

East Asia

The outbreak of severe acute respiratory syndrome (SARS) disrupted East Asia's economic growth in the second quarter of 2003. Reflecting differences in macroeconomic and structural conditions, expansion varied across economies. Except in the People's Republic of China (PRC), where gross domestic product (GDP) grew by 8.2% for the first half of 2003 and the economy is showing signs of investment overheating, growth in most East Asian economies remains subdued. Some nascent signs of a rebound, however, have emerged. East Asia is expected to grow by 5.6% in 2003 and by 6.5% in 2004, as the adverse effects of SARS disappear, expansionary macroeconomic policies continue, and international economic conditions strengthen.

Macroeconomic Developments

GDP Growth

The economies of East Asia experienced a diverse performance in the first quarter of 2003. Growth reached an impressive 9.9% in the PRC. The Hong Kong, China economy also showed signs of recovery, where GDP grew by 5.1% in the fourth quarter of 2002 and by 4.5% in the first quarter of 2003. In Taipei, China, first quarter 2003 GDP increased by 3.5%, while Mongolia's total industrial output rose by 3.1%. In contrast, falling consumer demand caused the Republic of Korea (Korea) economy to fall into recession in the first half of 2003, as it experienced two successive quarters of contraction, on a seasonally adjusted quarter-on-quarter basis.

Growth was seriously disrupted by the outbreak of SARS, mainly in the second quarter. The economies of the PRC; Hong Kong, China; and Taipei, China were among the world's worst affected. In the second quarter, GDP growth dropped to 6.7% in the PRC; Hong Kong, China's nascent recovery halted abruptly as GDP contracted by 0.5%; and Taipei, China's GDP contracted by 0.1%.

Consumption bore the brunt of the SARS impact. Growth in retail sales in the PRC fell from 9.2% in the first quarter to 6.7% in the second, while in Hong Kong, China consumer spending declined by 2.2% in the second quarter. In Taipei, China, it contracted by 1.8% over the same period.

SARS particularly affected services (see Part 3). While the services sector in the PRC grew by 4.2% in the first half of 2003, its industry sector expanded by 11.6%. The services sector growth rate in Taipei, China was

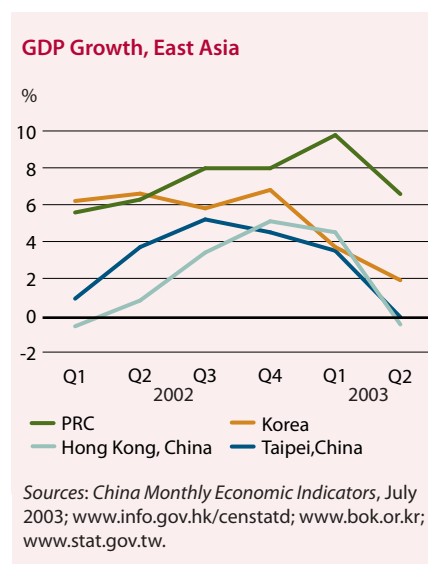
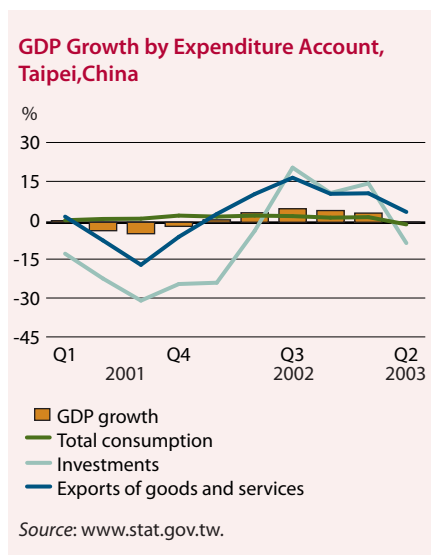


Table 2.1 Selected Economic Indicators, East Asia, 2002–2004, %

Item	2002	2003		2004	
		ADO 2003	Update	ADO 2003	Update
GDP Growth					
Average	6.5	5.6	5.6	6.2	6.5
China, People's Rep. of	8.0	7.3	7.8	7.6	7.9
Hong Kong, China	2.3	2.0	2.1	4.0	4.8
Korea, Rep. of	6.3	4.0	3.1	5.3	5.0
Mongolia	3.9	5.0	5.0	5.2	5.2
Taipei,China	3.5	3.7	3.1	3.9	4.4
Inflation Rate (CPI)					
Average	-0.1	1.1	1.0	1.4	1.5
China, People's Rep. of	-0.8	0.5	1.0	1.0	1.5
Hong Kong, China	-3.0	-1.5	-2.8	0.5	0.5
Korea, Rep. of	2.7	4.0	3.4	3.5	2.7
Mongolia	1.7	5.0	5.0	5.0	5.0
Taipei,China	-0.2	0.4	-0.1	0.6	0.5
Current Account Balance/GDP					
Average	4.1	3.0	2.4	2.7	1.9
China, People's Rep. of	2.9	1.6	0.2	1.5	-0.1
Hong Kong, China	10.8	11.5	12.0	8.5	9.0
Korea, Rep. of	1.3	0.0	0.3	-0.3	0.1
Mongolia	-16.1	-13.4	-13.4	-12.1	-12.1
Taipei,China	9.2	7.9	7.9	8.0	8.0

CPI = consumer price index; GDP = gross domestic product.

Sources: ADO database; staff estimates.



reduced from 2.2% year on year to 0.2% between the first and second quarters. The economy of Hong Kong, China was particularly affected because of its role as a subregional financial, aviation, and logistics services center. Services exports there were dealt a severe blow, with a 12.6% growth rate in the first quarter of 2003 plummeting to a 14.7% contraction in the second. The number of incoming visitors plunged by 58% in the second quarter year on year after surging by more than 20% in the previous quarter. The hotel room occupancy rate in April and May was only about a quarter of the normal 80% plus rate.

