

Executive management's report

business ENVIRONMENT

Renewed economic weakness

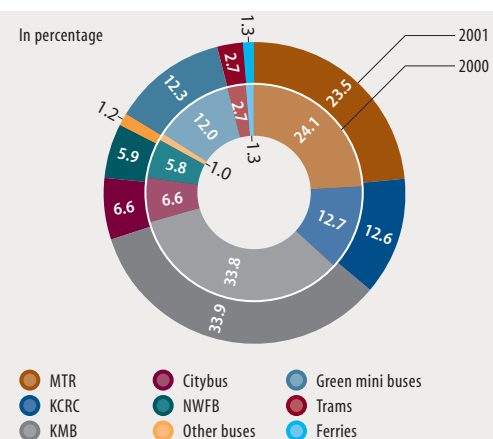
The year 2001 saw a deterioration in prospects for a recovery of the Hong Kong economy, as conditions in the United States and other major markets worsened over the course of the year. Although the terrorist attacks of September 11 and the immediate aftermath have become a dominant event, the US had begun to show signs of a slowing economy as early as March. Not until the end of the year did the 11 rate cuts by the US Federal Reserve Board appear to arrest the pace of the decline.

The weakness in the US economy has inevitably affected Hong Kong, given its open marketplace and significant trade flows with the United States. Despite the support afforded by continued strong growth in Mainland China, domestic export and re-exports registered substantial decreases of respectively 15.2% and 4.6%.

Tourism was also affected. Inbound visitors number remained flat while arrivals from developed countries fell markedly.

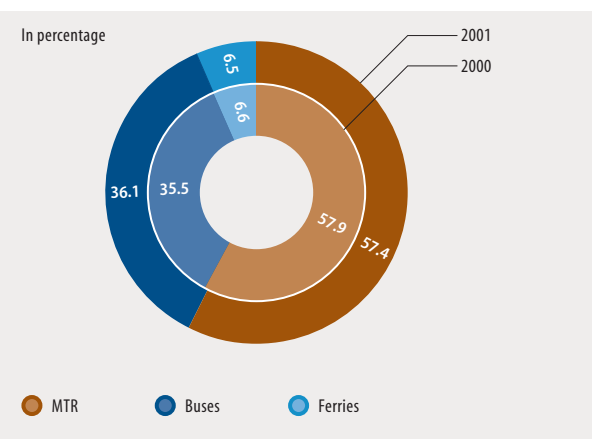
In addition to a poor external environment, Hong Kong continued to undergo a significant structural adjustment brought about by the Asian financial crisis and the currency board system that links the Hong Kong currency to the US dollar. Deflation remained a major threat as the consumer price index registered a decline of 1.6% for the year. Despite high levels of liquidity in the banking system and lower nominal interest rates in line with the US, an uncertain outlook continued to discourage business investment and reduce employment. The local stock market was among the worst performers of the major markets, the Hang Seng Index closing the year at 11,397, down 25%. With property and stock prices depressed and unemployment worsening, consumer

Market shares of major transport operators in Hong Kong



Total public transport utilisation for 2001 was 4,017 million passengers of which 3,971 million were carried by the franchised transport operators.

Market shares of transport operators crossing the harbour



Reliability and value for money have helped the MTR retain a strong market share among the franchised operators for cross-harbour transport.

confidence and spending remained weak. For the year, Hong Kong's GDP rose only 0.1%, after a rise of 10.5% in 2000.

Despite the economic downturn, the Government remains committed to its investment plans in education and infrastructure to support Hong Kong's long-term development. Major projects such as Castle Peak Road improvements, Container Terminal 9 back up facilities, Phase I of Disneyland, and the Science Park are in progress. Initiatives will be taken to capitalize on Hong Kong's excellent transport infrastructure and its links with the Mainland to promote Hong Kong as a logistics centre. These new investments and initiatives will not only provide a solid foundation for Hong Kong's long-term development, but also help to mitigate the economic burden felt by the community.

