

# EAST ASIA

During the first half of 2002, economic expansion in the East Asian subregion as a whole was more robust than had been projected in *ADO 2002*. Although downside risks are increasing, growth in all East Asian economies is expected to be sustained during the remainder of 2002, and to edge up further in 2003. East Asia is now forecast to expand by 5.7% in 2002, as compared to the original forecast of 5.2% in *ADO 2002*. Growth is forecast to reach 6.1% in 2003, slightly lower than the 6.2% previously expected.

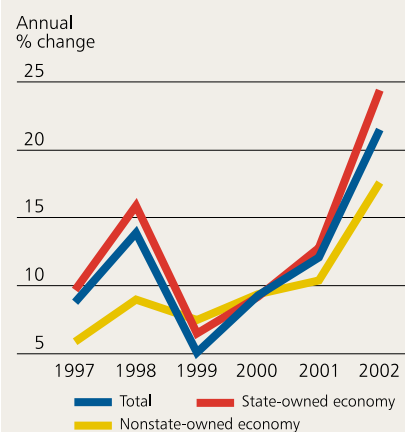
## MACROECONOMIC ASSESSMENT

**E**conomic activity strengthened across all East Asian economies in the second quarter of 2002, but rates varied significantly among economies. The PRC and Korea posted among the highest growth rates in Asia, spurred by strong domestic demand and rising external demand. In the PRC, growth in the first half of 2002 reached 7.8% year on year as GDP rose by 8% in the second quarter. Korea's economic recovery started in late 2001 and gathered momentum in 2002. Real GDP grew by 5.8% in the first quarter and by 6.3% in the second, equivalent to annualized growth of 6.1% for the first half of 2002. The economy of Taipei, China also showed signs of rebounding. GDP increased by 1.2% in the first quarter, ending three consecutive quarters of contraction, and further strengthened to 4% in the second. The economy of Hong Kong, China grew slowly by 0.5% year on year in the second quarter of 2002, after contracting for three consecutive quarters. Growth in Taipei, China and Hong Kong, China was supported by strong export recovery. Domestic demand in these two economies, however, continues to be weak. Preliminary data for Mongolia indicate that the economy is performing better than in 2001, due to more favorable weather conditions.

The divergent economic performances in East Asia were in part the result of differences in domestic demand. In the PRC, increases in urban household incomes boosted domestic consumption. The per capita income of urban residents rose by 17.5% in the first half of 2002, partly attributable to the implementation of pay rises for government employees and retirees that were approved by the Government in March and October 2001. Retail sales of consumer goods grew by 8.6% in the first 6 months of the year. The surge of investment particularly has been an important driver of domestic demand. Fixed investment grew by 21.5% over the same period, underpinned by strong growth in the state-owned, collective, and private sectors. Investment in the state-owned sector was bolstered by a rapid disbursement of Treasury bond investment funds, which reached Y76.2 billion by the end of June 2002, or nearly half the total amount planned for 2002.

**The surge of investment has been an important driver of domestic demand.**

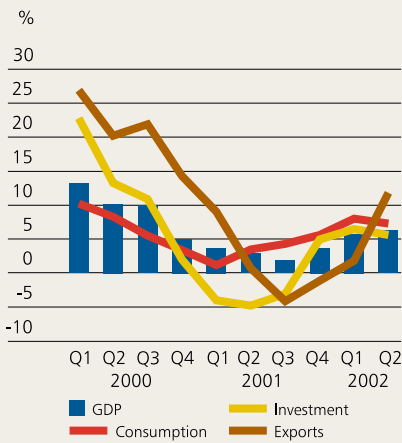
**Growth of Nominal Fixed Investment, People's Republic of China, 1997-H12002**



Sources: Asian Development Bank, 2002, *Country Economic Review, People's Republic of China*; *China Statistical Abstract 2002*; PRC National Statistical Bureau, *China Statistical Yearbook 2001*, China Statistics Press.

