

# East Asia

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



# People's Republic of China

Economic growth exceeded 10% for a fourth consecutive year, driven by strong investment. A gradual tightening in monetary policy and the use of administrative tools moderated investment growth in the second half of the year. In 2007 and 2008, softer external demand and policy curbs are expected to pull growth down gradually. In the short run, the Government is likely to restrict investment growth and cool the economy. In the medium to long-term, the aim is to achieve a more balanced and inclusive economy, dependent less on exports, investment, and industry, and more on private consumption and services. This evolution will probably mean lower GDP growth rates.

## Economic performance

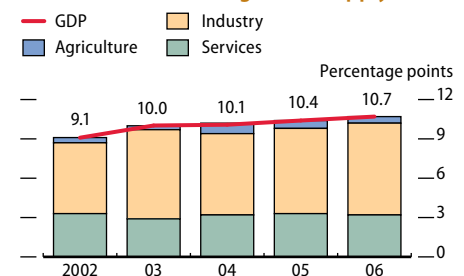
The People's Republic of China (PRC) recorded a strong economic performance in the first year of its 11th Five-Year Program. GDP in 2006 grew by 10.7%, a 10-year high and a fourth year of double-digit growth. Concerned about overheating in some sectors, the Government imposed restrictions that slowed growth modestly, from 11.5% in the second quarter to 10.4% in the fourth.

Industry, including manufacturing and construction, contributed 7.0 percentage points, or 65% of total GDP growth, and services another 3.2 percentage points, or 30% (Figure 2.8.1). Agriculture made a minor contribution. On the demand side, the economy continued to be driven by strong investment, which contributed 4.4 percentage points, or 41% of total GDP growth (Figure 2.8.2). As the contribution of net exports declined to 21% in 2006, that of total consumption edged up to 38%. Private consumption grew robustly, but by less than GDP growth.

Investment surged in the first half of 2006 as a result of accelerating urbanization, the drive of local governments (which have incentives to push growth through investment), and excess liquidity (which made access to credit easy for some firms). As the Government's efforts to cool the economy took effect, the growth of fixed asset investment slowed from about 30% in the first half of the year to 21% in the second (in nominal terms). Investment slowed sharply in industries that have built excess production capacity, such as textiles, coal mining, and electricity (Figure 2.8.3).

The relationship between investment and industry is key to understanding the PRC's growth acceleration. Certainly, growth was helped by economic reforms that made labor and capital more productive, and by a favorable global environment. However, the reinvestment of large profits into new industrial activity was perhaps the most important driver. Higher investment allows more capital deepening, which in turn increases labor productivity and potential GDP. Profits of industrial enterprises grew faster than industrial value added for much of last year, which indicates a decline in the share of wages in GDP. This, together

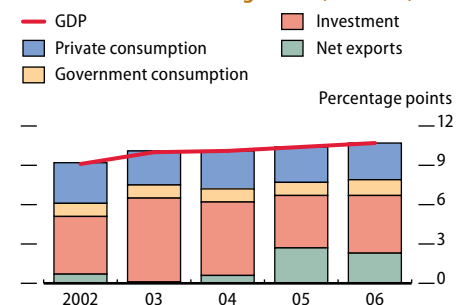
### 2.8.1 Contributions to growth (supply)



Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

### 2.8.2 Contributions to growth (demand)



Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

with low inflation and impressive productivity gains, helped keep the growth of unit labor costs under control. The gap between growth in nominal industrial profits and nominal industrial value added widened from 3.1 percentage points in the first 5 months of 2006 to 7.8 percentage points in the 11 months to November (Figure 2.8.4), encouraging companies to lift investment.

Faster growth in exports than imports (Figure 2.8.5) boosted the trade surplus by \$60 billion to \$194 billion in 2006. Bilateral surpluses with the United States (US) and European Union (EU) surged, while the deficit with the rest of Asia continued to widen. This is consistent with the growth of supply chains, where manufacturing plants in the PRC import intermediate inputs from the rest of Asia. (See also *Uncoupling Asia: Myth or reality* in Part 1.) Processing trade, which involves the assembly and export of imported intermediate items (with most inputs exempted from customs tariffs), is the largest contributor to the trade surplus (Figure 2.8.6).

The surge in the trade surplus, coupled with higher tourism receipts and interest income on the large official foreign reserves, boosted the current account surplus to around \$227 billion, equivalent to 8.6% of GDP. Foreign direct investment for the year totaled \$69.5 billion. Besides these inflows, short-term speculative capital flowed into property and stock markets. Foreign exchange reserves reached \$1.07 trillion by year-end (Figure 2.8.7), prompting discussions on how to use reserves more efficiently, and calls from some trading partners for faster appreciation of the yuan. In a move to liberalize the capital account, a pilot program was introduced to allow PRC residents to purchase foreign securities through the Qualified Domestic Institutional Investors plan.

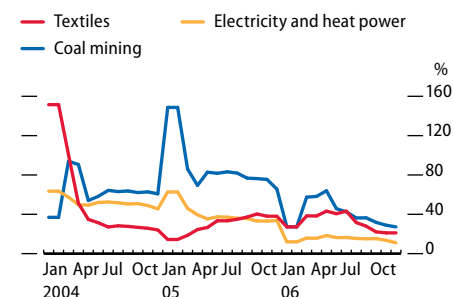
About 11.8 million new jobs were created in urban areas last year, well above target. The private sector and small and medium enterprises generated about 80% of these jobs, mainly in manufacturing, construction, and services. But millions of migrants from the countryside, new graduates, and laid-off workers still went without work. The National Development and Reform Commission estimated at the beginning of the year that urban areas needed about 25 million new jobs in 2006 to absorb all newcomers to the labor market.

The overall fiscal deficit narrowed to an estimated 0.4% of GDP. Revenues rose by 24.3%, helped by gains in incomes and rising corporate profits. Expenditures also rose rapidly, by 18.5%. Given buoyant private investment, the Government reduced its issuance of special treasury bonds used to finance public investment, from the equivalent of about \$10 billion in 2005 to \$7.4 billion in 2006.

As a result of the excess capacity in some industries and strong competition in manufactured products, inflation slowed to 1.5% in 2006. Late in the year, though, food prices accelerated, reflecting a sharp rise in global grain prices. Housing prices in several big cities grew rapidly because of excessive liquidity, speculation, and some structural imbalances in housing supply.

Worried about possible overheating, the Government took several steps to curb credit expansion and to slow investment. The People's Bank of China, the central bank, tightened credit five times, with increases in commercial banks' reserve-requirement ratio, beginning in mid-2006 and

### 2.8.3 Growth of investment, selected industries

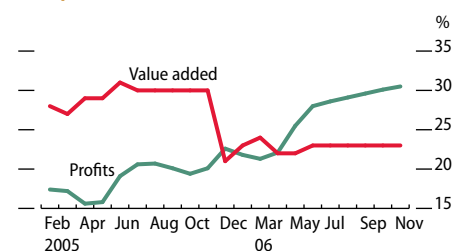


Note: Heat power refers to hot water and steam for city heating systems.

Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

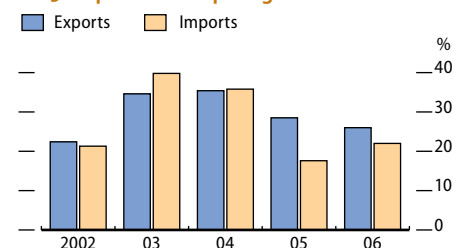
### 2.8.4 Growth of industrial value added and profits



Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

### 2.8.5 Export and import growth



Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

running through February 2007, from 7.5% to 10.0% (Figure 2.8.8); and three hikes in the benchmark 1-year lending rate through March 2007, from 5.58% to 6.39% (Figure 2.8.9).

Commercial banks with the highest growth in lending were required to purchase special central bank bills at below market interest rates. These measures moderated growth in domestic credit, but actual lending and broad money increased faster than targets set by the central bank at the beginning of 2006. To ease upward pressure on the yuan from the surging trade surplus and strong capital inflows, the authorities allowed a slightly faster appreciation of the currency in nominal terms (2.4% against the US dollar in the second half compared with 0.9% in the first; Figure 2.8.10). The real effective exchange rate depreciated by 1.6% over the year, indicating that PRC goods became more price competitive.

The stock market expanded significantly in 2006, with major domestic banks among companies to sell shares to the public. Share prices climbed (Figure 2.8.11), underpinned by strong economic expansion, high liquidity levels, and the conversion of nontradable, state-owned shares into tradable shares.

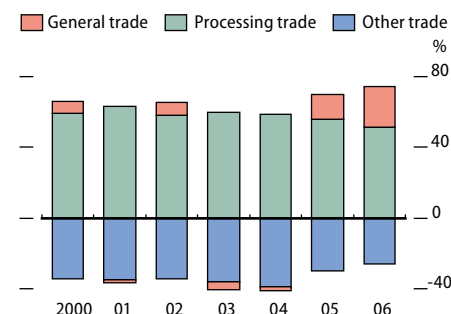
## Economic prospects

Rapid GDP growth in 2006 set a high starting point for the 11th Five-Year Program (2006–2010), which has an indicative average annual growth of 7.5% for the period. This implies that overall macroeconomic policy should tighten in 2007. The projections assume that the authorities will keep the fiscal deficit below 1.0% of GDP. Also, it is assumed that the central bank will continue its current monetary policy stance by using interest rates, the reserve ratio, and open-market operations. Likewise, with rising profit growth and ample liquidity in the system, it is assumed that investment will again grow at a fast rate (although not at the 2006 pace) and will remain the main driver of growth. In the meantime, reforms will be implemented that, in the medium to long term, may have an impact on the structure of the economy.

Economic growth is projected to moderate in 2007 and in 2008, but will remain close to 10%, far from the indicative program target (Figure 2.8.12). Industrial growth is forecast to slow to 11.0% in 2007 and to 10.8% in 2008, from about 12% in the past 2 years, because of: significant oversupply in some sectors; slower growth in investment as a result of the tightening measures; and easing export growth caused by softer external markets. Agriculture is expected to benefit from a new official emphasis on rural development. Assuming no serious weather problems, agricultural production is projected to increase by 5.2–5.4% in the next 2 years, accelerating from an average of about 4% growth over the past half decade. Services are expected to grow by 10.4–10.5% (10.3% last year), supported by government efforts to promote consumption as well as expenditures associated with the Olympic Games in 2008.

Responding to various restrictions, especially those targeted at energy use and pollution, and others curbing property speculation, fixed investment growth is projected to moderate to 20%. It will be important that efforts be made to improve the efficiency of investment, so that a

### 2.8.6 Shares of trade

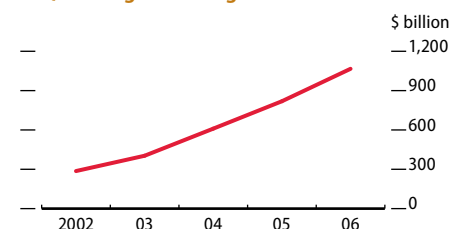


Note: General trade refers to the import or export of goods by enterprises with import-export rights.

Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

### 2.8.7 Foreign exchange reserves



Source: National Bureau of Statistics.

[Click here for figure data](#)

### 2.8.1 Selected economic indicators

	2007	2008
GDP growth	10.0	9.8
Inflation	1.8	2.2
Current account balance (% of GDP)	8.8	8.9

Source: Staff estimates.

given investment share can translate into a higher growth rate of capital accumulation.

Public investment will increase in priority areas including agriculture, education, and health: rural areas will get a larger share of infrastructure spending; schools fees will be eliminated up to the end of junior high school; and spending on health care will increase this year by 87%, and a medical insurance program launched in 2003 is expected to be extended to cover 80% of rural areas. These measures should support rural development and stimulate services. Private consumption will grow, reflecting projected increases in both urban and rural incomes, the latter assisted by government spending in rural areas and grain price guarantees. Retail sales have already risen by 14.7% in the first 2 months of 2007, up from a 12.5% pace in the year-earlier period, a sign of stronger consumer demand.

The softening in export markets and a reduction in PRC tax rebates for exports are expected to reduce the growth of merchandise exports to 18% in 2007, from 26% last year. Import growth will ease to about 18% (versus 22%) as investment decelerates. The large export base and the moderation in import growth suggest that the trade surplus in goods will climb to about \$257 billion by 2008. Trade in services will remain in deficit, but the surplus in the income account is likely to increase sharply, reflecting earnings from accumulating foreign exchange reserves. Consequently, the current account surplus will rise further (Figure 2.8.13).

The acceleration in food prices late last year is not expected to continue through 2007, in part because the push on rural development is encouraging the planting of grain. Inflation will pick up, though, to about 1.8% in 2007 and 2.2% in 2008 (Figure 2.8.14), because of expected rises in labor costs (as a result of substantial productivity increases) and higher prices of water, electricity, and fuel. In the first 2 months of this year the consumer price index rose by 2.4%.

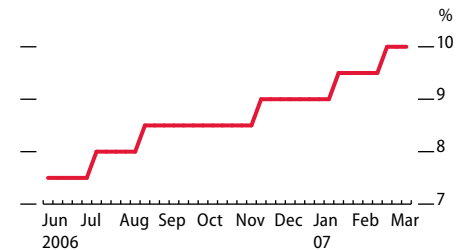
Domestic risks and uncertainties stem from two sources. First, if local governments do not fully respond to the central Government's restrictive measures—and they have not done in the past several years—GDP growth could surpass the above forecasts. (Urban fixed asset investment rose by 23.4% in the first 2 months of 2007, down slightly from the year-earlier pace.) Should investment continue to run at more than 20% a year, what has been a source of growth for many years could turn out to be a curse, if it leads to a further buildup in excess capacity and deflation.

Indeed, the combination of sometimes inefficient investment, overcapacity, and falling prices would erode profitability. To prevent this, the Government would need to step up its use of administrative measures to curb investment. Conversely, if all the measures to rein in growth are successfully implemented, GDP growth in 2007–2008 could slow more sharply, to about 9%. The main risk on inflation is that the Government may increase prices for administered utilities and services at a faster pace than anticipated, which would push inflation above forecast levels.

Over the medium term (2007–2011), GDP growth is expected to average about 9%. Inflation during this period will be higher than it is now, but probably less than 3% on average.

Several factors underpin the medium-term projections. The PRC will

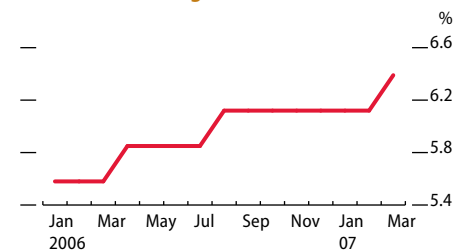
#### 2.8.8 Bank reserve-requirement ratio



Source: People's Bank of China.

[Click here for figure data](#)

#### 2.8.9 Base lending rate

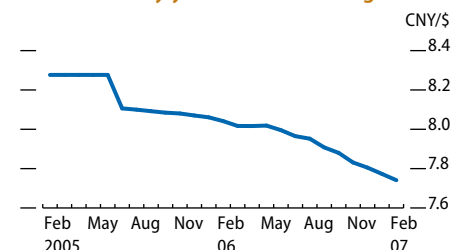


Note: One year rate for working capital.

Source: CEIC Data Company Ltd., downloaded 20 March 2007.

[Click here for figure data](#)

#### 2.8.10 Monthly yuan-dollar exchange rate



Source: CEIC Data Company Ltd., downloaded 8 March 2007.

[Click here for figure data](#)



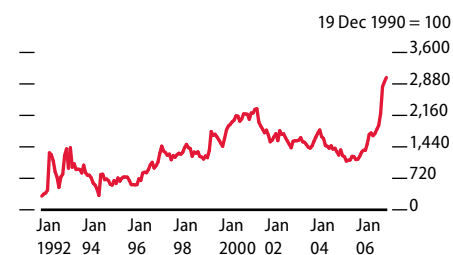
be industrializing rapidly for some time to come, so that investment will continue to support high levels of growth. The trend toward urbanization will also continue, which requires rapid development of urban infrastructure and housing. In the context of wide gaps in incomes and in development between urban and rural areas, the Government plans to promote the laggards rather than hinder the leaders. Moreover, large numbers of unemployed and underemployed people mean that pressure will be maintained on the authorities for many years to generate jobs, which requires high rates of economic growth. Finally, rising imports of technology, improved domestic productivity, and flows of foreign direct investment and other capital, support these imperatives for rapid economic expansion.

Further support will come from efforts being made to create the legal and regulatory structure that underpins development of a market-based economy. The third national financial work conference, held in January 2007, outlined a raft of financial reforms. To increase access to finance in rural areas, the China Banking Regulatory Commission issued rules to encourage private sector participation in rural finance, a change that will be first tried in five provinces. This move aims to address funding restrictions faced by farmers, who have little access to bank loans and generate only 15% of total bank loans and deposits. The conference also set plans for the PRC's three policy banks to open commercial operations so that they base lending decisions on commercial grounds. And it discussed management of the country's huge foreign exchange reserves.

In March, the Ministry of Finance announced that a foreign exchange investment corporation would be established to allocate a portion for strategic investments (e.g., international equity markets, natural resources, and as foreign direct investment). Although the portion of the reserves that could be managed this way was not determined, initial estimates indicate that a sizable amount could be transferred to the new corporation in phases. More active management of the reserves aims to increase returns. Independent estimates put at about 3% the central bank's return in 2006 on its reserves (the majority of which is invested in dollar-denominated instruments, mostly US treasury bonds). (See also Box 1.1.2 in Part 1.)

In other policy developments early in 2007, the Government decided to unify corporate tax rates paid by local and overseas enterprises, at a 25% rate from January 2008. Previously, domestic firms were taxed at up to 33% while foreign companies paid 15%. The National People's Congress in March passed a new property law (to come into effect in October 2007), following a change in the PRC constitution in 2004 to protect private property rights. The new law reassures the growing middle class that its assets (mainly houses) are secure. However, it does not give small farmers marketable ownership rights, nor does it allow them to use land as collateral to borrow and invest, which is what would help boost productivity in the countryside. Moreover, the state retains the right to appropriate farm land. Farmers do, though, get the right to renew land-use leases as they expire. (Rural land is "collectively owned" in the PRC and farmers are given 30-year leases.)

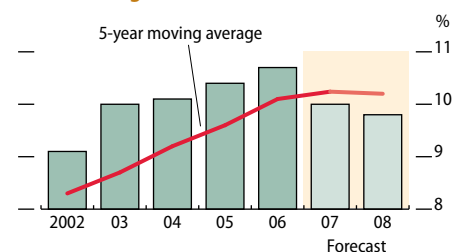
#### 2.8.11 Shanghai stock exchange index, A-share



Source: CEIC Data Company Ltd., downloaded 8 March 2007.

[Click here for figure data](#)

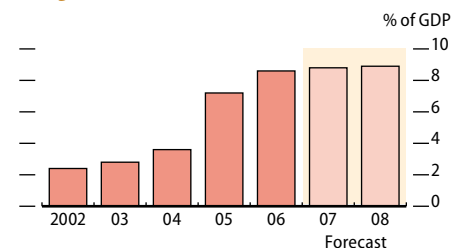
#### 2.8.12 GDP growth



Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

#### 2.8.13 Current account balance



Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

## Development challenges

Four years of double-digit growth, rising government revenues, low inflation, and a manageable public deficit would be cause for celebration in most countries. In the PRC, this record has raised some concerns. The authorities believe that the economy can continue growing, but are aware that a number of corrections are necessary, in particular an overheated investment sector.

Efforts to cool the economy in the past 3 years have relied heavily on increases in bank reserve requirements and some increases in interest rates. But monetary policy, and in general the use of macro stabilization instruments, does not have the same impact in this economy as in a full market economy. Much of the PRC's bank lending is in the hands of autonomous local bank branches.

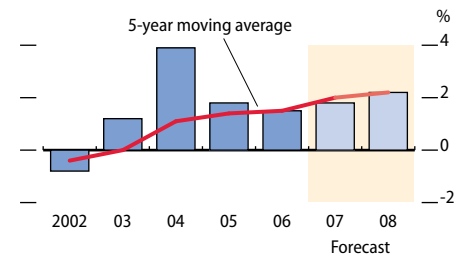
The most direct way for the authorities to control investment is by deciding what investments to approve on a case-by-case basis. Thus, while central planners were finally able to reduce the growth of investment toward end-2006, bank lending still grew at a rapid rate. This has resulted in an excess of bank-funded liquidity that is spilling over into the financial system. Under current methods, the only mechanism available is to continue using administrative measures, and perhaps extend them to the financial system to deal with excesses.

The need to rebalance the economy by reducing the emphasis on investment and export-led growth while lifting private consumption is embraced by the 11th Five-Year Program. Policy makers view economic rebalancing as not just an economic objective, but as part of an overall strategy to achieve “social justice.” Since 2004, the Government has advanced a series of strategies to build what it describes as a “harmonious society.” This involves achieving “five balances”—between rural and urban development, interior and coastal development, economic and social development, people and nature, and domestic and international development. The political leadership decided in 2004 to change the growth pattern from investment- and export-led to more consumption-led growth. During 2005 and 2006, policy makers reiterated that improving the quality of economic growth and rebalancing the economy would be a priority in the medium and long term.

Rebalancing implies altering the model followed for decades. This entails, on the demand side, reduced reliance on exports and investment for growth, in favor of private consumption; and on the production side, a shift from industry-led growth to more services-led growth. Policy measures taken in the past 3 years in pursuit of these goals have included raising minimum wages, reducing income taxes, increasing public spending, as well as taking the steps needed to contain rapid growth in investment and promote consumption.

