People's Republic of China

Despite macroeconomic tightening measures that cooled overheated sectors in 2004, economic growth was stronger than forecast. A more balanced development strategy and continued macroeconomic controls are expected to slow growth by about 1 percentage point in 2005. There are challenges to achieving this soft landing from both sides—investment could surge again and spark overheating, or growth could slow more abruptly than planned if potential problem areas are not addressed.

Macroeconomic assessment of 2004

Gross domestic product (GDP) growth in the People's Republic of China (PRC) accelerated from 9.3% in 2003 to 9.5% in 2004, the highest level since 1997, even though the Government took several steps to damp sectors that it considered overheated. On the supply side, the growth rate of industry fell to 11.1% in 2004 from 12.7% in 2003. Supply shortages were still experienced in coal, electricity, petroleum, and transport. For example, 26 out of 31 provinces suffered power outages. The growth rate of agriculture more than doubled to 6.3%, supported by subsidies to grain growers and a cut in agricultural taxes. Grain production recovered from a 4-year decline to increase by 9% to 469.5 million tons. The services sector grew by 8.3%, a percentage point faster than in 2003, when services were hurt for a while by the outbreak of SARS.

In the breakdown of demand, fixed asset investment grew by 25.8% in 2004, which was marginally slower than 2003's rate of 27.7% because of the macroeconomic controls. Investment grew faster in manufacturing than in agriculture, services, and small and medium enterprises (SMEs). When the growth rate of fixed asset investment shot up to 43% in the first quarter of 2004, the Government implemented a combination of monetary, fiscal, and administrative measures to cool it, especially in the overheated steel, cement, aluminum, automobile, and real estate subsectors. As a result, growth of investment in manufacturing eased for the full year to 38.3% from 46.3% in 2003. Investment in agriculture rose by 20.3%, a turnaround from 2003 when investment fell.

Total consumption increased faster in 2004 than in 2003, driven by improving rural and urban incomes. Due to rising grain prices and subsidies to farmers, real rural incomes grew by 6.8% in 2004, the highest rate since 1997. Urban incomes increased by 7.7%, helping push up retail sales by a fast 10.2% in 2004, though retail sales growth in rural areas still lagged that in urban areas.

In spite of the stronger growth in total consumption, private consumption has declined as a share of GDP in recent years (Figure 2.1). In the past 3 years, private consumption has expanded at a slower rate than government consumption and fixed asset investment. Also, growth of consumption in rural areas has been slower than in urban areas. Private consumption as a share of GDP in the PRC is below the 60% average seen in other countries with a per capita GDP of around $1,000. An increase in the share of private consumption to GDP would help smoothen fluctuations in economic growth caused by swings

in investment and would reduce the imbalance between supply and demand in some industries.

External trade maintained its robust uptrend on strong domestic and external demand, with the result that the PRC overtook Japan to become the world's third-largest merchandise trader, after the United States (US) and Germany. Merchandise exports rose by 35.4%, with production at foreign-funded enterprises estimated at about 58% of exports. Merchandise imports grew by 36.0%. Most of the increase came from energy products and raw materials. Factors behind the import surge were booming investment-led domestic demand, rising international oil prices, and the reduction in import tariffs and removal of nontariff barriers following the PRC's accession to the World Trade Organization (WTO) in 2001. The PRC played a more important role in interregional trade; bilateral trade between the PRC and countries in the Association of Southeast Asian Nations (ASEAN), for instance, grew by 36% to over $100 billion in 2004. Overall, the trade surplus on goods increased from $45 billion in 2003 to about $58 billion in 2004, and the current account maintained a surplus of about 3.3% of GDP.

The PRC continued to be a favored destination for foreign investment. Actual foreign direct investment (FDI) rose by 13.3% to $60.6 billion in 2004. Investors come partly for unskilled labor, which is about 4% of the cost in the US and one third of the cost in, for example, Malaysia. Moreover, the country's infrastructure continues to strengthen, and its business environment has improved significantly since it joined WTO. Multinational enterprises have accelerated their relocation of labor-intensive and export-oriented industries to the PRC. WTO membership has prompted an opening of services to more foreign participation, so that FDI in services during 2002–2004 on average grew slightly faster than in agriculture and manufacturing. FDI in steel and cement slowed significantly in the second half of 2004 as those industries faced government curbs. A combination of strong FDI inflows, the trade surplus, and fund inflows pushed higher by speculation that the yuan would appreciate led to a 51% surge in foreign exchange reserves, to $610 billion by year-end. Total external debt amounted to $229 billion, equivalent to 14% of GDP. The yuan was kept steady at CNY8.28/$1.

Table 2.1 Major economic indicators, People's Republic of China, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	9.5	8.5	8.7	8.9
GDI/GDP	45.6	44.7	43.8	41.0
Inflation (CPI)	3.9	3.6	3.3	3.2
Money supply (M2) growth	14.6	14.1	13.7	14.6
Fiscal balance/GDP	-1.5	-0.9	-0.7	-0.2
Merchandise export growth	35.4	20.4	14.8	12.5
Merchandise import growth	36.0	22.1	19.6	14.1
Current account/GDP	3.3	1.2	0.4	-0.2

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product.

Sources: National Bureau of Statistics of China, available: www.stats.gov.cn/english/index.htm, downloaded 9 March 2005; People's Bank of China, available: www.pbc.gov.cn/english, downloaded 9 March 2005; staff estimates.

