ASIAN DEVELOPMENT

Outlook 2002

ECONOMIC TRENDS AND PROSPECTS IN DEVELOPING ASIA

East Asia

People's Republic of China
Hong Kong, China
Republic of Korea
Mongolia
Taipei,China

PEOPLE'S REPUBLIC OF CHINA

In spite of the global economic slowdown, the People's Republic of China maintained its robust economic expansion in 2001, though some signs of slowing appeared in the second half of the year, due partly to a sharp deceleration in growth of external trade. Driven by domestic demand and supported by World Trade Organization accession, the macroeconomic outlook for 2002–2003 is bright.

MACROECONOMIC ASSESSMENT

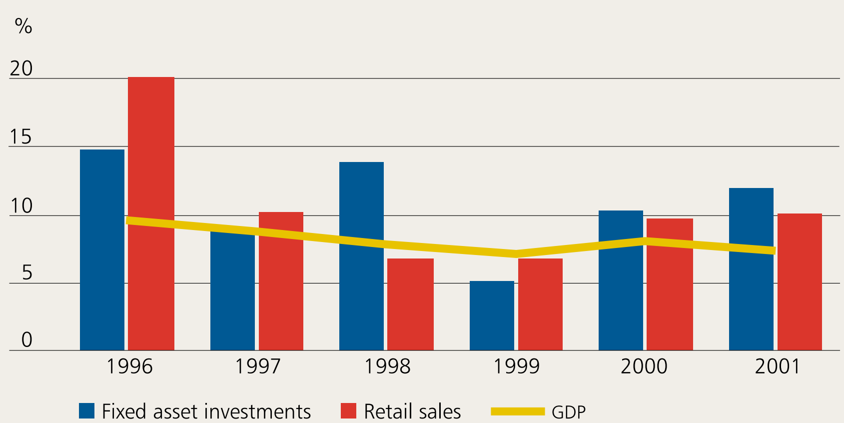
The People's Republic of China (PRC) remained one of the best-performing economies in the Asia and Pacific region in 2001, with GDP expanding at a rate of 7.3%. However, there were clear signs of deceleration in the second half of the year, with GDP growth slowing from a quarterly rate of 8.1% to 6.6% between the first and fourth quarters.

The industry sector posted a gain of 8.7%, led by the robust performance of foreign-invested enterprises. Their value added rose by 11.9% in the year, compared with 8.1% for state-owned enterprises (SOEs). The services sector grew by 7.4%, supported mainly by high growth in transport and telecommunications. Suffering from a severe drought and a decrease in the planted area, the agriculture sector grew by 2.8% in 2001. Grain output declined by about 2.1%, following a 9.1% drop in 2000.

Investment rose strongly by 12.1%, pushed by fiscal stimulus measures and accelerated foreign direct investment (FDI) inflows. However, momentum declined after August 2001, in which month investment had surged to 21% year on year, slowing to only 9.4% in November. One characteristic of investment during the year was a sharp rise in flows to the western region where economic development has lagged far behind that in the eastern and central regions: investment growth there was 5.1 percentage points higher than in the rest of the country. In contrast to high growth in public sector investment, that in the private sector stayed weak, partly because of a shortage of loanable funds available to the sector from the banking system and partly because of a generally cautious attitude toward lending to the private sector, especially to small and medium enterprises (SMEs).

Due to increasing incomes, retail sales strengthened by 10.1% in 2001, a slightly higher rate than in 2000 (Figure 2.1). Purchasing power stayed largely in the hands of urban residents, as the Government increased salaries for civil servants and pensions for government retirees twice during 2001. A large increase in automobile credit and housing mortgage lending also stimulated domestic consumption demand. Although rural income and consumption rose more rapidly in 2001 than in 2000, the rates of growth still trailed those in urban areas.

FIGURE 2.1 **Domestic Demand and GDP Growth, People's Republic of China, 1996-2001**



Source: National Bureau of Statistics.

TABLE 2.1 Major Economic Indicators, People's Republic of China, 1999-2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	7.1	8.0	7.3	7.0	7.4
Gross domestic investment/GDP	37.4	36.1	36.3	36.1	36.4
Gross domestic savings/GDP	39.4	38.9	38.1	37.9	37.6
Inflation rate (consumer price index)	-1.4	0.4	0.7	1.0	1.5
Money supply (M2) growth	14.7	12.3	14.4	13.0	14.0
Fiscal balance[a]/GDP	-2.9	-2.8	-2.6	-3.0	-2.8
Merchandise export growth	6.1	27.9	6.8	6.0	10.0
Merchandise import growth	15.8	35.4	8.2	10.0	14.0
Current account balance/GDP	1.6	1.9	1.7	1.0	0.4

[a] Central and local government.
Sources: National Bureau of Statistics; International Monetary Fund; staff estimates.

The PRC has significantly reduced rural poverty over the past few years. Sustained, rapid economic growth and targeted poverty interventions have brought down the number of absolute rural poor to below 30 million.

Inflation rose slightly in 2001, partly because of an upward adjustment in government-controlled prices of utilities and services. The consumer price index edged up by 0.7%, compared with 0.4% in 2000. However, some deflationary pressure built up as economic growth slowed in the latter part of the year, and prices fell slightly.

The official estimate of urban unemployment in 2001 was 3.6%, putting it slightly higher than in 2000. However, this does not cover workers who were laid off as part of SOE restructuring and who have not found new jobs. The reemployment rate of these workers, which has been declining in the past 3 years, is an important determinant of real urban unemployment.

The PRC has significantly reduced rural poverty over the past few years. Sustained, rapid economic growth and targeted poverty interventions brought the number of absolute rural poor in terms of the official poverty line down from 80 million in 1994 to below 30 million, or about 3% of the rural population, in 2001. However, the official poverty line was set in the mid-1980s and is substantially lower than the international standard of a dollar a day. About 213 million people, or 23% of the rural population, still live below that level.

During 2001, fiscal revenues increased by 22.2%, 5.2 percentage points more than in 2000. Fiscal expenditures grew by 18.6%, somewhat less steeply than in 2000. As a result, the fiscal deficit slightly declined to around 2.6% of GDP. However, these official figures give only a partial picture. If the Government's social security obligations and the costs associated with the nonperforming loans (NPLs) of the state-owned commercial banks (SOCBs) were included, the fiscal deficit would be significantly higher.

Monetary policy remained accommodative to stimulate domestic demand. Broad money (M2) increased by 14.4% in 2001, 2.1 percentage points higher than in 2000. However, M1 growth dropped in the second half of the year, reflecting slower economic activity. Interest rates remained unchanged in 2001, despite declining rates in many other economies in the region and in industrial countries. The asset market fluctuated sharply. Reflecting stronger domestic demand and a better economic outlook, the Shanghai and Shenzhen stock exchange indexes rose by 7% in the first half of the year. In February 2001, the B-share market, which used to be restricted to foreign investors, was opened to domestic investors with foreign currency. As a result, the B-share indexes on these two exchanges soared by about 200% in the first half of 2001, closing the price gap with the A-share market, which is open only to domestic investors. However, both markets experienced a sharp downturn in the second half of the year, triggered by plans to reduce state-owned shareholdings through increasing the volume of share offerings, restricting banks from injecting funds into the stock market, and punishing a number of listed companies for misconduct. Between June and December 2001, the A- and B-share indexes dropped by about 26% and 20%, respectively.