The scorecard shows that limited progress has been made on most fronts. The dependence on external demand for growth is still high. Since the PRC joined the World Trade Organization in 2001, its foreign trade has grown annually at an average rate of more than 20%. External trade as a proportion of GDP rose from about 42% in 2002 to 66% in 2006 (Figure 2.8.15). Large bilateral trade surpluses have sparked more trade friction with the US and EU. Further, the huge trade surpluses, combined with growing surpluses in the capital account, have created a surge in

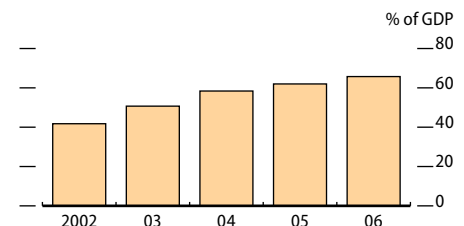
2.8.14 Inflation



Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

2.8.15 External trade



Source: National Bureau of Statistics.

[Click here for figure data](#)

foreign exchange reserves that complicates monetary policy operations and puts pressure on the yuan to appreciate. Currently, the PRC needs to conduct extensive sterilization operations to drain liquidity and prevent the extra money from fueling inflation.

The surge in investment and commercial bank lending has not yet been brought under control. Aside from monetary tightening, the Government has taken administrative steps to restrain investment. These include raising downpayment requirements for housing purchases to curb speculation and sending inspection teams to provinces to check if new investment projects violate land-use and environmental regulations.

But key targets were not met in 2006: fixed asset investment growth was 24% (Figure 2.8.16), while the target was for growth below 18%; broad money (M2) grew by 16.9% (target below 16%); and bank loans rose by CNY3.1 trillion (target less than CNY2.5 trillion). In a further sign of a lack of rebalancing, the share of gross capital formation in expenditure-based GDP rose from 36.3% in 2001 to 45.0% in 2006, while that of consumption (private and public) fell from 61.0% to 51.9% (Figure 2.8.17).

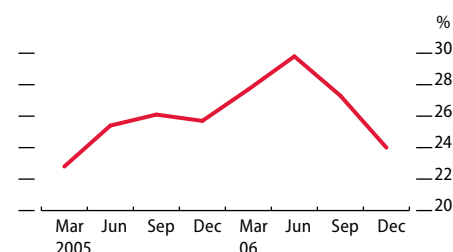
Environmental protection targets were not met either. The Government wanted to reduce energy consumption per unit of GDP by 4% in 2006. The outcome was a decline of just 1.2%. Similarly, there was slippage in achieving an emission reduction target. For example, sulfur dioxide emissions increased by 1.8%. Energy consumption (Figure 2.8.18) and pollution have increased and could become constraints on growth. Although the Government tried to induce local governments and enterprises to improve energy efficiency and cut pollution, these targets were not met.

Furthermore, the share of services in total GDP remains low—it actually fell from 41.7% in 2002 to 39.5% in 2006, lower than in other countries in Asia (Figure 2.8.19). The contribution of services to GDP growth fell from 38.7% in 2001 to 29.7% in 2006, while the contribution of industry rose from 56.3% to 65.2%. The concern is that continued industry-led growth requires more energy and natural resources and puts a heavy burden on the environment, so it may not be sustainable in the longer term.

Income inequalities have worsened. The ratio between urban and rural nominal per capita incomes rose from 2.9:1 in 2001 to 3.3:1 in 2006. Real per capita household income rose by 7.4% in rural areas in 2006, against 10.4% in urban areas. Increasing income inequality impedes the growth of private consumption and adds to social tensions. Unemployment and underemployment have become serious concerns for policy makers.

Restrictive measures involving energy consumption, the environment, and land use are expected to have a greater impact in 2007 and 2008. In this regard, the Ministry of Land and Resources plans to crack down on the use of arable land for construction of buildings, especially for luxury housing and golf courses. Policies on energy conservation and environmental protection have been toughened. The State Environmental Protection Administration (SEPA) has decided to suspend project approvals for any region, sector, or large enterprise if the project violates SEPA's standards on energy consumption and pollution, until action is taken to meet the standards. In the first 2 months of 2007, SEPA

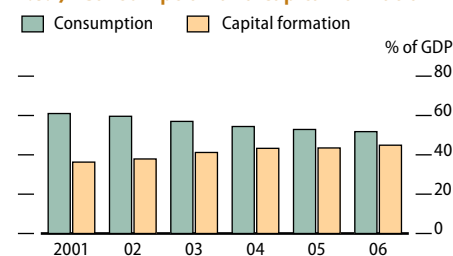
**2.8.16 Growth of fixed asset investment**



Source: CEIC Data Company Ltd., downloaded 20 March 2007.

[Click here for figure data](#)

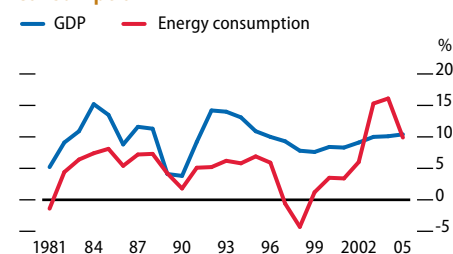
**2.8.17 Consumption and capital formation**



Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)

**2.8.18 Growth in GDP and energy consumption**



Sources: National Bureau of Statistics; staff estimates.

[Click here for figure data](#)



suspended more than 80 construction projects and four cities' rights to approve new projects.

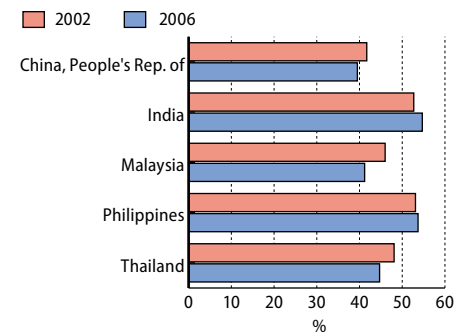
Steps to be taken during the next few years toward rebalancing the economy involve reforms to the social security system—including establishing a minimum living standard in rural areas, similar to that in urban areas. This aims to eradicate absolute poverty (i.e., poor people who live below the official poverty line) in rural areas and help diminish the income gap between rural and urban areas. The Government will spend more on rural areas and less-developed regions.

The authorities have already increased salaries for civil servants, in late 2006, which lifted their purchasing power. Importantly, a plan is being drafted for state-owned enterprises to pay dividends to the state rather than reinvest all their retained earnings. This should impel enterprises to be more selective with their investments and, at the same time, provide financial resources to the state for development of social infrastructure and the social safety net, which is likely to lead to gradually increased consumption spending.

Rebalancing the economy is not easy from the point of view of policy design, implementation, or consequences. It will most likely be associated with lower rates of economic growth over the longer term. An increase in the share of wages in GDP will lead to higher private consumption; but as the increase in the share of wages is mirrored in a decline in the share of profits, this will eventually lead to a decline in investment (potentially larger than the increase in consumption) and, as a consequence, in employment.

A transformation to a more services-oriented economy may bring benefits from the point of view of employment creation (e.g., labor-intensive urban jobs), but services are likely to deliver lower GDP growth rates. The PRC cannot afford this in the short run. One source of growth that should play a more important role in the future is the relocation of labor out of agriculture into activities of higher labor productivity. Given that the share of employment in manufacturing has been decreasing, the services sector will likely have to play a key role in this between-sector transfer. At the same time, growth rates of about 10%, fueled by investment that is leading to overcapacity, and by substantial and growing liquidity in the banking system, pose serious threats to macroeconomic management.

**2.8.19 Share of services in GDP**



Sources: Asian Development Outlook database; staff estimates.

[Click here for figure data](#)

# Hong Kong, China

Above-trend growth was recorded for a third year in a row, supported by domestic and external demand. GDP growth will be trimmed this year and next by the slowing in the economies of the United States (US) and People's Republic of China (PRC), although budget concessions will underpin domestic demand. Medium- to long-term challenges include broadening the tax base, preparing to meet the needs of an aging population, and maintaining high standards of financial infrastructure and regulation as the high-end services sector expands on the strength of closer ties with the PRC.

## Economic performance

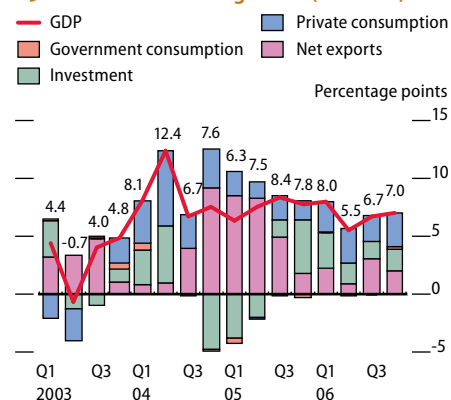
The economy grew robustly by 6.8% in 2006, a third successive year of above-trend growth, on strong support from domestic and external demand. Private consumption (accounting for 52% of GDP) grew by 5.1%, fixed capital investment (23%) grew by 7.9% on the strength of business optimism, and net exports (17.5%) expanded by 12.6%. Government consumption (7.5%) remained restrained.

The generally good year was punctuated by a brief deceleration in the second quarter (April–June; Figure 2.9.1) as trade slowed. Growth bounced back in the third quarter, pulled up by a recovery of exports just ahead of a fourth quarter recovery in the US. Declining oil prices contributed to the recovery of trade, as did booming PRC exports and the falling US dollar. Given that the US and Hong Kong dollars are linked, US dollar depreciation tends to reduce the international price of Hong Kong, China's exports. Corporate investment continued apace, as the economy consolidated its position as a popular entry point for companies doing business in the PRC. Private consumption also was robust in the third quarter. Consumption spending has strengthened over the past 3 years as unemployment has fallen, wages have risen (Figure 2.9.2), and tourism has continued to grow.

The balance of payments surplus grew during the first 3 quarters of 2006, even with a sharp concurrent rise (81.0%) in the merchandise trade deficit (Figure 2.9.3). This spike in the goods trade deficit mostly reflected the slowdown of exports in the second quarter. However, this deficit was small (7.8% of GDP over three quarters) compared with merchandise exports, which amounted to 167% of GDP over the same period.

This reflects the key role of goods reexport in Hong Kong, China, especially from the PRC. In value terms, 90% of exports are reexports. This includes an estimated margin of 17.5% added to goods reexported. The merchandise trade deficit arises because, given the economy's specialization in services (agriculture and industry together accounted for less than 10% of GDP in 2005), it consistently imports more merchandise for domestic consumption than it produces for export. However, net services exports more than compensated for the widening merchandise trade gap, growing by 23.4% and restoring the current account surplus to 9.7% of GDP.

2.9.1 Contributions to growth (demand)



Source: Census and Statistics Department, available: <http://www.censtatd.gov.hk>, downloaded 1 March 2007.

[Click here for figure data](#)

2.9.2 Unemployment and growth in wages



Note: Average pay includes wages, all bonuses, and overtime payments.

Source: Census and Statistics Department, available: <http://www.censtatd.gov.hk>, downloaded 9 March 2007.

[Click here for figure data](#)

Robust net exports of services reflected a significant expansion of financial services. Indeed services (over 90% of GDP) continue to drive growth on the supply side. The development of new financial services with the mainland under the Closer Economic Partnership Arrangement has helped, as has the launch and subsequent expansion of yuan-denominated retail banking services in Hong Kong, China.

