East Asia

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

People’s Republic of China

A V-shaped economic recovery in 2009 was underpinned by very expansionary fiscal and monetary policies. Strong investment and, to a lesser extent, growth in consumption largely offset the impact of shrinking external demand. Allowing for some adjustments, expansionary policies will continue this year. Coupled with a stronger global economy, GDP growth is forecast to accelerate. Inflation will rise from low rates. A new five-year plan provides an opportunity to revamp the structure of growth, in particular to encourage increases in private consumption.

Economic performance

Aggressive fiscal and monetary stimulus in the People’s Republic of China (PRC) in 2009 offset much of the impact of the global recession. After a weak first quarter, the economy picked up pace over the rest of the year (Figure 3.9.1), spurred by the stimulus measures and a recovery in exports, to record growth of 8.7%. That outturn compares with double-digit expansion in the 2003–2007 period and with 9.6% in 2008.

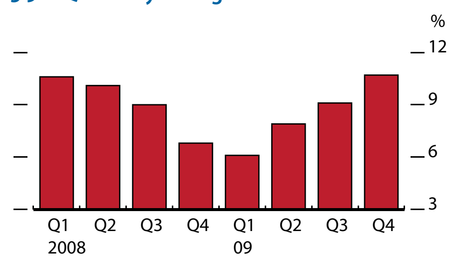
A slowdown in industry, which produces nearly three-fifths of GDP, was the main cause of last year’s slower GDP growth on the output side. Growth in industry decelerated to 9.5% in 2009, although it still contributed most to the total expansion of GDP (5.5 percentage points—Figure 3.9.2). Industry picked up as the year progressed (Figure 3.9.3) as a result of a stimulus-led investment boom and some improvement in exports. Growth eased in services to a still robust 8.9%, and in agriculture to 4.2%, owing to a drought in the south.

The V-shaped recovery was driven mainly by domestic demand, especially public investment that benefited from the stimulus policies. Total investment contributed 8 percentage points, or a record 92%, of total GDP growth on the demand side. The investment-to-GDP ratio rose to nearly 46% (Figure 3.9.4), the highest level in at least three decades. Consumption contributed 4.6 percentage points of total growth. In contrast, a fall in net exports subtracted 3.9 percentage points from GDP growth.

Fixed asset investment accelerated by just over 30% in nominal terms in 2009, from 26% in 2008. Reflecting the priorities of the government’s stimulus plan, investment in agriculture soared by nearly half and investment in services (mainly transport such as railways and urban public systems) jumped by 33%. Investment in industry also surged (by about 27%), while a 17.2% rise in property investment was a little slower than in 2008.

Consumption, both private and government, played a role in 2009’s recovery, although not the leading role taken by investment. The volume

3.9.1 Quarterly GDP growth



Source: CEIC Data Company (accessed 15 March 2010).

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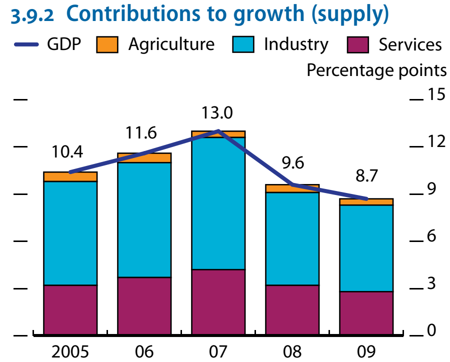
3.9.2 Contributions to growth (supply)



Sources: National Bureau of Statistics of China. http://www.stats.gov.cn (accessed 15 March 2010); ADB estimates.

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This chapter was written by Jian Zhuang, and its box by Yolanda Fernandez-Lommen, both of the People’s Republic of China Resident Mission, ADB, Beijing.

of retail sales, a proxy for consumption, took a hit early in the year amid widespread layoffs of migrant workers and a fall in consumer confidence, but it then strengthened (Figure 3.9.5) to be up by 16.2% in real terms for the year. Government incentives to buy cars propelled automobile sales to 13.6 million (when the PRC became the world's biggest car producer). Consumption was also supported by rising real incomes—by 9.8% in urban areas and by 8.5% in rural areas.

The slump in exports caused by the global recession bottomed during the first half of 2009 (Figure 3.9.6), and export growth was back in positive territory by December. For the year though, merchandise exports in US dollar terms fell by 16.1%. Merchandise imports, too, shot up late in 2009, reflecting robust domestic demand and recovering exports—but again, for the year they fell by 11.2%. As this was a smaller contraction than exports', the trade surplus narrowed by $111 billion. With a widening deficit in services trade, the current account surplus was trimmed by about 33%, to $284.1 billion (5.8% of GDP).

Reflecting the global financial crisis, foreign direct investment (FDI) fell for the first 7 months of 2009, then started to rebound. FDI for the year was down moderately but was still substantial at about $90 billion.

The trade surplus, FDI, and other capital inflows boosted foreign exchange reserves to $2.4 trillion. However, the stepup in capital inflows also raised some concerns about speculation in booming property and stock markets.

A key element of the stimulus program was to flood the economy with credit from state-owned banks, mainly for fixed asset investment. Bank lending surged by CNY9.6 trillion, more than double the amount in 2008 and equivalent to about 29% of GDP. About a quarter of the credit went on infrastructure, such as airports, railways, and city transportation networks, and 15% on housing. State-owned enterprises received the majority.

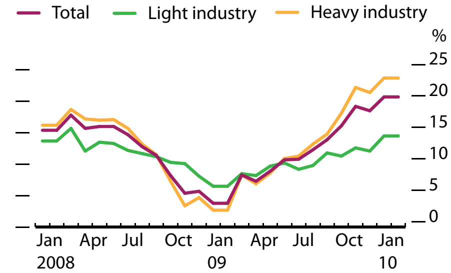
After the first half's huge surge in credit, the authorities started to check it in the second (Figure 3.9.7), concerned that it could fuel asset bubbles and inflation, and erode the quality of bank loan portfolios. Broad money supply (M2) climbed by 27.7% over the year, exceeding the target of 17%.

The yuan was kept steady against the US dollar in 2009, part of the stimulus program to support exports. Against a basket of currencies, though, it depreciated by 5.0% in real effective terms, according to the Bank for International Settlements.

Inflation dissipated in 2009, owing to lower global oil prices, another bumper harvest at home, and overcapacity in several manufacturing subsectors. The consumer price index fell for most of the year, recording year-on-year increases only in November and December (Figure 3.9.8), when food and housing costs rose. The flood of bank lending fed into rising asset prices—the Shanghai A-share stock market index gained 80% last year and property prices rose after midyear (Figure 3.9.9) to be up nearly 6% year on year in the fourth quarter. Local governments rely on land sales for much of their revenue, so have an incentive to promote real estate development. Their income from land sales, according to the central government, climbed by 60% to $233 billion in 2009.

Fiscal stimulus measures designed to counteract the impact of the global recession focused on infrastructure and, to a smaller extent,

3.9.3 Growth in industrial value added



Source: CEIC Data Company (accessed 15 March 2010).

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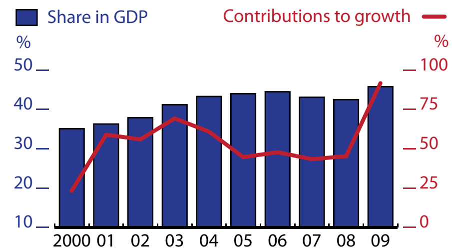
3.9.4 Total investment



Sources: National Bureau of Statistics of China. http://www.stats.gov.cn (accessed 15 March 2010); ADB estimates.

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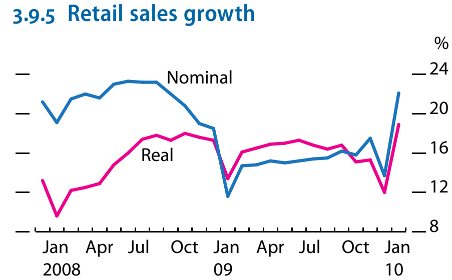
3.9.5 Retail sales growth



Source: CEIC Data Company (accessed 15 March 2010).

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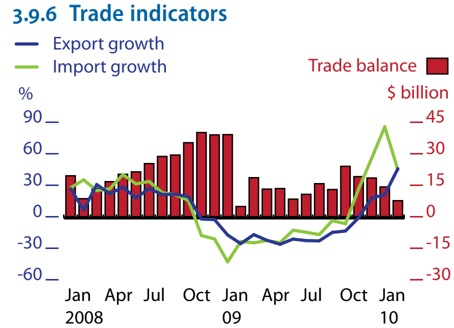
3.9.6 Trade indicators



Source: CEIC Data Company (accessed 15 March 2010).

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affordable housing, rural development, and social spending. The fiscal package involves expenditure of CNY4 trillion over 2 years from November 2008 (equivalent to 12.7% of 2008 GDP). The allocation for infrastructure was reduced in March 2009 from 45% to 38% of the total, and funds for social projects (such as health care and education) were raised from 1% to about 4%.

Given relatively low levels of central government debt (about 30% of GDP including domestic and foreign debt) and small budget deficits, the debt-funded package is manageable. The government will issue bonds to cover 25% of the fiscal stimulus, with the rest provided by local governments and low-interest loans from state banks. About half the fiscal stimulus was disbursed in late 2008 and during 2009, leaving the rest for this year.

Total fiscal expenditure, including that for the fiscal stimulus, rose by just over 21% in 2009. Revenue increased by nearly 12%. The fiscal deficit came in at just 2.8% of GDP (Figure 3.9.10).

An estimated 20 million migrant workers had lost their jobs by early 2009 as demand for manufactured exports dived. The labor market started to improve in the second quarter, on the back of improving industrial production and construction. By year-end, some employers in eastern provinces reported labor shortages, a result of strengthening export orders and moves by unemployed migrant workers to other regions that were benefiting from stimulus-funded infrastructure projects. The government said that 11 million new jobs were generated last year, above its target, but fewer than the average 24 million new job seekers who enter the labor market every year.

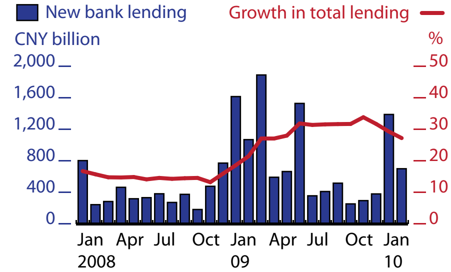
Economic prospects

Fiscal policy is expected to remain expansionary in 2010. There will likely be adjustments as the government acts to avoid potential problems caused by the flood of investment. For example, the authorities have indicated that they will make efforts to contain investment that results in excess industrial capacity, and will curb rising indebtedness of local governments brought about by their extensive investment projects. The fiscal deficit is projected to remain around 2.8% of GDP in 2010 but slightly fall to 2.6% of GDP in 2011.

Some moderation is expected in the highly stimulatory monetary policy, in light of the strengthening of economic activity and rising inflation and asset prices. Policy fine tuning was seen from July last year. A more potent adjustment was made in January and February 2010 when the People's Bank of China (the central bank) raised the reserve-requirement ratio for banks twice, to 16.5%. This ratio may well be raised further this year, and banks may be required to put aside larger provisions for bad debts. Interest rates will probably be raised as the year progresses.

The government's target for M2 money supply growth in 2010 is 17% (as in 2009). The exceptional rate of increase in new bank lending seen in 2009 is to be pared back, but the 2010 target of CNY7.5 trillion is still more than 70% higher than the 2007–2008 average. The monetary authorities will probably shift from a relatively easy monetary policy in 2010 to a tighter stance in 2011.

3.9.7 Bank lending



Sources: CEIC Data Company (accessed 15 March 2010); ADB estimates.