Fiscal revenues expanded considerably in 2004, rising by 21.4%, driven by high levels of economic and trade activity and strengthened tax collection. Fiscal expenditures rose by 15.1%. Priorities in public spending shifted from infrastructure to agriculture, social security, and health care as part of government efforts to better balance economic growth and social development. The fiscal deficit narrowed to an estimated 1.5% of GDP from 2.5% in 2003. However, if off-budget obligations, including the implicit pension debt and costs related to nonperforming loans (NPLs) in the banking sector were considered, the fiscal deficit would be much higher.

The growth of broad money (M2) moderated to 14.6% at end-2004 from 19.6% in 2003. Growth of total bank deposits slowed in the third quarter due to negative real deposit rates. Deposit growth picked up, though, after the People's Bank of China (PBC), the central bank, raised interest rates in October. The macroeconomic controls were expected to curb medium- and long-term lending to state-owned enterprises (SOEs) and to major investment projects. Instead, much of the impact fell on SMEs, when banks pulled back on short-term lending that SMEs use mainly as working capital, which affected their operations.

Inflation measured by the consumer price index (CPI) picked up to 3.9% in 2004 from 1.2% in 2003. During June–September, inflation

exceeded 5%, prompting the October interest rate rise. Food, which accounts for around one third of the CPI basket, was the main cause of higher inflation. A better than expected grain harvest helped bring down inflation to 2–3% late in the year. However, ex-factory industrial prices, regarded as comparable to a producer price index, rose by 6.1% in 2004, the fastest rate in 8 years. Rising prices for oil and raw materials were the main reason. There were also signs that labor shortages in coastal manufacturing regions, such as the Pearl River delta, were causing factory managers to increase wages and benefits to attract workers, thereby stoking inflationary pressure.

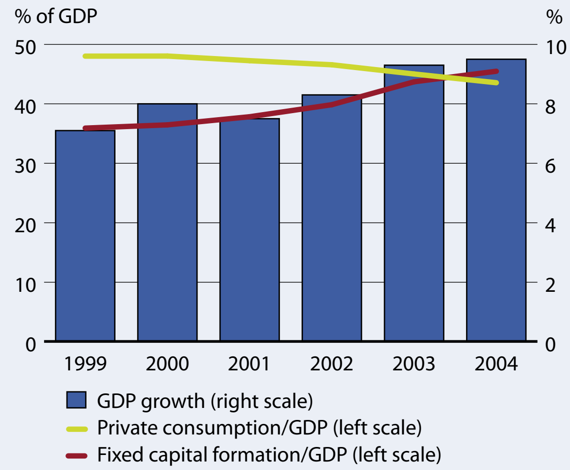
Unemployment edged down to 4.2% of the urban workforce from 4.3% in 2003. However, this does not include laid-off SOE workers or those who migrate to cities looking for work. The number of urban employees went up by 9.8 million, 800,000 more than the Government's target. In addition to the labor shortages in some manufacturing regions, many college graduates are finding it difficult to get work in their professions. The number of rural poor with per capita incomes below CNY668 (the official poverty line) decreased from 29 million to 26 million as rural incomes increased and more budget resources were applied to poverty reduction.

Macroeconomic policy developments

The long-term goal of the Government is to raise per capita GDP to $3,000 by 2020, from $840 in 2000, and to quadruple GDP in this period, which requires growth of at least 7.2% annually. Although continued rapid expansion looks achievable, challenges need to be overcome. Rapid growth and structural changes, while resolving many problems, have created new ones: increasing income inequalities, weaknesses in the social security system, rising regional disparities, and environmental pressures. At the National People's Congress (NPC) in March 2004 the Government affirmed that sustaining strong economic growth would remain a priority, but it also started to address some of these problems to achieve more balanced and equitable development.

The latest NPC, in March 2005, set out the following targets for 2005: GDP growth of around 8%; 9 million new jobs for urban residents and keeping the registered urban unemployment rate under 4.6%; inflation held to 4% or less; and a sound balance of payments.

Figure 2.1 GDP, private consumption, and fixed capital formation, People's Republic of China, 1999–2004



Source: National Bureau of Statistics.

Fiscal policy will be tightened further, now that pump priming is not needed to maintain economic growth. The issuance of long-term government bonds was limited to CNY110 billion in 2004, a reduction from the budgeted amount of CNY130 billion, partly so that there would be less available for capital construction. Issuance will be reduced further this year, to CNY80 billion. The budget deficit target for 2005 is CNY300 billion, narrower than CNY319.8 billion in 2004.

Expenditure priorities were shifted in 2004 from infrastructure construction to agriculture, education, health care, and social security. Poorer central and western regions received greater attention, as did rundown industrial locations, and areas where ethnic minority groups live. The Government speeded up a trial of a change in the value-added tax (VAT) for some enterprises, to allow those in Jilin, Liaoning, and Heilongjiang provinces to claim tax deductions when buying new machinery. The trial will be expanded to more provinces. To assist farmers, the Government decided in March 2004 to abolish agricultural tax within 5 years. By end-January 2005, 23 out of 31 provinces and municipalities had done this. The aim now is to end the tax throughout the country in 2006.

Administrative measures taken in 2004 to rein in investment in sectors considered to be overheated included an order to curb credit expansion and investment in the overheated subsectors; restrictions on the transfer of arable land to nonagricultural use; and addition of industries to the restricted-investment list. The Government is expected to adopt more market-oriented pricing measures to control and direct investment from this year.