Mongolia's limited direct exposure to SARS did not prevent it from suffering from reduced tourism, transport, and trade as the PRC is Mongolia's largest trading partner, although industrial output showed resilience, growing by 5.9% in April year on year. For example, the first SARS case in Mongolia coincided with the beginning of the construction season. Consequently, concerns over SARS prompted the Government to delay the expected arrival of thousands of construction workers from the PRC in April–May. SARS also disrupted “Visit Mongolia” year in which increased revenue from tourism was expected. Tourist arrivals fell substantially in April–May, and the number of international flights declined from 89 to 39.

The economic impact of SARS will continue to be felt for some time, although signs of recovery in affected sectors have been apparent since the removal of the PRC; Hong Kong, China; and Taipei, China from the list of SARS-affected areas by the World Health Organization in June and July.

Despite SARS, the PRC economy grew by 8.2% in the first half of 2003. Strong investment growth more than offset the impact of SARS on consumption. Total fixed asset investment in this period reached CNY1.9 trillion (US\$234 billion), up by 31.1% from the same period of 2002, and representing the strongest improvement since 1994. Rising investment has contributed around half of the PRC's GDP growth in recent years. In the first half of 2003, this contribution reached a new high of around 60%.

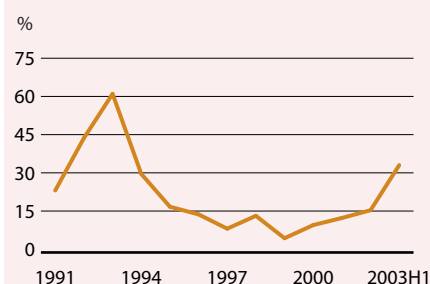
Several signs of investment overheating in the PRC have emerged, however. The rise in fixed asset investment has been accelerating. After a 17% increase in 2002, such investment rose by 31% in the first half of 2003, approaching the level seen in the 1992–93 economic bubble. The recent investment expansion, however, was mainly fueled by large infrastructure projects and, especially, increased housing mortgage loans from commercial banks, a relatively new phenomenon in the PRC. Investment in real estate increased by 34% in the first half of 2003. (The experiences of many countries have shown that rapid real estate investment can lead to the creation of asset bubbles.) The rapid growth of prices of raw materials and of other production inputs also suggests overheating. In the first half of 2003, the price index of real estate, land prices, and raw materials rose by more than 4%. The average price of steel products went up by more than 10% and shortages of electricity were reported in 19 provinces by July 2003. Another warning sign is that broad-based money supply (M2) and outstanding lending increased rapidly in the first 6 months of 2003. By the end of June, M2 had grown by 20.8% year on year and the volume of medium- to long-term loans by 28.9%, 8.3 percentage points higher than in the same period of 2002. Outstanding loans in the first half-year rose by CNY1,781 billion, close to the total lending increase in 2002. In response, the People's Bank of China has taken measures to counter investment overheating (see Policy Developments, below).

Investment spending in Hong Kong, China presents a dramatic contrast to that in the PRC. Total investment fell by 5.3% in the second quarter of 2003, in which time total expenditure on building and construction shrank by 7.2%. Private expenditure on building and construction also fell as existing projects (such as Container Terminal No. 9) were close to completion and no new projects came on stream. Public expenditure fell with heavy cuts to the Public Housing Program and the winding down of major railway projects. The unpromising business environment dampened expenditure on machinery, equipment, and computer software.

The sluggish construction investment in Hong Kong, China reflected weak property market conditions. Government policy measures implemented in late-2002 only provided a short-lived boost to the market in January. The number of transactions fell in February. However, other, longer-term factors are also present. Commercial property markets remained weak through further consolidation and downsizing in the corporate sector in an uncertain business environment. Industrial property markets reflected the continued downsizing of local manufacturing activity, while concerns over job security and falling property prices depressed residential property investment. The number of transactions, however, has increased moderately since May.

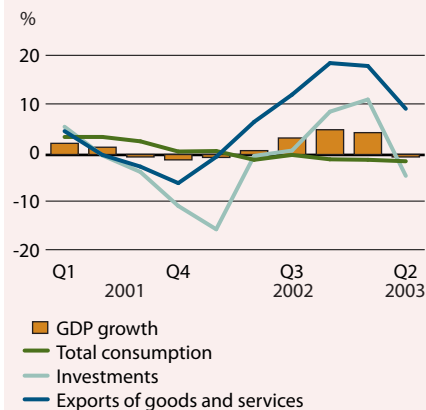
Investment has also been weak in Korea. Heavy restructuring after the 1997-98 Asian financial crisis caused the financial markets to reduce

Growth of Nominal Investment in Fixed Assets, PRC

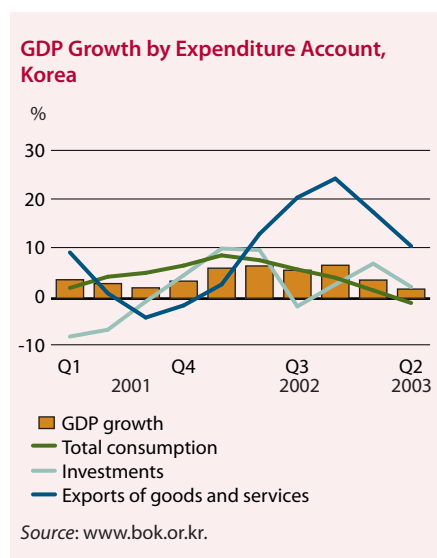


Sources: China Statistical Yearbook 2002; China Monthly Economic Indicators, July 2003.