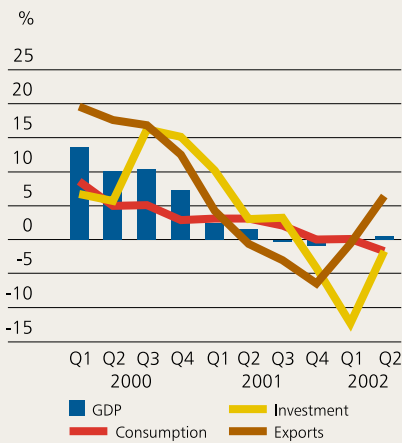
**Divergent economic performances were partly due to differences in domestic demand.**

**Growth Rates of GDP and its Expenditure Components, Korea, Q1 2000-Q2 2002**



Source: www.bok.or.kr.

**Growth Rates of GDP and its Expenditure Components, Hong Kong, China, Q1 2000-Q2 2002**



Source: www.info.gov.hk.

This compares to 30% of the total disbursed over the same period in 2001. Private investment reflected an acceleration of investment in real estate, which expanded by 32.9% in the first half of the year due to increasing housing mortgage loans from commercial banks.

The current strength of the Korean economy also owes much to strong domestic demand, in contrast to the beginning of previous expansions. Private consumption was up by 8.0% in the first 6 months, year on year. In the second quarter, fixed investment rose at an estimated 5.6% year on year. Domestic demand has been fueled by a reduction in excise taxes as well as a sharp rise in construction activities. The robust recovery in the economy, and greater economic flexibility resulting from corporate and banking sector restructuring in recent years, contributed to a decline in the unemployment rate to 2.7% as of June 2002.

By comparison, domestic demand in Taipei, China and Hong Kong, China remained sluggish, dampened by record high unemployment, falling earnings, deflation, and the languid performance of asset markets. Weak consumer sentiment is evident in Hong Kong, China, with real consumption spending falling by 2.4% in the second quarter year on year. Real investment spending contracted by 1.7% in the second quarter from a year earlier. In Taipei, China, private consumption increased by only 1.6% and 2.4% in the first and second quarters of 2002, respectively. Investment was particularly weak, with gross fixed investment contracting by 5.4% in the second quarter of 2002, following a 14.4% fall in the first quarter. Investment over the past 2 years in Hong Kong, China and Taipei, China has been held back by uncertain growth prospects, significant excess capacity, and the relocation of manufacturing production to the PRC.

The weak domestic demand in Hong Kong, China partly reflects the prolonged impact of the Asian financial crisis. Hong Kong, China's property market, for example, continued to weaken. As of June 2002, prices had fallen by about 60% since the third quarter of 1997. Between December 2001 and March 2002, prices for residential buildings fell by 1.1% while prices for offices fell by 4.1%, after both had dropped by 12% in 2001. The wealth effect resulting from declining property prices has depressed domestic demand in the short term. Promising signs are beginning to emerge, however. Mortgage lending rose for the fourth consecutive month in June with refinancing loans surging by 29.2% from the previous month. In addition, residential property sales have picked up in recent months. The Government resumed sales of subsidized public housing in July following a 10-month moratorium, albeit scaled back to avoid competing with the private sector and further depressing the real estate market. Demand for commercial property, however, continued to fall during the first half of 2002 in the wake of more corporate downsizing, suggesting that the property slump may still take some time to abate.

In Mongolia, preliminary data indicate that total industrial output grew by 14.2% year on year during the first 7 months of 2002. While no data on agriculture are available, a slight recovery in the livestock sector is expected due to the mild winter. Overall growth in the first quarter of 2002 appears more promising than it was in the equivalent period in 2001.

Due to the pursuit of expansionary fiscal policies, fiscal deficits increased in most of East Asia's economies. In the PRC, public expenditures were 17.8% higher in the first half of 2002 than in the same period a year earlier. Fiscal revenues, however, grew by only 9.2% in the first half of 2002 year on year, significantly lower than the 27% growth recorded in the first half of 2001. Revenue growth slowed, due mainly to lower stamp duties resulting from falling stock market prices, increased tax rebates for exporters, and reduced import duties following tariff reductions after the country's WTO accession. As a result, the budget deficit rose from 2.6% of GDP in 2001 to a targeted 3% in 2002. Concern over the

shortfall in revenue collection has led the Government to step up its efforts to crack down on smuggling and to close tax loopholes. In Hong Kong, China, the 2002/03 budget released on 6 March 2002 included a partial waiver of property tax payments by households for 1 year, as well as several other waivers on fees and public service charges. Weak economic growth and these tax relief measures caused the budget deficit to swell to 5.2% of GDP in fiscal year 2001/02 (which ended in March 2002). In Taipei, China, the weak economy, combined with a number of tax incentives, led to a decline in general government revenues of 22.3% in 2001, while they increased by only 3.2% in the first 7 months of 2002 year on year. The public debt to GDP ratio increased from 28.8% by the end of 2001 to 29.2% in June 2002. Korea is the exception, in that its consolidated fiscal balance for the first half of 2002 was in surplus to the tune of about 2.7% of GDP.