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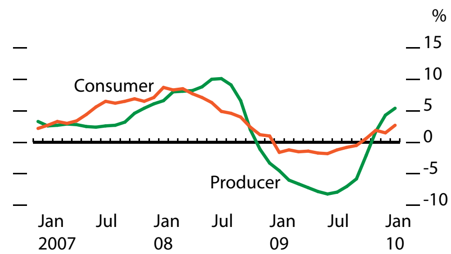
3.9.8 Monthly inflation



Source: CEIC Data Company (accessed 15 March 2010).

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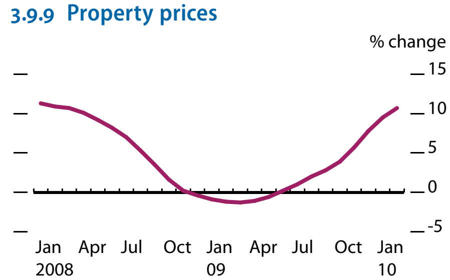
3.9.9 Property prices



Note: Data cover both residential and nonresidential buildings.

Source: CEIC Data Company (accessed 15 March 2010).

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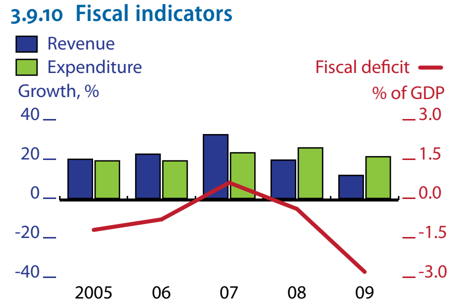
3.9.10 Fiscal indicators



Source: CEIC Data Company (accessed 15 March 2010).

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Forecasts assume the authorities may well tolerate some slight appreciation of the yuan this year, and more in 2011, in the context of sustained economic growth, a revival of inflation, and a rising current account surplus. They also assume there will be no significant natural disasters or serious epidemic diseases in the forecast period.

Investment in fixed assets is projected to grow by 25% in nominal terms, underpinned by the huge stimulus funding yet to be disbursed and by an expected increase in private investment now that global financial flows are accelerating. Still, investment will slow from 2009's hectic pace because of the firmer stance on bank lending. As the fiscal stimulus phases out, growth in fixed asset investment in 2011 is projected to moderate to 18%.

Private consumption growth in nominal terms is forecast to speed up to 12% in 2010, from 9.0% in 2009, responding to rising incomes and improving consumer confidence (Figure 3.9.11). Planned increases in government spending on health care, education, and pensions will support consumption. Furthermore, the government is considering changes to the *hukou* (household registration) system, which divides the population into rural and urban residents and limits migrant workers' access to subsidized education, health care, housing, and pensions when they move to work in cities. The system hampers the mobility of labor, reduces disposable incomes of migrant workers, and widens the income gap between rural and urban areas. The authorities late last year marginally eased the *hukou* system but only for some small and medium-sized cities.

The modest recovery in world trade envisaged in *ADO 2010* will prompt a rebound in PRC merchandise exports in 2010, forecast at nearly 13.0% in 2010 and 13.5% in 2011. A free-trade agreement between the PRC and members of the Association of Southeast Asian Nations, effective 1 January this year, will contribute to growth in trade. Imports are forecast to increase by 13.5% in 2010 and 15.0% in 2011, owing to robust domestic demand and higher global prices for oil and other commodities. The increase in the trade surplus and the income account will be more moderate than in domestic demand, and the current account surplus is forecast to narrow a little as a share of GDP.

In contrast to 2009, net exports in real terms will probably rise this year and contribute slightly to GDP growth. Net exports will rise further next year, but not to levels seen prior to the global recession, given the modest recovery expected for industrial countries.

Based on the above considerations, GDP is forecast to grow by 9.6% in 2010 (Figure 3.9.12). Growth will be stronger in the first half of 2010 owing to the relatively lower base in the prior-year period than the second half. Taking into account the phasing out of the stimulus policies, growth is forecast at 9.1% in 2011. The declining contribution to GDP growth from investment will be partly offset by a larger contribution from consumption and net exports.

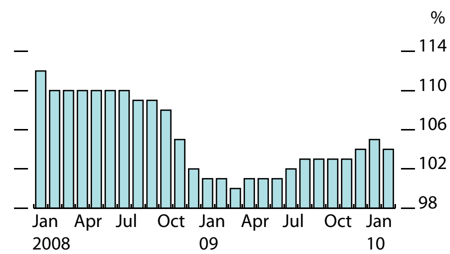
Growth data for the first 2 months showed a solid start to 2010, although some of this was a low-base effect—the prior-year period was the weakest part of 2009. In year-on-year nominal terms, fixed asset investment climbed by nearly 27%, retail sales by about 18%, and exports by 31% in January–February 2010 from a year earlier. Industrial value added grew by about 21% in real terms. M2 money supply growth of

3.9.1 Selected economic indicators (%)

	2010	2011
GDP growth	9.6	9.1
Inflation	3.6	3.2
Current account balance (share of GDP)	5.7	5.3

Source: ADB estimates.

3.9.11 Consumer confidence



Source: CEIC Data Company (accessed 15 March 2010).
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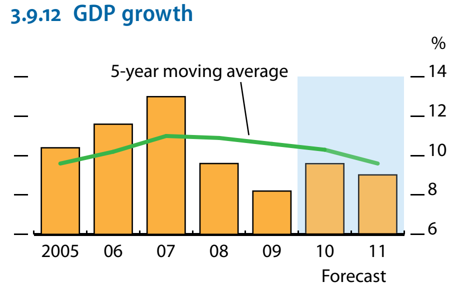
3.9.12 GDP growth



Sources: National Bureau of Statistics. http://www.stats.gov.cn (accessed 15 March 2010); ADB estimates.
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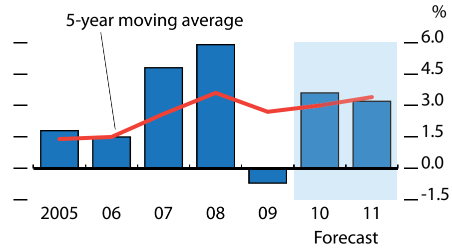
25.5% in February was well above the 2010 target, and new bank lending in the first 2 months totaled CNY2.1 trillion, or already 28% of the full-year target.

Higher prices for oil and commodities, coupled with a narrowing of the economy's output gap, will put upward pressure on prices, offset to some extent by the expected firmer stance in monetary policy. Consumer price inflation is forecast at 3.6% in 2010 and 3.2% in 2011 (Figure 3.9.13), still below the 2007–2008 levels of about 5%–6%. For the first 2 months of 2010, it averaged 2.1%. Residential property prices jumped by 13.0% year on year in February, even though the growth rate of housing sales eased.

Downside risks to the growth forecasts are a weaker than expected global recovery and an intensification of trade-related disputes. On the upside, a continuation of highly stimulatory monetary policy (without the expected adjustments) would likely produce higher rates of GDP growth, but could overheat the economy so that a spike in inflation and increased speculation in stocks and property trigger a more severe monetary tightening later. Rapid rates of lending, if maintained for too long, also raise the risk that local governments, in particular, pursue imprudent investment projects that erode bank asset quality, leading to higher levels of nonperforming loans that weaken the banking system.

3.9.13 Inflation



Sources: National Bureau of Statistics. http://www.stats.gov.cn (accessed 15 March 2010); ADB estimates.

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Development challenges

The global recession and expected modest recovery in industrial countries have reduced the potential for exports to be a major driver of growth. While massive fiscal and monetary stimulus has acted as a substitute in the short term, there is a limit to public investment and monetary expansion. Sustaining economic growth in the medium and long term is likely to require a revamp of the structure of growth.

From the supply side, services have great potential to generate growth and employment. They accounted only for about 42% of GDP and 35% of employment in 2008, much less than in other countries with similar per capita incomes (Figure 3.9.14). However, unlocking the potential of services requires comprehensive reforms (Box 3.9.1).

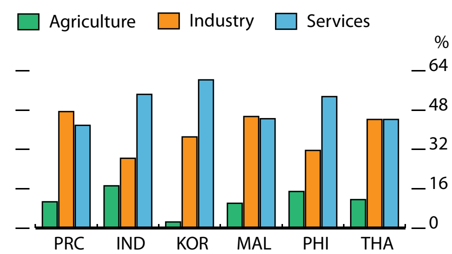
On the demand side, a greater emphasis on private consumption would promote economic growth and raise living standards. Under the current investment-driven economic growth model, the share of private consumption in expenditure-based GDP has fallen by 15.8 percentage points in the past 20 years (Figure 3.9.15).

The stress on investment has also led to overcapacity in some industries and unsustainable use of natural resources. Expanding investment is relatively easy in a system where state-owned enterprises are fed with substantial amounts of public investment that they promptly channel into expansion. Increasing private consumption, in contrast, requires raising purchasing power and changing saving habits across the population.

Growth in consumption is limited by household income's declining share of total income. The share of household income in total national disposable income shrank from about 66% in 1997 to 58% in 2007, while the share of government income increased from about 17% to 20% and that of enterprises from 17% to 22% (Figure 3.9.16).

Furthermore, households are concerned about saving for education,

3.9.14 Sector shares in current GDP, 2008



PRC = People's Rep. of China; IND = India; KOR = Rep. of Korea; MAL = Malaysia; PHI = Philippines; THA = Thailand.

Source: Asian Development Outlook database.

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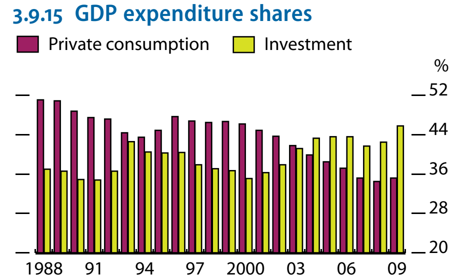
3.9.15 GDP expenditure shares



Source: CEIC Data Company (accessed 15 March 2010).

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health care, and old age, in the context of inadequate social services. Urban and rural incomes in nominal terms rose by an annual average of 12.4% and 9.7%, respectively, in 2000–2008. Savings of all households rose faster than incomes, by 16.5%. Against this backdrop, a significant increase in consumption is likely to require a strengthening of the social safety net, and provision of well-targeted public goods, such as education, health care, and affordable housing, as well as higher incomes.

High GDP growth rates in the past three decades have not been accompanied by the expected increases in employment generation. On the contrary, the relationship between GDP growth and employment has weakened, given the capital-intensive nature of growth in the past few years. This has led to large labor surpluses, mainly in rural areas, compounded by rigidities in the labor market, including the non-portability of benefits and restricted labor mobility owing to the cumbersome *hukou* system.

To address these issues, a profound reform in the labor market is warranted. The main targets should include labor mobility through the relaxation of the *hukou* system, improved social security provision for all workers (including migrants), and greater portability of acquired benefits of potentially mobile workers. Enhanced mobility will help both lift rural incomes and narrow urban-rural and regional income disparities. This process would greatly benefit from development of labor-intensive services and from further urbanization, the latter entailing great potential for future growth.

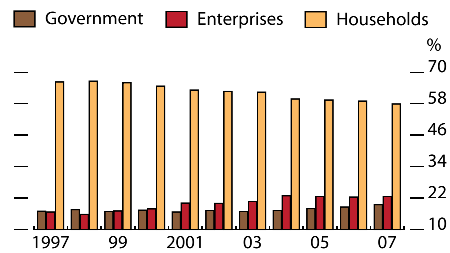
Increased labor mobility and a better educated and trained workforce would also help mitigate the impact on the economy of the aging of the population. Aging is particularly challenging in the PRC, because it is happening at a relatively low level of per capita income.

The sustainability of the current high energy-consuming and environment-unfriendly growth model is doubtful. A more sustainable model would be more reliant on technology, innovation, and skills. That could be achieved by increasing spending on research and development, which at present is below the government's target. Large investments in education and vocational training are also needed.