Since the second half of 2003, PBC has taken steps to tighten monetary policy, including: curbing real estate lending by raising the proportion of capital that developers must contribute to a project to 30%, and raising the cost of loans for investment in second houses; raising commercial banks' reserve requirement ratio from 6% to 7.5%; removing the ceiling on most commercial lending rates; and increasing the benchmark interest rate on 1-year loans from 5.31% to 5.58% and the rate on 1-year deposits from 1.98% to 2.25%. As the first rate rise since 1995, this October 2004 move signaled that the monetary authorities will use interest rates to cool the economy when necessary. During its annual meeting in January 2005, PBC announced that it would maintain its tighter stance, pointing to continuing inflationary pressures and a risk that growth in investment might surge again. PBC set its 2005 M2 growth target at 15%, slightly higher than the actual increase of 14.6% in 2004, and committed to using monetary levers such as interest rates to achieve the macroeconomic goals.

Speculation that the yuan may be allowed to appreciate was triggered in 2004 by the weakening US dollar, surging exports to the US and euro zone, and rising foreign exchange reserves. The International Monetary Fund called for greater exchange rate flexibility through a widening of the narrow band in which the yuan can move, and the G7 group of industrial countries said that it also favors more flexible exchange rates for Asian nations. While the Government stated its commitment to a long-term goal for a more flexible system, the current official stance is for a gradual transition to a more flexible exchange rate regime that does not put at risk macroeconomic stability and the financial system.

The PRC's stock markets performed weakly in 2004, even as stock prices rebounded in most other Asian markets. An overhang of nontradable state-owned shares and a relatively opaque stock-pricing system hurt the domestic stock market. In an effort to revive new share issues, the China Securities Regulatory Commission introduced a new pricing system for initial public offerings from January 2005. It also will promote better corporate governance and information disclosure by listed companies.

Progress was made in SOE reform in 2004. The State-owned Assets Supervision and Administration Commission continued its efforts to strengthen its supervision over 178 major central SOE groups and improve the management of SOEs nationwide. The commission tightened policies on management buyouts and stated that privatizations should be carried out through open and competitive bidding. Efforts to repair state-owned commercial banks continued when the Government injected $45 billion of its foreign exchange reserves into the Bank of China and the China Construction Bank to strengthen their balance sheets and prepare them for stock market listings.

For the private sector, the Government issued guidelines to improve the legal, policy, and market environment. More industries and sectors were opened to nonstate capital, and financing channels were widened for private enterprises.

Three years after WTO accession, the PRC has reached its goal in terms of cutting trade tariffs, with the general tariff level lowered from 15.6% in 2001 to 10.1% in early 2005. Nontariff barriers have also come down, with the number of quota-administered commodities reduced to 52 on the export side (from more than 100 in 2001) and eight on the import side (from 26). In services such as banking, insurance, and securities, the PRC has met its WTO commitments on time (Box 2.1). Over the past 3 years, the country has revised more than 2,300 national laws and regulations that ran counter to WTO rules. A series of laws and related regulations on the protection of intellectual property rights, including legislation on trademarks, patents, copyright, and protection of computer software, has been passed or revised. However, enforcement remains difficult.

Box 2.1 Action taken since the People's Republic of China joined the World Trade Organization in 2001

Sector	Commitment	Action
Agriculture	• Reduce the average tariff rate on imported farm products from 22% to 15% before 2010 • Significantly increase the import quota of low-tariff grain and cotton	• Average tariffs on farm products cut to 15.4% in 2004 • Import quotas for grain and cotton increased to 5% of total output in 2003 from less than 3% in 2001
Automobiles	• Cut the tariffs from 70–80% to 30% in 2005, 28% at the start of 2006 and 25% in mid-2006 • Gradually remove quotas on vehicle and spare parts imports and remove them completely in 2005	• Tariffs reduced to 43.8–50.7% in 2002, 38.2–43% in 2003, 34.2–37.6% in 2004, and 30% in 2005 • Tariffs lowered to 30% and quotas on vehicle and spare parts imports removed at start of 2005
Energy	• Gradually open the crude and refined oil sectors to private traders and end the state monopoly on oil trading • Open retail oil distribution 3 years after WTO accession and allow foreign firms at least 30 wholly owned gasoline stations each, and open the wholesale market 5 years after accession	• Import quota management for the three state-owned oil companies—China National Petroleum (CNPC), Sinopec, and China National Offshore Oil—removed on 1 January 2004 • Ten new oil importers ratified in April 2004. In August 2004, all private oil importers ratified. Total joined with Sinopec, and BP signed with Sinopec and CNPC to build gasoline stations in the PRC
Banking	• Allow foreign banks to conduct foreign currency business without geographic limit from the time of WTO accession • Foreign banks can conduct yuan business with domestic enterprises 2 years after WTO entry, with all geographic and customer restrictions to be removed by 2006	• Foreign currency business opened fully to foreign banks in 2001 • From December 2003, foreign banks allowed to conduct yuan business with domestic enterprises • By December 2004, 18 cities in the PRC allowed foreign banks to conduct corporate yuan business • In August 2004, Volkswagen, General Motors, Ford, and Toyota approved to carry out automobile financing • Foreign banks allowed to own 20% of a PRC bank, exceeding a commitment of 15%, from January 2005
Insurance	• Open reinsurance on accession; open health and pension insurance by 2004; and allow foreign nonlife companies to form joint ventures with a stake up to 51% (life companies up to 50%) • All geographic restrictions to be removed by 2004	• Eleven foreign insurance firms have entered the PRC market since accession, bringing total foreign insurers in the PRC to 39, with 70 outlets • A total of 124 foreign insurance companies have opened resident offices in the PRC
Securities	• Allow foreign firms to form joint ventures with local partners to manage investment funds	• Eleven overseas investment institutions granted qualified foreign institutional investor status • China Securities Regulatory Commission has ratified 13 Sino-foreign joint-venture fund management firms
Retailing	• Phase out restrictions on distribution services for most products by 2004 • Lift joint-venture restrictions on large department stores and virtually all chain stores by 2004. Scrap space restrictions on foreign-owned stores	• A regulation took effect 1 June 2004 allowing foreign retailers to do business freely in major PRC cities. The rule stipulates removing all geographic, commodity (except tobacco and salt), and shareholding limits on 11 December 2004

