HONG KONG, CHINA

Hong Kong, China's high rate of economic growth in the first half of 2000 was based upon strong external demand and strengthening private consumption. The main short-term concern is the lagged effect of interest-rate hikes on economic activity.

Economic Indicator (percent)	1997	1998	1999	2000	2001
GDP growth	5.0	-5.3	3.1	8.5	8.8
Inflation rate	5.9	2.8	-4.0	-3.5	2.1
Current account/GDP	-3.9	1.9	5.8	3.3	1.8

Economic Assessment. Hong Kong, China's modest 1999 recovery accelerated in the first half of 2000. Real GDP growth rose to 14.3 percent in the first quarter of 2000—the fastest rate since the third quarter of 1987—and registered 10.8 percent in the second quarter. The underlying growth momentum was brought about by a buoyant external sector and a marked recovery in consumer confidence.

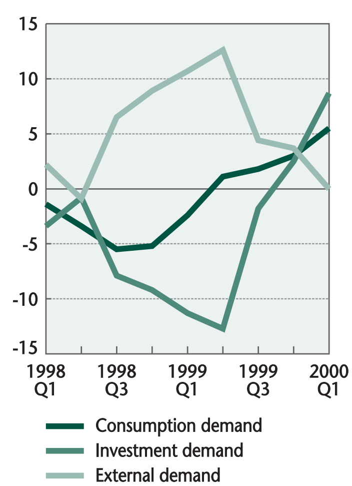
Exports of goods and services increased by 18.7 percent year-on-year in real terms in the first half of 2000, based on a broad-based strengthening of import demand in major markets and improved price competitiveness of exports. Total imports also grew markedly by 20.7 percent in real terms in the same period, based on significant re-export growth of 20.1 percent and improvement in retained imports of 22.4 percent.

Driven by strengthening consumer confidence, rising equity markets, and improved labor market conditions, domestic demand rose by 10.4 percent year-on-year in the second quarter of 2000. Private consumption grew by 5.2 percent over the same period. Gross domestic fixed capital formation expanded by about 5.0 percent in the first half of 2000. Amid strengthening investment sentiment as business prospects improved, machinery and equipment acquisition rebounded sharply by 19.6 percent in real terms. The contraction in private sector building and construction prevailing since the third quarter of 1998 appears to have bottomed out.

The composite consumer price index fell 4.8 percent year-on-year in the first half of 2000. Prices remained on a downward trend, due not only to the continued freeze in government fees and charges, but also to the ongoing cost and price adjustments induced by a stagnating property market and existing excess capacities. With the economic revival, unemployment declined from 5.5 percent in the first quarter of 2000 to 5.0 percent in the second quarter. This level of unemployment is due partly to structural unemployment and skill deficiencies among certain sections of the population.

Following the movements in the US Federal Funds target rate, interest rates firmed up slightly during the first six months of 2000. The strengthening of the local equity markets in the first quarter of 2000 also imposed further upward pressure on interest rates. Real interest rates remained high in light of persisting deflation. The Hang Seng Index recorded an all-time

Decomposition of GDP Growth by Quarter (percent)

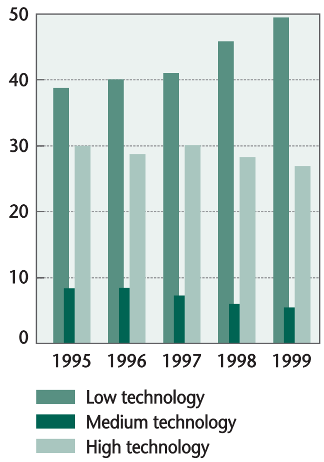


high of over 18,000 in late March 2000, led by global investor interest in telecommunications and technology shares. The market then consolidated amidst concern over further US interest rate hikes, and the index declined to around 17,000 at the end of August 2000.

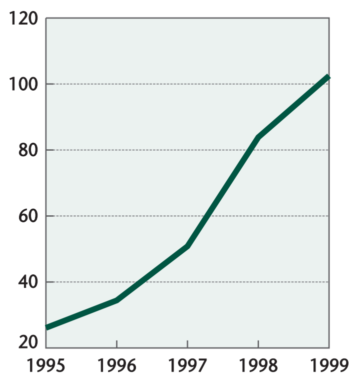
Structural Issues. In contrast to pre-budget speculation, the government budget for fiscal year 2000/2001 includes no major initiatives in consumption and corporate taxes. The overall fiscal balance unexpectedly moved from a projected deficit of HK$36.5 billion to a surplus of HK$10.0 billion in fiscal year 1999/2000, reducing the urgency to implement new revenue-raising measures. The unexpected surplus reflected not only low government spending but also gains from investment earnings on fiscal reserves due to the surge in the stock market.

As part of the 30-point plan of financial reforms of 1998, the Securities Law was promulgated in December 1999. The legislation is aimed at preventing a recurrence of the extreme financial market volatility which was believed to be caused partly by market manipulators. In another initiative, in January 2000 the Government awarded more licenses to companies that provide broadband telecommunications services in Hong Kong, China, in an attempt to increase competition and investment.

Technology Exports as Share of Total (percent)



Ratio of Reserves to Short-Term External Debt (percent)



Forecast. In light of the strong economic recovery achieved in the first half of 2000, GDP growth is expected to reach 8.5 percent in 2000 and 8.8 percent in 2001. Exports are expected to expand by 12.4 percent in 2000. Imports will show stronger growth than exports at 13.5 percent, due to growing import demand for re-exports and domestic consumption. Thus, expectations are that in 2000 a steadily widening merchandise trade deficit will be recorded. This will be partly offset by an increase in service exports in 2000 and 2001, given a recovery in Hong Kong, China's tourist industry, leading to a surplus in the current account. Consumer prices will continue on a downward trend until the end of 2000. Prices may firm up in 2001 and 2002, when inflation in the People's Republic of China (PRC), which supplies 40 percent of Hong Kong, China's import demand, starts to rise.

Under the link between the US and Hong Kong dollars, the benchmark interest rates in Hong Kong, China will likely follow the interest rate trends in the US. Although further interest rate rises may impose a slight drag on domestic demand recovery, this could be mitigated by a continuing rise in external demand and by favorable structural shifts under way. Hong Kong, China, being the preferred entry point for foreign investment into the PRC, is likely to benefit from the latter's accession to the World Trade Organization (WTO) and the resulting increase in trade and investment flows into the PRC. However, the growing economic integration of the two economies may well adversely affect Hong Kong, China's nontradable sector as it could create downward pressure on land and residential property prices.