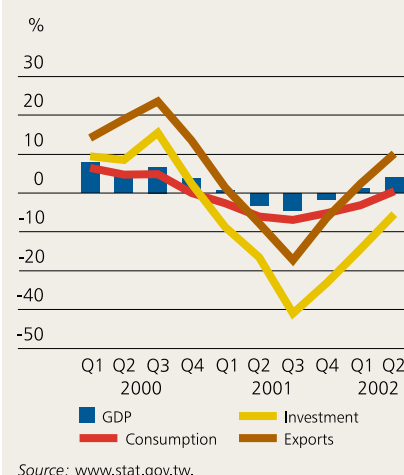
Monetary policies have generally been expansionary in East Asia. Due to continued deflation, the PRC central bank reduced the deposit rate by 25 basis points and the lending rate by 50 basis points in February 2002, after holding them unchanged for more than two and a half years. Money supply (M2) was up by 14.7% at the end of June 2002 from a year earlier. Liquidity in the banking system remains high as deposits in both local and foreign currencies far outpace loans. In Taipei, China, the central bank cut its official discount rate by 25 basis points to 1.875% in June 2002. The average prime lending rate of the five leading domestic banks declined from 7.38% in December 2001 to 7.23% in July. In Hong Kong, China, interest rates remain at historically low levels in line with those in the US. The 3-month Hong Kong dollar interbank offered rate (HIBOR) declined from 6.57% in the fourth quarter of 2000 to 1.81% in the second quarter of 2002. Bank lending to households surged in Korea, thus boosting private consumption. This contrasted with greater lending to firms in previous expansion periods. One noteworthy feature of recent bank lending to households in Korea has been the rapid increase in the use of credit cards, a trend promoted by the Government. This not only facilitated household consumption spending, but also pushed up fiscal revenues, since more transactions are recorded.

Despite expansionary monetary policies, deflation remains an issue in East Asia. Taipei, China's CPI showed very little movement in the first 7 months of 2002. Deflation is showing few signs of abating in Hong Kong, China. The general price level, as measured by the composite consumer price index (CCPI), had been falling for 44 consecutive months as of June 2002. The CCPI was 2.9% lower in the first half of 2002 than a year earlier. In the PRC, the CPI dropped by 0.8% in the first half of this year. Macroeconomic conditions are only part of the reason behind deflation in the PRC and Hong Kong, China; structural factors also exert an influence. Tariff reductions after the PRC's WTO accession contributed to the fall in prices, while Hong Kong, China's deflation partly reflects weakening property prices.

Among East Asian economies, Korea stands out in that inflationary pressures mounted as the economy recovered strongly. During the second quarter of 2002, the price index rose by 2.7% year on year as a result of price hikes for some petroleum and agricultural products, and of the continued upward trend in property rental prices. Inflationary pressures also came about because of increased capacity utilization in manufacturing, from 73.2% in 2001 to 76.3% in the first half of 2002. Wages, led by construction and some services, were up by 8.4% year on year in the first quarter of 2002.

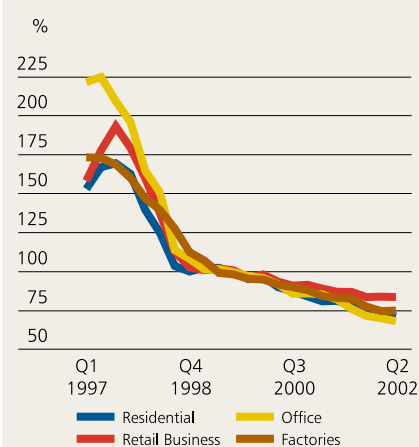
Weak economic conditions and structural changes have made unemployment a feature of the economic landscape of Hong Kong, China and Taipei, China. The seasonally adjusted unemployment rate for the former climbed to a record high of 7.8% in the 3 months ending July 2002. The effects of more extensive corporate downsizing and layoffs were felt, and employers remain