Sources: "Nation Progressing Well with WTO Commitments," available: http://www.china.org.cn/english/BAT/114565.htm; "Car Drivers Face Market Overhaul," available: http://edu.sina.com.cn/en/2004-12-24/28840.html.

Outlook for 2005–2007 and medium-term trends

The economy is likely to achieve its targeted soft landing, with GDP expected to grow by 8.5% in 2005, 8.7% in 2006, and 8.9% in 2007. Manufacturing and construction, hampered by bottlenecks in energy and transportation, land constraints, and reduced levels of investment, will slow. The growth rate of industry overall is forecast at 9.3–10.1% over the 3 years. Agriculture will expand by 4.1–4.6%, reflecting government efforts to support rural production and farmers' incomes. The opening of more services to external competition should ensure continued growth of around 8% for this sector. More emphasis on developing agriculture and services will benefit job creation and poverty reduction.

Investment in fixed assets is expected to grow by about 18% in 2005, slowing from 2004's rapid 25.8% expansion, and by about 13% in 2006–2007. Overheated subsectors face the biggest cutbacks. However, curbing investment growth will be difficult in some industries, such as construction, where substantial work is in progress. Also, private sector investment is likely to grow rapidly and foreign investment looks set to remain strong. Rising labor costs and labor shortages in coastal areas may persuade some investors to move factories to inland provinces.

Consumption will maintain double-digit growth rates, but these will be significantly lower than the rates for investment. Surging investment in the past 2 years has raised the proportion of capital formation to GDP to about 45%, the highest since 1994, while the proportion of consumption in 2004 fell to 55%, the lowest since 1978. Over the past 25 years, periods of extraordinarily high investment, without support from high levels of consumption growth, have resulted in excess production capacity and have been followed by sharp declines in economic growth. This time, the authorities are reducing investment growth and taking steps that should stimulate private consumption—raising rural incomes is an example.

The growth rate of exports is forecast to fall to 12–20% in 2005–2007 from over 30% in 2004, largely for the following reasons: growth in industrial nations will slow; major trade partners may well take more protectionist and antidumping action against PRC exporters; and rising labor costs and high oil prices will raise costs for exporters. Import growth is expected to outpace that of exports as more sectors are opened to foreign competitors and as domestic demand remains strong. Consequently, the trade surplus will decrease over the forecast period. The current account will maintain a small surplus of 0.4–1.2% of GDP in 2005–2006, but move to a 0.2% deficit in 2007.

Inflation is forecast to step down to 3.6% in 2005, 3.3% in 2006, and 3.2% in 2007. Prices of electricity and coal will rise. Production costs have been pushed up by higher prices of energy and raw materials, and some of this will flow through to prices of final products. Labor costs, too, will edge up as the economy maintains rapid growth. These upward price pressures will be eased in part by overcapacity in many industrial subsectors and by smaller price rises for grains.

Risks to the outlook include a possible return to extraordinarily high growth rates of investment. A relaxation of the macroeconomic controls could spark a rebound in investment growth and overheating in some subsectors. Capital buildups add to the risk of overheating. Commercial banks, with their deposits growing, are under pressure to expand lending, and people with substantial private wealth are seeking investment outlets.

Conversely, the soft-landing scenario could be disrupted by potential problems that cause growth to slow more sharply than planned. In rural regions, the rapid increase in farmers' incomes may be unsustainable if prices of agricultural products turn down, which would reduce consumption spending. Among SMEs, the contraction in their working capital loans during the macroeconomic tightening period seems to have curtailed their development. Finally, the financial sector may lose resources as it is opened to more competition from foreign banks to meet the country's commitments under WTO.

The expansion of SMEs is important because they create much of the employment and can assist in reducing income inequalities. However, they are one of the most vulnerable economic groups in the PRC, with limited access to financing. Strengthening the SME credit

guarantee system would help by reducing risks to lenders, as would developing private banks, which are more inclined to lend to SMEs. PBC should consider allowing banks to increase short-term lending to SMEs for working capital purposes. The Government could consider encouraging private investment companies to mobilize equity finance for SMEs, perhaps with some initial government funding. On the subject of competition for domestic banks, the critical time will be 2006, when all geographic and customer restrictions on foreign banks will be removed. If the state-owned commercial banks cannot improve their service, increase their capital, and reduce their NPLs, there is a risk that much of their deposit base could be moved to their competitors, putting further strain on them.