With the global economic slowdown, export growth decelerated sharply to only 6.8% from 27.9% in 2000. This was the result of lower import demand from the major trading partners—United States (US); European Union (EU); Japan; and Hong Kong, China. From 2000 to 2001, the growth rates of exports to these economies dropped from 24.2%, 26.4%, 28.6%, and 20.7% to 4.2%, 7.1%, 7.9%, and 4.6%, respectively. Import growth also slowed sharply, to 8.2% from 35.4% in 2000, largely reflecting a decline in demand for intermediate inputs by exporters. The current account surplus in 2001 dipped to $19.6 billion.

Robust economic growth and accession to the World Trade Organization (WTO) have made the PRC more attractive to foreign investors, and FDI regained its growth momentum in early 2001. Actual FDI inflows rose by 14.9% after 0.9% growth in 2000. Foreign exchange reserves stood at $212 billion at end-2001, or $43 billion higher than 12 months previously, and equivalent to about 11 months of imports of goods. The debt service ratio was 10%.

POLICY DEVELOPMENTS

To contain the effects of the Asian financial crisis, three fiscal stimulus packages were implemented in 1998, 1999, and 2000 (Y100 billion or 1.3% of GDP, Y110 billion or 1.3% of GDP, and Y150 billion or 1.7% of GDP, respectively). Such investment contributed to the construction of key infrastructure projects, including a rural power network, flood protection structures along major rivers and lakes, environment protection projects, and infrastructure in the western region. Expansionary fiscal policy continued in 2001: Y150 billion in government bonds were issued and a large proportion of the proceeds were targeted to support western region development.

While expansionary fiscal policy has contributed significantly to robust economic growth in recent years, the effectiveness of this kind of fiscal stimulus is probably declining. Furthermore, since a large volume of counterpart funds from commercial and policy banks were needed to match state investment, there has been some crowding out of other private sector investments. However, at the end of 2001, the Government announced that the expansionary fiscal policy would be continued into 2002 as growth in the world economy was expected to be slow.

On the monetary front, the Government focused attention on the performance of the finance sector. During the financial crisis, it intensified financial risk control, helping reduce the NPL ratio of all the commercial banks by 3.8% in 2001. To improve the quality of lending, the career path of bank staff was often tied closely to the quality of loans processed. As a result, commercial banks, particularly the four SOCBs (which still account for 71.8% of outstanding loans), tended to be very careful in making loans, particularly to SMEs in the private sector. It is the private sector though, consisting mainly of SMEs, that is very dynamic and has been growing quickly in recent years. The SMEs also provide the bulk of new employment opportunities. However, their development is seriously hindered by this lack of adequate financing. To encourage the commercial banks to lend to SMEs, more than 200 SME guarantee funds were established by local governments to enhance the credit of SMEs. The central bank also encouraged the commercial banks to increase their lending to SMEs.

More widely, there is a need both to improve the policy environment for supporting the private sector in general and SMEs in particular, and to strengthen the regulatory system (Box 2.1).

To minimize the adverse impact of the slowdown in the global economy, the Government adopted several measures in 2001 to encourage exports, such as speeding up export-tax refunds and customs procedures, and granting permission to private companies to engage in external trade.

To minimize the adverse impact of the slowdown in the global economy, the Government adopted several measures in 2001 to encourage exports.

In May 2001, the PRC adopted its new 10-year poverty strategy (2000–2010). In it, the Government designated 592 key counties for poverty reduction development work. The selection was based on income, social, geographic, and physical conditions. Priority was given to remote and mountainous areas and minority areas. Poor villages in non-key counties are also eligible for national poverty funding. The Government has placed a strategic priority on promoting development in the western region since 1999.

The PRC became a member of WTO at the end of 2001, and membership involves significant opportunities as well as challenges for the economy. Over the long term, PRC's accession and its commitments to cut tariffs, liberalize trade and investment, and open up domestic sectors to foreign participation should lead to significant efficiency gains. Hundreds of laws and regulations have to be revised to make them consistent

BOX 2.1 A Dynamic Engine for the Economy of the People's Republic of China

In the next few years, the PRC needs to create 8 million–10 million jobs annually for new labor market entrants and to find jobs for the more than 5 million workers who have been made redundant by SOE reform and not yet reemployed. A dynamic private sector is needed to serve as the engine for economic growth and employment generation. Official statistics show that the domestic private sector, consisting of formally registered private firms and small individual businesses, accounts for 13% of GDP.

However, if shareholding companies, foreign firms, private township and village enterprises, and private agricultural entities are included, the private sector generates more than 60% of GDP.

More than half the 200 million urban workers are self-employed, or are employed by private firms, privatized collective enterprises, foreign firms, or joint ventures. Private enterprises are also dominant in high-growth sectors, including services and the high-tech sector. Most private enterprises are SMEs, of which 8 million are in industry. An increasing number of state-owned SMEs are in the process of being privatized.

The Government has taken some steps to stimulate private sector development. In 1999, the National People's Congress amended the Constitution to recognize the private sector. A law on sole proprietorship, which became effective at the beginning of 2000, was the first law governing private investment in the PRC and protects the interests of investors and creditors. In 2000, the Government eased the registration rules for private businesses, and lowered their minimum capital requirement to one yuan ($0.12), doing away with the need to provide bank certificates and obtain bureaucratic approval. The Ministry of Foreign Trade and Economic Cooperation also issued import and export permits to 450 private companies, allowing them to conduct external trade. The scope of these permits has since been extended to all private firms with a certain scale of operation. Such trade was previously limited to government-approved medium and large SOEs. The China Securities Regulatory Commission recently announced that all qualified firms, including private firms and joint ventures, would be allowed to list on the A- or B-share market. This measure provides an opportunity for foreign joint ventures to access the domestic capital market and will improve the quality of listed companies on the domestic stock market. The Commission has also focused on promoting transparency, disclosure, and corporate governance, including the use of foreign auditors. These increasingly strict regulations and enforcement mechanisms should help in the sound development of the stock market in the long run.

While the PRC is making progress in these areas, more improvements are needed to develop the enabling framework for the private sector, including market entry, finance, land-use rights, and enforcement of private property rights. Private firms are still prohibited from operating in a number of sectors, while the legal environment affects private sector development. Enforcement of the rule of law, particularly of laws needed to resolve commercial conflicts, as well as legal recourse, is more difficult for private enterprises than for SOEs. Nevertheless, over the longer term, WTO accession is likely to help the economy build a rules-based system to facilitate the development of the private sector.

with WTO rules. All these changes will set a foundation for the country to be fully integrated into the world economy. By forcing the economy to reallocate resources in line with its comparative advantage (from capital- to labor-intensive sectors), membership should also generate more employment for a given rate of growth of the economy. It should further improve the country's export prospects. Many studies estimate that the economy's long-term gain from WTO membership will be equivalent to about 1–2% of GDP per year.

However, these positive effects will take time to make themselves felt. In the meantime, the Government's WTO commitments could pose adjustment challenges, especially in protected sectors such as agriculture, automobiles, banking, insurance, and telecommunications. To face these challenges, the Government needs to speed up economic reforms and create a more probusiness environment, including increasing the transparency of regulations, streamlining administrative procedures, and improving legal and accounting practices.

OUTLOOK FOR 2002–2003

Driven largely by domestic factors and supported by WTO accession, the PRC economy should continue to grow robustly over the next 2 years. Economic growth is forecast at 7% in 2002 and 7.4% in 2003, led by strong domestic consumption and investment. The industry and services sectors should grow by 7–9%, and the agriculture sector by 2–3%.