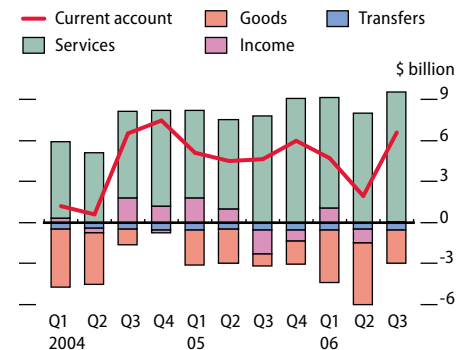
Financial services have also boomed outside retail banking. Initial public offerings (IPOs) have surged—with Hong Kong, China raising more funds through IPOs than the New York Stock Exchange in 2006. Corporate debt issuance is also on an upward trend. Hong Kong, China's sophisticated institutions assist PRC companies that seek access to international financial markets. With a large population in the PRC preparing for retirement, mainland banks are offering a growing array of retirement planning instruments, which are attracting considerable savings. These funds will require management, and financial institutions in Hong Kong, China are well placed to assist.

Thus, the economy is becoming increasingly specialized in high-end services. This is reflected in labor productivity growth rates, which between 2000 and 2005 were particularly high in the communications, international trade, and financial sectors (Figure 2.9.4). Labor market adjustments are apparent in the disaggregated unemployment figures, which, even as they show jobless rates falling for all classes of workers, display disparities by skill level. Only 1.9% of higher-skill workers were unemployed as of January 2007, compared with 4.8% among the lower skilled. The labor market is tightening faster higher up the skill spectrum. However, this tightening did not create inflationary pressures because aggregate labor productivity grew faster than wages in 2000–2006.

After climbing for over 2 years, property prices remained stable through 2006 (Figure 2.9.5), though rents, which usually follow property prices with some lag, continued to rise. With rents rising, inflation edged up, averaging 2.0%. Appreciation of the yuan against the Hong Kong dollar added upward pressure on food prices (Figure 2.9.6), since much food in Hong Kong, China, particularly perishables, is imported from the PRC. Large capital inflows (contributed, in part, by the successful IPOs), and the leveling-out of US interest rates, to which rates in Hong Kong, China are linked, in the latter half of 2006 contributed to liquidity growth (Figure 2.9.7).

Government revenues have grown rapidly on the strength of a strong economic performance since 2003. Accordingly, the budget for FY2007 (ending 31 March 2008) includes both tax cuts and new spending. Particularly noteworthy are: revisions of marginal income tax rates and brackets back down to FY2002 levels, a sizable tax waiver for FY2006 (50% of personal taxes up to a ceiling of HK\$15,000), an additional month's social security payment, a 2-quarter holiday on rates assessed on almost all residential and most nonresidential property, increased tax deductions for education and child-rearing, higher allocations for social expenditures, and commitments to infrastructure development. These provisions are likely to provide a significant boost to demand, while serving to reduce key prices. Private-sector analysts have commented that the measures are affordable and leave room for largesse in future budgets.

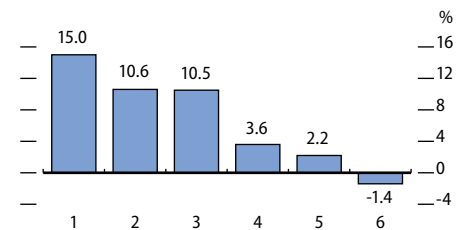
### 2.9.3 Trade and current account



Source: Hong Kong Monetary Authority.

[Click here for figure data](#)

### 2.9.4 Productivity growth in selected services segments



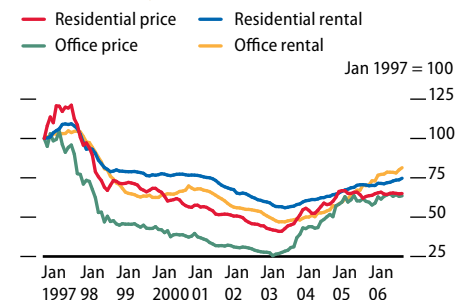
1 = communications; 2 = import and export trade; 3 = financing; 4 = transport and storage (excluding land transport); 5 = wholesale and retail trade; 6 = restaurants and hotels.

Note: Refers to average productivity growth in 2000–2005.

Source: 2006 Economic Background and 2007 Prospects, Government of the Hong Kong Special Administrative Region (2007).

[Click here for figure data](#)

### 2.9.5 Property indexes



Source: Rating and Valuation Department, available: <http://www.rvd.gov.hk>, downloaded 19 February 2007.

[Click here for figure data](#)

## Economic prospects

Given the importance of trade and financial services, the economy's performance depends critically on external conditions. *Asian Development Outlook 2007* expects a slowing of growth rates in the PRC in 2007 and 2008. It is assumed that the US economy will decelerate in 2007, before recovering a bit in 2008. This outlook considers further, mild, and gradual appreciation of the yuan possible. The baseline forecasts assume the yuan will be stable relative to the currencies of Hong Kong, China and the US.

On the basis of these assumptions, growth is expected to slow to 5.4% in 2007 (Figure 2.9.8). Trade expansion will fall as the PRC and US economies decelerate, but domestic spending is expected to strengthen further, with consumer spending supported by the large budget givebacks. The returns to taxpayers amount to about US\$2.6 billion, or 2.3% of consumption spending in 2006. The tightening labor market also supports consumption spending.

At the same time, the growth potential of new services facilitated by closer integration with the PRC will underpin a healthy rate of business investment. However, with trade slowing and domestic demand still healthy, the current account surplus is projected at 9.5% of GDP (Figure 2.9.9).

Budget initiatives will exert downward pressure on prices. The waiver of housing rates for 2 quarters as well as a waiver of public housing fees in February 2007 will arrest any inflationary pressures accruing from housing costs. Other budget concessions will also help, to a lesser extent.

Conversely, the budget (together with the strong domestic demand growth likely to follow) implies some upward price pressure, though in a small open economy heavily dependent on trade this is likely to be mostly felt through the prices of nontraded services. On balance, inflation of 1.6% is expected in 2007 (Figure 2.9.10). It could be slightly higher if the yuan appreciates further against the US dollar.

In 2008, since US interest rates are expected to ease and US economic growth is projected to turn up, trade volumes will grow faster, boosting reexports. Falling US interest rates will be matched in Hong Kong, China. Lower interest rates will limit the likely decrease in domestic spending as the effects of the 2007 budget on consumption fade. The trade deficit will therefore narrow, while GDP growth will slow slightly to 5.2%.

Continued expansion of financial linkages with the PRC will raise services exports. Tourism is likely to keep expanding, assisted by rising incomes in the PRC. The current account surplus is therefore projected to rise, to 11.5% of GDP in 2008. Inflation is likely to rise to 2.3%, as the effects of the FY2007 budget wear off and as monetary conditions loosen.

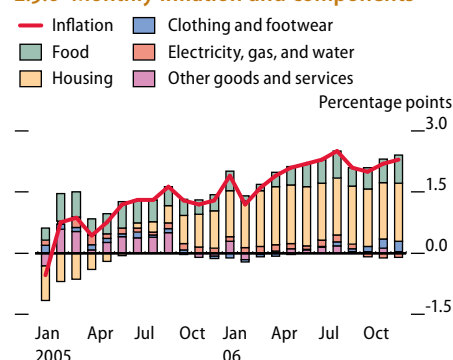
The key risks to this outlook are external. Reexports are volatile, and are very large relative to trade flows and GDP. Trade fluctuations therefore present a significant source of uncertainty for this economy. Moreover, given the loss of manufacturing jobs in North America and Europe, protectionist pressures abroad present a growing cause for concern.

### 2.9.1 Selected economic indicators

	2007	2008
GDP growth	5.4	5.2
Inflation	1.6	2.3
Current account balance (% of GDP)	9.5	11.5

Source: Staff estimates.

### 2.9.6 Monthly inflation and components

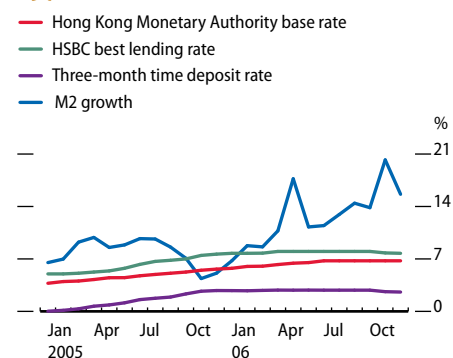


Note: Year-on-year rates of change from October 2005 were estimated using 2004/05-based consumer price indexes (CPIs). For earlier months, the year-on-year rates of change were derived from CPIs with a 1999/2000 base period.

Source: CEIC Data Company, Ltd., downloaded 19 February 2007.

[Click here for figure data](#)

### 2.9.7 Financial indicators



Sources: CEIC Data Company Ltd.; Hong Kong Monetary Authority, available: <http://www.info.gov.hk>; both downloaded 19 February 2007.

[Click here for figure data](#)

## Development challenges

The economy faces several challenges in the medium to long term. The Government obtains much of its revenues from income taxes, charges, and levies tied to property values. These are procyclical, which in an economy subject to externally driven volatility implies fiscal uncertainties. Holding excess reserves to provide assurance against such uncertainties is costly.

The Government wants to broaden the tax base, and launched public consultations in 2006 focusing on a proposal for a Goods and Services Tax (GST). A GST is economically appealing because it minimizes distortions to relative prices needed to raise revenue. However, some retailers opposed the GST, arguing that it might reduce sales and involve compliance costs. Advocates for the poor maintained that a GST would be regressive and would widen the wealth gap. The Government announced in December that while the consultation on the GST continues, it is seeking other ways to broaden the tax base.

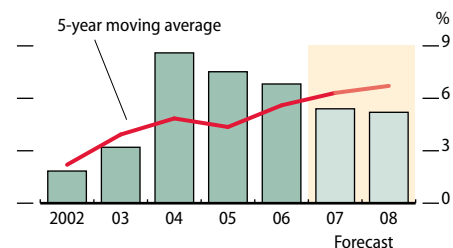
The economy stands to profit substantially from its high-quality institutions for ensuring financial stability and predictability, which facilitates the flow of capital into and out of the PRC. Hong Kong, China's capacity to minimize information asymmetries between players on financial markets is therefore vital. However, as the range of assets traded in its financial markets grows, and becomes increasingly tied to mainland companies that have historically operated to different financial standards, the difficulties associated with ensuring such transparency may increase. Thus ensuring institutional standards in the face of rapid financial development will require considerable effort.

On a related issue, several important markets, including those for basic services such as retailing leave market power concentrated in relatively few hands. Recent moves to liberalize entry into services suggest there will be new competitors from the mainland. This will be helpful, but only if it leads to more autonomous firms in the market, not just a rotation of new players into the market, and old ones out. Thus, the development of competition policies remains a challenge.

Rapid growth in the Pearl River Delta has degraded air quality, and this has led, reportedly, to difficulties in retaining internationally mobile services sector staff. Recognizing the transboundary dimension to this problem, in that many of the emitting plants are outside Hong Kong, China, the governments of Hong Kong, China and Guangdong province have developed a plan and signed agreements to substantially reduce four major air pollutants by 2010.