GDP Growth by Expenditure Account, Hong Kong, China



Source: www.info.gov.hk/censtatd.



corporate sector lending and significantly increase consumer credit. This fueled a rise in private consumption and boosted GDP growth. GDP expanded at a relatively solid pace of 6.3% in 2002. However, the economy weakened substantially and fell into recession in the first half of 2003 as increased household debt resulted in slower private consumption growth, which was further affected by stricter regulation of consumer credit from the second half of 2002 after 2 years of rapid expansion. In the first half of 2003, private consumption contracted due to a series of unanticipated shocks such as the fall in semiconductor prices, the US\$1.2 billion accounting fraud at SK Global and the associated instability of financial markets, and concerns over the nuclear policy of the Democratic People's Republic of Korea. Declining private consumption and sluggish investment drove the Korean economy into recession: seasonally adjusted data show that GDP contracted by 0.4% and by 0.7% quarter on quarter for the first and second quarters, respectively. On a year-on-year basis, however, GDP grew moderately by 3.7% in the first quarter and 1.9% in the second. The current economic recession, in fact, owes more to weak domestic demand in services than in industry: services sector growth plunged from 7.4% in 2002 to 1.3% in the first quarter of 2003 and to 1.0% in the second quarter, while the growth rate of industrial production fell from 6.1% to 5.8% and to 3.3% over this period. This is unusual, since industrial production is normally more sensitive than services output to business cycles, and is a reflection of the fact that services are affected mainly by domestic demand, rather than by exports.

East Asia continues to grapple with unemployment problems. Weak demand, SARS, and structural adjustments in some economies have contributed to rising unemployment. In the PRC, rapid economic growth has been insufficient to absorb surplus agricultural labor, new labor-market entrants, and workers laid off from uncompetitive state-owned enterprises (SOEs). According to official statistics, which underestimate the problem, registered urban unemployment rose from 4.0% at end-2002 to 4.2% by end-June 2003. The inclusion of laid-off SOE workers still without work would raise this figure to about 7.2%. In addition, with 10 million young urban residents and tens of millions of jobless farmers seeking work in cities, the unemployment rate could be much worse. In the second quarter of 2003, however, construction and manufacturing employed, respectively, 254,000 and 220,000 more people than in the first quarter. Overall, 64,000 more people were officially employed in urban areas in the second quarter of 2003 than in the first, despite SARS.

Hong Kong, China's unemployment rate reached 8.6% in the second quarter, a three-decade high. Job losses were especially severe in the services sector. In Taipei, China, average unemployment was 5.0% in the first half of 2003. While SARS exacerbated the faltering labor market in Hong Kong, China and in Taipei, China, more deep-rooted problems that are harder to address also contributed, such as the relocation of firms to the PRC and changing economic structures.

Korea's seasonally adjusted unemployment rate rose from 3.1% in January to 3.6% in June 2003, after declining since 1998. These figures may understate the actual figure, because many potential workers in Korea tend not to participate in the labor market in recessions. Employment growth began to turn negative from the second quarter of 2003, mainly

due to the contraction in services, particularly the labor-intensive sectors dependent on domestic demand such as wholesale and retail trade, and restaurants and lodging. The abrupt reversal of consumer credit caused private consumption to collapse, which led to the contraction of services output. Slow labor demand was a major factor in the fall of the nominal wage growth rate from around 11% in 2002 to about 8% in the second quarter of 2003, year on year. Real wage growth declined from 8.5% in 2002 to 4.9% in the second quarter of 2003, year on year.

Fiscal Situation

In the PRC, the growth of fiscal revenue fell from 36.7% in the first quarter to 20.0% in the second. A strengthening economy helped push revenues up by 27.4% in the first half of the year, significantly higher than the 9.2% rise recorded in the same period in 2002. Revenue growth also accelerated due to rapid increases both in tariff collection in line with higher imports and in taxes on enterprise income, of 39.8% and 30.4%, respectively. Fiscal expenditures in the first half of 2003 were 16.5% higher than in the same period a year earlier. Spending on health care, social security, and various subsidies grew rapidly in the first 6 months of 2003. In particular, the PRC central Government spent CNY1.3 billion (US\$157 million) on SARS control, and local governments allocated over CNY10 billion (US\$1.2 billion) by the end of June in combating SARS. In May, the Ministry of Finance and the State Administration of Taxation announced that taxes and fees levied on some sectors, including catering and hotels, would be reduced or waived between 1 May and 30 September to help offset the impact of SARS. The central Government promised free medical treatment to farmers and poor urban residents who contracted SARS, which helped prevent SARS from spreading to rural areas. The central Government also adopted a series of policies to support medical staff treating SARS patients by granting subsidies and temporary exemptions from personal income tax.

SARS has had a strong impact on Hong Kong, China's fiscal situation. It prompted the authorities to switch fiscal policy priority from addressing the budget deficit to stimulating the economy. In April, they announced a HK\$11.8 billion (US\$1.5 billion) SARS relief package, equivalent to 1% of GDP. The package includes rent concessions on government-owned properties; temporary waivers of rates, sewage, and water charges; salary tax rebates; and government guarantees of up to HK\$3.5 billion-worth of bank loans to help businesses pay salaries. Support for sectors worst affected by SARS included a 1-year waiver on license fees for business activities in tourism, catering, entertainment, and transport. The package will be funded from fiscal reserves and will thus not contribute to the deficit as such. However, SARS has also reduced revenue by depressing economic growth. This has aggravated Hong Kong, China's fiscal problems. Heavily reliant on property-related revenue, government revenue has dwindled in the past 5 years as property values declined. At the same time, increased spending on public services, education, health, and welfare added to budgetary pressure. Over the past decade, public spending has increased from about 15% of GDP to over 20%. Large fiscal reserves have, however, allowed the authorities to remain free of external debt.

Similarly, weak economic growth since 2001 has dampened revenue

flows in Taipei,China, while ever-higher welfare costs and the need to stimulate the economy have increased government expenditure. In July 2003, the Taipei,China authorities allocated NT\$50 billion (US\$1.5 billion) to deal with SARS, 40% of which is for assisting industries affected by SARS, and 60% for the disease's prevention and treatment. In November 2002, the authorities announced a NT\$58 billion program of public works designed to stimulate domestic growth through road construction, agricultural and educational spending, and urban development.