**Growth Rates of GDP and its Expenditure Components, Taipei, China, Q1 2000-Q2 2002**



### Property prices continued to weaken in Hong Kong, China.

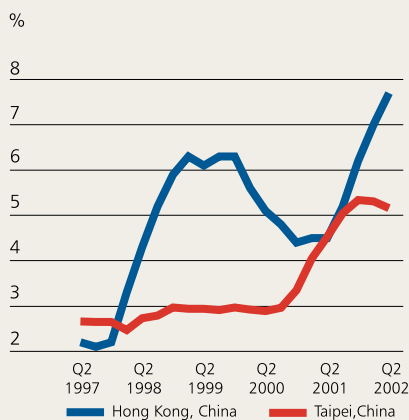
**Property Price Index by Type, Hong Kong, China, Q1 1997-Q2 2002 (1999=100)**



Source: CEIC Data Company Ltd.  
Note: Data refer to average for the quarter.  
Q2 2002 comprises April and May only.

**Weak economic conditions and structural changes have made unemployment a feature of the economic landscape of Hong Kong, China and Taipei,China.**

**Unemployment, Hong Kong, China and Taipei,China, Q2 1997-Q2 2002**



Sources: www.info.gov.hk; CEIC Data Company Ltd.  
Note: Data are end-of-period unemployment rates, seasonally adjusted.

cautious about recruiting new staff. The average nominal wage index fell by 0.8% during the year ending March 2002. The seasonally adjusted unemployment rate in Taipei,China reached a historical high of 5.2% in the first 6 months of 2002, and average monthly earnings for industry sector workers fell by 1% over this period. Wage restraints, rising unemployment, and wealth erosion resulting from falling asset prices have undermined household incomes in both these economies.

In contrast to the varying trends in domestic demand, export growth strengthened in all subregional economies, except Mongolia. In the first half of 2002, PRC exports were 14.1% higher, year on year. Growth in exports to the US; ASEAN countries; Hong Kong, China; and Korea more than offset a slowdown in exports to Japan and the EU. Imports grew more slowly than exports, but were still 10.4% higher in the first half-year compared to a year earlier. As a result, the overall trade surplus amounted to \$13.4 billion. FDI to the PRC also grew significantly. Contracted FDI inflows increased by 31.5% to reach \$44 billion in the first half of 2002, while actual FDI inflows grew by 18.7% to \$24.6 billion over the same period. Due to a wider trade surplus and larger FDI inflows, the foreign exchange reserves increased to \$242.8 billion by the end of June 2002, or 14.4% higher than at the end of 2001.

Much of Taipei,China's economic recovery stemmed from the growth of exports in ICT products. While total exports rose by 5.8% in the second quarter of 2002, exports of information and communication products increased by 10.8%. Due to weak domestic demand, imports increased by only 2.5% on a yearly basis during this period. Consequently, the trade surplus amounted to \$4.3 billion for the second quarter of the year—an increase of 34.1% on the same period in 2001. The external sector is also strengthening in Hong Kong, China. The value of merchandise exports grew by 2.8% year on year in the second quarter, after declining for four consecutive quarters. This pickup was mainly driven by exports to other economies in Asia and the Pacific, with total merchandise exports to East Asia growing by 9% in the second quarter. Exports to North America have also strengthened in recent months. The value of merchandise imports rose marginally by 0.7% in the second quarter. Services exports expanded by 4.6% in the second quarter of 2002 year on year, while services imports remained weak. Consequently, the total trade surplus in the first half of 2002 was more than twice as high as a year earlier.

In Korea, exports of ICT products surged. This contributed to Korea's high export growth of 20.4% in August year on year, with 5.1% expansion in the second quarter of 2002, in strong contrast to the 11.1% contraction in the first quarter. Imports also shifted to positive territory in the second quarter in response to growth in domestic demand and increased exports. As a result, the merchandise trade surplus for the first half of 2002 was \$7.7 billion, compared to \$5.1 billion in the second half of 2001.