Domestic consumption and investment will remain strong in 2002–2003 with a growth rate of about 9–10%. Increased domestic consumption and continued solid economic growth will exert some upward pressure on prices. However, inflation should be moderate at 1–1.5% due to significant excess capacity in many industry subsectors, large unutilized supply potential of the agriculture sector, and cheap imports after WTO-related tariff liberalization.

The fiscal deficit will remain at around 2.8–3% of GDP in 2002–2003. Considerable public resources will be needed to reduce the NPLs of the SOCBs and to implement social security reforms. Substantial funding will also be needed to develop the western region, address poverty, and tackle environment and human resources development problems. Monetary policy is likely to remain accommodative. Money supply (M2) should continue growing by 13–14% in 2002–2003. In an attempt to stimulate the economy, the central bank reduced the interest rate for savings by 25 basis points and for lending by 50 basis points in early 2002.

Assuming that the global economy begins to recover in 2002 and gathers further momentum in 2003, exports are forecast to grow at the rate of 6% and 10%, respectively. With WTO accession, imports will continue to grow faster than exports, and the trade and current account surpluses will gradually decline. However, the decline in the current account surplus will be partly offset by foreign investment inflows as the Government further opens up the economy to fulfill WTO commitments. It is expected that the economy will post a current account surplus of $12.6 billion, or 1% of GDP, in 2002, which will likely fall to about $5 billion, or 0.4% of GDP, in 2003. The official foreign exchange reserves will be close to $230 billion by 2003, while the debt service ratio should fall to below 10%.

The external risks facing the PRC relate mainly to the prospects for global economic recovery, the speed and depth of which remain uncertain. If the improvement in external conditions is much less pronounced than expected, the Government may further strengthen its expansionary fiscal and monetary policies.

Driven largely by domestic factors and supported by WTO accession, the PRC economy should continue to grow robustly over the next 2 years.

HONG KONG, CHINA

Hit by the slowdown in industrial countries, GDP growth collapsed to 0.1% in 2001. Assuming a modest recovery in the US and in other key trading partners, the economy is forecast to gradually strengthen over 2002. The effects of globalization and of accelerating integration with the mainland will require the economy to make changes in its institutional and production structures if it is to remain competitive in the long term.

MACROECONOMIC ASSESSMENT

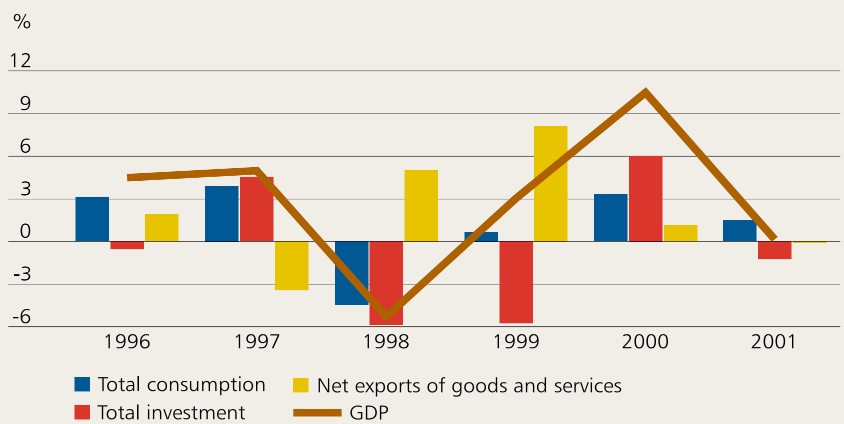
The economy of Hong Kong, China suffered a sharp slowdown in 2001, with GDP growth decelerating to a virtually stagnant 0.1% from 10.5% in 2000. The major contributing factors were a drop in exports and a weakening of consumer and business sentiment, stemming from the difficult economic environment worldwide (Figure 2.2).

Domestic demand growth slumped to 0.2% in 2001 from 10% in 2000. Expansion in private consumption fell to 2% from 5.4% over this period, reflecting consumer sentiment that was undermined by a drop in asset prices and rising uncertainty over employment. Given the bleak business outlook, gross fixed capital formation averaged a 2.1% increase, compared with a 9.8% rise in 2000. Slower growth in capital expenditure was mainly due to a sharp slowdown in the growth of spending on new machinery and equipment in 2001 as corporations cut their investment in information and communications technology upgrades. Expenditure on building and construction declined further by 2.5%, the fourth year of contraction. Private sector developers remained cautious in view of the overhang of supply in the residential property market while residential public sector projects were also scaled back. With the weakening demand in the economy, inventories underwent a modest depletion in 2001 after a substantial buildup in 2000.

Labor market conditions deteriorated during the year. The seasonally adjusted unemployment rate, having trended downward from a peak of 6.4% at the beginning of 1999 to 4.4% in the fourth quarter of 2000, edged up to 6.1% by the fourth quarter of 2001. The rise was attributed to increased corporate downsizing and layoffs in the context of slowing aggregate demand and the skills mismatch caused by ongoing economic restructuring.

Partly as a result of a sustained fall in import prices, a depreciation of regional currencies against the US dollar, and a benign external inflationary environment, deflation took hold, as the consumer price index fell by 1.6% in 2001. Fierce retail price competition and a weak property market that resulted in falling property rentals also put downward pressure on prices.

FIGURE 2.2 **Contribution of Demand Components to Change in GDP, Hong Kong, China, 1996-2001**



Source: Census and Statistics Department, 2002, available: www.info.gov.hk.

TABLE 2.2 Major Economic Indicators, Hong Kong, China, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	3.0	10.5	0.1	2.1	4.8
Gross domestic investment/GDP	25.0	27.6	25.8	28.0	27.7
Gross domestic savings/GDP	30.4	32.3	31.1	34.9	34.7
Inflation rate (consumer price index)	-4.0	-3.8	-1.6	-0.8	0.6
Central government budget/GDP	0.8	-0.6	-5.2	-3.5	-3.0
Money supply (M2) growth	8.1	8.8	-2.9	4.0	5.3
Merchandise export growth[a]	3.7	17.1	-3.0	2.5	7.5
Merchandise import growth[a]	0.1	18.1	-2.4	2.8	8.5
Services export growth[a]	5.7	14.1	3.5	4.0	13.0
Services import growth[a]	-3.0	2.1	0.1	2.2	8.0

[a] Based on GDP series, in real Hong Kong dollars.

Sources: Census and Statistics Department, 2002, available: www.info.gov.hk; Hong Kong Monetary Authority; staff estimates.

Under the currency link to the US dollar, the Hong Kong dollar strengthened against most regional currencies in 2001. Money market interest rates fell, due to aggressive monetary easing by the US Federal Reserve and to excess liquidity in the domestic market. Notwithstanding the economic slowdown and difficult operating environment, the profitability of the retail banks (locally incorporated banks plus a number of the larger foreign banks which operate a branch network and which are active in retail banking) held up well, recording only a moderate decline. With low interest rates making debt servicing more affordable, the overall asset quality of the retail banks continued to improve. Preliminary figures indicate that the consolidated capital adequacy ratio of locally incorporated authorized institutions remained strong at 16.8% at end-2001.