Finally, Hong Kong, China has an aging population, and must prepare for a surge in retirements. It has a mandatory pension fund that is well resourced and privately managed. This will help finance retirement expenses. However, health care presents concerns. The International Monetary Fund reports that 82% of in-patient and 46% of out-patient care is publicly funded. Thus fiscal pressure looms as the population ages. Discussions are under way on mechanisms to limit public health-care liabilities by encouraging potentially subsidized private insurance, especially for catastrophic incidents. Needless to say, to the extent that costs will be shifted to those about to retire, tensions will rise.

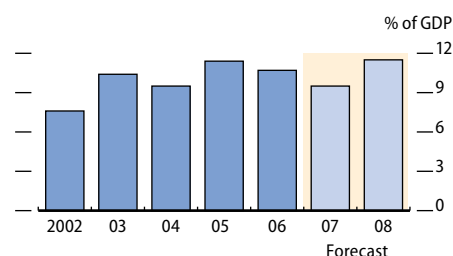
2.9.8 GDP growth



Sources: Census and Statistics Department, available: <http://www.censtatd.gov.hk>, downloaded 1 March 2007; staff estimates.

[Click here for figure data](#)

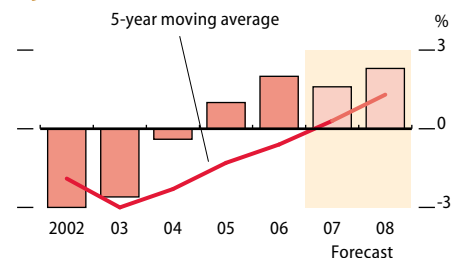
2.9.9 Current account balance



Sources: Hong Kong Monetary Authority; staff estimates.

[Click here for figure data](#)

2.9.10 Inflation



Sources: Census and Statistics Department, available: <http://www.censtatd.gov.hk>, downloaded 8 March 2007; staff estimates.

[Click here for figure data](#)



# Republic of Korea

Growth accelerated to its fastest rate in 4 years in 2006, spurred by a recovery in domestic demand and strong exports, though momentum slowed over the course of the year. In 2007, a continued expansion in investment, particularly in manufacturing, and a recovery in construction are likely to underpin a rebound in domestic demand over the year. The strength of the rebound will depend on a continued recovery in consumption. Growth in exports is likely to ease, trimming the expansion in GDP for the whole year. Structural reforms at the moment are incomplete, particularly in services, capping growth potential.

## Economic performance

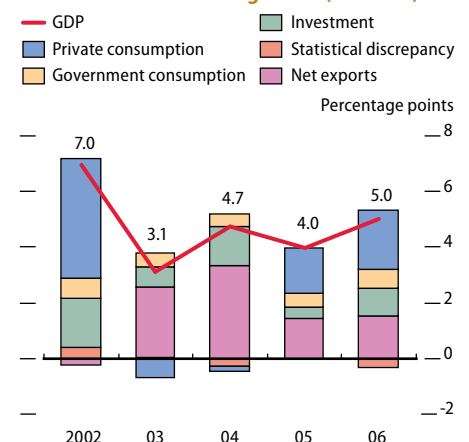
GDP grew by 5.0% in 2006 in the Republic of Korea (hereafter Korea), a marked improvement from the prior year's 4.0%. This outturn masks, though, decelerating momentum over the course of the year amid some softening in growth of both exports and domestic consumption. Quarterly GDP growth rates slid from 6.1% (year on year) in the first quarter to 4.0% in the fourth. After peaking in the first quarter, industrial production eased and inventories accumulated. A cooling in the housing market early in the year hurt construction investment and consumption spending throughout the summer months. Although buoyant exports continued to support a recovery in nonconstruction investment, domestic demand weakened over the year as a whole.

Private consumption posted healthy growth of 4.2% in 2006, the highest rate since the credit card crisis in 2003, when a sharp increase in card issuance resulted in a surge in household debt and a subsequent spending slump. Here too, quarterly growth rates slipped over the year, partly because of a renewed buildup in household debt. Despite extensive government efforts to cool a buoyant residential property market, house prices accelerated in the second half of the year. This resurgence, in an environment of relatively low interest rates and ample liquidity, prompted households to borrow more to finance home purchases. Household debt rose to nearly 67% of GDP by September 2006, from 65% in 2005, and is up sharply from about 40% a decade ago.

The economic recovery broadened with a pickup in capital investment. Capital spending increased by 3.2%, despite a shrinkage in construction investment in the first half of the year. Rising house prices lifted construction in the second half. Corporate spending on machinery and equipment made a steady recovery, increasing by 7.5% during the year. Total investment contributed 1.0 percentage point to overall GDP growth (Figure 2.10.1). Given that many large companies are export-oriented, robust export performance and strong balance sheets augur well for a continued investment recovery.

Merchandise exports rose by 14.4% in nominal US dollar terms in 2006, in the face of a strengthening won, a muted recovery in global

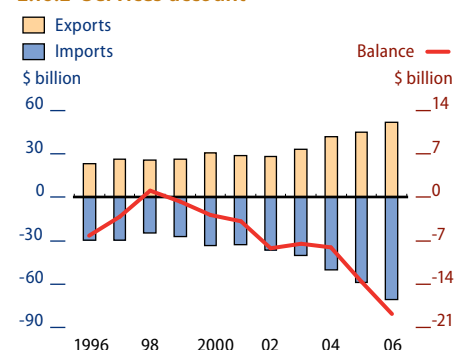
### 2.10.1 Contributions to growth (demand)



Source: Bank of Korea, Economic Statistics System, available: [http://ecos.bok.or.kr/ElIndex\\_en.jsp](http://ecos.bok.or.kr/ElIndex_en.jsp), downloaded 26 January 2007.

[Click here for figure data](#)

### 2.10.2 Services account



Source: Bank of Korea, Economic Statistics System, available: [http://ecos.bok.or.kr/ElIndex\\_en.jsp](http://ecos.bok.or.kr/ElIndex_en.jsp), downloaded 18 February 2007.

[Click here for figure data](#)

information technology activity, and high oil prices. Automobiles, consumer electronics, semiconductors, and ships continued to lead Korea's exports. Generally benign external demand conditions and improved large-company competitiveness underpinned the robust export performance in these industries. Even faster growth in imports (up 18.4%) compressed the trade surplus. High prices for oil and raw materials lifted the import bill in most of 2006, though signs of moderation appeared in the fourth quarter. Merchandise trade still posted a significant surplus, but it was largely offset by a widening gap in services trade. The services deficit more than doubled between 2004 and 2006, to \$18.8 billion, as more Koreans opted for overseas education, vacations, and other services (Figure 2.10.2). Productivity growth in a number of domestic services has stagnated (Figure 2.10.3), in part owing to a pervasive public-sector presence in the sector and also to restrictions on international firms operating in some services areas, which limits competition.

The pickup in economic growth led to some strengthening of the labor market, and for the year unemployment averaged 3.5%, down from 3.7% in 2005. Average monthly earnings rose by 2.6%. However, while 2006 saw 295,000 new jobs, the economy is generally sluggish at creating employment, even during upturns. Rising labor costs have encouraged manufacturers to relocate production overseas or to outsource parts of their production to countries with cheaper labor.

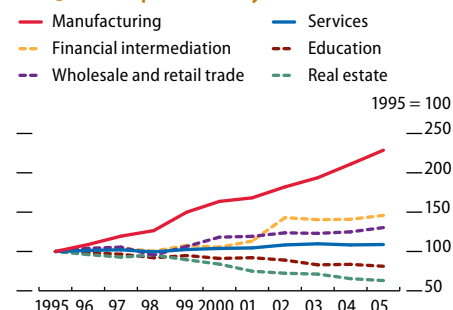
Another barrier to creating more jobs is structural rigidity in the labor market. After years of labor union action, employees in jobs classified as permanent positions have gained strong legal protection for job security, improved working conditions, and higher wages. Employers increasingly have turned to workers they can hire on fixed-term contracts, often at lower overall compensation. Government efforts to contain the trend toward fixed-term employment could result in companies being more reluctant to hire, unless permanent workers agree to give up some of their existing benefits.

Consumer price inflation decelerated by a half percentage point to 2.2% in 2006. The easing of global oil prices from their peaks in 2006 and a stabilizing of food prices helped, and monetary tightening over 2 years also took effect. The won appreciated against both the US dollar and the yen from already strong levels, also helping keep a lid on inflation (Figure 2.10.4). Surpluses in both the current and capital accounts have underpinned the currency's strength. Despite significant capital outflows of portfolio investment, the capital account posted a large surplus due to a sharp increase in short-term borrowing by banks for the purposes of export industries' currency hedging. The pressure on the currency to appreciate appears to be easing though, as export growth moderates and as Koreans are allowed to invest more overseas.

## Economic prospects

Growth is expected to pick up again from late-2006 levels on the back of a steady increase in investment and continuing support from exports, as well as a gradual consumption recovery in 2007. Although annual growth is projected to slow to 4.5% (Figure 2.10.5), quarterly economic performance is likely to accelerate over the year. The recovery will

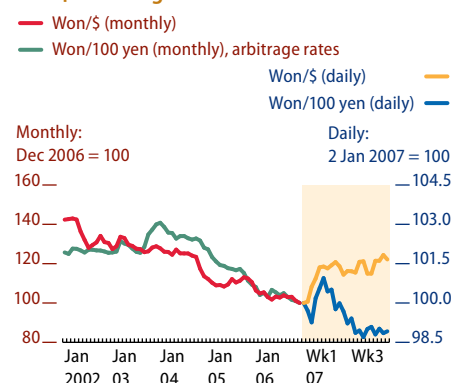
### 2.10.3 Labor productivity



Source: Staff estimates based on employment data from International Labour Organization and gross value added from Bank of Korea.

[Click here for figure data](#)

### 2.10.4 Exchange rate index



Source: Bank of Korea, Economic Statistics System, available: [http://ecos.bok.or.kr/EIndex\\_en.jsp](http://ecos.bok.or.kr/EIndex_en.jsp), downloaded 6 February 2007.

[Click here for figure data](#)

### 2.10.1 Selected economic indicators

	2007	2008
GDP growth	4.5	4.8
Inflation	2.4	2.6
Current account balance (% of GDP)	0.1	0.1

Source: Staff estimates.

### 2.10.1 Dangers of the house price boom

Surging housing prices have raised concerns in the Government that a bubble may form, which ultimately could damage the economy. At this stage, there are fundamental reasons behind the price gains: an underlying housing supply shortage and strong demand underpinned by low borrowing costs. The house price/rental value ratio—its historic average may be used as proxy for property values—also remains low for the country overall, even though home prices have been rising much faster than rental values over the past few years (Box figure 1). Nevertheless, the pace of increase in house prices in some affluent areas of Seoul has been alarming, rising by nearly 25% between September 2005 and September 2006.