Rail expansion remains desired goal

Despite the weak economy, the franchised public transport industry experienced a modest growth of 1.5%. Total public transport demand for the year was 4,017 million, up from 3,971 million in 2000, of which franchised operators including MTR, KCR, buses, green mini-buses, trams and ferries, carried 3,276 million. However, the weak economy and continued strong competition from other modes of transport saw MTR's market share fall marginally from 24.1% to 23.5%, while that of buses rose from 47.2% to 47.6%.

Although overseas tourist arrivals rose by 5.1% mainly due to a dramatic increase in visitors from Mainland China, the air passenger traffic stayed flat at 23.0 million in 2001. The market share of the Airport Express Line fell marginally from 28% to 27% in 2001.

In spite of the short-term decline in patronage, the longer-term trend for Hong Kong to favour railway as the preferred mode of

transportation remains firmly in place, bolstered by the public's increasing demand for a better environment, especially air quality. With the risk that Hong Kong's status as a regional financial and service centre could also be threatened by pollution, the business community has also shown increasing support for measures to protect and enhance Hong Kong's environment.

Against this backdrop, the Government continues to work towards the implementation of Railway Development Strategy 2000 (RDS-2000), which affirms that railways will form the backbone of the future transport system in Hong Kong. RDS-2000 has identified six new railway systems for priority development, including the North Island Link, West Island Line and Shatin to Central Link. This aims to bring 70% of the population within one kilometre of a railway station and raise railway's overall share of public transport from 31% in 2000 to 43% in 2016.

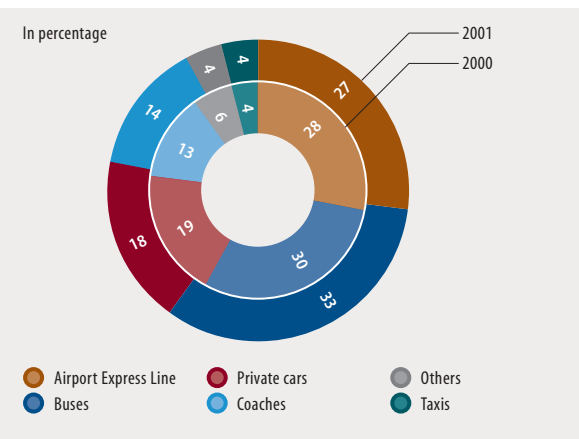
A challenging property sector

The Hong Kong property market remained fundamentally weak throughout the year, with buying confidence suffering a further setback as Hong Kong's economy slowed considerably. Although affordability improved significantly during the year, rising unemployment, uncertain job prospects and excess supply weighed heavily on the market. The number of transactions rose only marginally from a 10-year low of 85,774 units in 2000 to 88,190 units. With interest rates bottoming out and developers offering more aggressive pricing and financing terms, activity picked up in the fourth quarter and a number of new projects in prime locations registered impressive sales. However, with the timing of recovery in Hong Kong still unclear and unemployment set to rise further, it is far from certain that this momentum can be carried into 2002.

In the office sector, a continued influx of companies wishing to use Hong Kong as a regional base heightened demand for quality office space. This was largely offset by shrinking demand overall, owing to poor business conditions and further consolidation in sectors such as technology and financial services. As a result, the significant rise in rental rates in 2000 was reversed, dampening capital values. Despite continuing excess supply of Grade A office space, a greater balance is expected to emerge over coming years, as strong demand emerges from multinational companies locating their Asian headquarters in Hong Kong to take advantage of China's accession to the World Trade Organisation.

Although consumer sentiment and spending remained weak throughout the year, the retail property sector was relatively stable, holding on to rental gains acquired since mid 1999. Larger, higher quality and well-managed shopping centres in good locations have continued to be the main beneficiaries in the sector, attracting quality brand name retailers and strong retail traffic.

Market shares of transport operators to/from the airport



The Airport Express Line remained a key provider of transport to and from the airport.