The Hang Seng Index fell in 2001, on concern about the global economic outlook as the external environment deteriorated. Share prices plummeted to a near 3-year low of 8,934 in the wake of the September 11th events in the US, but recovered to over 10,000 in October, as anxieties surrounding the likelihood of future attacks subsided. Mirroring the strength of the US stock markets, the Index subsequently rose, to 11,397 at end-December, though this was still 24.5% below the level of a year earlier.

Amid the deterioration of global growth, total exports of goods and services dropped by 2.1%, reversing a 16.7% surge in 2000. Merchandise exports contracted by 3% from 17.1% expansion in 2000. Within this total, domestic exports tumbled by 11%, in contrast to a 7.5% rise in the previous year, and reexports registered a 2% decrease, after soaring by 18.5% a year earlier. Domestic exports of electronic components registered a marked fall, while reexports of consumer goods, raw materials, and semimanufactures also slumped. The growth in services exports moderated to 3.5% from 14.1% in 2000, largely on account of a fall in tourist arrivals and a deterioration of regional demand for trade-related and other business services. Total imports of goods and services likewise fell, by 2.2% from a robust 16.7% growth in 2000, in tandem with slower reexports and a worsening of domestic demand. The combined visible and invisible trade surplus, nevertheless, widened slightly by $0.8 billion to $8.6 billion in 2001, as the fall in imports outpaced the decrease in exports.

POLICY DEVELOPMENTS

The volatility of fiscal revenues and the faster growth of recurrent expenditures over recurrent revenues in the past decade have raised concerns about the tax system.

The volatility of Hong Kong, China's fiscal revenues and the faster growth of recurrent fiscal expenditures over recurrent revenues in the past decade have raised concerns about the tax system. The authorities have been running operating deficits since fiscal year (FY) 1998/99 (1 April 1998–31 March 1999). On the revenue side, while a significant amount of total revenue is derived from nontax sources, the tax base is narrow, with nearly 93% of income tax coming from 15.6% of the employed workforce and 60% of profit tax

Enhancing human resources to support the transition to a full-fledged knowledge-based economy is at the top of the policy agenda.

from 1% of the registered corporations. In addition, revenues have fallen, reflecting the slump in the property market. On the expenditure side, the growth in government spending has exceeded revenues at an average rate of 8% a year since 1998. Moreover, social expenditures, including social welfare, health, and education, are expected to grow over time, in response to an aging population and the need to upgrade human capital.

Against this background, in 1999 the authorities enacted the Civil Service Reform to enhance the efficiency and cost-effectiveness of the civil service. In 2001, a 3-year Training and Development Program was introduced, to upgrade staff capabilities in providing an effective service. Two reviews by the Task Force on Review of Public Finances and the Advisory Committee on New Broad-Based Taxes were conducted. The Task Force assessed the nature of the operating deficit and concluded that the public finances were confronted with structural problems. The Advisory Committee suggested that a goods and services tax be adopted over the longer term to broaden the tax base. To address the issues, the 2002 budget sets out a 5-year plan to restore the operating and consolidated accounts to balance and reduce public expenditures as a proportion of GDP to 20% or below by 2006. While the budget will be countercyclical, expansion in government expenditures over the medium term will be below GDP growth. In light of the economic slowdown, the authorities are unlikely to introduce any new taxes but will need to make good any shortfall by raising additional revenues or reducing expenditures in the medium term to sustain healthy public finances.

Against the backdrop of a worsening economic outlook, the authorities, in the Chief Executive's October policy address, proposed HK$15 billion-worth of measures to relieve economic difficulties faced by the community. Enhancing human resources to support the transition to a full-fledged knowledge-based economy is at the top of the policy agenda. Aimed at improving labor flexibility and upgrading the labor skills required for technological development and application, reforms of basic and tertiary education will be continued. The measures include updating the school curriculum, strengthening the preservice training and professional development of teachers, and increasing the allocation of secondary school places to improve accessibility of educational resources. The authorities are pushing ahead with large-scale infrastructure projects, including both roads and railways linking with the Pearl River Delta, to enhance the transport network and economic cooperation between Hong Kong, China and neighboring provinces in the PRC.

Measures to improve the business environment were also emphasized in the policy address, involving financial assistance to SMEs and investing in the construction of a new exhibition center. Finally, the policy address emphasized both reinforcing the comparative advantage in tourism and in transport and logistics, and tapping the opportunities brought about by the new knowledge-based economy and economic growth in the PRC.

OUTLOOK FOR 2002–2003

GDP is projected to grow by 2.1% in 2002. A moderate economic recovery by the second half of the year is forecast, following an anticipated gradual firming in external demand and some stabilization in domestic sentiment. Exports are expected to pick up, particularly in the second half of the year, as the world economy strengthens further. Imports are expected to grow at a modest rate in 2002. Private consumption will probably remain lackluster, dragged down by high unemployment rates and the uncertain outlook for the property market. Machinery and equipment investment by the private sector will stabilize and begin to improve in late 2002, along with the gradual upward trend of exports. The trade-related services sector is expected to register growth again in 2002, reflecting the recovery in exports, while the banking sector will continue to be weighed down by the supply overhang in real estate.

Over the near term, the economy will continue to suffer the restructuring pains of intensifying integration with lower-cost production centers in the PRC. While economic growth is expected to pick up in the second half of the year, structural unemployment will likely remain high as displacement of employees in traditional manufacturing and low-end services continues. Unemployment, coupled with subdued consumer sentiment and ongoing supply and demand integration with the Pearl River Delta, will exert a downward pressure on prices, maintaining deflation for yet another year in 2002. As global economic growth gathers momentum, the economy is forecast to strengthen by 4.8% in 2003.

REPUBLIC OF KOREA

The Republic of Korea performed better than most economies in the region in 2001. This was largely due to the resilience of domestic demand, which arose from significant progress in restructuring the corporate and finance sectors after the Asian financial crisis. More diversified exports also contributed to relatively sustained growth. Strong domestic and external demand is expected to continue over 2002–2003.

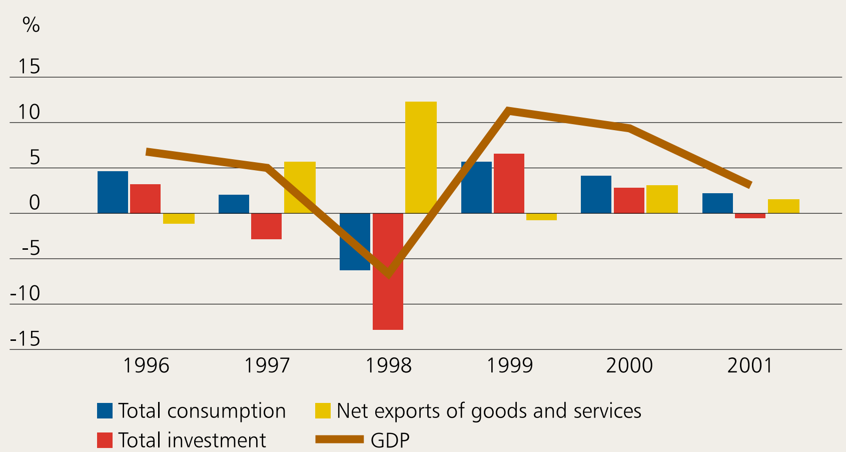
MACROECONOMIC ASSESSMENT

The Republic of Korea (Korea), although hit hard by the global economic downturn in terms of a large deceleration in export growth, did not experience as severe a shock as economies that are heavily dependent on exports of information and communications technology (ICT) products. This was because Korea has a more diversified industrial base and because its domestic market, though having significant linkages to the export sector, did not suffer as big a drop in private consumption. As a result, GDP growth decelerated to 3% in 2001 from 9.3% in the previous year (Figure 2.3). This modest expansion was driven mainly by private consumption, in contrast to the broad-based domestic and external demand expansion in 2000. Gross fixed capital formation increased in 2000 by 11.4% but declined in 2001 by 1.7%. Because of the weak earnings outlook in the ICT sector, and sluggish private spending, companies had little incentive to invest in new plant and equipment in 2001. Export growth began to slow in the first quarter of 2000 and continued decelerating through the middle of 2001, bottoming out in the fourth quarter of the year.