Energy bottlenecks are being addressed, but are unlikely to be eliminated soon, particularly as car ownership is rising rapidly. However, there is considerable potential to improve energy efficiency. The PRC uses 0.78 tons of oil equivalent to produce $1,000 of GDP, about twice the average for Organisation for Economic Co-operation and Development member countries. Steps taken so far in power reform include dismantling the State Power Corporation, separating policy and regulatory functions from production, and unbundling generation from transmission and distribution. Other measures that policy makers could consider are: encouraging the use of cleaner fuels and energy-saving technologies; imposing a consumption tax on fuel; removing constraints to private sector participation in the power industry; improving access to electricity supplies and the pricing structure for the poor; and strengthening interregional power transmission capacity to improve power system efficiency.

Hong Kong, China

The economic recovery strengthened and broadened in 2004, benefiting from buoyant consumption—supported by a rebounding property market—and rising exports. While export growth will ease, it will remain robust over the forecast period, and consumption and investment will be strong. The authorities are considering a goods and services tax to help stabilize revenues in the longer term, even though the fiscal position has improved with the economic upswing.

Macroeconomic assessment of 2004

The economy grew faster than expected in 2004, expanding by 8.1%, compared with 1.9% average growth in the previous 3 years. Private consumption, benefiting from the property market rebound, stronger household balance sheets, and rising employment, grew by 6.7% and contributed 3.7 percentage points to GDP growth. Total investment grew by 3.2%, contributing 0.8 percentage point to GDP growth.

Services, which account for nearly 90% of the economy, rebounded after being hit hard by the SARS outbreak in 2003. Inbound tourism was particularly strong, with a record 21.8 million foreign visitor arrivals, up by about 6 million from 2003. More than half of the visitors came from the PRC, a result of a further easing of restrictions on individual travel to Hong Kong, China. The surge in tourism helped lift retail sales by 9.1% in volume terms.

Exports of goods and services rose by 15.2%, boosted by the continued strength of the PRC economy, the weak US dollar to which the Hong Kong dollar is linked, and the robust inbound tourism. Strong domestic demand led to import growth of 13.8%. Net exports, which had been the driving force in GDP growth in 2003, contributed 3.5 percentage points in 2004, about the same as private consumption.

The strong economic recovery created 78,100 jobs in 2004 and reduced the unemployment rate to 6.5% by end-2004 from a SARS-induced peak of 8.6% in mid-2003. Median monthly employment earnings during the fourth quarter of 2004 stood at HK$9,500, the same as a year earlier; median household income edged up to HK$15,500 in the fourth quarter, from HK$15,000. Yet poverty remains a concern. According to the Hong Kong Council of Social Service, for every 100 children below the age of 15 in Hong Kong, China, almost 25 live in families with household income below half the median.

Residential property prices, as measured by the Centaline Leading Index, bottomed out in August 2003 and had risen by over 60% by end-February 2005, in part reflecting supply management policies introduced by the authorities late in 2002. Rising prices reduced the number of apartment owners suffering from negative equity, i.e., when mortgages exceed the value of the property, though apartment prices in the first quarter of 2005 were still well below their 1997 peaks. Prices of commercial property—offices and retail—rebounded even more strongly, some by as much as 80–100% in 2004. The recoveries in the economy and property market also lifted corporate earnings and the stock market, with the Hang Seng Index finishing the year with a modest gain of 13%.

Bank earnings and the quality of bank assets also benefited from the stronger property market. The recovery in investment and consumption stimulated demand for bank loans, and robust external trade increased trade financing activity. The launch of yuan business further helped the environment for banks.

The Closer Economic Partnership Arrangement (CEPA) between Hong Kong, China and the PRC, which was fully implemented in January 2004 and was expanded to cover more goods and services in January 2005, has helped strengthen investor confidence. Under the agreement, Hong Kong, China products covered by 1,108 PRC tariff codes have tariff-free access to the PRC market, and suppliers in 26 service areas receive preferential treatment from the PRC.

Inward FDI rose sharply to US$34.0 billion in 2004, more than double the 2003 figure. The increase apparently was related in part to PRC enterprises taking advantage of CEPA and setting up businesses in Hong Kong, China.

Government revenues, too, received a lift from the economic rebound and buoyant property market. General revenues, including operational and capital income, rose by 14.0% in FY2004 (ended 31 March 2005), while operating expenditures declined by 1%. The Government reported a small consolidated surplus equivalent to 0.9% of GDP, but after excluding receipts from bond issues the result was a deficit of 1.0% of GDP. This compared with a FY2003 deficit of 3.3% of GDP (Figure 2.2). Fiscal reserves at March 2005 rose to HK$287 billion, equivalent to 14 months of government expenditures.

Deflation concerns faded in the first half of 2004. In July, the consumer price index rose by 0.9% from July 2003, the first year-on-year increase since November 1998. For the full year, though, the composite CPI recorded a small decline of 0.4%. Meanwhile, the money supply (M2) growth rate picked up to 9.3% in 2004 from 8.4% in 2003, and domestic credit rose through the year.

Hong Kong, China has for many years maintained a current account surplus on its balance of payments, with a surplus on trade in services exceeding the merchandise trade deficit, while net investment income usually offsets unilateral transfers. This pattern recurred in 2004, with the merchandise trade deficit widening to US$9.3 billion and the current account surplus representing 9.7% of GDP.