The government is aware of these challenges—indeed it started planning some restructuring of the economy in the mid-1990s, as reflected in the Ninth five-year plan (1995–2000). By the 11th plan (2006–2010), it had set certain targets, such as raising the shares of services in nominal GDP (from 40.3% to 43.3%), that of services in total employment (from 31.3% to 35.3%), that of research and development expense in GDP (from 1.3% to 2%), and that of urban residents in the total population (from 43% to 47%). However, trends in the past 4 years suggest that it will be difficult to realize these targets by the end of this year.

The 12th five-year plan (2011–2015), which will likely be unveiled in March 2011, provides an opportunity to add momentum to the restructuring efforts by establishing new targets, including one for the share of private consumption in GDP, coupled with policy adjustments to achieve such a target.

3.9.16 Income distribution



Source: Shanghai Security News. 2010. The Growth of Household Incomes Should Be Matched with the Growth of the Macroeconomy (translated from Chinese). http://www.cnstock.com/paper_new/html/2010-02/25/content_72101965.htm. 25 February.

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3.9.1 Developing services

Expanding the services sector would strengthen the domestic engine of growth, generate new sources of employment, and raise living standards. However, unlocking the sector's potential requires policy action on a long list of constraints. They include:

- *Excessive market concentration and entry barriers*. The authorities committed to liberalizing the services sector when it joined the World Trade Organization in 2001; however, implementation and enforcement of the commitments remain weak. As a result, state-owned enterprises dominate services, a fact that restrains competitiveness and obstructs the entry of new players, thus reducing the benefits that greater competition and liberalization would bring. Entry barriers include administrative hurdles; opaque regulations; cumbersome licensing requirements; and restrictions on the geographic range in which businesses can operate, their legal structure, and their access to banking services.
- *Restrictions on direct foreign participation*. With the exception of a few subsectors, such as hotels and some types of banking, services remain largely closed to foreign firms and hence the capital, technology, skills, and competition that they would inject.
- *Incentive bias toward manufacturing*. Fiscal incentives direct investment to the production of goods, and exemptions and rebates favor export of goods, discouraging investment in services.
- *Inefficient allocation of capital*. Large state-owned enterprises, including those in services, receive about two-thirds of total lending. In contrast, private enterprises get only one quarter of the credit available and face much higher interest rates. Despite their significantly smaller capital allocation, private firms generate about half of GDP and are the main generators of employment. The current embryonic stage of capital market development aggravates the difficulties in accessing credit.
- *Incomplete urbanization and labor market rigidities*. Service providers generally thrive in cities, where demand is strong and customers are concentrated in a relatively small area. While there are many cities, about 65% of the population still lives in far-flung rural areas. Urbanization has been slowed by rigidities in the labor market, in particular by the *hukou* system.
- *Underinvestment in education and training*. Not only is expenditure on education relatively low, but the education system is oriented toward rote learning and exam-based performance. Further, there is a decline in the proportion of students in science and engineering, which will hinder development of technology-oriented services and, more broadly, innovation. Employers report shortages of specialized skills. The policy investment bias favors the acquisition of equipment and materials, to the detriment of investment in training.

Wide-ranging policy changes are needed to facilitate the transition to a more services-oriented growth model. These include improving the regulatory framework, changing production incentives, further liberalizing the finance sector, reforming the labor market, and investing more in education and training.

To ease barriers to entry into services, reform should aim at fostering greater private sector participation in services. This could be achieved through enforcement of antitrust legislation, including against all state-owned enterprises, and opening more services to foreign participation. There is significant scope to improve the policy environment for small and medium-sized enterprises and the self-employed, for example, by improving their access to credit. Liberalizing the finance sector and developing capital markets would help to lower the cost of, and improve access to, finance, including in rural areas that often lack basic financial services.

Given that the private sector generally is more productive and innovative than state-owned enterprises, as shown by its contribution to GDP and employment, more efficient capital allocation could increase the rate of GDP growth by several percentage points.

A larger services sector could absorb much of the surplus labor from agriculture and manufacturing, as well as a significant share of new workers entering the labor force. Reforming the *hukou* system would maximize employment gains, as would other policies that speed up the move of the population to cities. To minimize the impact of job losses caused by reducing policy incentives for low-skilled manufacturing, it would be necessary to implement supportive measures, including large investments in education, vocational training, and social safety nets.

Hong Kong, China

This trade-oriented economy was dealt a heavy blow by the global recession and financial crisis. A gradual recovery from the second quarter accelerated late in 2009, spurred by a pickup in exports, strong growth in the People's Republic of China, and a massive expansion in the monetary base. The economy is forecast to grow in 2010, driven by the better global outlook for trade and financial services. Inflation will rise to moderate levels. A near-term challenge is to prevent speculation in housing from inflating an unsustainable property boom.

Economic performance

Owing to its heavy reliance on trade-related and financial services, this economy was shaken by the financial crisis and the plunge in global trade that unfolded from 2008 through early 2009. Exports, consumption, and fixed investment contracted sharply.

The first signs of recovery emerged in the second quarter of 2009 (Figure 3.10.1), as the global outlook improved and recovery gathered pace in the People's Republic of China (PRC), driven by its aggressive stimulus programs. Further impetus was provided by targeted fiscal stimulus enacted by the Hong Kong, China authorities, combined with a massive expansion of the monetary base, reflecting the Hong Kong dollar's link with the United States (US) dollar. For the full year, GDP shrank by 2.7% (Figure 3.10.2), compared with average growth of 6.2% over the previous 5 years.

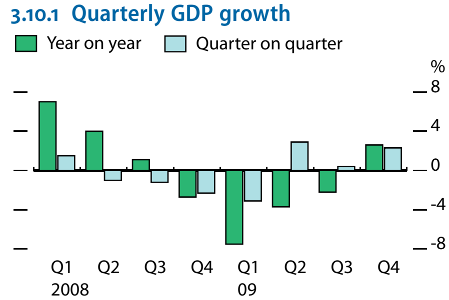
Private consumption fell by 0.3%, depressed in the first half of the year by the slump in trade in goods and services and the related softening of the labor market. Retail sales gradually improved, after a plunge early in the year (Figure 3.10.3).

As companies cut back on investment in equipment and construction, private fixed investment fell by 3.7% in 2009. The rate of contraction slowed in the second half. By contrast, public fixed investment rose by 13.5% in 2009. Public sector construction grew by 10% in the second quarter and 31% in the third, because of increased public spending on infrastructure projects. The government also stepped up its consumption spending to support aggregate demand.

The external sector was a major drag on the economy throughout the year. Goods exports—about 98% of which are reexports—plunged in the first quarter as external demand evaporated, but then improved progressively, thanks to solid growth in the PRC and the better global trade environment toward the end of the year. Nevertheless, goods exports fell by nearly 13% in real terms in 2009.

Faring better than goods trade, services exports fell by 0.7% in real terms. Trade and transportation services contracted over the year, but

3.10.1 Quarterly GDP growth



Source: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 11 March 2010).

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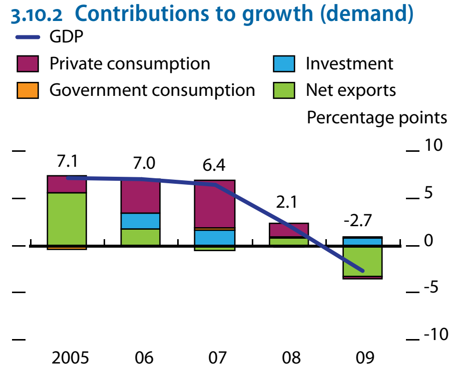
3.10.2 Contributions to growth (demand)



Source: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 11 March 2010).

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This chapter was written by Benno Ferrarini of the Economics and Research Department, ADB, Manila.

travel and financial and business services staged a strong rebound during the second half, benefiting from a rise in visitor arrivals, coupled with a brightening economic outlook and abundant liquidity in the banking system. Capital raising activity rebounded in the second half, mostly for PRC companies. Initial public offerings of shares raised the equivalent of US$31.4 billion last year, more than any other financial center. Since services accounts for more than 90% of GDP, this sector's rebound was crucial to the overall pickup. In the fourth quarter, services contributed all the economy's growth.

The current account remained in surplus throughout 2009, though narrowing, and averaged 8.7% over the year. The overall balance of payments registered a huge surplus equal to 33.6% of GDP, reflecting sustained financial capital inflows that more than outweighed the narrowing of the current account surplus.

Employment shrank for the first time since 2003. The jobless rate rose to 5.4% in April–June 2009, in part a result of layoffs in private construction. As recovery took hold in the second half, the unemployment rate declined to 4.9% by year-end. Loan guarantees provided by the government to small and medium-sized firms facing a credit squeeze, together with increased public construction, helped protect jobs. The slack labor market put downward pressure on wages (Figure 3.10.4), which fell by 1.3% in real terms in 2009.

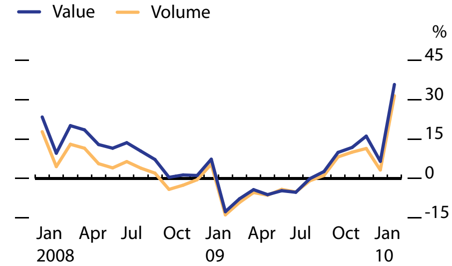
Asset markets slumped, then rebounded. By year-end, the Hang Seng index of share prices had climbed by 87% from its March 2009 low. Similarly, price indexes for residential, office, retail, and factory property turned up (Figure 3.10.5), against the background of substantial inflows of funds and easy monetary conditions that drove interest rates to very low levels.

Sales of residential properties surged, and prices of apartments rose by an average 28% last year. Mortgage loans increased markedly, driven by the ample banking liquidity and low interest rates. Acting to maintain stability in the banking system and limit increases in apartment prices, the Hong Kong Monetary Authority (HKMA) in October 2009 raised the minimum deposit requirement to 40% (from 30%) for residential mortgages valued at HK$20 million or more, and capped maximum loans at HK$12 million for properties valued at less than HK$20 million.

The surge of capital inflows (Figure 3.10.6), driven by expansionary monetary policies in the US, boosted the monetary base (Figure 3.10.7), reflecting the Hong Kong dollar's link to the US dollar through a currency board framework. Inflows early in 2009 reflected firms' repatriation of funds to meet liquidity needs and investors' search for a safe haven.

Later, inflows were driven by investment in the buoyant asset markets and in share offerings. The HKMA undertakes to buy US dollars at HK$7.75 and sell them at HK$7.85 (the convertibility band). The inflows pushed the Hong Kong dollar to the strong side of its convertibility band, and the HKMA acted as counterparty to banks selling foreign currency. The monetary authority purchased US$62 billion in 2009, in doing so it injected HK$480.8 billion into the banking system. Although this drove interest rates to very low levels, bank credit contracted in 2009 (banks

3.10.3 Growth in retail sales



Source: CEIC Data Company (accessed 31 March 2010).
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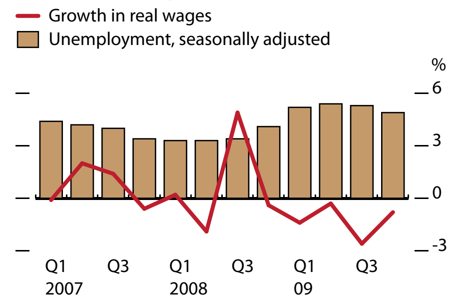
3.10.4 Unemployment and wages



Source: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 11 March 2010).
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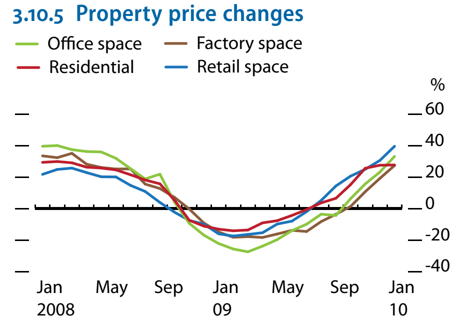
3.10.5 Property price changes



Source: CEIC Data Company (accessed 11 March 2010).
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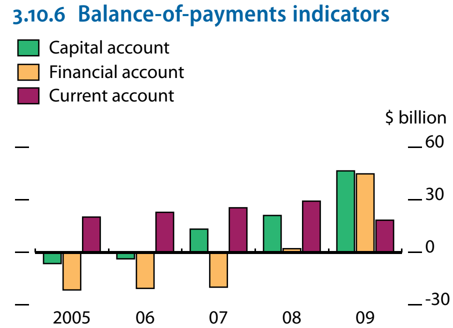
3.10.6 Balance-of-payments indicators



Sources: Hong Kong Monetary Authority; CEIC Data Company (accessed 11 March 2010).
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were cautious to lend and demand for credit was suppressed by the recession), except for mortgage lending, which rose in the second half.