Key concerns are the rapid buildup in household debt associated with mortgage lending and its possible knock-on effects. Fast-rising house prices and expectations of further gains have encouraged households to take on more mortgage debt. For example, bank lending to households increased by 10.7% in the 12 months to September 2006, with more than 60% of this mortgage related. As household debt has grown much faster than incomes, households' ability to repay debt has deteriorated: the ratio of household debt to income has resumed its rise since 2005 (Box figure 2) and the number of personal bankruptcies has more than doubled in this period.

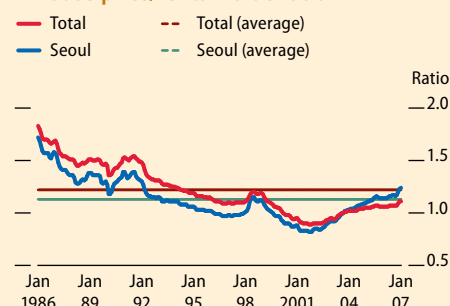
Heavy household debt burdens have also hurt prospects for a speedy recovery in consumer spending. A sharp downturn in house prices could push financially weak households into bankruptcy, starting another prolonged slump in private consumption, and threaten the health of the financial system by eroding loan collateral values and swelling the number of delinquent loans. For now, though, bank stability indicators show little sign of stress.

The Government introduced another set of measures in November 2006 in an effort to stabilize house prices, the eighth such package in 3 years. These latest measures include plans to increase the housing supply, which has

not been a focus of previous packages. They also involve tighter financial regulations to curtail growth of household borrowing.

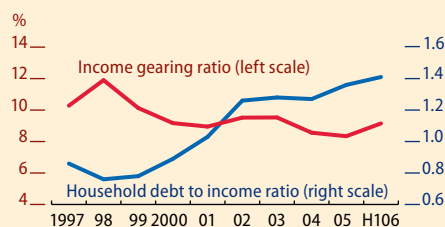
A major policy challenge is to ensure sufficient housing supply by addressing inefficiencies arising from heavy public sector involvement and regulation of the housing market, and by securing adequate public provision of housing for low-income earners, who may be bypassed in the market mechanism. But there is always a risk that measures taken to contain price rises could in themselves precipitate a sharp fall in housing prices.

#### 1 House price/rental value ratio



Source: Staff estimates based on housing price data from Bank of Korea, Economic Statistics System.

#### 2 Household debt and income



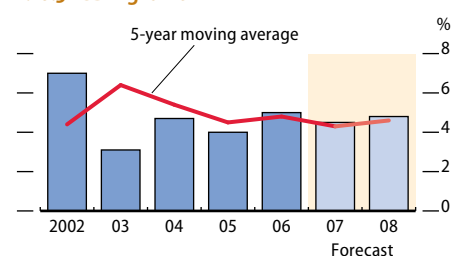
Note: Income gearing ratio refers to the share of household interest payments in household disposable income.

Sources: Household Assets and Debts: Flow of Funds Statistics, Bank of Korea; Household Disposable Income: System of National Accounts, Bank of Korea.

broaden with domestic demand strengthening. Economic indicators in late 2006 showed signs of a stabilization in industrial production, construction investment, and consumption. As 2007 progresses, the external environment could turn more favorable with the global downturn bottoming in the second half. The Korean economy is projected to continue building momentum in 2008, based largely on firming domestic demand, with growth of 4.8% that year.

Private consumption is recovering, as the improvement in the job market underpins growth in household incomes. However, household debt remains high at a time when increases in interest rates in 2005–2006 are adding pressure on consumer spending. Given the underlying weakness in household balance sheets, private consumption growth

#### 2.10.5 GDP growth



Sources: Bank of Korea, Economic Statistics System, available: [http://ecos.bok.or.kr/ElIndex\\_en.jsp](http://ecos.bok.or.kr/ElIndex_en.jsp), downloaded 26 January 2007; staff estimates.

[Click here for figure data](#)

is expected to remain moderate. Moreover, consumer sentiment has declined (Figure 2.10.6) because of concerns about the global economic outlook, uncertainty surrounding the implementation of new tax laws targeting real estate, and political tensions involving the Democratic People's Republic of Korea.

Export-led manufacturing firms are for the most part in good shape, with strong profits, to continue an expansionary cycle in investment. Capacity utilization has edged up too, indicating a potential need for expanding production facilities (Figure 2.10.7). The upturn in house prices in the second half of 2006 is likely to be followed by a pickup in housing construction over the forecast period, helped by new measures from the Government to increase housing supply.

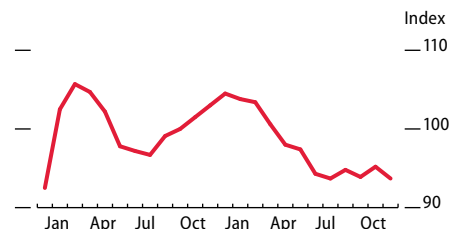
In 2007, the expected moderate slowdown in the US economy suggests there will be some easing in Korea's export growth rate. Nevertheless, a still-robust export performance will support a recovery in industrial production and business spending. However, rapidly rising imports, driven in part by demand for overseas travel and education, will cut by half the contribution of net exports to GDP growth. Although merchandise trade looks set to achieve a record surplus, based on the robust exports and declining oil and commodity prices, growth in imported services will remain high. The current account surplus, which narrowed to less than 1% of GDP last year, is projected to shrink further (Figure 2.10.8).

Monetary and fiscal policies are projected to be set in generally neutral positions. The Bank of Korea is expected to loosen the tightening bias that it maintained throughout 2006, as inflationary pressures subside in a context of softening economic growth and declining import prices. Consumer price inflation is likely to remain below the central bank's target band of 2.5–3.5% in 2007 (Figure 2.10.9). On the fiscal front, an expected increase in tax revenues, drawing on last year's stronger economic growth, should make room for some additional fiscal outlays this year. Fiscal spending will continue to focus on strengthening social infrastructure and the social safety net, on enhancing productivity in the services sector, and hence on preparing for long-term structural changes including an aging society. However, growing concerns both about long-term fiscal sustainability caused by the aging population and about the projected costs of social services will restrain the use of expansionary budgets.

New tax laws take effect in 2007 intended to streamline sources of tax revenues and restore fairness by removing some of the wide array of tax credits and deductibles. A fiscal tightening effect from efforts to broaden the tax base and to strengthen tax collection has been balanced by measures to leave in place a majority of tax credits for small and medium enterprises (SMEs) and for business investment for the time being, given that economic activity will slow in 2007 relative to 2006.

Risks to the projections would most likely originate in any sharp slump in the US economy, which would undermine Korea's export performance and reduce GDP growth. Domestically, a surge in housing prices has led to an increase in household mortgage debt. A significant downturn in the housing market could intensify financial pressures on households, which would retard the recovery in consumption spending (Box 2.10.1).

**2.10.6 Consumer expectations index**



Source: Bank of Korea, Economic Statistics System, available: [http://ecos.bok.or.kr/ElIndex\\_en.jsp](http://ecos.bok.or.kr/ElIndex_en.jsp), downloaded 10 January 2007.

[Click here for figure data](#)

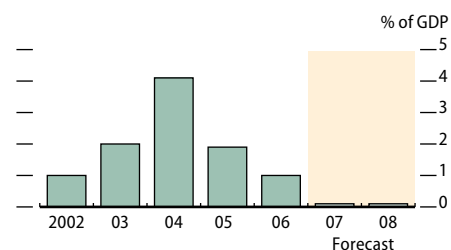
**2.10.7 Manufacturing capacity utilization (3-month moving average)**



Source: National Statistical Office, available: <http://www.kosis.nso.go.kr>, downloaded 5 February 2007.

[Click here for figure data](#)

**2.10.8 Current account balance**



Sources: Bank of Korea, Economic Statistics System, available: [http://ecos.bok.or.kr/ElIndex\\_en.jsp](http://ecos.bok.or.kr/ElIndex_en.jsp), downloaded 18 February 2007; staff estimates.

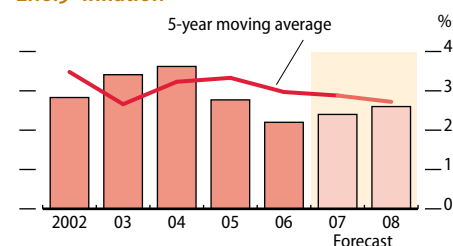
[Click here for figure data](#)

## Development challenges

Korea faces important challenges resulting from intense global competition and an aging population. The recovery in GDP growth rates after the 1997–98 Asian financial crisis partly reflects successes in addressing certain structural weaknesses in the economic and financial framework. Reforms are incomplete though, as illustrated by the 2003 credit card crisis and the subsequent prolonged slump in private consumption. A more fundamental problem that is damping private consumption is lagging productivity in the services sector and among SMEs. This is holding back improvements in the labor market and in wages growth. The likely key to resuming rapid growth over the medium term is to accelerate productivity growth by continuing with structural reform, particularly in the labor market and in the services sector, including SME restructuring.

As the economy matures and as the population ages, slowing labor and capital inputs will require a more efficient and flexible economic structure that can ensure productivity gains while accommodating the necessary socioeconomic adjustments. In the medium to long term, reforms should focus on health, education, and facilities for the aged; undue regulatory burdens; and weaknesses in the services sector.

### 2.10.9 Inflation



Sources: Bank of Korea, Economic Statistics System, available: [http://ecos.bok.or.kr/EIndex\\_en.jsp](http://ecos.bok.or.kr/EIndex_en.jsp), downloaded 24 January 2007; staff estimates.

[Click here for figure data](#)



# Mongolia

Buoyant commodities markets and good weather made 2006 another year of strong economic expansion. Growth is projected to step down a little in 2007, but remain brisk. The main challenges are to use the Government's revenues from mineral wealth in a manner that sets the country on a sustainable development path; and to address immediate poverty and environmental problems.

## Economic performance

The economy performed well in 2006: growth in GDP picked up to 8.4%, a fourth straight year of 6%-plus expansion. Inflation moderated from high levels and both the fiscal and current accounts were in surplus. As an economy based on agriculture (which supports nearly half the population) and mining, Mongolia usually does well when the weather is favorable and commodity markets are buoyant.

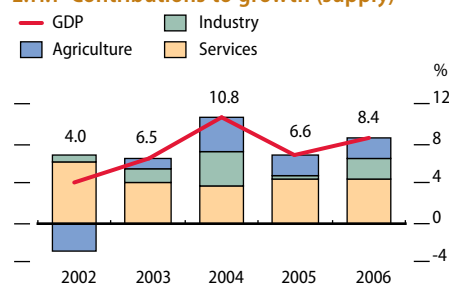
That describes 2006, when the winter was mild and copper and gold brought high prices. Livestock numbers rose by 14.5% to a record 34.8 million as herders responded to demand from the People's Republic of China (PRC). Goats and sheep make up over 80% of the total, with the remainder cattle, horses, and camels. Copper export receipts in US dollars nearly doubled, though copper export volumes increased by only 2.1%.

The clothing industry, too, was a strong performer. It contracted in 2005 after the global textile and clothing trade quota system ended, but rebounded last year as manufacturers focused on the European Union and took advantage of its tariff concessions. For mining, total mineral extraction grew marginally and reported gold production fell. The latter may have been caused by greater smuggling of gold after the Government imposed a windfall profits tax on gold and copper. Transport and telecommunications maintained robust growth, such that services contributed the most (4.4 percentage points) to total GDP growth. Agriculture and industry contributed about 2 percentage points each (Figure 2.11.1).