Table 2.2 Major economic indicators, Hong Kong, China, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	8.1	5.7	4.1	5.6
GDI/GDP	23.0	23.5	23.3	22.6
Inflation (CPI)	-0.4	1.5	1.6	2.1
Money supply (M2) growth	9.3	-	-	-
Fiscal balance/GDP	-1.0	-1.2	-0.8	0.1
Merchandise export growth	15.9	12.2	12.3	14.2
Merchandise import growth	17.0	12.6	12.1	13.5
Current account/GDP	9.7	7.7	7.3	5.4

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product.

Sources: Census and Statistics Department; Hong Kong Monetary Authority; staff estimates.

Macroeconomic policy developments

With a target to balance the budget by FY2008, the authorities in 2004 maintained a policy of expenditure cuts, including reducing the number of civil servants and cutting the pay of the remaining personnel by 3% from January 2005. While the economic recovery pushed up revenues in 2004, the debate on a goods and services tax (GST) continued. About 40% of Hong Kong, China's income in its general revenue account is derived from salary and profit taxes; 30% comes from direct land-based revenues and investment receipts; the balance is indirect taxes and fees. A GST would be a way to broaden the narrow tax base, ensure a more stable revenue flow, and reduce the number of people who do not pay any taxes. The 5% GST under discussion could raise US$3 billion–4 billion a year. The financial secretary noted in the March budget that it usually takes about 3 years in any jurisdiction between making a decision to introduce a GST and actual implementation. He said that the authorities would consult the public before making a decision.

The authorities expect to balance the operating account by FY2008 and the

consolidated account by FY2007. Over the next 5 years, fiscal reserves will be maintained in a range of HK$270 billion–340 billion, equivalent to 13–17 months of expenditure.

The March 2005 budget proposed the abolition of estate duty (a tax on the estate of a deceased person). Many bankers and the Hong Kong General Chamber of Commerce had contended that repealing this tax would spur the development of asset-management services since wealthy people would not take assets offshore to avoid estate duty.

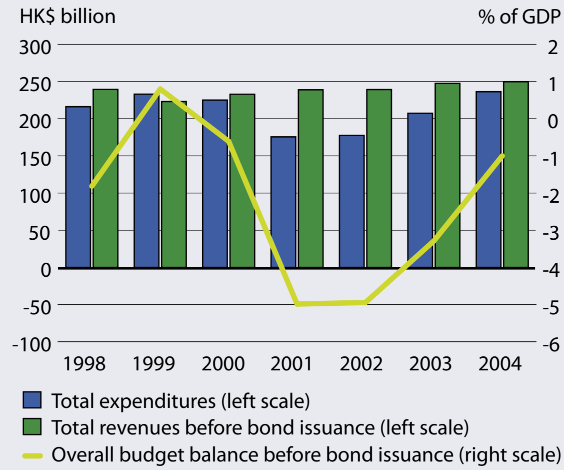
With a view to enhancing corporate governance, the authorities propose to establish a Financial Reporting Council, with two main functions. The first is to investigate irregularities of auditors of listed companies, and the second is to inquire into the financial reports of such companies to help ensure that they comply with legal and accounting requirements. The proposed law is expected to be introduced into the legislature around midyear.

Decisions in 2004 to securitize future toll income from government-owned tunnels and bridges with an offering of HK$6 billion-worth of bonds and the launching of a separate HK$20 billion government bond issue were aimed in part at stimulating the underdeveloped bond market.

Legislation for a deposit insurance plan was passed in May 2004. It will provide insurance for the first HK$100,000 of deposits per depositor per bank and is expected to come into effect in 2006. Also in 2004, banks were allowed to offer personal banking and credit cards in yuan. Together with a sharp increase in the amount of yuan that can be taken in and out of the PRC to CNY20,000 ($2,417), effective 1 January 2005, this signals closer financial ties between Hong Kong, China and the PRC, mirroring the closer CEPA trade ties.

On the monetary front, the Government and the Hong Kong Monetary Authority reaffirmed their intention to maintain the exchange rate link at HK$7.8 to the US dollar. Under this arrangement, interest rates should move in tandem with US rates. However, a combination of speculation about a revaluation of the yuan, weakened sentiment toward the US dollar, and improved economic conditions led to strong

Figure 2.2 Consolidated fiscal position, Hong Kong, China, FY1998–FY2004



Sources: Census and Statistics Department, *Hong Kong Annual Digest of Statistics*, 2004 Edition; The Government of the Hong Kong Special Administrative Region, available: www.budget.gov.hk/2005/eng/sum_p_e.pdf, downloaded 16 March 2005.

capital inflows. This resulted, in 2004, in a persistently large aggregate balance held by banks with the Monetary Authority. Consequently, Hong Kong, China's interest rates could remain below US rates, giving impetus to the property market and domestic credit expansion.

To address unemployment, the authorities adopted a combination of approaches—direct job creation, offering training to young workers and displaced workers, and more education opportunities. These approaches have been effective in reducing the jobless rate. On the poverty front, the authorities have recently established a commission on poverty to identify the needs of the poor, as well as make policy recommendations to reduce poverty and promote self-reliance.

Despite 6 years of generally weak growth up to 2004, Hong Kong, China's trend growth rate appears to be around 5%. Over the longer term, an aging of the population and low fertility rates could cause labor shortages, leading to wage inflation and lower economic growth. An aging population will also require much higher spending on welfare, care facilities, and health. The authorities have acknowledged the need for a sound population policy, which will require new approaches to immigration issues.