Consumption increased in 2001 by 3.7%, a much lower rate than in 2000. This helped support the labor market, and unemployment fell by December 2001 to a seasonally adjusted rate of 3.3%.

One reason for the relative strength of consumption in 2001 was the fact that the corporate sector had, after the financial crisis, generally engaged in significant cost cutting as part of the restructuring process. As a result, firms were not forced to make large-scale layoffs during this downturn. Also, negative wealth effects were weaker due to the solid performance of the stock market (albeit artificially supported by the Government to a degree). In addition, a high level of liquidity in the financial system, along with low loan demand from the corporate sector, led to increased credit availability for consumers in the fourth quarter, part of which was used for buying houses and other real estate. Furthermore, a drop in the savings ratio after 1998, combined with a rising debt-to-asset ratio among households, suggests that the propensity to consume may have risen. These factors may partially explain the pickup in retail sales toward the end of 2001.

FIGURE 2.3 **Contribution of Demand Components to Change in GDP, Republic of Korea, 1996-2001**



Source: Bank of Korea, 2002, available: www.bok.or.kr.

TABLE 2.3 Major Economic Indicators, Republic of Korea, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	10.9	9.3	3.0	4.8	6.0
Gross domestic investment/GDP	26.7	28.2	26.7	29.0	30.7
Gross domestic savings/GDP	33.5	32.6	30.1	30.5	31.0
Inflation rate (consumer price index)	0.8	2.3	4.1	3.5	4.0
Money supply (M2) growth	27.4	25.4	13.2	20.0	25.0
Fiscal balance/GDP	-2.7	1.1	1.3	1.5	1.6
Merchandise export growth	9.9	21.2	-14.0	7.0	10.0
Merchandise import growth	29.1	36.2	-13.3	12.0	14.0
Current account balance/GDP	5.8	2.7	2.0	1.9	0.7

Sources: Bank of Korea, available: www.bok.or.kr; National Statistics Office, available: www.nso.go.kr; Asian Development Bank Statistical Database System; staff estimates.

After the Asian financial crisis, the corporate sector had generally engaged in significant cost cutting as part of restructuring. As a result, firms were not forced to make large-scale layoffs during this downturn.

On the supply side, manufacturing growth decelerated sharply as a result of weaker orders for ICT products, which account for roughly half the exports of goods and services. As a result, industrial production growth slowed in the first half of 2001. In the second half of the year, external demand led to stronger growth in the automotive sector, helping offset some of the weakness in demand for ICT products. With a substantial depletion of inventories over much of the year and some improvement in domestic demand conditions, industrial production showed an upturn in the second half of 2001. Growth in the construction sector returned, to around 3.5%, from a 3.7% contraction in 2000. This was due to public spending on ports and roads as well as an upswing in residential building construction. Growth in the services sector remained resilient in 2001, although it was slower than in 2000, due to fairly brisk demand for recreational activities, hotel and restaurant services, communications services, and increased trade in construction materials.

Due to a large surplus in the National Pension Fund, the government surplus rose to 1.3% of GDP in 2001. A supplementary budget worth W1.5 trillion was introduced in June, mainly to provide local government subsidies and to improve education facilities. The Government also directed state pension funds worth W2 trillion toward share purchases in the aftermath of the September 11th events. This was done to support equity markets specifically and the economy generally. In November, it announced a reduction of sales taxes on a wide array of luxury goods to boost consumption. With regard to monetary policy, the Bank of Korea had to balance the risks of lowering interest rates to stimulate the economy versus the prospect of sparking inflation through a more accommodative policy stance. Inflation picked up in 2001 due to an escalation in services charges in the form of housing rents. To stimulate economic activity, and recognizing that interest rates were lowered throughout the year in industrial countries, the Bank of Korea cut policy interest rates by 125 basis points in 2001. Real short-term interest rates dropped close to zero. Monetary aggregates rose strongly, as did other indicators, such as the ratio of consumer lending to total bank assets (which underpinned consumer spending) in the second half of the year.

On the external front, ICT exports slumped in 2001, after double-digit expansion in 2000, due to the contraction in the ICT sector worldwide. This caused overall merchandise exports to fall by 14%, compared with 21.2% growth in 2000. Imports also contracted, by 13.3%, due to softer demand for oil, capital goods, and intermediate materials. As a result, the merchandise trade surplus declined to $13.4 billion in 2001. This combined with worsening deficits in travel and other areas of the services sector to narrow the current account surplus to $8.6 billion. The external debt position improved due to the early repayment of an IMF program loan and to a buyout by domestic creditors of Daewoo Motor's $55 billion debt from foreign creditors at a 60% discount. As a result, official reserves increased to over $100 billion at the end of the year from $96 billion at the end of 2000. The debt service ratio was around 14.1%.

POLICY DEVELOPMENTS

The Government's traditional focus on supporting exports and investment may shift toward consumption in the medium term. Manufacturing is now highly export oriented as well as cyclical in nature, and most investment is concentrated in this subsector. As a result, the past decade has been marked by increased volatility in both the finance and real sectors.

In response, and for the first time, the Government has begun to utilize tax policy to stabilize consumption. Less dependence on export industries and on investment in plant and equipment will have an impact not only on the composition of GDP but also on the volatility of the equity market. Since the early 1990s, there has been a significant increase in listings of capital-intensive companies with an export orientation, and these companies tend to be cyclically volatile. A move toward domestic demand would help reduce this volatility and indeed, the tax cuts in 2001 could be the first steps in implementing such a longer-term policy of diversifying the economy into domestic demand-related activities.

Korea's high savings ratio is partially grounded in the country's inadequate social welfare and pension systems, although benefits and national pension coverage have increased since early 1998. A corporate pension scheme may be introduced soon, possibly resulting in some of these savings being used for consumption. In addition, the Government may make more funds available to shore up the National Pension Fund, which is expected to face insolvency issues within the next 2 decades due to large benefit payouts resulting from changing demographic profiles. One proposal to address this concern is limiting the Fund's benefits at current levels or reducing them and introducing corporate pensions to cover some of the living costs of retirees. Since 2002 is an election year, any government impetus in this direction will likely be seen only in 2003.

OUTLOOK FOR 2002–2003

On a quarter-on-quarter seasonally adjusted basis, private consumption and gross fixed capital formation seem to have bottomed out in the fourth quarter of 2001. Private consumption growth is expected to be stronger in 2002–2003 since liquidity conditions are forecast to remain favorable, consumer and business sentiment should improve, and tax cuts will have multiplier effects on consumption and income. Fixed investment is expected to improve moderately. Given that a significant inventory correction took place in 2001, inventory investment is likely to gain momentum in the first half of 2002 and continue to do so for the rest of the year.