Korea's fiscal policy stance changed to help boost the economy in response to weakening economic performance. The economy suffered somewhat from the reduced subregional travel that SARS induced. The central bank earmarked W385 billion (US\$315 million) in loans to financial institutions to help support trade financing. In addition, the National Assembly approved a supplementary economic stimulus package of W4.5 trillion (about 0.8% of GDP). Tax deductions for corporate capital investments were not only extended beyond their initial expiry date of June 2003 until December 2003, but also the deduction rate was increased from 10% to 15%. In addition, special tax rates for luxury goods such as automobiles were lowered. Tax measures have been tightened to reduce the possibility of a loose monetary policy stance causing real estate price hikes. For example, the Government now calculates capital gains tax rates on actual market prices instead of reported prices by traders, which were previously significantly undervalued.

Mongolia's tax laws were amended to promote rural economic activity and to offset high prices and shortages of imported goods resulting from the SARS outbreak. This kept revenue below initial estimates. Although the deficit increased by US\$16 million in the first quarter of 2003, the post-1991 debt continued to be serviced. However, notwithstanding high-level talks with the Russian Federation in July, the settlement of Mongolia's pre-1991 debt of MNT10.5 billion to the Russian Federation remains unresolved. Mongolia has been seeking a way to cancel this debt along the lines taken by the Russian Federation in relation to the Eastern European economies. Given the substantial size of the debt, it is perhaps not surprising that discussions have been slow and that no consensus has yet been reached. Current negotiations between the two countries aim to produce a mutually acceptable solution. However, the process is fraught with difficulties, as resolution requires significant political commitment as well as technical expertise.

Money and Prices

Monetary policies remained accommodative in most economies, although some moderate tightening occurred. In the PRC, the broad money supply (M2) rose by 20.8% in the year to end-June 2003. Total yuan deposits grew by 23.3% and total yuan loans increased by 23.1%. There are some concerns that the rapid expansion of M2 and loans may lead to economic overheating and further weakening of the banking sector unless this expansion is handled appropriately. These concerns have prompted action by the People's Bank of China (see Policy Developments, below).

The authorities in Taipei,China maintained a broadly expansionary monetary policy while domestic inflationary pressure remained subdued. Interest rates continued falling with the overnight interbank call rate

declining to 1.16% in June. In the first 7 months of 2003, M2 expanded at an average rate of 2.64%, and M2 plus bond funds grew by 4.05%.

Korea loosened its monetary policy stance. Despite falling international and domestic long-term interest rates, the Monetary Policy Committee of the Bank of Korea kept its key call-rate target steady at 4.25% from May 2002 until May 2003, when it lowered the target to 4.00%, then to 3.75% in July. Short-term interest rate cuts and the rise of long-term rates steepened the yield curve in August. Some commentators attribute the relatively easy credit that has been available to households as the cause of apartment price rises. For this reason, the Bank of Korea was reluctant to lower the call rate despite the incipient economic recession in the second quarter. Apartment prices will continue to be one of the important variables that will affect the monetary policy stance in the near future of Korea, and although the explosive growth of bank lending to households has slowed, the sluggish pace of lending to large corporations continued, resulting in a rise in lending to small and medium enterprises (SMEs). In the first half of 2003, bank lending increased by W0.8 trillion for large corporations, by W26.6 trillion for SMEs, and by W13.9 trillion for households.

Mongolia's monetary policy is also accommodative. M2 accelerated rapidly by 38.1% in July year on year, while the togrog depreciated by 3.0% in June 2003 compared to the same month in 2002.

Price changes in East Asia reflect different economic outcomes. Strong growth in the PRC saw deflation abate and inflation return. The consumer price index (CPI) rose by 0.6% year on year in the first half of 2003. While prices of clothing, transportation, communications, and household appliances fell, those for food, medicine, education, and housing increased. Ex-factory prices, raw material purchasing prices, and real estate prices were particularly buoyant in the first half of 2003, rising by 2.9%, 5.4%, and 4.9%, respectively. These figures add weight to suggestions of investment overheating in the PRC.

In contrast, deflation continued in Hong Kong, China. The Composite Consumer Price Index fell by 2.5% in the second quarter year on year, and further by 4.0% in July. This marked the 56th consecutive month of consumer price deflation. Various factors contributed, not the least of which was the ongoing substantial decline in property prices. SARS and government relief measures, such as recent various concessions on public utilities, also contributed to deflation. The weakening of the Hong Kong dollar against other currencies in line with the US dollar decline, higher import prices, and the firming up of the commodity market were insufficient to offset these effects. Price pressures also remained weak in Taipei, China, as the CPI decreased by 0.16% in the first half of 2003.

The CPI in Korea rose by 4.1% in the first quarter of 2003, but then slowed to 3.3% in the second quarter. While the housing price index appeared to stabilize in the first quarter (with a 1.2% increase from December 2002 to March 2003) after a 16.4% rise in 2002, it then rose by 3.3% in the second quarter. In particular, Seoul's apartment price index declined by 0.8% in the first quarter of 2003 after soaring by 30.8% in 2002, before rising by 3.3% in the second quarter. Mongolia's inflation, while moderate in historical terms, is still relatively high, rising by 5.7% in the first 4 months of 2003, partly due to disruption in supplies from the

SARS-affected PRC. While demand conditions play a major role in determining current price changes in other East Asian economies, supply-side constraints seem to be a more important factor in Mongolia.