Broad money (M2) growth was again high in 2006 at 35% (Figure 2.11.2), but inflation slowed from an average of nearly 13% in 2005 to 5.1% last year. This deceleration reflected a much more moderate rise in food prices and a 4% appreciation of the togrog against the US dollar, which made imports less costly.

On the back of rising income from mining, the budget was in surplus in 2006 (by 3.9% of GDP; Figure 2.11.3). Revenues benefited from the Government's 51% share in the biggest copper mine, operated by Erdenet Company, and from taxes on mineral output. In 2006 the Government also imposed a 68% windfall tax on copper and gold for prices exceeding \$6,500 a ton for copper and \$500 an ounce for gold. This tax generated \$152.4 million. Moreover, overall tax collections have been buoyed by the solid economic growth.

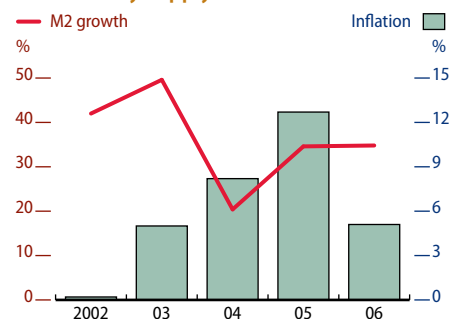
2.11.1 Contributions to growth (supply)



Source: National Statistics Office.

[Click here for figure data](#)

2.11.2 Money supply and inflation



Source: Bank of Mongolia.

[Click here for figure data](#)

Expenditures also rose noticeably. The Government increased salaries of public officials by 30% and started cash transfers to families with newly born children, to newly married couples, and to families for each child below the age of 18. The parliament agreed to budget those payments for years into the future, raising questions about the sustainability of public finances.

Exports soared by 44% in nominal terms, as a result of high prices for copper and gold and an increase in cashmere exports (the number of goats rose by 16.5% to 15.6 million). Textile and clothing exports to the United States continued the decline that set in when global quotas ended, but rose substantially to the European Union, which exempts certain Mongolian products from import duties. Many of Mongolia's exports have benefited in recent years from strong demand from the PRC, Mongolia's main export market.

Mongolia imports all its petroleum products, and the surge in global oil prices last year was the main reason for the strong growth in imports of 26%. The trade account produced the first surplus for many years (Figure 2.11.4) and the current account was in surplus for the third consecutive year. Foreign direct investment was \$367 million in 2006, four times as high as in 2000. Most has gone into mining. Gross international reserves more than doubled to \$718 million in 2006.

In the policy arena, the Government adopted a new mining law that gives it the right to acquire up to 50% stakes in "strategic" mineral deposits. As well as the imposition of the windfall profits tax, mining royalty rates were raised. Negotiations continued between the Government and Ivanhoe Mines Ltd. of Canada, which holds the license for the large Oyu Tolgoi copper and gold deposit, on an agreement concerning taxes and royalties. Companies from the PRC are negotiating to develop coal mines and build power plants, for export to their home market.

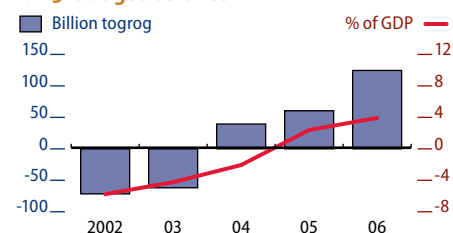
Sustained economic growth in recent years, plus inflows of foreign capital mainly into mining and a more competitive financial market, have spurred sharp increases in credit growth (by more than 40% in 2006). This rapid growth has heightened risks. Officially, the reported ratio of nonperforming loans to total loans has been fairly steady at around 9%, but actual figures are likely to be higher. Some banks do not have adequate risk management and internal control mechanisms, and their rapidly inflated lending may be at the cost of quality.

In this regard, the recent establishment of a financial regulatory commission and a stronger statement of intent by the Bank of Mongolia, the central bank, on banking supervision are encouraging.

## Economic prospects

The projections assume that prices of copper and gold will be fairly stable in 2007 and that the price of cashmere will decline slightly. Government expenditures are taken to rise as elections approach in 2008. The forecasts also presuppose that policies will be implemented to maintain the confidence of international mining investors. Economic growth in the important PRC export market is forecast to ease to about 10.0% this year from 10.7% last year.

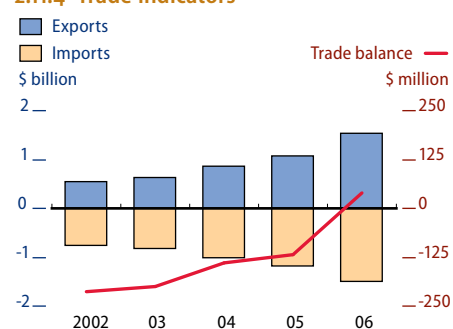
### 2.11.3 Budget balance



Source: National Statistics Office.

[Click here for figure data](#)

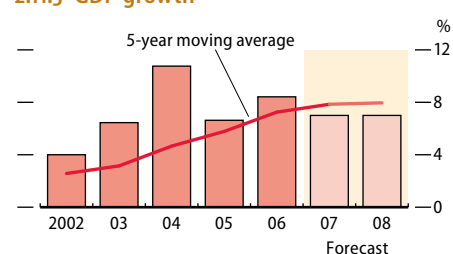
### 2.11.4 Trade indicators



Source: Bank of Mongolia.

[Click here for figure data](#)

### 2.11.5 GDP growth



Sources: National Statistics Office; staff estimates.

[Click here for figure data](#)

### 2.11.1 Selected economic indicators

	2007	2008
GDP growth	7.0	7.0
Inflation	6.0	6.0
Current account balance (% of GDP)	2.0	2.0

Source: Staff estimates.

On this basis, Mongolia's GDP growth in 2007 and 2008 is projected to step down to about 7% (Figure 2.11.5), after averaging 9% for 3 years. Livestock and manufacturing growth rates have been unusually high and are projected to slow. Agriculture in particular could be bumping up against sustainability constraints in terms of herd size.

The minerals law and the tax regime for mining may well be modified to be more investor friendly, which would encourage higher mining output and attract further investment. If the Government and Ivanhoe Mines agree on terms for development of the Oyu Tolgoi deposit, Ivanhoe's investments would rise substantially over the next couple of years. In that case production could start in 2010.

Major international mining company Rio Tinto would join Ivanhoe in developing the Oyu Tolgoi deposit, which could produce an estimated 1 billion pounds of copper and 330,000 ounces of gold a year for at least 35 years. This would have a significant impact on exports and government revenues. Also, initial investment in the large Tavan Tolgoi coal deposit could start over the forecast period.

A government pledge to provide 40,000 households with improved housing should stimulate the construction industry. In addition, Mongolian banks have started to tap international financial markets, which could provide an increasing flow of longer-term funding for investment projects. The Trade and Development Bank of Mongolia issued a \$75 million bond in early 2007 at a yield of 8.75%. The 3-year bond attracted strong demand from investors.

Inflation over 2007 and 2008 is projected at about 6%. The past high inflation rate (the annual average exceeded 8.0% in 3 of the past 6 years) has been driven mainly by supply shocks to food and oil prices and to exchange rate movements. Consequently, the stronger trade position is expected to support the exchange rate and so help contain price pressures. The Bank of Mongolia has found little evidence that money growth drives inflation in the economy. Continuing monetization of the economy could account for the weak link between money growth and inflation.

The current account is expected to show surpluses of about 2% of GDP in the forecast period as prices of copper and gold stabilize, but mineral export volumes rise.

The biggest risk to the economy would be a sharp drop in international metals prices. In addition to direct links to GDP, mineral exports are the major source of government revenues and affect the exchange rate, which in turn has an impact on inflation. Significant declines in prices of copper, coal, gold, and cashmere would hit the current account and, in the longer term, could lead toward debt distress. Severe winter weather can devastate agriculture in any year.

Further out, there is a threat to the sustainability of the natural-resource base. Overstocking in agriculture and lax controls over smaller mines, as well as environmental problems related to urbanization, have damaged the environment, including water resources. Unless the Government can reorient agriculture toward a sustainable growth path, this sector's growth will likely slow in the medium term and it could face longer-term contraction. Potential instability in the financial sector is a further risk, since some banks have tried to expand by offering high rates for deposits and using funds to make high-interest, high-risk loans.

### 2.11.1 Development challenges

Once Mongolia started its transition in 1991 from a command economy, it was quick to dismantle that system, institute legal and institutional frameworks, and adopt market-oriented policies.

Nevertheless, cumulative growth has been insufficient to resolve high levels of poverty that emerged after the initial shocks. Poverty incidence was estimated at 32.6% in 2006. The benefits from mineral wealth have not been broadly distributed.

Moreover, social services, particularly education and health, have deteriorated. Current expenditures in the budget account for an inordinately large proportion (almost 80%) of total public spending, and little public investment is directed to building infrastructure.

An important development challenge is to use government revenues from mineral resources for setting the country on a sustainable long-term development path while also addressing social and environmental problems. This will require significant investment in social and physical infrastructure, which would facilitate the development of new growth sources and an upgrading of labor productivity.

Such a plan should be linked into the budget and set out development priorities. This also will require the building of capacities in strategic planning and in project preparation and appraisal.

Among other issues the public investment plan should address the degradation of the environment. In addition to the problems outlined, the overuse and illegal trade in forest products and wildlife have inflicted heavy damage and put under threat the sustainable economic growth, primary education, and environment targets in the Millennium Development Goals.

Corruption also is a challenge to development. In 2006, Mongolia ranked 99 out of 163 countries on the Transparency International Corruption Perceptions Index.

# Taipei, China

On the back of stronger exports, economic growth accelerated in 2006. Domestic demand was subdued for most of the year, weighed down by a tightening of consumer credit. This year, consumption and investment demand are projected to pick up, cushioning the economy from an expected slowdown in external demand. That would leave GDP growth slightly below last year's pace. Structurally, higher performance levels require manufacturers to move further up the value chain and services firms to become more outward oriented.

## Economic performance

Supported by strength in exports, the economy grew by nearly 5.0% in the first 3 quarters of 2006, but slowed to 4.0% in the fourth when the pace of exports decelerated sharply (Figure 2.12.1). For the year as a whole, exports of goods and services measured in US dollars expanded by 12.9%, up from 7.8% in 2005, led by optical equipment, electronics, and machinery. Growth in imports accelerated to 9.9%, from 8.2%, driven by purchases of inputs needed for the expanding export industries and by a strengthening in domestic investment. As a result, net exports in national account terms jumped by 31.3%, contributing 3.5 percentage points of total 2006 GDP growth of 4.6% (Figure 2.12.2).