Moderate deflation pressures prevailed during the first 3 quarters of 2009 (Figure 3.10.8), given the slack economy and lower global oil and commodity prices. Inflation picked up in the last quarter, and averaged 0.5% for the year.

High transaction volumes in property markets generated considerable tax revenue, and produced a budget surplus estimated at 0.8% of GDP in FY2009 (ended 31 March 2010).

Economic prospects

The growth momentum that built in late 2009 is forecast to continue through 2010, lifting GDP by 5.2% this year (Figure 3.10.9). This open economy will benefit from its close links with the PRC (where growth is forecast to accelerate to nearly 10%), from solid growth in much of Asia, and from the expected modest recovery in industrial economies. The low base set in 2009 will contribute to the growth spurt forecast for this year. In 2011, GDP growth is forecast to ease to 4.3%, taking into account that base effect in 2010 and the phasing out of exceptional government stimulus policies in the PRC.

Private consumption is forecast to pick up throughout the year, underpinned by the strengthening labor market. Retail sales rose by just over 17% in volume terms in the first 2 months of 2010 (from a low prior-year base). Private demand will receive a further boost on the investment side, as business confidence continues to improve in light of the improved global economic and financial environment.

Outlays on public works are expected to be at least US$6.5 billion a year for some time, according to the FY2010 budget. Several large public infrastructure projects that began in late 2009 will continue through 2010 and beyond. The government expects to have a budget deficit equivalent to 1.5% of GDP this fiscal year, compared with the actual surplus last year.

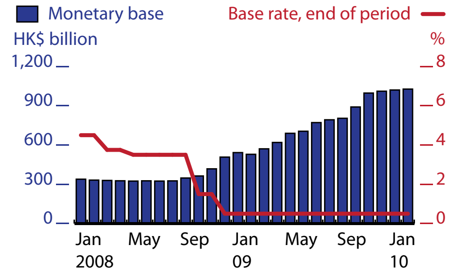
On the supply side, financial services are set to benefit from the capital inflows and corporate fund-raising activity. Fund management and retail sales of mutual funds have picked up considerably since the second quarter of 2009, and insurance has recorded strong gains in premium incomes. Tourism, too, is rising.

Inflation is forecast to pick up moderately, to average 2.2% in 2010 and 2.8% in 2011, a result of the stronger domestic demand, higher prices for imported food and fuel, the end of a subsidy on household electricity bills, and expected increases in residential and commercial rents. In the first 2 months of 2010 inflation averaged 1.9%.

Merchandise exports are expected to rebound by about 13% in US dollars this year. Services exports will rise, too, a result of robust demand for financial services, as well as a rebound in tourism and business travel. Merchandise imports are seen rising by about 11% in 2010. (In the first 2 months of 2010 exports rose by nearly 23% and imports by 31%). (Figure 3.10.10).

The merchandise trade deficit will be more than offset by a healthy surplus on trade in services. Supported also by sustained earnings from foreign exchange reserves and overseas investments, the current account

3.10.7 Monetary indicators



Source: Hong Kong Monetary Authority. http://www.info.gov.hk/hkma (accessed 31 March 2010).
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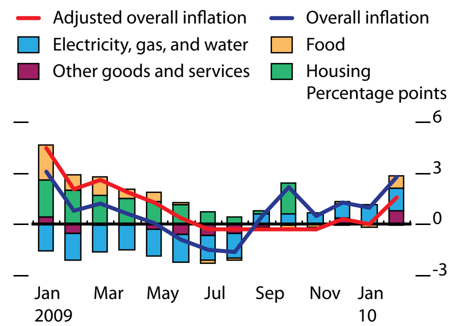
3.10.8 Monthly inflation and components



Note: Adjusted overall inflation refers to the rate once the effects of temporary subsidies by the government are removed.
Sources: CEIC Data Company (accessed 31 March 2010); Census and Statistics Department. 2010. *Monthly Report on the Consumer Price Index*. February. http://www.censtatd.gov.hk
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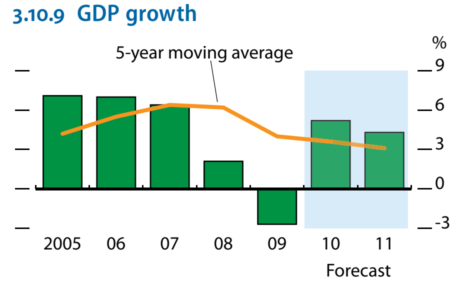
3.10.9 GDP growth



Sources: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 11 March 2010); ADB estimates.
Click here for figure data

3.101 Selected economic indicators (%)

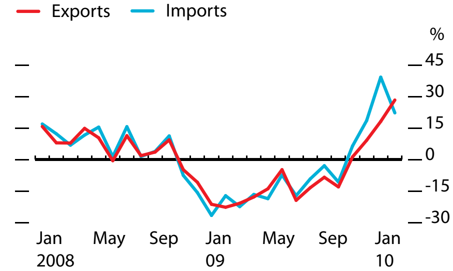
	2010	2011
GDP growth	5.2	4.3
Inflation	2.2	2.8
Current account balance (share of GDP)	7.6	7.2

Source: ADB estimates.

is forecast to record comfortable surpluses exceeding 7% of GDP this year and next.

There are a number of risks to the forecasts. Depending on the pace of withdrawal of monetary stimulus in the US and PRC, it is likely that excess liquidity and very low interest rates will prevail in Hong Kong, China, with the associated risk of fueling a credit boom and further upward pressure on asset prices. Conversely, capital flows might reverse and interest rates rebound when the US phases out its monetary stimulus. The Hong Kong dollar exchange rate will likely move to the lower side of its convertibility band and the HKMA will absorb Hong Kong dollar liquidity. These adjustments could cause disruptions in financial markets.

3.10.10 Merchandise trade growth



Source: CEIC Data Company (accessed 2 April 2010).
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Development challenges

While the flood of liquidity and low interest rates have fueled speculation in high-end apartments, speculative activity does not appear to have significantly spilled over into the broader residential market at this stage. A housing affordability index rose to 38% of median incomes in the fourth quarter year on year (Figure 3.10.11), still below the historical average and far below the peak in 1997. Similarly, the number of transactions involving a buyer reselling a property before the completion of the original sale, usually for a quick capital gain, is around 2%, also well below the previous peak.

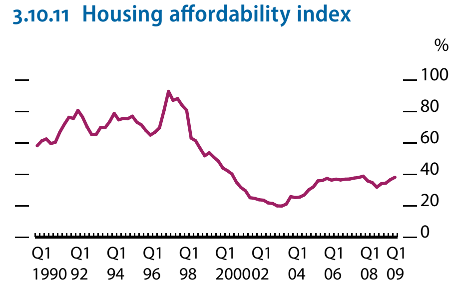
Nevertheless, at a time of low interest rates and rising investor confidence, apartment prices may continue to increase for some time, raising the risk of an overextended market that would eventually peak and then dive, denting consumer and investor sentiment with knock-on effects for economic growth and for the health of the banking sector.

In an effort to prevent such an outcome, the government in February 2010 followed up its tightening of bank prudential regulations for housing loans with moves to check speculation in housing. The FY2010 budget raised the stamp duty tax on high-end housing and indicated that the increase will be extended if speculation takes hold in the broader residential market. To increase supply of apartments, the government plans to speed up the pace of auctioning urban residential sites.

Still, it will take several years for these moves to substantially increase the number of apartments on the market. In the meantime, affordability of private housing is likely to worsen and rents are likely to rise, after a lag of 1 or 2 years.

Hong Kong, China is constrained by its linked exchange rate system from raising interest rates to damp a housing boom. Rather, it is tied to US monetary policy, which is unlikely to tighten much this year. Monetary policy also remains expansionary in the PRC, with some spillover impact on the housing market. Further, if the yuan starts to appreciate against the US dollar, the attractiveness of Hong Kong, China's assets to investors from the PRC would increase.

3.10.11 Housing affordability index



Note: Data refer to the ratio of mortgage payments (for a 45-square meter apartment) to median income of households (excluding those living in public housing).

Source: Economic Analysis and Business Facilitation Unit, Financial Secretary's Office.
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Republic of Korea

Growth surprised on the upside in 2009 as the economy avoided an expected contraction. Fiscal stimulus and better than expected export performance fueled recovery from the impact of the global recession. A sharp rebound in growth is forecast for 2010 as domestic demand picks up and the export recovery broadens. Medium-term policy challenges are to encourage the employment of women and accelerate the transition to economic growth that is based on productivity improvements.

Economic performance

After hitting bottom in the fourth quarter of 2008, when output contracted by 4.5% (quarter on quarter), the Republic of Korea (hereafter Korea) staged a strong recovery in 2009. GDP grew by 0.2% in the year, a much better outcome than expected, although far below the 5-year average of 4.2% in 2004–2008. Figure 3.11.1 shows the year-on-year and quarter-on-quarter trajectory of GDP growth in 2008 and 2009.

Despite weakness of external demand, net exports were the primary driver of growth in 2009 (Figure 3.11.2), helping offset weakness in domestic private demand. Mirroring the impact of a sizable fiscal stimulus, government consumption also contributed substantially to growth. However, private investment dragged down growth throughout 2009. Interestingly, although Korea's slowdown started as a collapse of exports, net exports helped the economy get back on its feet, while the negative impact of domestic demand on growth persisted.

Exports of goods in real terms plunged in late 2008 and early 2009, then bounced back (Figure 3.11.3), to be flat for the year. Two factors account for the resilience of exports in the face of weakness in industrial economies.

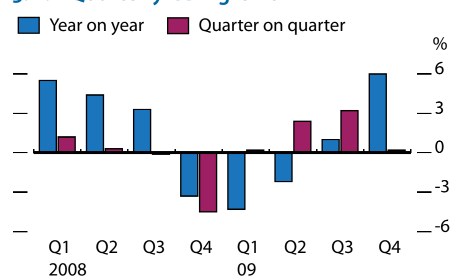
First, exports benefited from continued robust appetite for imports from the People's Republic of China (PRC). Also, the PRC's fiscal stimulus had positive spillover effects. In particular, subsidies for rural households to buy household appliances benefited Korean electronics exporters. Exports to other developing economies also held up relatively well. An underlying driver of exports in 2009 was an average 12.7% depreciation of the won relative to 2008 (Figure 3.11.4).

Second, manufacturing diversification over the past 20 years has reduced the former export dependence on a few product groups. Since the impact of the global crisis differed across product groups, this contributed to export resilience.

Private consumption was weak in early 2009 before picking up (Figure 3.11.5), to be little changed for the full year. The turnaround was most evident in durables and services. Consumer sentiment improved during the year, and, with an appreciating won, buoyant stock market, and rising housing prices, supported consumption, as did lower interest rates and tax cuts.

This chapter was written by Donghyun Park of the Economics and Research Department, ADB, Manila.

3.11.1 Quarterly GDP growth



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 26 March 2010).