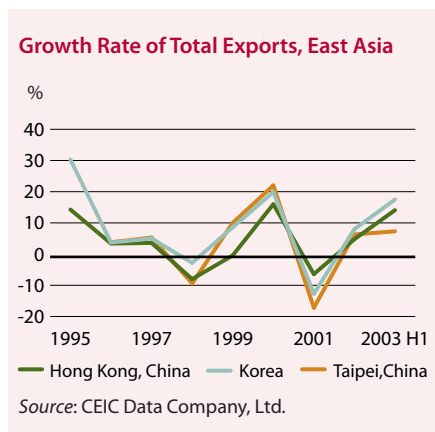
External Sector Developments

While domestic demand has been patchy or weak in East Asia (except in the PRC), export growth has been strong in most economies. This is partly because SARS has affected the movement of people more severely than the movement of goods. In the PRC, exports surged by 34.0% in the first half of 2003 while imports rose by 44.5% over the same period. The PRC's trading activities have provided considerable momentum for export expansion in other East Asian economies, as well as in Southeast Asia. It has emerged as the largest export market—or one of the largest—for all other East Asian economies and is one of the fastest growing export markets for Southeast Asian countries. This has spurred economic growth in both subregions. More important, the process has become a driving force behind economic integration among East Asian and Southeast Asian economies. Bolstered by PRC demand, merchandise exports, and especially reexports, from Hong Kong, China boomed. In the first half of 2003, the volume of Hong Kong, China's reexports of goods rose by 19.4% year on year. This more than offset the decline of domestic exports and lifted overall export growth in volume terms to 16.5% in the first half of 2003.

Year on year, Korea's exports climbed by a healthy 21.0% in the first quarter, by 14.6% in the second, and by 16.0% in July. Exports to the PRC were particularly strong, growing by 47.0% in the first 7 months of 2003. SARS was more damaging to export growth in Taipei,China, however, where exports grew by only 3.6% in the second quarter, substantially lower than the 11.4% of the first quarter. However, in June, export orders recovered to register double-digit growth. Taipei,China's exports to Hong Kong, China and the PRC increased by 18.4% in the first half of 2003, accounting for 33.2% of that economy's total exports.

Most East Asian economies have accumulated large foreign exchange reserves. Due to faster import growth, the PRC's trade surplus of US\$4.5 billion in the first half of 2003 was US\$8.9 billion less than in the corresponding period of 2002. However, foreign direct investment (FDI) inflows do not seem to have been damaged by SARS. Contractual FDI and actual FDI increased by 40.3% and 34.3%, respectively, in the first half of 2003, year on year. With a continuous trade surplus and FDI inflows, the PRC's foreign exchange reserves reached US\$346.5 billion by end-June 2003, 21% higher than at the end of 2002. In Korea, weaker domestic demand and stabilized oil prices since April lowered import growth from a year-on-year 30.9% in the first quarter to 12.0% in the second. This resulted in the current account switching from a deficit of US\$1.7 billion in the first quarter to a surplus of US\$2.6 billion in the second. Foreign exchange reserves increased from US\$121.0 billion at the end of 2002 to US\$132.9 billion at the end of July. The accumulation is largely due to portfolio investment inflows and foreign loans.

Hong Kong, China's widening trade surplus and significant reduction in net outflows of portfolio investment assisted its balance-of-payments account in the first quarter of 2003, creating an overall surplus of US\$10.4 billion (or 3.5% of GDP). Reserve assets correspondingly



strengthened by the same amount over this period. The economy's foreign exchange reserves totaled US\$114 billion at the end of June 2003. Mongolia's first quarter export value increased by 12.4% compared to the same period in 2002 due to higher exports of copper concentrate and textile products. The corresponding increase for total imports was 45.3%, triggered by growing imports of oil, machinery, equipment, transport vehicles, and spare parts. However, SARS reduced Mongolia's imports from the PRC in the second quarter. International reserves declined by about 16% to US\$294.2 million in May 2003 from end-2002.

While large foreign exchange reserves can cushion adverse currency or balance-of-payments shocks, continued accumulation also carries a cost. Often foreign exchange reserves are invested in low-risk financial assets, while countries pay higher interest for foreign debt. While the purchase of foreign exchange by central banks can help maintain a lower exchange rate, it can also reduce the capital imports that are needed for long-term economic growth. Furthermore, countries cannot accumulate foreign exchange forever. When countries switch policies, the resulting exchange rate appreciation may cause substantial adjustments in the export sector, which may have built up excess capacity under the low exchange rate regime. East Asian policy makers therefore need to carefully evaluate the suitable level of foreign exchange reserves and the best ways to manage the reserves.

Policy Developments

Increasing fiscal deficits and emerging signs of economic recovery prompted some East Asian governments to contemplate fiscal tightening in late 2002 and early 2003. The SARS outbreak, however, forced most of them to set aside fiscal consolidation and focus on dealing with the epidemic and stimulating the economy. In line with generally subdued price pressures and weak growth, monetary policy remained accommodative in Korea; Mongolia; and Taipei, China. While Hong Kong, China's currency board arrangement limited its monetary independence, monetary policy has been tightened somewhat in the PRC recently.

The PRC Ministry of Finance outlined five measures for dealing with SARS and strengthening economic growth. First, it assigned budgetary priority to fighting SARS, combating floods, providing disaster relief, developing rural and old industrial areas, and developing the western region. In addition to dealing with SARS, from the beginning of 2003 the Government provided a total of CNY801 million (US\$96.5 million) to support nationwide efforts fighting floods and droughts. Second, it aimed to improve the export tax rebate policy, channeling any revenue surplus in 2003 into this area. Third, it took steps to strengthen revenue collection and reduce tax evasion. Fourth, it imposed a freeze on the expenses of all departments except health, water conservation, and those fighting SARS and natural disasters. Fifth, it continued rural tax reform to reduce the financial burdens faced by farmers.