Exports from Mongolia rose by only 1.6% in the first 7 months year on year. The value of copper exports, the country's main export commodity, declined by 10.5% due to falling international copper prices, despite an 8.1% increase in the volume exported. The average price of copper concentrate per ton for the first 7 months in 2002 was 17% lower than over the same period in the previous year. Imports increased by 26.4%. The trade deficit accordingly rose to \$164.2 million.

Closer economic integration among the PRC; Hong Kong, China; and Taipei,China is clearly evident, and trade among these three economies is thriving. In Taipei,China, export orders from Hong Kong, China increased by 11.3% year on year in the first half of 2002, which is by far the highest among Taipei,China's trading partners. Much of Hong Kong, China's export rebound has come on the back of strong demand from its biggest export market, the PRC,

**Selected Economic Indicators, East Asia, 1999–2003**

	1999	2000	2001	2002		2003	
				ADO 2002	Update	ADO 2002	Update
<b>GDP Growth (%)</b>							
Average	7.6	8.2	3.9	5.2	5.7	6.2	6.1
China, People's Rep. of	7.1	8.0	7.3	7.0	7.4	7.4	7.5
Hong Kong, China	3.4	10.2	0.6	2.1	1.4	4.8	3.5
Korea, Rep. of	10.9	9.3	3.0	4.8	6.0	6.0	5.8
Mongolia	3.2	1.1	1.5	3.0	3.0 <sup>a</sup>	4.9	4.9 <sup>a</sup>
Taipei, China	5.4	5.9	-2.2	2.8	3.0	4.0	4.0
<b>Inflation (%)</b>							
Average	-0.7	0.7	1.4	1.5	1.0	2.3	2.0
China, People's Rep. of	-1.4	0.4	0.7	1.0	0.5	1.5	1.5
Hong Kong, China	-4.0	-3.8	-1.6	-0.8	-2.7	0.6	0.5
Korea, Rep. of	0.8	2.2	4.1	3.5	3.1	4.0	3.5
Mongolia	10.0	8.1	11.2	6.0	6.0 <sup>a</sup>	5.0	5.0 <sup>a</sup>
Taipei, China	0.2	1.3	0.0	0.7	0.3	2.1	1.5
<b>Current Account Balance (% of GDP)</b>							
Average	3.3	2.3	2.7	1.8	1.8	1.0	1.2
China, People's Rep. of	1.6	1.9	1.7	1.0	1.0	0.4	0.4
Hong Kong, China	—	—	—	—	—	—	—
Korea, Rep. of	6.0	2.7	2.0	1.9	1.1	0.7	0.0
Mongolia	-13.7	-17.2	-16.7	-14.7	-14.7 <sup>a</sup>	-13.4	-13.4 <sup>a</sup>
Taipei, China	2.9	2.9	6.7	3.9	6.1	3.4	7.0

— Not available.

<sup>a</sup> ADO 2002 forecast.

Sources: ADO database; staff estimates.

which absorbed 37.8% of the economy's total exports by value in the first half of 2002. Hong Kong, China's tourism growth also benefited from a large inflow of PRC visitors after the PRC Government relaxed its quota restrictions on the number of its citizens allowed to visit Hong Kong, China. Consequently, total tourist arrivals in Hong Kong, China reached 7.5 million in the first half of 2002, 12.8% higher than a year earlier.

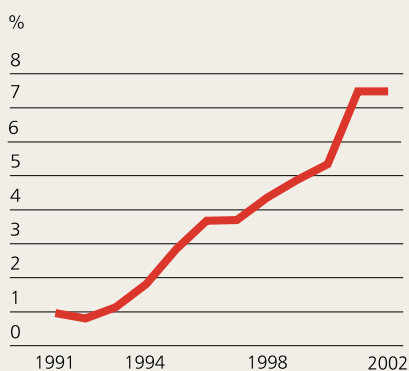
The closer economic integration among these three economies has spurred structural changes. Reexports from Hong Kong, China have grown rapidly to account for more than 90% of its total exports. Its reexports consist mainly of goods shipped from the PRC to other destinations. Services exports have outpaced merchandise exports, partly as a result of the need to cater for increased reexports. In recent years, manufacturing facilities in both Hong Kong, China and Taipei, China have been relocating to the PRC to take advantage of low labor costs. This has induced both economies to adopt a greater services sector orientation. While these structural changes will bring significant long-term benefits, the process of adjustment can be arduous in the economies that are losing manufacturing capacity. Employment in manufacturing has steadily fallen from about 234,000 in March 2000 to about 197,000 in March 2002. This continual shrinkage of manufacturing employment has exacerbated Hong Kong, China's unemployment problem during the current economic downturn.