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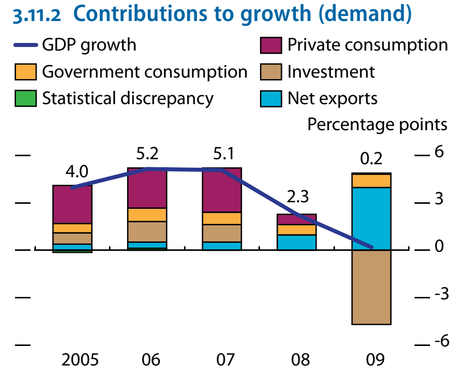
3.11.2 Contributions to growth (demand)



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 26 March 2010).

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Hit by the gloomy global economic outlook early in 2009, total fixed investment fell by 0.2% for the year, mainly because equipment investment dropped by 9.1%. As the year progressed, business confidence improved and average manufacturing capacity utilization rose (Figure 3.11.6). Construction investment grew by 4.4% in 2009 after a contraction of 2.8% in 2008. The turnaround was based on public works projects in the fiscal stimulus.

Aggressive monetary and fiscal easing, adopted as the global recession intensified, helped prop aggregate demand. The Bank of Korea cut its key policy interest rate six times from the beginning of October 2008 through February 2009 (Figure 3.11.7). In addition, the government provided liquidity support to the financial system.

The government brought forward a large part of its 2009 budget to the first half of the year. It also quickly adopted a sizable fiscal stimulus package. The 3-year (2008–2010) package amounts to around 6.5% of 2008 GDP, and contains a mix of tax cuts and additional spending. Tax cuts consist of both specific, temporary measures (such as tax incentives for replacing old automobiles, which had a big effect on automobile purchases and overall private consumption from the second quarter of 2009) as well as longer-term cuts in personal and corporate income taxes. Key areas for spending are public infrastructure, assistance for low-income groups, and job-creation initiatives. A 5.0% increase in government consumption and additional public works also supported domestic demand. The overall budget deficit widened from 2.0% in 2008 to 3.9% in 2009 as a result of fiscal easing.

Inflation slowed to 2.8% in 2009 from 4.7% in 2008, reflecting weak private demand and lower global oil and commodity prices. The impact of low economic growth was felt in the labor market, where the number of employed persons fell last year, though only by 71,000. While the labor market remained soft, the unemployment rate rose only modestly, from 3.2% to 3.6%, helped by the job-creation programs and women workers dropping out of the workforce.

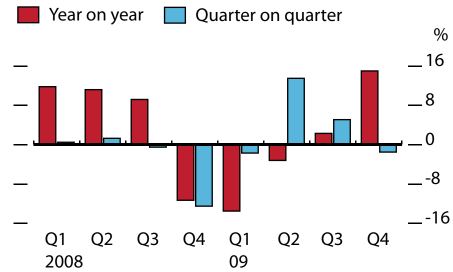
A much steeper fall in the United States (US) dollar value of merchandise imports (25.7%) than in the value of merchandise exports (13.7%) produced a huge trade surplus, and led to a current account surplus equivalent to 5.1% of GDP.

Economic prospects

Strengthening domestic demand and a brightening global outlook point to the Korean recovery gathering momentum this year. Private consumption and investment are set to replace government spending and public works as the primary engines of domestic demand growth. Improving external conditions will also contribute significantly. In particular, the consolidation of recovery in industrial economies will broaden the scope of export recovery.

Korean manufactured exports such as automobiles, electronics, and capital goods tend to be highly sensitive to the global business cycle. Hence, after their earlier plunge, exports to industrial countries began to recover in the second half of 2009, a trend set to continue through 2010. Elsewhere, given projected acceleration of PRC growth and strong

3.11.3 Merchandise real export growth



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 26 March 2010).

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3.11.4 Exchange rate

Source: CEIC Data Company (accessed 26 March 2010).

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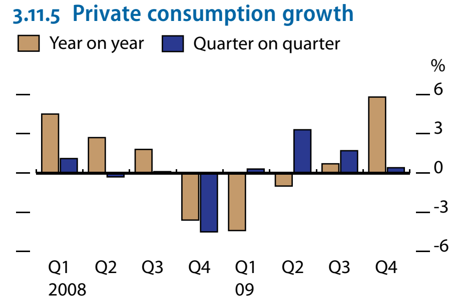
3.11.5 Private consumption growth



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 26 March 2010).

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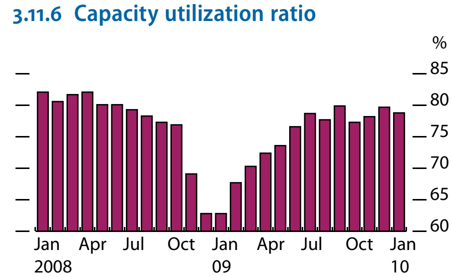
3.11.6 Capacity utilization ratio



Source: CEIC Data Company (accessed 15 March 2010).

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recovery in many other developing countries, exports to developing countries as a whole will remain robust.

In terms of export industries, the information technology (IT) product group—primarily semiconductors, liquid crystal displays, and mobile phones—will continue to play a leading role, underpinned by global demand recovery and competitive advantage in supply capacity and product innovation. Global demand for automobiles is projected to bounce back, fueled by demand expanding in the PRC and recovering in the US. Still, the outlook for petrochemical exports is clouded by the prospect of global supply outpacing global demand as a result of Middle Eastern production capacity coming online in mid-2010, while difficulties at global shipping companies are leading to delays and cancellations of orders, affecting Korean shipbuilders' prospects. An expected increase in export unit prices brought about by higher prices for refined petroleum products and some IT products will have a positive effect.

On the downside, the won is projected to average around W1,100/$1 in 2010, which would be an appreciation of about 15% from 2009. The stronger won will hurt price competitiveness in global markets, but past experience suggests that the impact will be limited. Net exports will add to GDP growth in 2010, although by less than in 2009.

Private consumption is expected to increase by about 5%, with stronger growth in the first half reflecting the base effect from a sharp compression of consumption in the first half of 2009. The biggest impetus will come from strong growth in incomes as a result of expected large bonuses by corporations. Robust growth of gross national income, which adjusts GDP for terms of trade and so better reflects purchasing power, will also support consumption. Gross national income began to grow faster than GDP in the second quarter of 2009, owing to rising export unit prices of IT and some other products, and this is likely to persist to the end of 2010.

In light of favorable overall conditions, buoyant consumer confidence (Figure 3.11.8) is likely to persist this year. The won's appreciation will boost household purchasing power by helping contain inflation. Against this, the tax incentives for replacing old automobiles ended in mid-2009, which will somewhat slow the momentum of consumption.

Total fixed investment is expected to grow by close to 10% in the first half of 2010 and by about 5% in the second. The primary cause will likely be a rebound in equipment investment. Growing by as much as 15% (again with a stronger first half, partly due to a low-base effect), this surge is underpinned by a rapid improvement in business confidence (Figure 3.11.8). Increased capacity utilization in manufacturing and rapid growth of industrial production will prompt companies to expand investment. Furthermore, the corporate sector is in good financial shape, due to improving profitability, and this is most evident in the IT sector, which accounts for about 30% of total investment.

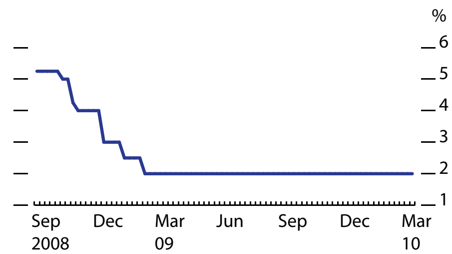
At a broader level, the slowdown of global growth (relative to before the global recession) and persistent global overcapacity will constrain investment. Construction investment is projected to rise by 3% this year, a little weaker than in 2009. Public works will slow as the government unwinds its fiscal stimulus, but housing construction will pick up because

3.11.1 Selected economic indicators (%)

	2010	2011
GDP growth	5.2	4.6
Inflation	3.0	3.0
Current account balance (share of GDP)	1.5	1.0

Source: ADB estimates.

3.11.7 Policy rate



Source: Bank of Korea. Base Rate. http://eng.bok.or.kr (accessed 15 March 2010).

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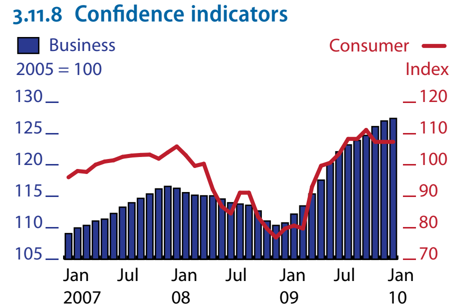
3.11.8 Confidence indicators



Note: Data for consumer confidence from January 2005–August 2008 refer to the Consumer Expectations Index, while values after that were derived using the Composite Consumer Sentiment Index. Business confidence refers to the Leading Composite Index.

Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 15 March 2010).

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the government has eased some constraints on private housing supply and plans to continue to increase the supply of public housing.

The labor market picture is less benign. Government job-creation programs will be scaled back, while private sector hiring will be sluggish in light of the usual lag between growth and employment. A further constraint is weakness in the self-employed sector, which shed more than 300,000 workers in the third quarter of 2009. The number of employed persons is projected to rise by about 150,000, but unemployment will remain an area of concern.

The speed and scale of the exit from the monetary and fiscal stimulus will impinge on the recovery process, but are not expected to act as a serious drag on growth. The conducive environment for keeping inflation under control suggests that increases in the policy interest rate are likely to be small. The fiscal stimulus, which amounted to W38.8 trillion or 3.6% of GDP in 2009, will be scaled back to W17.2 trillion, or 1.7% of GDP, in 2010. As a result, the fiscal deficit is expected to narrow from 3.9% in 2009 to about 3% in 2010.

Taking all these factors into account, GDP growth for 2010 is projected to climb to 5.2% (Figure 3.11.9). This above-trend performance, largely driven by the low-base effect of 2008 and 2009, will mostly close the wide output gap that opened when growth slumped in those years. GDP growth is forecast to ease to a still-high 4.6% in 2011, as the pace of equipment investment slows from this year's exceptionally high rate.

Inflation is projected to hover around 3.0% in the forecast period, within the central bank's 2%–4% target band. The stronger won will help contain import prices, and an output gap persists in the economy. These factors are likely to offset the inflation impact of higher oil prices.

In the external accounts, merchandise exports in US dollar terms are projected to grow by about 12% this year, whereas merchandise imports, driven by stronger domestic demand and higher oil and commodity prices, will grow by about 20%. The current account surplus will shrink from its record high in 2009 to the equivalent of about 1.5% of GDP and then to 1.0% in 2011.

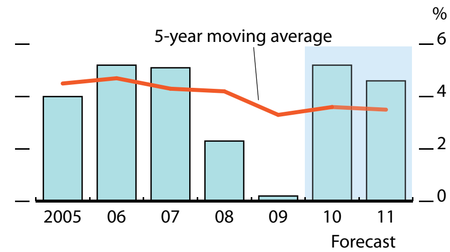
Slower and weaker than expected recovery among industrial countries is the main downside risk to the forecasts, given Korea's openness to trade and financial flows. The primary domestic downside risk is the structural problem of high household debt. The ratio of personal debt to personal disposable income has reached about 150%, and is much higher among low-income households. However, various mortgage-related risk-management measures imposed on banks and nonbank financial institutions should retard the growth of mortgage-dominated household loans.

Overall, the positives outweigh the negatives, and growth may surprise on the upside again, as hinted at by recent trends in a key leading indicator (producers' shipments to inventories—Figure 3.11.10).

Development challenges

Creating a better working environment for women and accelerating the transition to an economy based on productivity improvements (Box 3.11.1) are two medium-term policy challenges.

3.11.9 GDP growth



Sources: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 26 March 2010); ADB estimates.