Rising unemployment in several economies of East Asia has prompted action from governments. The PRC Government has placed priority on strengthening the social safety net, social security and labor market reform, and creating jobs in the private sector. It also broadened its official

definition of “unemployed” to include those earning less than the local basic living allowance. The new classification is a response to criticism over the country’s statistical methods. The Hong Kong, China Government announced enhanced employment measures in June 2003, worth US\$715 million, to ease youth unemployment. Other measures include the Youth Pre-employment Training Program, the Youth Work Experience and Training Scheme, and the Graduate Employment Training Scheme. The Government aims to create 33,350 employment/training opportunities for young people in 2004, and 39,000 opportunities for other age groups. So far, 16,500 people have started working/training under these programs.

The Government of Taipei, China’s Plan of Employment Expansion through Public Services, which started in June 2003, also aims to reduce unemployment. The Executive Yuan¹ recently approved a special budget of NT\$20 billion to create employment opportunities. About 60,000 jobs had been created by end-August 2003. While these programs may increase employment, their effect is temporary and limited. These measures also intensify fiscal pressures and widen budget deficits. Sustained employment growth ultimately requires stronger economic growth.

On the monetary policy front, the People’s Bank of China expressed concern that indications of overheating may be a prelude to renewed inflation, and therefore slowed the approval procedure for real estate loans. Similar curbs are planned for automobile loans. It issued new rules forbidding banks to issue mortgages to people for properties that are still being planned or constructed to reduce the number of loan defaulters and to cool a property market that many believe is in danger of overheating. The deposit reserve requirement ratio increased to 7% from 6% effective 21 September 2003.

The PRC exchange rate remained stable at CNY8.28/US\$1 in the first half of 2003. While the PRC resisted calls by several governments to allow its currency to appreciate, a decline in export rebates resulted in an effective appreciation of the currency. In light of increased foreign exchange reserves, the State Administration of Foreign Exchange announced that, from 1 September, foreign trade companies would be allowed to retain their foreign exchange incomes in full in foreign exchange accounts. The State Administration has granted qualified foreign institutional investor status to international investment banks and security companies including UBS Ltd., Nomura Securities Co. Ltd., Citigroup Global Markets Ltd., Morgan Stanley International Ltd., and Goldman Sachs Co. The minister of commerce is also encouraging domestic companies to increase their imports. In addition, the Government is encouraging PRC companies to invest abroad to ease the pressure of rapidly increasing reserves.

The China Banking Regulatory Commission was established in 2003 to take over supervisory power from the People’s Bank of China. It will not adopt the new, strict Basel II accord proposals. The Basel Committee on Banking Supervision, the global rule-setting body for central bankers and financial regulators, is drawing up an accord that will keep the minimum capital requirement for banks at 8.0%. This is a level that many debt-ridden PRC banks are still unable to reach. The PRC will thus continue to implement the old 1988 accord, at least for a few years, after the G10 group of leading industrial countries starts implementing the new capital rule in 2006.

East Asian governments continue to implement structural reforms. In early August, the PRC Government announced plans to accelerate the restructuring of traditional heavy industrial bases in the northeast. Priority will be given to intensifying reform efforts, opening more sectors to global competition, continuing to adopt market-oriented policies, and introducing new technologies. The State-owned Assets Supervision and Administration Commission (SASAC), created in March 2003, will accelerate SOE reforms and provide an institutional framework to improve SOE corporate governance. Under this framework, about 2,000–3,000 SOEs will be declared bankrupt within the next 5 years with most of the income that it has recovered used to support firms' laid-off workers. To ensure efficiency and avoid disputes, SASAC is drafting wide-ranging rules for state asset management and supervisory schemes. The position, salary, and relative awards and penalties of SOE managers will be more closely connected to their actual performance.

Hong Kong, China and the PRC signed a Closer Economic Partnership Agreement (CEPA) on 29 June 2003. It stipulates cutting tariffs on Hong Kong, China-manufactured exports, increasing access of the services sector in Hong Kong, China to the PRC, and enhancing bilateral cooperation in trade and investment. Under CEPA, about 273 types of goods manufactured in Hong Kong, China will receive tariff-free entry into the PRC from 1 January 2004. Tariff-free status will be extended to other manufactured goods by 1 January 2006. The agreement's overall impact on manufacturing in Hong Kong, China is likely to be modest, given the sector's small size. As the economy's factories have relocated to the PRC to benefit from lower costs, manufacturing's share of economic output has fallen. Furthermore, domestic exports account for only about 10% of total merchandise exports; the bulk of exports are reexports. CEPA may have a deeper impact on services, however. Under CEPA, about 18 services subsectors in the PRC will be open to Hong Kong, China firms, including advertising, telecommunications, construction, tourism, banking, insurance, and professional services. In these subsectors, Hong Kong, China companies will gain access to the PRC ahead of the deadlines stipulated in the PRC's World Trade Organization (WTO) accession agreement.

On balance, CEPA would appear to favor Hong Kong, China, given its open economic regime. However, the agreement may prove invaluable to the PRC as it will help better prepare it for the increased competition after more substantial opening up under WTO obligations. The entry of services firms into the country will also provide the PRC with much-needed skills in areas such as law, accountancy, and financial services.

East Asian economies have experienced various difficulties since the Asian financial crisis. All have subsequently shown much dynamism and flexibility in carrying out structural adjustment. Difficult challenges still lie ahead in the next few years. In the PRC, for example, rapid economic growth has provided benefits, but it has also been accompanied by widening income disparities between rural and urban residents. For example, the per capita income of rural residents increased by 2.5% while that of urban residents rose by 8.4% in the first half of 2003, compared to the corresponding period of the previous year. The income earned by farmers from working in cities accounted for about 70% of the total annual increase in their incomes. Farmers' incomes were also adversely affected

by the SARS outbreak. According to a survey conducted by the National Bureau of Statistics in mid-June, only 23.3% of the rural migrant laborers who had returned to their villages in the SARS period had since returned to work in cities. This will make it difficult to fulfill the Government's objective of increasing rural income by 4% this year. Reforming SOEs is also an ongoing and difficult task. In the first half of 2003, investment in private, collective, and state-owned sectors grew by 24.3%, 34.0%, and 32.8%, respectively, year on year. Given the prevailing inefficiency of SOEs, the continued increase in SOE investment may have drained resources from more productive areas.