On the supply side, industrial production rose strongly in the second half of 2001, and, under the influence of restocking and improving domestic demand conditions, it should continue its recovery in 2002–2003. Furthermore, Korea is well placed to benefit from a recovery in the world economy since it has a diversified economy, a sound structural base (after significant postcrisis restructuring), and a low level of nonperforming loans. These factors suggest that economic growth will accelerate in the next 2 years.

Korea is well placed to benefit from a global economic upturn since it has a diversified economy, a sound structural base, and a low level of nonperforming loans.

There are, however, two concerns. The first is whether domestic demand will remain resilient, given the uncertainty of the timing of a strong recovery in export growth, as well as the absence both of strong social welfare and pension systems and of other automatic stabilizers. The second is how rapidly the global economy will recover and how this will impact on the demand for Korean exports. On the first point, the shift in emphasis toward an expansionary fiscal policy that began in 2001 is likely to continue, although at a somewhat subdued pace, and this should help support consumption demand. On the second, since Korean exports and US imports of ICT products are closely correlated and since US new ICT orders appear to have stopped declining in the fourth quarter of 2001, prospects are for a gradually strengthening rebound in ICT exports in 2002. On this basis, GDP growth is forecast at 4.8% in 2002 and 6% in 2003. Inflation should remain at about 4%. As economic activity improves, the current account surplus will rise slightly to about $8.8 billion in 2002 but fall to about $4 billion in 2003. As GDP growth picks up in 2002–2003 and as government revenues rise with an expanding tax base, the fiscal surplus is projected to increase to 1.5% and 1.6% of GDP, respectively.

MONGOLIA

Despite growing inflationary pressure, Mongolia has achieved some macroeconomic stability. This contributed to a positive environment for stronger private sector-led growth, particularly in the services and industry sectors, which offset the impact of a severe contraction in agricultural output due to a harsh winter. Future economic growth will depend on how quickly the economy can diversify so as to reduce its vulnerability to external shocks. Until then, growth will remain below potential.

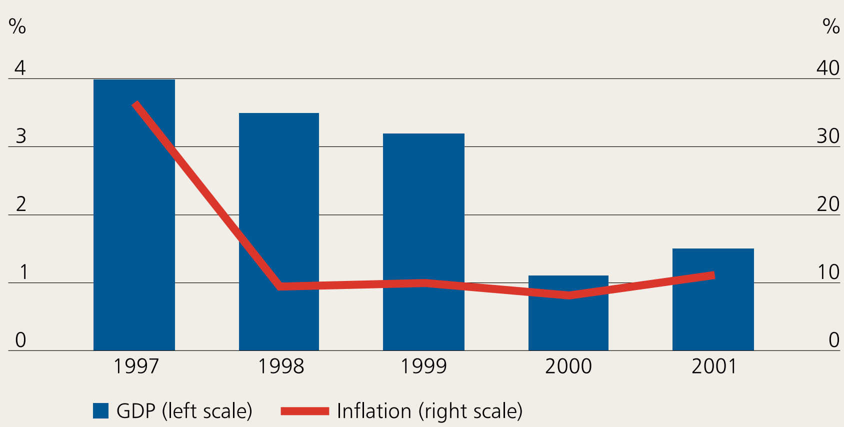
MACROECONOMIC ASSESSMENT

In 2001, the economy continued to be affected by exogenous factors, mainly severe natural shocks and declining exports, which kept its performance below potential. As a result, GDP grew at a moderate 1.5%. This growth was due primarily to the expansion of the industry sector that helped cushion a sharp drop in agricultural output. The losses in the livestock sector in 2001, still reeling from the ill effects of two successive harsh winters (*dzud*) and the outbreak of foot-and-mouth disease, were estimated at 10% of the country's total herd, or about 4 million animals. As a result, agricultural output, which still accounts for about 30% of GDP, posted an alarming 16% decline. The industry sector grew by 11.8%, driven by its main components, namely mining and manufacturing, which grew by 10% and 23%, respectively. The services sector, accounting for about half of GDP, registered 9.2% growth due to the buoyant outcome of the wholesale and retail trade, financial services, and transport and communications. While domestic investment reached 28% of GDP, savings remained low at 18%, and this gap contributed to the current account deficit and the external debt.

Growing unemployment, with only a poor social safety net, remains the Government's main concern and a primary cause of poverty. The extreme severity of the last two winters revealed the vulnerability of the rural economy and accelerated the migration of people seeking better access to social services and employment opportunities from remote to urban areas, particularly to Ulaanbaatar. Strong growth in the nonagriculture sectors has resulted in urban employment recovery. However, national unemployment, as measured by international standards, stood at 17% in 2000; 60% of the unemployed were under 35 years of age. To enhance the pro-poor orientation of wage policies, the Government announced a 6.1% increase in public sector wages and pensions on 1 October and raised the minimum monthly wage from MNT18,000 ($16) to MNT25,750 ($23).

Mongolia achieved some progress in restoring macroeconomic stability by reducing the budget deficit from 6.8% of GDP in 2000 to 5.1% in 2001. The key macroeconomic assumptions underlying the initial 2001 budget changed significantly as the impact of the second

FIGURE 2.4 **GDP Growth and Inflation, Mongolia, 1997-2001**



Source: National Statistical Office.

TABLE 2.4 Major Economic Indicators, Mongolia, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	3.2	1.1	1.5	3.0	4.9
Gross domestic investment/GDP	27.0	29.0	28.0	29.0	31.0
Gross domestic savings/GDP	20.0	18.0	18.0	19.0	21.0
Inflation rate (consumer price index)	10.0	8.1	11.2	6.0	5.0
Money supply (M2) growth	31.7	17.5	27.9	17.0	15.0
Fiscal balance/GDP	-12.2	-6.8	-5.1	-4.5	-4.0
Merchandise export growth	-1.7	18.2	-17.4	9.4	7.7
Merchandise import growth	-2.6	21.2	-9.7	4.9	6.2
Current account balance/GDP	-13.7	-17.2	-16.7	-14.7	-13.4
Debt service ratio	9.3	6.0	7.0	5.3	5.4

Sources: National Statistical Office; International Monetary Fund; staff estimates.

dzud was harsher than expected, leading to amendments to the budget in June 2001. The enhanced revenue collections generated from an introduction of temporary excise taxes and an increase in VAT from 13% to 15% (both measures were budget amendments) permitted a slight expansion in the provision for selected social programs without putting greater pressure on the overall deficit. A privatization scheme scheduled for 2001 was postponed to 2002–2003, removing from the budget the potential benefits of the sales of the major SOEs.

A tighter monetary policy was implemented to limit the effect of inflationary pressure stemming from large price rises for meat, energy, and fuel. However, the effect of this policy was partially offset by an expansion in wages and pensions. The result was an inflation rate of 11.2% (Figure 2.4). Broad money (M2) increased by 27.9% and commercial credit doubled due to the entry of new banks and expanded lending facilities supported by some multilateral and bilateral donors. Real rates on Bank of Mongolia bills fell sharply and remained negative through the first half of the year, but in the second half the Bank of Mongolia took decisive steps to increase the placement of these bills, allowing interest rates across all maturities to rise toward positive levels in real terms. The central bank's flexible exchange rate policy, applied through recourse to intervention, proved successful in avoiding excessive fluctuation in the exchange rate. Hence the national currency, the togrog, showed no significant deviations from the average level of MNT1,097 to the dollar during 2001.