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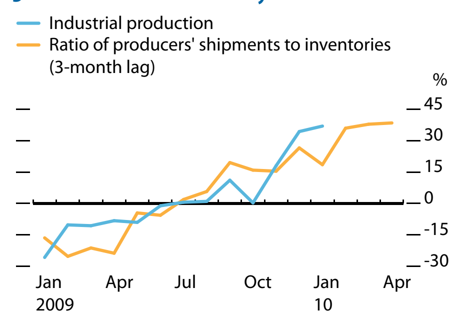
3.11.10 Growth in industry indicators



Sources: CEIC Data Company (accessed 15 March 2010); ADB estimates.

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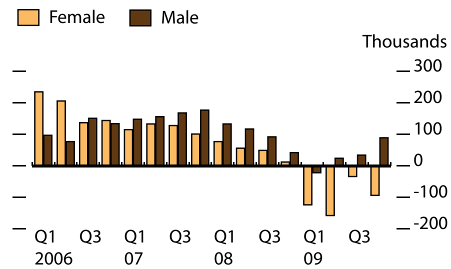
Improving the working environment for women has become more pressing in light of prospective labor shortages due to rapid population aging and low fertility in Korea. The global recession highlighted this point: its impact on the Korean labor market was much more pronounced for women than men (Figure 3.11.11). Women tend to land less stable first jobs than men, including a large share of nonwage and temporary-contract wage jobs, so were more vulnerable when the economy turned down. Finally, of women who left their employment, among the core working-age groups—the 30s–50s—a large majority dropped out of the labor force altogether, with child raising and household work the dominant reasons.

As well as leaving the workforce, too many women do not join it. For example in 2007, the employment rate among female university graduates was nearly 20 percentage points below the average of countries in the Organisation for Economic Co-operation and Development. Using the female workforce more efficiently could bring significant benefits for the economy and the women involved. Indeed, rapid population aging and the consequent prospective reduction of the labor force make full use of female workers, especially highly skilled ones, even more important.

3.11.11 Change in employment



Source: Korea National Statistical Office. http://www.kosis.kr/eng/index.html (accessed 15 March 2010).

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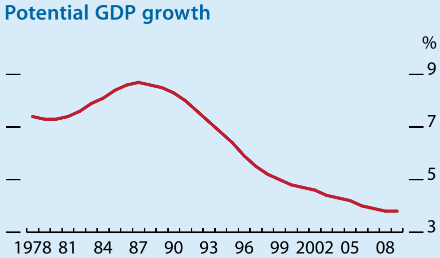
3.11.1 Raising Korea's potential growth rate

As the global recession recedes, an issue that will come back to center stage is: What is Korea's longer-term potential growth rate—the economy's aggregate supply capacity—and what are the policy options to boost it?

Korea's GDP growth has slowed since the early 1970s, from an average of 10.3% in 1971–1979 to 4.9% in 2000–2008. Potential GDP growth has also declined (Box figure).

Potential GDP growth



Note: Potential GDP growth was estimated using the Hodrick-Prescott filter, a smoothing method to remove cyclical components of a time series.

Source: ADB estimates.

Click here for figure data

Broadly, the deceleration of potential growth reflects a slowing in the accumulation of capital and in the growth of the labor force. The growth of the working-age population fell sharply from 2.4% in 1980–1989 to 1.2% in 1998–2008. The growth of equipment investment slowed from 8.7% in 1991–1997 to 4.8% in 1998–2008. Technological progress and other productivity improvements have been insufficient to significantly offset the decline in growth due to slower factor accumulation. Research and development (R&D) expenditures have risen rapidly, but their size is not enough (3.5% of GNP in 2007) to have a notable positive effect on economywide efficiency.

In the coming years, rapid population aging, lack of competitiveness in knowledge-based industries, and the catch-up of latecomers, such as the People's Republic of China, in Korea's main industries all point to clear limits to growth.

Still, Korean policy makers have a range of options to accelerate the transition from a growth model based on factor accumulation to one based on productivity improvements. Here, the broad thrust should be to promote the acquisition of capital goods that embody new technology and the accumulation of highly skilled human capital for high-tech industries and knowledge-based service industries.

For example, the government could consider providing fiscal incentives for hiring older and female workers to lessen the impact of the decline in the working-age population and expanding its R&D support to communications, finance, and other service industries. Services, which lag manufacturing in productivity, would benefit from an easing of regulations that constrain the entry of new competitors. Such measures would help raise potential growth.

Mongolia

After contracting for the first 3 quarters of 2009, the economy started to recover late in the year as global commodity prices picked up and the government adopted an extensive policy reform program. The economy is forecast to return to solid growth this year and next, spurred by development of a large copper and gold mining project. Inflation faded in 2009 but will accelerate this year. Domestic risks to the outlook center on weaknesses in the banking system and possible fiscal pressures.

Economic performance

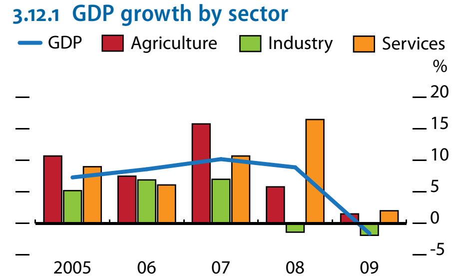
Despite a rebound in the fourth quarter, the economy contracted by 1.6% in 2009 (Figure 3.12.1), hit hard by the impact of the global recession, notably the fall in prices of Mongolia's commodity exports. The contraction in GDP followed robust average growth of 9% during 2004–2008, when world commodity prices were rising. GDP contracted in each of the first 3 quarters of 2009. The slump was mainly a result of a plunge in world copper prices in late 2008 and reduced inflows of foreign direct investment (FDI) into the country's mining and construction industries as global investment flows dwindled.

These external shocks knocked the economy at a particularly vulnerable time: macroeconomic policy had been overly expansionary during the commodity boom years, resulting in high inflation (peaking at 34.2% in August 2008), deteriorating external and fiscal balances, and serious strains in the banking system. Consequently, in early 2009 the government had to rein in spending and hike the policy interest rate, further suppressing consumption and investment.

Mongolia turned to the International Monetary Fund, agreeing in March 2009 to borrow $224 million under an 18-month standby arrangement, and received additional funding from other development institutions and governments. In return, the government pledged to follow fiscal policies that would repair the budget and monetary policies to safeguard dwindling international reserves. The authorities also agreed to allow greater exchange rate flexibility, to strengthen the fragile banking system, and to improve the targeting of social spending. The funding and policy actions stabilized the economy, positioning it to resume growth as the price of copper and other minerals recovered (Figure 3.12.2).

Still, for the full year industrial production fell by 1.9%, hurt by weakness in world markets for the major exports copper, coal, and zinc. Investment in mining was hampered by the global tightening of credit and by continued delays in reaching agreements between the government and international companies to develop new mines, especially the large Oyu Tolgoi copper and gold resource.

3.12.1 GDP growth by sector



Source: National Statistical Office of Mongolia. 2009. *Monthly Statistical Bulletin*. December. http://www.nso.mn

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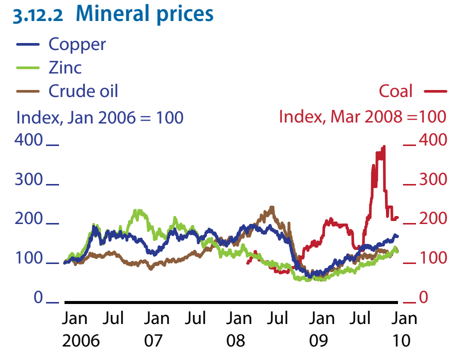
3.12.2 Mineral prices



Source: Bloomberg (accessed 18 January 2010).

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This chapter was written by Christer Ljungwall of the Mongolia Resident Mission, ADB, Ulaanbaatar.

Construction activity fell abruptly in 2009 as both the public and private sectors cut back capital investment and banks tightened lending.

Agriculture, which supports about 40% of the population, grew by just 1.5% in 2009. The sector suffered from lower prices for cashmere and other livestock-related products. Further, a summer drought, followed by heavy snow and lower than usual temperatures in late 2009, reduced feed available for livestock, worsening a problem caused by years of overgrazing, when the herd expanded to about 44 million (mainly goats, sheep, and cattle). Livestock losses from the bad weather were estimated in early 2010 at more than 5 million.

Growth in the services sector slowed sharply to 2.0% in 2009, in part reflecting a weak labor market and reduced government outlays that hurt consumer spending. Continued banking stresses hampered growth in financial services.

A Labor Force Survey put the unemployment rate in September 2009 at 10.5%, taking into account both those registered and not registered as unemployed. The loss of jobs and falling real wages in the informal sector aggravated poverty (35.2% of the population lived below the national poverty line in 2008).

Merchandise exports in US dollar terms fell by about 25% in 2009, largely a result of lower prices rather than lower volumes. Imports fell even more sharply, by about 35%, mirroring lower costs for imported oil and food, weaker consumption and investment, and a 36% depreciation of the togrog against the US dollar in the first quarter. As a result, the trade deficit narrowed. With earnings from tourism and remittances from Mongolian workers abroad taking a hit from the global recession, the current account remained in deficit, equivalent to 9.1% of GDP (Figure 3.12.3).

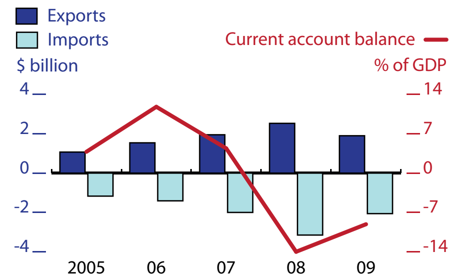
The current account gap was primarily financed by donor disbursements and FDI. International reserves, after plunging by half to about $500 million, climbed to $1.3 billion (about 7 months of import cover) by end-2009.

Inflation slowed sharply from 22.0% year on year at end-2008 to 4.2% by end-2009 (Figure 3.12.4), marking the slump in domestic demand, lower prices for imported commodities, and an increase in the policy interest rate in March. With inflation subsiding and the exchange rate recovering, the Bank of Mongolia lowered its policy interest rate in three steps starting from May 2009. Growth in the money supply (M2) picked up early in the year and posted an increase of 26.9% for all 2009.

Strains in the banking sector in 2008 persisted in 2009. The economic slump and rising real interest rates (as inflation slowed) caused a near doubling of nonperforming loans to 18.3% of total loans by end-2009 from a year earlier. Construction firms had the highest rate of bad debts. Commercial banks reported aggregate losses in 2009 (as they did in 2008), and capital-adequacy ratios fell in 2009. Poor governance and weak internal controls deepened the problems in the banking subsector.

After Anod Bank foundered and was taken over by the government in December 2008, the authorities tightened bank prudential ratios, raised capital requirements, and strengthened banking laws. The central bank provided liquidity to the banking system and introduced a blanket deposit guarantee. Nevertheless, Zoos Bank failed in November 2009 and

3.12.3 External sector



Source: Bank of Mongolia. 2009. *Balance of Payment Report*. December. http://www.mongolbank.mn

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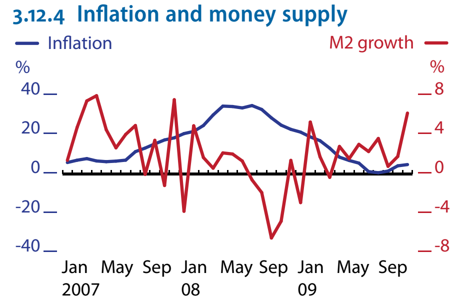
3.12.4 Inflation and money supply



Source: Bank of Mongolia. 2009. Statistical Bulletin. December. http://www.mongolbank.mn

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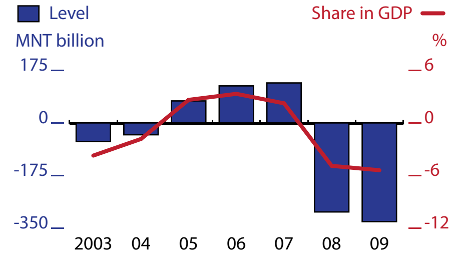
was put into receivership. The banks' difficulties, coupled with concerns about the financial soundness of borrowers, caused banks to cut lending in 2009, by 26.2%.