Outlook for 2005–2007 and medium-term trends

Growth is expected to slow to more sustainable rates of 5.7% in 2005, 4.1% in 2006, and 5.6% in 2007. Factors underpinning growth will be continued expansion of the PRC economy; low, though rising, interest rates; a soft US dollar; and FDI inflows. Private consumption and investment, rather than exports, are forecast to be the locomotives for growth. Buttressed by a surging tide of PRC visitors, declining unemployment, and rising wealth, private consumption is expected to grow by around 6–7% each year through 2007.

Investment growth is forecast in the 7–9% range. Construction activity is likely to revive now that the property market recovery is well under way. A revival of building activity—residential, commercial, and public works—will further reduce unemployment. Some of the major projects in the pipeline are extensions of railway lines; a 29 kilometer bridge to link the city with Macau and Zhuhai; and a new ocean liner terminal.

CEPA will continue to benefit the economy as implementation moves ahead, and is expected to help attract greater inflows of FDI. Other positive influences in the near term include: the PRC's liberalization of travel restrictions so that individuals from more PRC cities can travel to Hong Kong, China, which benefits hotels, restaurants, and retail businesses; improved investor sentiment toward the local stock market, which will boost new share offerings; and higher levels of confidence among SMEs, which will fuel investment.

Growth of goods and services exports will ease from 2004's strong rate to the 10–12% range, supported by a weak US dollar and a growing PRC economy. Services exports are expected to strengthen somewhat because of the buoyant inbound tourism—receiving a further fillip when a major theme park opens later in 2005—and the export of financial services. Imports of goods and services will grow faster than exports, by 11–13% through 2007, as a consequence of the continuing expansion of private consumption and investment. As a result, net exports will not add to growth.

Further improvement in the labor market is expected to reduce unemployment to 6.0% in 2005 and to below 5.0% in 2007. An increasing number of employees will reach retirement age in the medium term, so that the unemployment rate will continue to fall even though the pace of job growth may be only moderate. This trend may also put more upward pressure on wages over the next few years. Inflation, though, is expected to be mild at 1.5% in 2005, edging higher through 2007.

With the banking sector awash with liquidity, Hong Kong, China banks opted several times to not follow US interest rates up when the Federal Reserve raised its target for the Federal Funds rate. This widened the interest rate gap and funds started to move out of Hong Kong dollars in early 2005. In March, major banks raised rates closer to US levels. Domestic interest rates will probably continue to move up gradually, though the impact on the property market may be softened by changes to the housing finance market, under which banks are now able to grant mortgages on older buildings and are offering to lend up to 95% of the appraisal value of properties under a mortgage-insurance program. These changes will continue to support the property market recovery and, by raising land premiums collected and taxes on the profits of developers, banks, and brokerage houses, as well as stamp duties on both property and stock market transactions, bolster government revenues.

Risks to this medium-term outlook include a steeper than expected rise in US interest rates or sharper decline in world trade, and an outbreak of protectionist measures against the PRC from the US and European Union. Higher world energy costs have raised electricity charges in Hong Kong, China, but as a mainly services economy the damage is limited. Higher oil prices do hurt the economy's export destinations, though. Concerns that Shanghai could seriously erode Hong Kong, China's role as a financial center and gateway to the PRC in the medium term seem overstated. In terms of regulation, rule of law, transparency, and corporate governance, other cities in the PRC are unlikely to be competitive for many years.

Republic of Korea

The economy is on a gradual economic rebound from the 2003 slump induced by a household debt hangover, although the modest pace of recovery in private consumption will likely limit the speed and magnitude of near-term growth. To underpin the nascent recovery in domestic demand, the Government needs to address underlying structural weaknesses. Successful completion of comprehensive structural reforms remains key to achieving sustainable high growth.

Macroeconomic assessment of 2004

A robust recovery in early 2004—boosted mainly by strong exports—stands on shaky ground, as the usual knock-on effects of exports on investment and consumption spending failed to materialize. The economy grew by 4.6% in 2004, up from 3.1% in 2003, but its momentum weakened with year-on-year growth easing to 4.7% and 3.3% in the third and fourth quarters, respectively, from 5.4% in the first half. A 31% surge in merchandise exports proved insufficient to resuscitate private consumption, which fell by 0.5%, following a contraction of 1.2% in the previous year. Lingering effects of a household debt hangover, combined with underlying structural problems in the labor market and financial system, largely explain the weakness in consumption spending.

Despite considerable progress in debt restructuring since the credit card crisis in 2003, households remain reluctant to spend, with limited income growth and a continuing debt burden (Figure 2.3). Household debt stood at 73.8% of GDP at end-2004, with debt outstanding increasing by 5.7% from the prior year's level. More important, household disposable income (the amount of net income after tax and social security contribution that is available for household consumption or saving) has grown by an annual average of about 5.0% since the 1997 crisis, which is not enough to allow for both debt repayments and an increase in consumption spending.

Gross fixed capital formation rose by 1.9% in 2004 from a year earlier, on account of a pickup in export-led machinery and equipment investment, which grew by 3.8% in 2004 after a contraction of 1.2% in 2003. However, a continuing erosion of labor market competitiveness has deterred firms in the Republic of Korea (henceforth Korea) from investing domestically, limiting the investment gains. The absence of attractive domestic opportunities, compounded by sluggish demand, has induced corporations to use increased export earnings to lower their debts or divert their investment abroad.