## POLICY DEVELOPMENTS

Governments in East Asian economies have pursued expansionary macroeconomic policies over the past few years. The PRC Government carried out its

**The increasing level of NPLs has become a concern in Taipei,China, among others.**

**Nonperforming Loan Ratios of Domestic Banks, Taipei,China, 1991-Q2 2002**



Source: www.cbc.gov.

fifth year of fiscal expansion in 2002 by issuing long-term construction bonds worth Y150 billion (\$18 billion). The funds will be used to finance a number of areas, including projects in the western region, technological improvement of key enterprises, projects to divert water from the south to the north to supplement the water resources of Beijing and Tianjin, rural infrastructure, and universities and other higher education facilities.

The authorities in Hong Kong, China face the challenges of balancing the budget and reforming the taxation system. They consider the deficit, which is above 5% of GDP, to be structural rather than merely cyclical. In other words, economic recovery alone will not bring the budget back into balance. The authorities are obliged to eliminate a structural deficit under the provisions of the Basic Law. To curtail government expenditures and raise revenues, the 2002/03 budget released in March proposed to cut civil servants' wages by 4.75% from 1 October 2002, but, in July, the Legislative Council settled on cuts of only 1.6–4.4%. The budget also proposed measures to raise revenues, such as levying a HK\$18 per person land departure tax from 2003/04. Overall, the 2002/03 budget proposed keeping expenditure growth below the 3% forecast real GDP growth by capping real spending increases to an average of 1.5% a year between 2003/04 and 2006/07. Even then, the budget will not be balanced until 2005/06, and success still requires higher economic growth and spending constraints. This realization has led to debate about reforming Hong Kong, China's tax system. Government revenues have traditionally relied heavily on property-related incomes. Since 1997, property prices have plummeted and the volume of property transactions has declined. This has resulted in lower land premiums, stamp duties, and property taxes. Sluggish economic growth and prolonged deflation have further drained revenues. Much of the debate on taxation reform has centered on the need to reduce the degree to which fiscal revenues depend on real estate. The authorities have contemplated introducing a broad-based consumption tax. However, they are unlikely to introduce new taxes in the current weak economic conditions. The authorities are also reluctant to jeopardize the economy's low tax status.

Taipei,China also faces constraints on further fiscal expansion. Legal restrictions on the size of the public debt and government borrowing make it difficult for the authorities to increase public spending. At the same time, the President's promise not to raise taxes in the next 2 years has made raising revenues difficult. Consequently, the authorities have reduced certain tax breaks enjoyed by high-tech companies.

The increasing level of NPLs has become a concern for several East Asian economies. In Taipei,China, the NPL ratio of domestic banks was about 7.5% in the second quarter of 2002, slightly lower than the 8% in the first. In Mongolia, NPLs were about 8.4% of total loans outstanding. By the end of June 2002, the official estimate of the ratio of NPLs to total loans of the four state-owned commercial banks in the PRC was 23.1%. Banks in the PRC have been taking measures to reduce their NPLs, and the NPL ratio is lower than the 25.4% estimated at the end of 2001.

The authorities of Taipei,China have also taken steps to reduce NPLs. In 2001, a NT\$140 billion Financial Restructuring Fund was set up, and asset management companies (AMCs) were established to deal with NPL problems. The Fund was already stretched by 2002, so that the Ministry of Finance proposed to increase its size. This may necessitate lifting the current 40% ceiling of the public debt to GDP ratio and the 15% ratio of new government borrowing to accumulated borrowing. The development of AMCs is still at an embryonic stage in the economy, though. AMCs are designed to serve as an intermediary tool for the authorities to deal with NPLs. The ultimate goal is to develop the secondary

market through which NPLs can be traded, and for the authorities to be able to use financial asset securitization to deal with NPL problems. Given the conservative attitude and small trading volume that AMCs currently generate, it will be some time before they play a significant role in dealing with the NPL problem.