Reductions in government spending brought down total public expenditure and net lending to the equivalent of 38.3% of GDP (from 41.0% in 2008). In particular, the government slashed spending on construction and subsidies, partly offset by a higher wages bill. Revenue also fell, eroded by weak copper prices early in the year and the impact of the recession on tax collections. Total revenue and grants fell to 32.9% of GDP, from 36.1%. The overall fiscal deficit widened to 5.4% of GDP (Figure 3.12.5).

3.12.5 Budget balance



Source: National Statistical Office of Mongolia. 2009. *Monthly Statistical Bulletin*. December. http://www.nso.mn

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Economic prospects

The outlook depends heavily on the global price of copper, the development of new mines, and the continued implementation of policies that maintain macroeconomic stability.

As for copper, the price is projected to remain at high levels during the forecast period, which will stimulate production. Prospects for development of new mines brightened considerably in October 2009, when the government signed an agreement with an international mining company to exploit the Oyu Tolgoi copper and gold deposit. Investment in this project is expected to total $5 billion, with about $760 million to be spent this year and $1.5 billion next. Production is projected to start in 2013.

The long-awaited Oyu Tolgoi agreement and subsequent construction will raise investor confidence and have knock-on effects on other parts of the economy. Moreover, the government is considering proposals to mine the large Tavan Tolgoi coal deposit. FDI inflows into mining are expected to rise significantly over the forecast period.

Severe winter early in 2010 will curtail agricultural production. Livestock losses are likely to reduce incomes of herders, who constitute about 30% of the population. As for the services sector, transport and communications staged a strong rebound in late 2009 and other services will join in the recovery this year. However, the banking sector's problems damp its prospects for growth.

The need to strengthen public finances will limit budgetary stimulus to the economy in the forecast period. The government aims to narrow its budget deficit to 5.0% of GDP in 2010. Higher mineral prices should benefit revenue, but the scheduled ending of a windfall profit tax on mining in 2011 will erode total revenue by the equivalent of about 2% of GDP. Furthermore, donor budgetary support is expected to be phased down from 2011. On the monetary policy front, projected faster inflation limits further interest rate cuts.

Investment is expected to rebound, driven by Oyu Tolgoi. The outlook for growth in bank lending is clouded by the high level of bad loans, weak bank balance sheets, and high real interest rates. Consumption will benefit from an expected pickup in employment, offset by the impact of lower incomes in agriculture. Taken all together, the economy is forecast to grow by about 7.0% in 2010 (Figure 3.12.6).

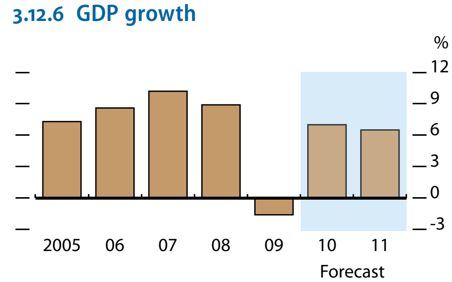
Growth is seen slowing a bit to 6.5% in 2011, mainly a result of the impact on government revenue and spending of the end of the windfall

3.12.1 Selected economic indicators (%)

	2010	2011
GDP growth	7.0	6.5
Inflation	7.9	6.0
Current account balance (share of GDP)	-16.1	-21.2

Source: ADB estimates.

3.12.6 GDP growth



Sources: National Statistical Office of Mongolia. 2009. *Monthly Statistical Bulletin*. December. http://www.nso.mn; ADB estimates.

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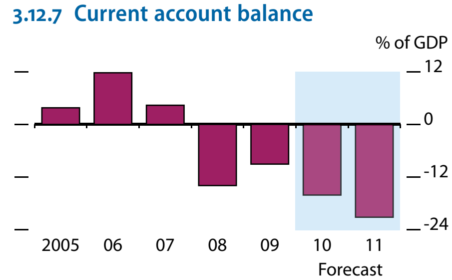
3.12.7 Current account balance



Sources: Bank of Mongolia. 2009. *Balance of Payment Report*. December. http://www.mongolbank.mn; ADB estimates.

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profit tax and reduced donor budgetary financing. Implementation of a proposed fiscal responsibility law would also impose limits on government spending. On the upside, growth could be faster if agreements are reached to mine several large mineral deposits.

In the medium term, GDP growth is expected to spurt to double-digit levels once production ramps up from the Oyu Tolgoi project.

Inflation is forecast to accelerate to an average of nearly 8% in 2010 from 6.3% last year, reflecting the rebound in domestic demand, increase in oil prices, and likely higher meat prices for at least part of the year due to the bad weather. Inflation is expected to ease in 2011 as fiscal consolidation efforts strengthen.

Policy reforms planned for 2010, if followed through, will improve the economy's prospects for sustained growth. The proposed fiscal responsibility law will promote budget discipline by effectively placing ceilings on spending growth, the fiscal deficit, and public debt. The law will require mandatory cost estimates for government spending proposals to ensure that spending is consistent with a medium-term fiscal framework. More broadly, the idea behind the law is to help insulate the budget, and the economy generally, from swings in the price of copper.

In other reforms, the government plans to replace some universal social transfer programs with better targeted transfers that focus on the very poor. It also proposes to strengthen the central bank's powers to supervise the banking system and to intervene when banks strike financial trouble.

Merchandise exports are expected to rise in line with commodity prices and improved external demand. Buoyant GDP growth in the People's Republic of China (forecast at 9.6% in 2010) will underpin exports, since that market takes most of Mongolia's exports. Merchandise imports will likely increase at an even faster rate than exports, reflecting the need for machinery and equipment for Oyu Tolgoi and the pickup in consumption. The current account deficit is forecast to widen sharply to about 16% of GDP in 2010 and to 21% in 2011 (Figure 3.12.7). FDI should finance much of the gap.

Domestic risks to the economic forecasts center on the weaknesses in the banking system and possible renewed fiscal pressures. More bank failures would hurt confidence and further restrict credit, and could deal a blow to the budget (as a result of the deposit guarantee). Fiscal pressures would also arise if the government hikes spending before significant extra revenue starts flowing from mining in about 2015. However, the authorities have so far demonstrated the will to undertake agreed fiscal reforms and to improve the economic policy framework. Volatile commodity prices are a perennial risk.

3.12.1 Development challenges

Expansion of mining will bring important benefits—new investment, jobs, export income, and a surge in government revenue that could fund social and development spending, so as to increase the productive capacity of the economy and reduce poverty.

However, the flood of new investment and revenue into this small, narrowly based economy may also aggravate problems. For a start, increased demand for labor and materials, plus higher incomes and public spending, could easily spur inflation to double-digit rates. Wages in mining and in the public service are likely to rise. The boost in export earnings will put upward pressure on the real exchange rate.

Such developments would hurt the competitiveness of manufacturing and other nonmineral industries, including tourism. Nonmineral industries trying to export, or exposed to competition from imports, might well contract.

At the least, the higher costs would make it more difficult to diversify the economy away from mining. Indeed, an increase in mining's role would likely amplify the economy's vulnerability to swings in global copper prices. (Mongolia experienced some of these problems during the copper boom from 2005 to early 2008 and, when copper prices crashed, it suffered recession.)

Managing windfall revenue and smoothing public expenditure will be critical to avoiding such boom and bust cycles. The government has proposed structures to address these issues, in particular the fiscal responsibility law. The challenge now is to adopt the law and adhere to its rules. It has also put forward a stabilization fund to manage revenue volatility, but it will be several years before the fund is large enough to help buffer the economy from another copper slump.

While steps have been taken to strengthen the central bank's role in maintaining price and banking system stability, more needs to be done, including changes to make inflation its main policy goal.

Taipei,China

The collapse in global trade reverberated through this economy, knocking manufacturing output and depressing private investment. Recovery started in the second quarter of 2009 and then accelerated, so that the contraction in GDP was milder than earlier anticipated. Supported by the strengthening world trade performance, GDP is forecast to expand this year and next. Inflation has returned (after consumer prices fell last year), but is forecast to be low this year and next.

Economic performance

An economy that relies heavily on trade (merchandise imports and exports together equal nearly 100% of GDP), Taipei,China suffered a sharp recession when global trade collapsed in 2008. During the slump, exports of goods in value terms plunged by about 30% year on year for several quarters. GDP contracted from the second quarter of 2008 for 4 quarters on a sequential basis (Figure 3.13.1), or by nearly 10% over that period.

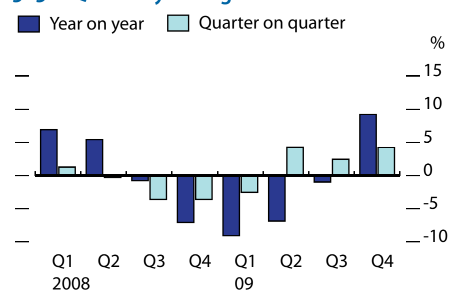
Still, the economic contraction in 2009 was not as severe as earlier anticipated. Exports picked up as the year progressed. So did private consumption and public investment, supported by fiscal and monetary stimulus. These developments contained the decline in 2009 GDP to 1.9% (Figure 3.13.2). (GDP was flat in 2008 and grew by 5.2% on average over the previous 5 years.)

Private consumption eased in the first half of 2009, owing to a weak labor market and decline in consumer confidence. It firmed in the second half, partly a result of government stimulus measures, to be up by 1.5% for the year. Layoffs, mainly in manufacturing and construction, pushed the unemployment rate up to 6.1% in August, before employment started to pick up again. Average monthly earnings in nominal terms fell for 8 consecutive months through October.

Government consumption grew by 3.6% in 2009, in part a result of its fiscal stimulus measures. Net exports were also positive—the fall in exports of goods and services from 2008 was outpaced by an even steeper drop in imports.

However, these positive factors were more than offset by a fall in private investment. Fixed capital investment, which is strongly correlated with the performance of merchandise exports, dropped by 29.4% in the first quarter, a deeper dive than seen after the global information technology bubble deflated in 2001. For the full year, fixed investment fell by 11.8%. Investment was particularly weak in machinery and equipment (down by 21.0%). The fall in fixed investment would have been worse if the government had not pumped up its capital works as part of the fiscal stimulus.

3.13.1 Quarterly GDP growth



Source: Directorate General of Budget, Accounting and Statistics. http://eng.dgbas.gov.tw (accessed 8 March 2010).

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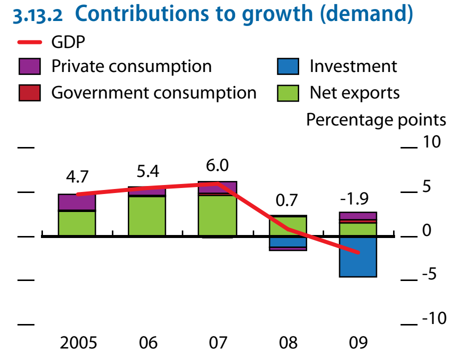
3.13.2 Contributions to growth (demand)



Sources: Directorate General of Budget, Accounting and Statistics. http://eng.dgbas.gov.tw (accessed 8 March 2010); ADB estimates.

Click here for figure data

This chapter was written by Akiko Terada-Hagiwara of the Economics and Research Department, ADB, Manila.

Manufacturing production (27% of GDP) slumped early in 2009 as export orders dwindled, and was down by 4.6% for the year. The pace of contraction later slowed, and manufacturing rebounded in the fourth quarter (Figure 3.13.3) along with exports.

Construction activity contracted by 6.7%. The services sector was virtually flat in 2009, with trade-oriented and transportation activities slack. Agriculture, too, put in a poor performance—production fell by 3.1% owing to bad weather. Typhoon Morakot, which hit the island in August 2009, left more than 700 people dead or missing and inflicted damage to agriculture and infrastructure.