As in other economies, Hong Kong, China's structural adjustments have created winners and losers. Unskilled workers are experiencing tough times because of the availability of cheap labor in the PRC. Falling property prices have hurt property developers and owners, particularly those struggling to repay mortgages on properties bought at boom prices. However, lower asset prices will increase Hong Kong, China's attractiveness for business and investment in the long run. In the coming decade, Hong Kong, China faces mounting concerns about its future economic role in the region as infrastructure and other conditions improve in the PRC.

Taipei, China shares many of Hong Kong, China's problems. While the property market has not undergone a similar drastic adjustment, its economic integration with the PRC has strengthened. This provides both opportunities and challenges. Lower production costs have lured firms to relocate to the PRC, leading to a "hollowing out" of manufacturing and increased unemployment. The movement of goods and services between the two economies has also led to some price convergence, contributing to deflation in Taipei, China. Despite increased competition from the PRC, the economic future of Hong Kong, China and of Taipei, China lies firmly anchored in their proximity to that country.

Korea has witnessed much debate over labor-market reform recently. Industrial production rose by only 0.7% in July as strikes hit the automobile industry. The new Government is perceived to be more supportive of labor unions than the previous one, and labor movements won victories on various issues. Bitter debates continue over matters such as a 5-day work week and labor participation in firm management. It will not be an easy task for the Government to design policies reconciling the need for economic reform and labor-movement concerns.

Mongolia's privatization program proceeded according to schedule. In 2003, three SOEs were offered for sale. The sales are expected to be completed by the end of the year, boosting government revenues. Funded by the European Bank for Reconstruction and Development (EBRD), and in preparation for the privatization of the state-owned airline, MIAT, a 12-month management contract was awarded to a foreign company. Some smaller state assets are also scheduled for privatization in 2003.

In 2002, the Mongolian Parliament approved two new land laws to be implemented in 2003. The first extends the system of quasi-ownership of urban and peri-urban land by establishing renewable, inheritable, and tradable long-term possession and use leases that can be pledged as collateral. The second allows every Mongolian family to privately own a small parcel of land. The laws remain controversial despite a start in imple-

mentation. The allocation of leases, through auction and at the discretion of local authorities, remains a concern due to the lack of sophisticated dispute-resolution procedures and the possibility that a wealthy few will dominate the market leases.

A persistent high incidence of poverty and widening economic inequality burden Mongolia. Furthermore, increased migration to a few population centers—particularly in and around the capital city, Ulaanbaatar, for better access to essential social services and market opportunities—has created new and urgent challenges for social and human development.

Outlook for 2003–2004

East Asian economies are recovering from the economic disruption caused by SARS. Consumer and business confidence are improving. Globally, there are signs of a firmer recovery in the US, and some improvements in Europe and Japan. These developments will benefit the economies of East Asia and lift their growth rates in the second half of 2003 and in 2004.

The economic impact of SARS in the PRC should diminish in the third quarter of 2004. Economic growth in the PRC will strengthen toward the end of the year. GDP is forecast to grow by 7.8% in 2003 and by 7.9% in 2004, compared to 7.3% and 7.6%, respectively, forecast in *ADO 2003*. The Hong Kong, China economy is expected to pick up from the second half of 2003, bolstered by strong exports to the PRC. Government spending will further boost growth. GDP is expected to grow by 2.1% in 2003, and accelerate to 4.8% in 2004.

There are indications that commercial activity in Taipei, China is rebounding since it was declared SARS-free. Expanding public expenditure will also lift the economy in the second half of the year. GDP is expected to expand by 3.1% in 2003. A broad recovery in both domestic and external demand will accelerate this rate to 4.4% in 2004. Korea's overall GDP growth rate is expected to stay at around 3% in 2003, improving to around 5% in 2004 as the recovery phase continues. In Mongolia, growth will be 5.0% in 2003, and 5.2% in 2004.

Economic performance will vary between sectors. In the PRC, rapid investment in real estate will cool as the People's Bank of China has taken measures to prevent a real estate bubble from developing. Strong FDI inflows and domestic private sector investment will continue. As a result, investment will remain robust for the remainder of 2003 and in 2004. Several developments suggest that consumption will resume its modest expansion. For example, the Ministry of Commerce recently adopted measures to revitalize the food and beverage and accommodation industries, such as publicizing and implementing the standards of "green" (environmentally friendly) hotels and restaurants and hotels ratings, advocating sanitary dining habits, and launching a series of marketing activities in the second half of 2003. Continued government measures to alleviate the impact of SARS, such as tax reduction for the hospitality sectors, will also help revive consumption spending in 2003.

The PRC's strong import demand will boost exports in other East Asian and Southeast Asian economies, particularly that of Hong Kong, China. Tourism in Hong Kong, China has begun to pick up since the

lifting of the WHO SARS travel advisory on 23 May. Visitor numbers from the PRC are rapidly recovering, partly as a result of the lifting of some travel restrictions for PRC tourists. Shop and restaurant customer numbers are also recuperating. Exports are forecast to grow by 16.5%, and imports by 13.5%, in 2003. Private consumption will remain subdued in 2003, however, since household confidence has suffered from falling property prices and high unemployment. Overall, investment spending in the economy, as represented by gross domestic fixed capital formation, is forecast to increase by 0.6% in real terms in 2003. Expenditure on building and construction will continue to decline in 2003. New construction works in the private sector will be delayed by sluggish property market conditions. Cuts to the Public Housing Program and the imminent completion of the construction of the KCR West Rail will further dampen construction output in the public sector.

A recovery in consumer demand and a pickup in investment will help the Hong Kong, China economy bounce back in 2004. In 2003–2004, the economy will maintain its sizable current account surplus. The deficit on the merchandise trade account is likely to narrow this year, before widening once again in 2004. The services balance will remain substantially in surplus. Overall, the current account surplus is forecast to fall from about 12% of GDP in 2003 to around 9% in 2004.