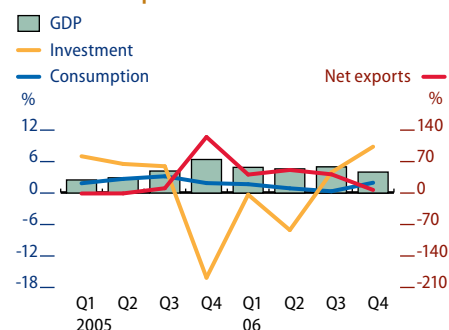
Private investment edged up by 2.1% in 2006, largely the result of a cyclical upturn in the second half, following 3 quarters of decline. The pickup was primarily seen in purchases of machinery and equipment prompted by strong exports of manufactures. Construction investment also continued to recover, as the property market strengthened. However, private investment growth was largely offset by a 4.9% contraction in public investment, due to the completion of some major projects. Overall, total fixed investment rose a paltry 0.3%, making little contribution to the overall outturn.

Private consumption decelerated to 1.5% from 2.7% a year earlier, weighed down by a tightening in consumer credit that followed the bursting of a credit-card bubble in late 2005. On a year-on-year basis, private consumption slowed to just 0.4% growth in the third quarter. It picked up in the fourth, in part because of a low-base effect from weak private consumption expansion in the last quarter of 2005. Government consumption slipped by 0.2%, reflecting efforts to tighten expenditures.

On the supply side, manufacturing grew by 7.1%, led by the subsectors of electronics components and computer and telecommunications products. Construction rose by 5.2% (from 0.5% in 2005). Services, which account for 73% of GDP, steadily progressed by 3.7% and were again the major contributor to GDP growth. Agriculture expanded by 5.4%, mostly a recovery from typhoons and floods in 2005.

Those natural disasters had hit vegetable and fruit production in 2005, pushing up the consumer price index by 2.3%. In 2006, as their

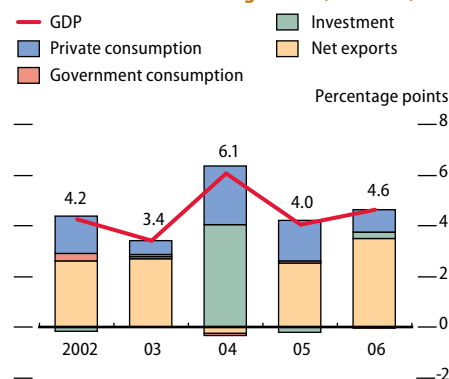
**2.12.1 Growth of GDP and demand components**



Source: Directorate General of Budget, Accounting and Statistics, available: <http://eng.stat.gov.tw>, downloaded 26 February 2007.

[Click here for figure data](#)

**2.12.2 Contributions to growth (demand)**



Source: Directorate General of Budget, Accounting and Statistics, available: <http://eng.stat.gov.tw>, downloaded 26 February 2007.

[Click here for figure data](#)

prices fell or steadied, inflation was marked down to 0.6%. Wholesale prices, in contrast, rose steeply by 5.6%, pushed up by rising international oil and commodity prices and a weakening of the New Taiwan dollar (Figure 2.12.3). The divergent trend between consumer and wholesale prices indicates limited pass-through from increased production costs into retail inflation, partly a consequence of firms having limited pricing power.

Labor market conditions improved with the faster pace of economic growth. Total employment expanded by 1.7% and the annual average unemployment rate fell to a 6-year low of 3.9%. Job creation was broad based, with construction growing strongest, by 3.3%. The reduction in labor market slack and lower inflation lifted real wages. Real average earnings of nonagricultural workers rose by 0.5%, a switch from a 0.9% decline in 2005.

Concerned about negative real interest rates and inflationary pressures from rising prices of imported oil and commodities, the monetary authorities raised the benchmark discount rate by 12.5 basis points in each quarter of 2006, to 2.75%. The policy rate is still below those of most other regional economies, however.

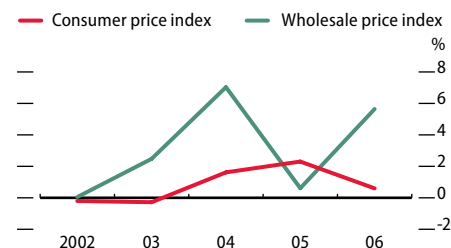
With an abundance of funds in the banking system, the cost of borrowing stayed low. The base lending rate rose by just 27 basis points over the year to 4.12%. However, the pace of domestic loan growth slowed markedly to 2.5% at end-2006 from 8.1% a year earlier, mainly due to the weakness in consumer lending. After 2 years of rising at double-digit levels, lending to consumers nudged up by 1% in 2006 as banks imposed more stringent lending standards after a surge in credit-card defaults. Banks wrote off US\$5.1 billion in bad cash-card and credit-card loans last year, more than double the amount in 2005.

On the back of the property market upturn, construction lending rebounded by 26.8%, which partly offset the impact of the consumer credit crunch (Figure 2.12.4). Despite weak credit expansion, broad money (M2) grew by an average of 6.2% in 2006, similar to that recorded in 2005, as financial institutions increased their portfolio investments.

The strong rise in exports pushed the trade surplus up by 30% and this followed through into the current account surplus, which reached \$25.2 billion in 2006, equivalent to 7.1% of GDP. This was partly offset by an upsurge in capital outflows channeled to overseas securities markets, and by a reduction in portfolio investment inflows. A widening gap between local interest rates and the US Federal Funds rate was the major factor driving capital outflows, though some domestic reasons apparently contributed, such as the gradual lifting of a cap on overseas investment by insurance companies. Gross international reserves rose to \$266.1 billion at end-2006. The capital outflows also contributed to weakness in the currency. Over the year, the New Taiwan dollar depreciated on average by 1.1% against the US dollar, and its real effective exchange rate by 0.4%.

In fiscal matters, the faster pace of economic growth was not reflected in tax revenues, which rose modestly by 1.8%. The tax-to-GDP ratio declined to 14.3% in 2006 from 14.6% a year earlier. Corporate income tax receipts fell by 5.3%, possibly a result of tax exemptions and tax preferences for certain investment and industries. The Government trimmed spending and ended the year in the black, reversing a run of deficits. The ratio of central government outstanding debt to GDP rose

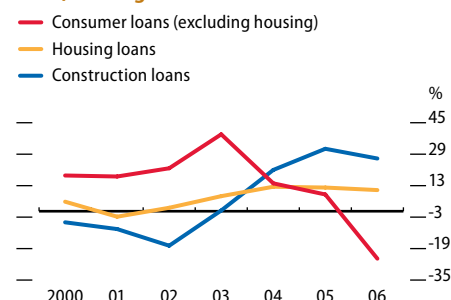
### 2.12.3 Inflation



Source: Directorate General of Budget, Accounting and Statistics, available: <http://eng.stat.gov.tw>, downloaded 13 March 2007.

[Click here for figure data](#)

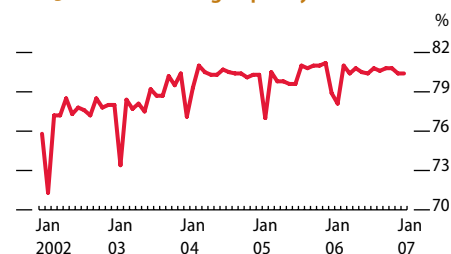
### 2.12.4 Loan growth



Source: Data downloaded from <http://www.cbc.gov.tw/economic/EBOOK/XLS/P113.xls> on 14 March 2007.

[Click here for figure data](#)

### 2.12.5 Manufacturing capacity utilization



Source: Business Indicators DataBase, available: <http://index.cepd.gov.tw>, downloaded 11 March 2007.

[Click here for figure data](#)

### 2.12.1 Selected economic indicators

	2007	2008
GDP growth	4.3	4.5
Inflation	1.6	1.5
Current account balance (% of GDP)	6.7	6.5

Source: Staff estimates.



slightly to 33.2% at end-2006, within a 40% ceiling stipulated by the Public Debt Law.

## Economic prospects

External conditions will be benign in 2007, despite the expected deceleration in the global economy and a softening in demand for some electronics. Resilient intra-Asian trade and robust demand from the People's Republic of China (PRC) will likely provide a buffer against the slowdown in other world markets. Export growth is expected to slow by about 4 percentage points to a still-solid 8.8%. An upturn in the global electronics cycle, starting in the second half of this year, is projected to take export growth back up in 2008, to 9.4%.

Domestic demand is forecast to recover gradually, bolstered by the modest upturn in investment that started in 2006 and a strengthening in consumer spending. The cyclical rebound in machinery and equipment investment will likely be prolonged by a high manufacturing capacity utilization rate (Figure 2.12.5) and by solid exports. Construction investment growth will ease because the buoyant property market is expected to slow. Public investment will increase owing to new public infrastructure projects in energy, water supply, and railways. Private consumption is expected to accelerate back to 3.0% in 2007 as the credit-card debt problems are resolved. Also, spending is underpinned by positive wealth effects from last year's gains in housing and equity prices as well as the strengthening of the labor market.

Based on the above factors, economic growth is projected to moderate to 4.3% in 2007, then inch up to 4.5% in 2008 as the global economy gains momentum. Inflation will creep up to around 1.6% in the forecast period from last year's low levels. Low inflation, a reduced risk of imported inflation, and the expected end of US interest rate rises suggest that the monetary authorities could adopt an accommodative monetary policy stance and keep interest rates steady over this year. Import growth measured in nominal terms is projected to outpace export growth, largely because of the imports needed for investment projects. The current account surplus is forecast to decline to 6.7% of GDP in 2007 and 6.5% in 2008.

These projections are subject to both downside and upside risks. Political uncertainties ahead of legislative elections in December 2007 and presidential elections in March 2008 could unnerve investors, as would any deterioration in cross-strait relations. On the upside, a possible move to liberalize economic relations with the PRC, such as relaxing limits on investment there or restrictions on tourists visiting the island from across the strait, would boost confidence in the economy.

### 2.12.1 Development challenges

Two important medium-term challenges face the authorities: to nurture new sources of growth and to redress income inequalities. The growth engine of recent decades—electronics—has faced significant competition from low-cost producers. Most of its labor-intensive production has relocated to the PRC.

Firms in Taipei, China still make some high-value products and play a dominant role in regional supply-chain management, but profit margins have been squeezed and their linkages to the domestic economy weakened. This is reflected in a reduction in manufacturing to 21.4% of GDP in 2006 from 37.6 % in 1986.

Services, which accounted for 73% of GDP last year, are mainly oriented toward the domestic market and are dominated by small and medium enterprises, so are unlikely to expand at much faster rates than they do now. New growth sources would be fostered if manufacturers moved further up the value chain and services firms tapped into regional markets.

Although the economy has a relatively equal income distribution, income disparities have widened over the past decade. Only the highest-earning 20% of households enjoyed gains in income in 2001–2005, partly because corporate and investment income outpaced wage income, helped by corporate tax breaks. Incomes for other groups stagnated or declined. Unskilled workers were the major losers as manufacturers relocated abroad. Some middle-income earners also suffered because of subdued growth in real wages and a disproportionate tax burden on salaried employees.

The widening income gap will restrain expansion in consumption, make it more difficult to win public support for further economic liberalization, and could even induce social tensions.