The current account deficit increased from $167 million in 2000 to $170 million in 2001, or 16.7% of GDP. Total exports decreased by 17.4% as a result of a decline in the international price of export commodities, particularly copper—copper concentrate accounts for nearly 40% of total exports—and cashmere. The volume of cashmere exports also dropped, under the impact of the severe winter. Purchases of capital equipment and the need for imports related to *dzud*-relief kept imports relatively high, although 9.7% lower than in the previous year. There was a large inflow of external assistance. This led to an increase in the level of international reserves to $209 million from $191 million in 2000, equivalent to about 15 weeks of imports. External debt has doubled since 1996, and is about 90% of GDP. Consequently, debt service obligations have risen, to 7% of exports from 6% in 2000.

A tighter monetary policy was implemented to limit the impact of inflationary pressure. However, its effect was partially offset by an expansion in wages and pensions.

POLICY DEVELOPMENTS

The Government followed its strategic objectives within the context of the Action Program of the Government of Mongolia for 2000–2004. The Action Program emphasizes promotion of sustained higher economic growth and the improvement of living standards by strengthening economic reform, enhancing the provision of social services, narrowing income disparities, and ensuring good governance. The Government is committed to its Poverty Partnership Agreement with ADB. An interim poverty reduction strategy paper, prepared with assistance from the donor community, identified three pillars in the country's poverty reduction strategy: macroeconomic stability, private sector-led and outward-oriented growth, and more equitable distribution of the benefits of growth. However, the Government had limited success in achieving these strategic objectives.

Poor fiscal data quality and lack of proper accountability were the main factors in unrealistic 2001 budget planning that required subsequent amendments. In spite of that, the stronger revenues resulting from higher VAT and excise taxes financed the increases in social expenditures and permitted a budget deficit of about 2% below the 2001 target. Failure to privatize large SOEs, including Gobi Cashmere, the Trade and Development Bank, Mongolian Civil Air Transport, and the oil importer Neftimport Concern, meant the loss of a substantial funding source.

Unless measures are taken to diversify the economy and reduce its vulnerability to external shocks, prospects for growth will remain below potential.

Restraining monetary measures were insufficient to contain the inflationary forces arising from the sharp rise in credit, higher wages, and increased pension benefits that were introduced in the second half of the year to bolster domestic demand. As a consequence, the inflation rate exceeded the original target by more than 3 percentage points. Policymakers have paid attention to maintaining an appropriate structure of interest rates, thereby fostering confidence in the domestic banking system through protection of the liquidity and solvency of the major state-owned banks.

The global economic slowdown made it difficult for the trade targets to be met. With exports declining faster than imports, the current account deficit widened beyond target and increased the stock of foreign debt. Further efforts to keep the exchange rate stable through central bank intervention, and preliminary steps to bolster domestic savings helped slow the rate of growth of foreign debt by the end of the year.

OUTLOOK FOR 2002–2003

Unless measures are taken to diversify the economy and reduce its great vulnerability to external shocks, prospects for growth will remain below potential. Projections show moderate but rising rates of growth of 3% and 4.9% over 2002–2003, sustained by a more stable macroeconomic environment. Official projections for the period are for inflation to fall below 7%, and the fiscal deficit to shrink to under 5% of GDP. A growing demand for capital goods to meet the needs of the modernization of the economy will put the current account under pressure and generate a deficit of about 14% of GDP. However, this imbalance should be matched by expected greater inflows from international donors, a sign of their rising confidence in the economy, based on the Government's commitment to structural reforms. This is likely to result in an expansion of international reserves to 16 weeks of imports.

Sustainable economic growth and poverty reduction in the coming years will be possible only if concerted efforts are made to further develop and strengthen the private sector in a stable macroeconomic scenario. Fiscal policy has to shift its focus toward fiscal accountability and transparency and ensuring a more efficient allocation of public expenditures. Comprehensive public sector reform is vital to rationalize the tax system for achieving higher revenues and better public expenditure management. This remains key to the future expansion of social programs. Additional measures are needed to continue the progress made in developing the private sector, which currently accounts for about 60% of GDP, and to ensure a subsequent reduction in unemployment. In this regard, more decisive steps are needed, targeting (i) banking sector reform, including indirect monetary management, increased bank supervision, restructuring of the state-owned banks, and greater independence of the central bank from the Government; (ii) reform of nonfinancial public enterprises; (iii) strengthening of an open trade and investment system, including the energy sector; (iv) reinforcement of a market-oriented regulatory framework; and (v) progressive reduction of the public sector arrears and removal of indirect subsidies.

Progress in poverty reduction over the medium term will depend crucially on the Government's success in generating faster and more equitable economic growth. The most vulnerable layers of Mongolian society—small livestock herders, the urban poor, and street children—remain highly vulnerable to even minor external shocks, adverse weather patterns, and the ongoing reform process. Hence, a social safety net for the very poor needs to be built as a matter of urgency. While recognizing the need to address urban poverty through employment generation, policymakers should place strong emphasis on improving the provision of basic social services and infrastructure in rural areas.

TAIPEI,CHINA

After a recession in 2001 induced by an export slump in the ICT sector, economic growth is expected to resume in 2002. Restocking and some support from a moderate upturn in exports in the second half of 2001 will help stimulate GDP growth in the medium term, but structural unemployment will remain a concern as elements of the manufacturing base continue to move offshore.

MACROECONOMIC ASSESSMENT

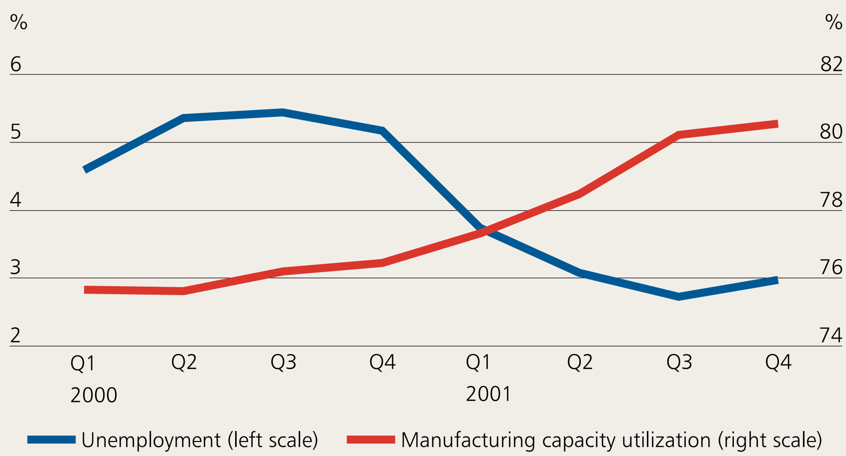
Economic growth decelerated rapidly in 2001 to register a contraction of 1.9%, representing the worst economic performance in 30 years. Much of the slowdown stemmed from the slump in exports of ICT products and the transmission of the export slowdown to private consumption and gross fixed investment. The economy's ICT exports account for more than 50% of exports of goods and services. The poor trade performance and associated recession in manufacturing pushed all components of domestic demand growth into negative territory in the second half of the year.

Taipei,China faced substantial spare capacity in manufacturing in 2001. Partly due to this, unemployment reached a historic high of 5.3% during the year (Figure 2.5). Combined with rapid worsening of the economic outlook, firms moving production to the mainland to cut labor costs, declining consumer confidence, and a negative wealth effect from a falling stock market, private consumption and fixed investment contracted in 2001. Adding to the downward pressure of falling investment, overdue loans reached a high of 7.5% of total loans. The severity of the downturn was exacerbated by a rising inventory-to-shipment ratio, indicating that the downward adjustment of stocks had not been large enough to adjust to falling sales. This partly explains why industrial production contracted over most of 2001. In the services sector, employment relative to that in industry increased by roughly 2% of the total labor force. However, employment growth in services did not fully offset the shrinkage of employment in manufacturing.