As a result of robust economic recovery in the first few months of 2002, the Korean Government felt confident enough to reduce the planned rate of expenditure in the first half of the year from 53% of the full-year budget to 50%. This year is the first one since the Asian financial crisis that a supplemental budget has not been implemented by mid-year in Korea.

Various reforms to strengthen and liberalize economies have been adopted in East Asia. The PRC, for example, has been taking steps to fulfill its WTO obligations. The general tariff rate has been lowered from 15.3% to 12.0% over the past few months. The categories of import products that require quota licenses have been reduced from 33 to 12. The number of industries open to foreign investment has been increased from 186 to 262. The opening up of the services sector has intensified. The Government has approved 14 joint ventures in health facilities, 12 for law firms, one joint-venture travel agency, and 10 foreign-funded logistics companies. These areas had previously been largely off limits to foreign investment. Commercial banks in the PRC have been encouraged to provide more credit to small and medium-sized enterprises (SMEs). Anticipated pressure from greater competition after WTO accession has prompted domestic commercial banks to accelerate reforms, provide better services, and improve corporate governance. Steps taken by the banks include shifting portfolios from SOE lending to increasing lending to consumers, and reallocating resources from less-developed areas to more advanced regions and cities. In Korea, the financial system has been strengthened, with NPLs forming just 2.5% of total loans in the banking system, and 4.6% in all financial institutions (excluding loans held by the Korean Asset Management Corporation).

The PRC economy would benefit from further promotion of SME development. More than 99% of domestic enterprises in the PRC are SMEs, and most are privately owned. SMEs produce 60% of industrial output, make up 40% of the tax and profit base, account for 60% of exports, and employ 75% of the urban workforce. However, their development is hindered by a lack of access to financing, with commercial banks reluctant to provide credit to SMEs, and access to capital markets highly restricted. By contrast, the state-owned sector still absorbs a large portion of available credit. Despite its declining relative importance, investment in this sector increased by 24.4% in the first half of 2002, compared to a 19.4% increase for the private sector and 15.8% for the collective sector. In June 2002, the Government enacted the Law on the Promotion of Small and Medium-sized Enterprises. The Law states that the Government will establish an SME development fund to encourage local governments, private entrepreneurs, and financial institutions to invest in SMEs. While this may help improve SMEs' access to financing, fundamental improvement can only come from reform of the financial institutions and markets.

Privatization is under way in Mongolia. The state-owned Trade and Development Bank, Mongolia's main commercial bank for international transactions, was sold to foreign investors in May 2002. The fuel importer, NIC (Neftimport Concern) and the Agricultural (Khaan) Bank are likely to be the next companies sold. Reforms have been carried out to improve the investment environment, including setting up free economic zones. The Mongolian economy still faces important challenges. Over one third of the population live below the poverty line, and inequality is rising. Economic growth is constrained by climatic conditions and the vagaries of commodity prices: copper, gold, and cashmere account for over 80% of Mongolia's exports. This narrow base makes the economy highly

vulnerable to natural disasters and price volatility in the world's commodity markets.

### OUTLOOK FOR 2002–2003

The prospects for East Asia in 2002 and 2003 are brighter than assessed in *ADO 2002*. However, there will be notable variation among economies. The PRC is likely to maintain robust growth on the back of both strong domestic and export demand. The economy is forecast to expand by 7.4% in 2002 and by 7.5% in 2003, compared to the *ADO 2002* forecast of 7% for 2002 and 7.4% for 2003. In Korea, the growth forecast for 2002 has been revised upward from 4.8% to 6% because of its strong performance in the first half of the year. Growth will be slightly weaker at 5.8% in 2003, however, compared to the forecast of 6% due to subsiding domestic demand. Continued weak domestic demand and an uncertain global economic recovery will affect economic recovery in Hong Kong, China. GDP is forecast to increase by 1.4% in 2002, lower than the 2.1% expected in *ADO 2002*. A rebound will take place from early 2003, and the economy will grow by 3.5% in 2003, weaker than the 4.8% forecast. The economy of Taipei, China is expected to experience moderate 3% growth in 2002, slightly stronger than the 2.8% forecast. The 4% forecast for 2003 is consistent with the expectations of *ADO 2002*. The Mongolian economy is expected to expand by a modest 3% in 2002 and by 4.9% in 2003, as reflected in *ADO 2002*, on the back of a recovery in domestic production and higher commodity prices.