The fall in merchandise exports, at just over 20% in US dollar terms for the full year, was the sharpest in more than 2 decades. External demand slumped for a wide range of exports—chemicals, electronics, machinery, optical products, plastics, and others.

Imports fell even more steeply, by 27%, reflecting the slide in exports (which use a high proportion of imported materials), slack demand for imported capital equipment, and lower prices for imported oil and commodities. By the fourth quarter of 2009, exports were growing again year on year, driven by a 46% surge in shipments to the People's Republic of China (PRC), whose expansion was benefiting from an aggressive fiscal and monetary stimulus.

The current account surplus rose to the equivalent of 11.2% of GDP, buttressed by a larger surplus in goods trade (as imports plunged), an uncommon surplus in services trade (freight payments for imports fell), and a surplus in the income account (including repatriated profits and dividends).

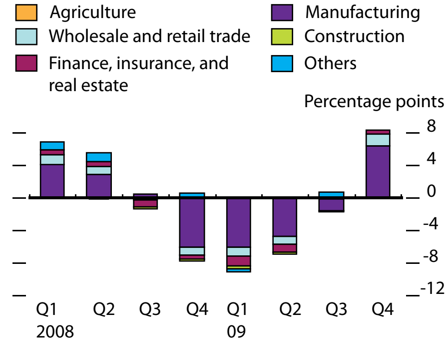
Inbound portfolio investment surged, to an extent that the monetary authorities expressed concerns about the speculative nature of these inflows. Residents' portfolio investment abroad was also substantial. Large net inflows totaling US$14 billion in the financial account (after 3 years of net outflows) were mainly attributable to an increase in withdrawals of overseas deposits by the private sector. The overall balance of payments recorded a very large surplus of US$54.1 billion, and gross international reserves grew to US$348.2 billion, to nearly three times as high as in 2001.

Consumer prices fell in 2009, owing to a large output gap and lower global oil and commodity prices. The consumer price index declined by 0.9% on a year-average basis. The pace of decline eased late in the year (Figure 3.13.4) owing to rising oil and commodity prices.

During the depths of the slump, the monetary authorities lowered the policy interest rate by a total of 238 basis points, to 1.25%, between September 2008 and February 2009. Broad money supply (M2) grew by 7.0% on average in 2009, but demand for credit contracted from March through December (Figure 3.13.5).

Fiscal stimulus measures deployed to combat the weakness in domestic demand included shopping vouchers for all citizens, cash transfers to low-income families, subsidies for car purchases, tax breaks, and a public infrastructure program to cost about US$16 billion over 4 years. Higher spending and weakness in revenue led to a budget deficit equal to 1.1% of GDP.

3.13.3 Contributions to growth (supply)



Sources: Directorate General of Budget, Accounting and Statistics. http://eng.dgbas.gov.tw (accessed 8 March 2010); ADB estimates.

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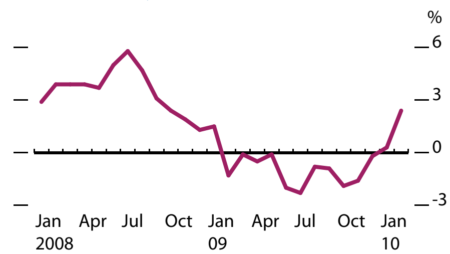
3.13.4 Monthly inflation



Source: CEIC Data Company (accessed 1 April 2010).

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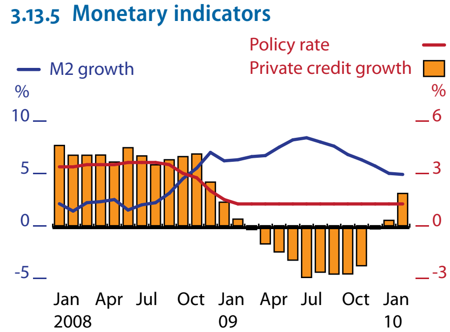
3.13.5 Monetary indicators



Source: CEIC Data Company (accessed 1 April 2010).

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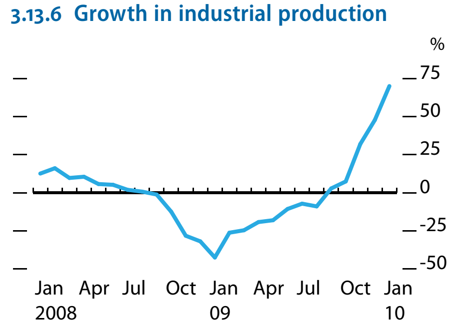
3.13.6 Growth in industrial production



Source: CEIC Data Company (accessed 1 April 2010).

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Economic prospects

Just as the slump in global trade sent reverberations through this economy in 2008 and 2009, the trade upturn that is expected to continue over the next 2 years will have positive spillover effects economywide, buoying consumption and investment.

Rising export orders propelled both industrial production and exports early in 2010 (Figures 3.13.6 and 3.13.7), though from a low base in the prior-year period. Strengthening global markets and the launch of new electronic products are expected to support export growth this year. So will improving economic links with the PRC (whose GDP is forecast to expand by nearly 10%). The PRC and Hong Kong, China together account for about 40% of Taipei,China's exports. Furthermore, economic growth in Southeast Asia, which accounts for 15% of exports, is forecast to accelerate sharply this year, and that subregion's overall imports are projected to jump by 20%.

The public infrastructure program will also support economic growth. About US$5 billion of the program's funds are allocated for this year. In addition, reconstruction work for areas hit by Typhoon Morakot in 2009 will add about NT$50 billion (US$1.5 billion) to public investment this year. Fiscal measures to stimulate consumption, though, largely expired in 2009. A fiscal deficit equal to 1.4% is projected for 2010.

Leading indicators of the economy have been broadly trending up. Domestic inventories of manufactured products bottomed in August 2009 and both export orders and permits for construction rose from early last year (Figure 3.13.8). Exporters are expected to ramp up fixed investment provided the rebound in export orders is sustained. Private fixed investment is projected to be a key driver of growth in 2010

Consumer confidence, too, strengthened headed into 2010 (Figure 3.13.9), assisted the pickup in the labor market and generally improved outlook for the economy. Gains in asset markets have contributed to the more positive outlook—stock prices rallied by 86% from the 2009 low point through March 2010, and Taipei city house prices rose by 20% year on year in February 2010. Private consumption is expected to grow this year but only moderately, constrained by relatively high unemployment and slight growth in wages.

Taking these influences into account, GDP is projected to increase by 4.9% this year (Figure 3.13.10) and by 4.0% in 2011 (as the low-base effect ends and the PRC's growth moderates).

Higher prices for imported oil and commodities, coupled with strengthening domestic demand and a firmer labor market, will revive inflation this year and next, but to low rates of about 1.5% (Figure 3.13.11), The consumer price index rose by an average of 1.3% in the first 2 months of 2010. As economic growth gathers pace and inflation edges up, the expansionary monetary stance adopted during the global financial crisis is expected to be withdrawn gradually. As a step in this direction, the monetary authorities increased issuance of certificates of deposit in the first quarter of 2010 to absorb excess liquidity from the financial system.

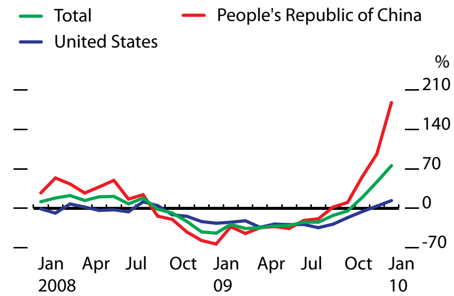
Merchandise exports in US dollar terms are forecast to increase by nearly 20% this year. Imports will rise faster than that, by a forecast 26.5%, driven by the rebound in export industries and their investment,

3.13.1 Selected economic indicators (%)

	2010	2011
GDP growth	4.9	4.0
Inflation	1.5	1.6
Current account balance (share of GDP)	8.2	6.7

Source: ADB estimates.

3.13.7 Merchandise export growth, by destination



Source: CEIC Data Company (accessed 1 April 2010).

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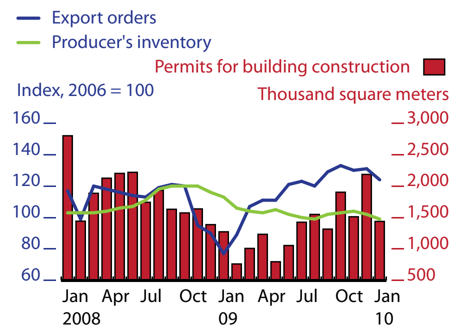
3.13.8 Leading indicators



Source: CEIC Data Company (accessed 1 April 2010).

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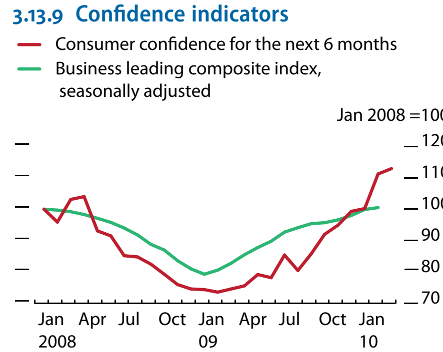
3.13.9 Confidence indicators



Source: CEIC Data Company (accessed 1 April 2010).

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as well as higher oil and commodity prices. The current account surplus is seen at a touch over 8% of GDP in 2010, declining to a little under 7% next year.

Development challenges

Closer trade and investment links have been forged with the PRC in recent years. Annual trade between the two economies has increased to about US$100 billion, and the PRC's share of Taipei,China's exports rose from less than 3% in 2000 to 26% in 2008, or 40% taking Hong Kong, China into account. (The share of exports going to Europe, Japan, and the United States declined in this time.)

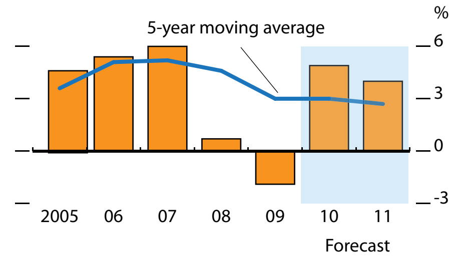
Companies from Taipei,China have invested at least US$80 billion in the PRC over the past couple of decades (some estimates are substantially higher), relocating production of electronic components, computers, and optical products to take advantage of lower costs in the PRC.

The challenge now is to broaden and deepen the economic ties. Cross-strait negotiators have reached several agreements in the past 2 years, covering areas such as financial cooperation and transport. However, the direct economic impact of these agreements has been limited so far.

Negotiators from both sides are now working on an Economic Cooperation Framework Agreement. This pact could include reductions in tariffs (on selected items to start) and in other trade barriers, investment protection measures, protection of intellectual property rights, and a mechanism for dispute mediation. Cooperation has been proposed in industries including solar energy and automobiles.

Successful conclusion of the agreement would facilitate trade and investment between the two economies and could pave the way for Taipei,China to be able to negotiate trade pacts with other economies. Taipei,China is likely to face heightened competition in the PRC market unless it gains some trade concessions there, since a free trade agreement between the Association of Southeast Asian Nations and the PRC came into force on 1 January this year.

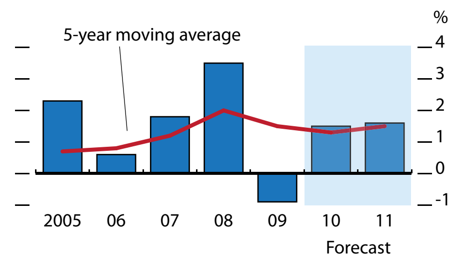
3.13.10 GDP growth



Sources: Directorate General of Budget, Accounting and Statistics. http://eng.dgbas.gov.tw (accessed 8 March 2010); ADB estimates.

Click here for figure data

3.13.11 Inflation



Sources: Directorate General of Budget, Accounting and Statistics. http://eng.dgbas.gov.tw (accessed 8 March 2010); ADB estimates.

Click here for figure data