Price pressures remained subdued in 2001 with a negligible inflation rate as measured by the consumer price index, compared with 1.3% in 2000. Weakening domestic demand and a sharp fall in food and oil prices were the main factors. A 1.3% fall in the wholesale price index helped moderate the effect of the downturn by reducing the costs of production.

On the external account, the trade surplus rose in 2001, to $20 billion from $14 billion in the previous year, reflecting the adjustment of imports to slowing demand conditions. Merchandise exports

FIGURE 2.5 **Unemployment and Capacity Utilization Rates, Taipei,China, Q1 2000-Q4 2001**



Source: CEIC Data Company Ltd.

TABLE 2.5 Major Economic Indicators, Taipei,China, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	5.4	5.9	-1.9	2.8	4.0
Gross domestic investment/GDP	23.4	22.9	18.2	18.7	23.0
Gross domestic savings/GDP	26.1	25.2	23.5	24.1	25.5
Inflation rate (consumer price index)	0.2	1.3	0.0	0.7	2.1
Money supply (M2) growth	8.3	6.5	4.4	5.8	6.4
Fiscal balance/GDP	-1.3	-4.8	-4.3	-4.2	-4.0
Merchandise export growth	9.9	21.8	-17.3	5.5	8.0
Merchandise import growth	6.2	25.9	-23.8	8.0	10.0
Current account balance/GDP	2.9	2.9	6.7	3.9	3.4

Sources: Central Bank of China, available: www.cbc.gov.tw; Directorate-General of Budget, Accounting, and Statistics, Executive Yuan, available: www.stat.gov.tw; and staff estimates.

The two key concerns for the authorities are their ability to use fiscal policy as a countercyclical measure and the growing level of nonperforming loans.

contracted by 17.3%, after 21.8% growth in 2000. Toward the end of 2001, on a year-on-year basis, merchandise exports and imports showed some signs of recovery. The sharp decline in trade flows was accompanied by a drop in services imports of insurance and transport-related items, in addition to an overall drop in services imports, which were hit by the collapse in domestic demand. As a result, the current account balance rose to $19 billion in 2001.

On the fiscal policy front, the public debt-to-GDP ratio of around 28% of GDP has become a concern. (This figure does not include other contingent liabilities related to health care and pension funds.) Therefore, rather than cut taxes to stimulate demand, the authorities relied on expenditure policy in the form of a supplementary fiscal package of NT$111.5 billion. They also considered tax cuts, but eventually decided that such cuts would be difficult to phase out once a sustainable recovery took hold. In addition, tax cuts are limited by a prescribed link between revenues and spending: new government borrowing cannot exceed 15% of the total budget (which includes debt repayments and contingent liabilities).

The discount rate was cut by 250 basis points in 2001 to 2.13%. However, monetary policy has proven to be rather ineffective as bank lending and monetary growth were low in 2001, in spite of falling interest rates. The banks are reluctant to lend, due to the high and increasing level of nonperforming loans (NPLs) and to concerns over corporate creditworthiness.

POLICY DEVELOPMENTS

The two key concerns for the authorities are going to be the ability to use fiscal policy as a countercyclical measure and the growing level of NPLs. On the first point, the authorities' freedom to maneuver will be restricted due to the 15% ceiling on new borrowing and a high public debt-to-GDP ratio. This will be a particular concern in 2002 since domestic demand conditions are expected to remain quite weak until the economy makes a significant export rebound. A proposal to change the 15% limit (of the total budget) to 3% of GDP was considered by both the Legislative Yuan and the Economic Development Advisory Council in 2001, but was defeated. This proposal may be reconsidered in 2002. If it is approved, it is estimated that borrowing can be increased by roughly 1% of GDP.

On the second concern, if economic contraction continues in the first half of 2002, banking sector balance sheets could deteriorate further and NPLs may rise. The authorities have already put together an asset management company, the Financial Rehabilitation Fund, to transfer NPLs from banks, extend the coverage of deposit insurance schemes, and set up universal banks. However, the experience of Indonesia and Thailand suggests that the sale of these distressed assets by asset management companies would be difficult without the authorities engaging in at least a partial bank recapitalization to improve asset quality. This bailout would be possible without putting pressure on the fiscal balance only if the limit on new government borrowing was relaxed. Otherwise, banks' continuing weak balance sheets will hamper credit growth and prospects for economic recovery. Consequently, the authorities have little scope to use fiscal or monetary policy for countercyclical measures.

The investment outlook is constrained by uncertainty over ICT exports and the movement of production to the mainland. Both components of domestic demand should rise as external demand conditions improve, but the relocation of investment to the mainland and associated high unemployment rates are structural features of the island's economy that restrict growth potential in the medium term. Reflecting pressure to relax trade and investment relations with the PRC, the upside for domestic demand is quite limited over this period. The process of restructuring will require Taipei,China to become a provider of high value-added services to the region, rather than a manufacturing hub. Furthermore, greater integration with ASEAN economies and, possibly, the countries of South Asia may open up new markets for Taipei,China, and this may be a more fruitful approach than exclusive reliance on the PRC, where it faces stiff competition from Hong Kong, China.

OUTLOOK FOR 2002–2003

The strength of recovery in 2002 and early 2003 will be determined by domestic demand conditions and the pace of recovery in industrial countries. So far, the backdrop for an upturn in private consumption and investment looks quite weak. Private consumption is unlikely to stage a sustained recovery since broad monetary aggregates have yet to show signs of an upturn, unemployment remains at historic highs, and spending continues to be sensitive to wealth effects. Some boost to inventory investment may take place in the second half of 2002 due to the low-base effect of 2001; a more sustained restocking may be seen in 2003 if exports show strong growth. This assumes that the inventory-to-shipment ratio finally starts dropping significantly in the first half of 2002.

Consequently, GDP growth is forecast at 2.8% in 2002 and 4.0% in 2003. With weak domestic demand conditions, the cyclical situation should allow interest rates to remain low for the whole of 2002 without running the risk of a sharp spike in inflation. The consumer price index is forecast to rise by 0.7% in 2002 and 2.1% in 2003. Assuming that the 15% limit on new government borrowing remains in place, the fiscal deficit as a proportion of GDP is forecast to stay at around 4%. The trade balance will stay positive, although import growth will exceed export growth in both years. This will result in a decline in the current account surplus to a projected 3.4% of GDP in 2003 from 6.7% in 2001.

ICT exports are an important component of overall exports, and the US is their most important market. Thus, US new orders of the product lines in which the economy specializes, such as personal computers and office equipment, and semiconductors and components, are crucial. Together, they account for 57% of exports of goods and services. Analysis of trends suggests that the island's exports lag US new orders of ICT equipment by one quarter. The recovery of Taipei,China's exports to the US will therefore likely be slow, given the current outlook for the ICT industry in the US. This could be followed by a moderate rise in the second half of 2002 as US (and EU) growth accelerates further. On the basis of these elements, exports are forecast to grow by 5.5% in 2002 and 8% in 2003, and imports by 8% and 10%, respectively, over these years.

The investment outlook is constrained by uncertainty over ICT exports and the movement of production offshore.