Domestic demand will vary among East Asian economies in the second half of 2002. Demand in the PRC will be strong. Consumption growth will be lifted by salary increases for civil servants and strong demand for housing and car purchases. The growth of public investment in the PRC is likely to moderate in the second half of 2002. However, the strengthening of FDI inflows and domestic private investment will continue over the next 2 years, as economic reform and liberalization proceed.

In Korea, domestic demand is likely to weaken. Domestic demand has been fueled by a reduction in the special excise tax, a sharp rise in residential construction due to government support for housing, and increased construction associated with the soccer World Cup and the Asian Games. The impact of these factors will gradually taper off in the second half of 2002. Exports and fixed investment expansion will help counteract relatively lower consumption spending and construction investment. Domestic demand will likely remain subdued in Hong Kong, China and Taipei, China in 2002. High unemployment in these two economies will persist into the second half of the year, with wages likely to stay flat. Weak labor market conditions could curtail consumer spending, while the uncertain outlook for the domestic and international economy could hold back domestic investment. In Hong Kong, China, the depressed property market will continue for the remainder of 2002, further dampening investment spending. Investment growth is expected to pick up in 2003 as the economy recovers and as property prices firm.

The weak inflationary pressures experienced in the first half of 2002 prompted a downward revision of price forecasts for all East Asian economies compared to the *ADO 2002* figures. The inflation rate in the PRC is forecast to be subdued at 0.5% in 2002 and 1.5% in 2003, on account of large excess capacity in manufacturing and greater competition after WTO accession. Inflationary pressures will be contained by high unemployment and wage restraint in Taipei, China in 2002. The CPI is expected to increase by 0.3% in 2002 and by 1.5% in 2003. Deflationary pressures in Hong Kong, China are unlikely to abate in 2002 due to weak domestic demand and the floundering property market. The CCPI is expected to

decline by 2.7% for 2002 as a whole, and remain largely unchanged in 2003. In Korea, inflationary pressures are expected to rise, as collective bargaining over wages will be concentrated in the second half of 2002. The CPI is expected to rise by 3.1% for 2002 as a whole, and register a 3.5% increase in 2003. The forecasts, however, are still lower than the 3.5% and 4% expected for Korea in 2002 and 2003 in *ADO 2002*.

East Asia's export sector will continue to strengthen over the next 2 years. Exports from the PRC are forecast to rise by 13% in 2002 and 10% in 2003, as against the 6% and 10% expected in *ADO 2002*. Strong export growth in the PRC will be underpinned by the relocation of labor-intensive, export-orientated production from other economies to the PRC. Increased Multifiber Arrangement quotas on PRC apparel and textile exports will also enlarge the PRC's share of the world market. Imports in the PRC are forecast to grow slightly faster than exports at 14% in both 2002 and 2003, due to tariff reductions and the expansion of domestic production. As a result, the current account surplus will decline to about 1% of GDP in 2002, narrowing further to 0.4% of GDP in 2003. In Korea, export growth will play an important role in propelling the economy as growth in domestic demand gradually subsides. Export growth will be robust, but the growth rate may moderate given that exports recovered from a low base this year. Imports will pick up as the recovery progresses. The current account surplus in Korea is expected to decline to \$5.0 billion in 2002, and the surplus is likely to disappear in 2003.

As the 10th largest trading economy in the world, Hong Kong, China's recovery hinges on export performance. The prospects for export growth are looking brighter as its trading partners' economic activities pick up, particularly those of the PRC and the US; together they absorbed 55% of the economy's total exports in 2002. A rebound of the US economy will not only benefit the economy's exports directly, but also increase reexports through higher export demand from the PRC. Export growth will also drive the economic recovery of Taipei, China. The strengthening of export performance will filter through to other parts of the economy, lifting overall performance. While export expansion in all East Asian economies is likely to continue throughout 2002 and 2003, the uncertain pace of the US recovery poses significant downside risks for economic growth in East Asia over the next 2 years. Nevertheless, the robust economic growth of a number of Asian economies, especially that of the PRC, will help mitigate the risks associated with the uncertainty surrounding the US economic recovery.