half of the year. Foreign companies set up technology and telecommunication joint ventures ("JVs") with Chinese companies in order to enter the China market after it had signed bilateral WTO agreements with various WTO members (except Mexico). Also, preferential treatments offered by Chinese government like reduced equipment import tariff and VAT rebate offered another boost for these JVs. Mobile phone and PC penetrations are still low compared to developed countries, and annualised double-digit growth in both areas are likely. Internet infrastructure enhancement is still underway, and more advanced networks and technologies are to be implemented. These created more opportunities for foreign investors to participate through cooperation with Chinese firms. China is going to liberalise different sectors in a stepwise manner, including telecommunications, insurance and service sectors. Indeed, multi-national insurance companies are trying to obtain licences to operate in China. Foreign banks, including banks in Hong Kong, are putting more effort to meet the minimum asset requirement of US$20 billion to open branches in China. Although still in its early stage, the development of an asset management industry is another significant reform of the financial sector. The government hopes to introduce foreign expertise and professionalism to China's financial markets through Sino-foreign asset management JVs.

Hong Kong's economy was bottoming out from the trough during 2000. In the first half of the year, Hong Kong's economy was boosted by the telecommunications, media and technology ("TMT") fever as NASDAQ was heading for its historic high. Corporations invested heavily in technology-related projects for exceptional returns. This mindset was doomed to fail, as US and European TMT stocks collapsed after the first quarter. Most of these investments brought severe losses to their investors, as most of these projects were far from breakeven. Consumption plunged, unemployment rose and depressed property prices dampened the economic picture of Hong Kong during the first half. Furthermore, the high real interest rate, deflationary pressure, reluctance of banks to lend, poor corporate earnings and weak retail sales have all accentuated the difficulties for Hong Kong to recover.

Things began to turn around in the second half of the year. Consumption and retail sales began to stabilise. Unemployment rate was improving and deflationary trend was easing. GDP and CPI figures were growing in a healthy trend. Meantime, foreign investments were rushing in after China signed agreements with WTO members and US Senate granted the Permanent Normalised Trade Relations ("PNTR") status to China. Hong Kong's role of being an entreport city for investments into China was becoming more important. Both business sentiment and consumer confidence improved albeit the economy was still in the early stage of recovery. Most importantly, the government abandoned its 85,000 annual housing target during this period, which halted the falling trend of residential property prices. In addition, increasing demand for prime office properties also helped to stabilise the property market. Home owners were delighted as the value of their properties is likely to recover, thus getting them out of the negative equity situation.

CHINA'S ECONOMY *(Cont'd)*

OUTLOOK FOR 2001

Another round of multi-lateral WTO negotiations between China and other WTO members will take place in the first half of this year. Presently, it is hard to tell if they can reach an agreement due to the disagreement on agricultural subsidies and whether China is going to join the WTO as a developed or developing country. The earliest time for China's accession into the WTO would be in the second half of 2001. The top priority for the Chinese government's economic reform package is SOE restructuring. More mergers and acquisitions, cost and workforce reduction measures, termination of inefficient entities, and privatisations will be in effect. The Chinese economy is moving towards a market-oriented economy and the financial burdens of SOEs will be shifted to the market. The role of SOEs is diminishing and the private sector's weighting in the overall economy is expected to increase. Banking sector reform is expected to accelerate to face the upcoming competitions in the post-WTO era. State banks will continue to clean up their balance sheets and NPLs. An increasing number of SOEs and state banks will be listed in 2001, including the mega-listing of China Telecom and Bank of China Group in Hong Kong. Meanwhile, the successful listing of Minsheng Bank in 2000 provided an example for private sector listing, which would lead to the growth of the private sector. The Chinese government is planning to trim its own structure by departmental merging and restructuring. Meanwhile, the government's plan of setting up a social security fund will help ease the social welfare burden on the government. Thus, the government will have a greater flexibility to utilize its fiscal budget in economic reforms. The excessive workforce being laid off by SOEs creates a social problem for the government. Unemployment rate is expected to rise in the short run but there are optimism on this issue. The rationale behind this is that increasing foreign investments, the development of northwestern part of China, and the growing technology sector will create more job opportunities and hence the possibility of a social unrest is unlikely. The post-WTO picture of the Chinese economy is promising: exports and FDI are expected to grow as foreign ownership restrictions are going to be removed, the substantial development of information technology ("IT"), financial and servicing industries, and domestic consumption is rising in a healthy trend. Consumption and retail sales are rising, leading to a positive CPI and easing deflationary pressures. Balance of payment is expected to remain healthy, thus supporting the Renminbi ("RMB"). In February 2001, the Chinese government announced that it would allow domestic investors with legal access to foreign currency to trade in the B-share market. This is viewed as a big step in market reform but the full merger of the A and B-share markets is unlikely until the Chinese government allows the free-float of the RMB.

Hong Kong Economy

Hong Kong's economy is expected to rebound in 2001 from the Asia financial crisis. The government has projected a GDP growth of 4.0% for the year 2001. Corporations and banks posted heavy loss provisions in 2000; thus their earnings are expected to improve this year. Growing private consumption and re-export figures, and rebounding retail sales and tourist arrivals are major fuels for economic recovery. Another boost to the recovery is the change of government's housing policies to stabilise the property market. The government announced that it will cut Home Ownership Scheme supply to an average of 15,000 units per annum in the next three years. It will also scale down residential land supply in 2001, remove restrictions on pre-sale balloting, and allow internal sales to increase to 30% from the current level of 20%. All these measures ensure a moderate rise in property prices. Finally, the emergence of the IT industry would also be conducive to the recovery and paradigm shift of Hong Kong's economy in the long run.