Due to weak growth in the first half of 2003 in Taipei, China, private consumption is expected to grow by just 1.6% in 2003. It will strengthen markedly in 2004, to 4.7%, as domestic demand improves and unemployment begins to fall. Export expansion in Taipei, China is set to strengthen in late 2003 and in 2004 on the back of a strong rise in exports to the rest of Asia, particularly the PRC. Macroeconomic policies will remain accommodative in 2003 and 2004. Domestic investment will firm up, aided by the improvement of the domestic investment environment, stronger trading partner growth, and government employment and public investment packages. Gross fixed capital formation is projected to rise by just 3.0% in 2003, and by 6.2% in 2004. The trade surplus will narrow in line with increased import demand.

Although the Korean economy suffered a worse than expected recession in the first half of 2003, the pace of decline has slowed recently. Both industrial and services output growth rates improved in May and June. Many of the adverse conditions that occurred in the first quarter appear to be dissipating. For example, oil prices have stabilized, and semiconductor prices are on the rise. Financial market uncertainties resulting from problems experienced by credit card companies and SK Global have decreased. Strong demand in the PRC and strengthening global economic conditions will boost Korea's export growth. Domestically, it seems likely that adjustments in household credit, particularly credit card loans, will proceed at a more gradual pace, thus helping stabilize private consumption. Expansionary macroeconomic policies may also boost the economy from the second half of 2003 onward. These factors are expected to improve the quarter-to-quarter growth rate in the second half of the year, although the year-on-year rate is not expected to be much higher than that of the first half. GDP growth in 2003 at 3.1% will be substantially lower than projected in *ADO 2003*. Private consumption might increase by less than 1% in 2003,

before fully recovering in 2004. The expected recovery of the global economy, particularly in the information and communications technology industries, will help Korea's export performance, although domestic demand will also boost imports, reducing the current account surplus from 0.3% of GDP in 2003 to 0.1% in 2004.

Inflation in most East Asian economies will remain subdued, although deflation remains a major issue in Hong Kong, China. The inflation rate in the PRC is forecast at 1.0% in 2003 and 1.5% in 2004 in spite of strong domestic demand, and the ongoing monetary reform that will widen financial institutions' channels for lending in the next 2 years. Reduced aggregate demand pressure in Korea will help stabilize inflation rates from 3.4% in 2003 to 2.7% in 2004. Given the weak consumer sentiment and heavy discounting prevalent in Hong Kong, China, deflation will persist in 2003. Temporary government economic relief measures, such as lower water and sewerage charges, will further contribute to deflation. As a result, prices in Hong Kong, China are expected to fall by 2.8% in 2003. Firming economic conditions and the end of government relief measures next year suggest that consumer prices are likely to rise by a moderate 0.5% in 2004.

Taipei, China is unlikely to face significant inflationary pressures until late 2003 as long as domestic demand remains sluggish. Marginally higher housing costs and lower subregional inflation, coupled with lower demand for labor and low upward movement in wages, will also contain inflationary pressure. As a result of these factors, consumer prices will fall by about 0.1% in 2003. Stronger domestic and international demand for goods and services are expected to revive price pressure in 2004, lifting inflation to an annual average of 0.5%.

The unemployment rate in Hong Kong, China will remain high in 2003 as new graduates and school leavers enter the job market in the next few months, and is forecast to average 8.0% for 2003 as a whole. Government employment and training initiatives will only offer minimal and temporary relief to the labor market. Most employers also remain cautious about recruitment. Unemployment will recede to 7.5% in 2004 in line with improved economic conditions. High unemployment will remain a major issue in all East Asian economies except Korea.

Revenues from a few key commodities, such as copper, gold, and cashmere, are the main sources of the Mongolian Government's fiscal revenues and the country's foreign exchange earnings. This narrow base makes Mongolia highly vulnerable to the whims of nature and to price volatility in world commodity markets. In the short term, the major economic concern is whether macroeconomic stability can be achieved, against increasing pressure for more expansionary fiscal and monetary policies in the run-up to the June 2004 general elections. The forecasts for the Mongolian economy remain unchanged from *ADO 2003*.

The PRC's exports are forecast to rise by around 25% in 2003 and by around 15% in 2004 for several reasons. First, the payment of tax rebates on exports will be accelerated, though the rebate rate will be reduced. Second, despite some temporary SARS-induced setbacks, the PRC is still one of the most popular destinations for FDI in the world—indeed, it has become the largest FDI destination in the world. This will stimulate exports since foreign-invested firms produce over half of all exports.

Third, the weakening of the US dollar will improve the competitiveness of PRC exports to non-US markets as the yuan is pegged to the dollar.

Imports into the PRC are expected to grow faster than exports, increasing by about 36% in 2003 and by about 25% in 2004 due to surging demand stemming from its robust economic performance as well as from lower tariffs and reduced import barriers associated with WTO accession. Average tariff rates were lowered from 12.7% to 11.5% in 2002. Only eight categories of commodities needed import licenses in 2003, compared to 12 in 2002. The PRC will also require more imports for use in its fast-growing manufacturing sector. Since imports will increase faster than exports in the coming 2 years, the current account will record a surplus of about 0.2% of GDP in 2003 and a deficit of 0.1% of GDP in 2004.

Downside risks in the subregion have been reduced over the past few months but remain significant. (These are analyzed in Part 1 of this *Update*.) Particular concerns include the security situation in the subregion and the possibility of another SARS outbreak. These pose major risks to these forecasts.

Endnote

¹ The government structure of Taipei, China consists of the Office of the President, the National Assembly, and five branches (called “yuan”), namely the Executive Yuan, the Legislative Yuan, the Judicial Yuan, the Examination Yuan, and the Control Yuan.