The sharp contrast between external and domestic demand was further evident on the supply side. Manufacturing output rose by 11.4% in 2004, driven mainly by major export items such as information and communications technology products and motor vehicles, while services sector gains were limited to 1.3% over the year. Wholesale and retail trade continued to contract, by 0.5%, reflecting sluggish consumption. Real estate services also stagnated, as the property market cooled. Despite a mildly improving trend through the year, financial services contracted by 1.2% in 2004 in the aftermath of the credit card crisis.

Industrial production expanded by 9% on the back of robust exports. Shipments of manu-

factured goods rose by 9.1%, with those going overseas dominating with a 20.0% increase. The average operating ratio in manufacturing reached 80.3% in 2004.

The divergence between large and small firms widened. Behind this disparity lies unfinished business in reform efforts since the Asian financial crisis of 1997–98. Whereas large firms, or *chaebol*, have been subject to restructuring and refocused their businesses on globally competitive manufacturing or the high-tech sector, SMEs remain largely sheltered from the reform process. As a result of their substantial restructuring efforts, the large export-oriented companies enhanced their operational efficiency and financial stability. However, a prolonged slump in private consumption has eroded profitability of SMEs, most of which cater to domestic services markets. This has a damping effect on the overall economy since SMEs account for such a high proportion of total employment (Box 2.2).

The unemployment rate averaged 3.5% in 2004, rising marginally from an average of 3.4% in 2003. Although about 382,700 new jobs were created in 2004, a steady increase in the share of temporary workers due to structural rigidities in the labor market lessened job security, delaying a consumption recovery despite a gradual upturn in wage income. A considerable gap between permanent and temporary workers in terms of job security and overall compensation remains a problem for sustainable improvement in the labor market. Following years of militant labor action, permanent employees have gained strong legal protection for job security, improved working conditions, and significant wage increases. However, such protection has made firms reluctant to hire for permanent positions, limiting both job market improvement and increases in household income during the expansion period.

The consolidated budget balance, excluding social security contributions and repayments of the public fund for financial sector restructuring, resulted in a deficit of W3.6 trillion in 2004, from a surplus of W1.0 trillion in 2003, providing a mild fiscal stimulus. However, in the second half of the year when the economy sharply slowed, the fiscal balance even turned into a slight surplus. Total expenditures and net lending amounted to W173.2 trillion in 2004, increasing by 5.5%

Table 2.3 Major economic indicators, Republic of Korea, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	4.6	4.1	5.1	4.9
GDI/GDP	29.1	30.3	30.4	30.2
Inflation (CPI)	3.6	3.0	3.3	3.6
Money supply (M2) growth	5.2	9.2	8.9	9.7
Fiscal balance/GDP	-2.0	-2.8	-	-
Merchandise export growth	30.6	11.8	9.6	9.0
Merchandise import growth	25.2	13.5	10.6	10.8
Current account/GDP	4.0	3.9	3.5	2.8

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product.

Sources: Bank of Korea, available: www.bok.or.kr/index.jsp, downloaded 9 March 2005; Korea National Statistical Office, available: www.nso.go.kr/eng, downloaded 9 March 2005; staff estimates.

year on year. On the revenue side, tax collection increased by 2.7% to W117.8 trillion. Property, inheritance, and gift taxes continued to account for a substantial share of tax revenues, while collection of personal income tax strengthened, which compensated for a continuing shortfall in VAT and excise tax. Total revenue collection reached W178.8 trillion over the same period.

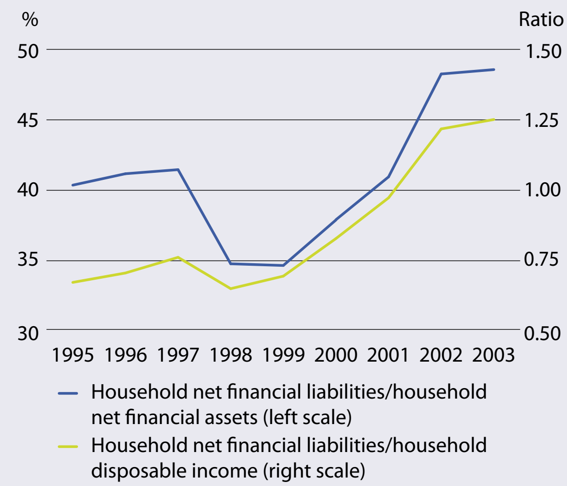
Both the consumer and producer price indexes rose in 2004, by 3.6% and 6.1%, respectively. Nevertheless, inflationary pressure abated somewhat in the fourth quarter of 2004, thanks to stabilizing global oil prices and strengthening Korean won. Prices of agricultural products subsided following a favorable harvest, significantly contributing to the price stabilization. The subdued inflationary pressure allowed the Bank of Korea to lower its policy rate from 3.50% to 3.25% in October, following a quarter-point cut in August. Long-term interest rates fell to low levels, flattening the yield curve after the rate cuts in the latter half of 2004. Money supply crept up, reflecting the mild improvement in investment demand. Picking up from 5.4% in the first half, growth in M3 averaged about 6.3% in the second half of 2004, although lower than the 2003 average of 8.8%.

The KOSPI index of share prices rose by 10.5% in 2004. A resilient export performance in the last quarter of the year, despite concerns

about slowing global demand and the rising won, underpinned the market's rebound from a retreat in the May–July period when US interest rates began climbing. Overall, corporations raised more than W58.7 trillion in 2004 through equities and bonds, a decrease of 19.4% from 2003's level. On the back of a revamped financial situation since the credit card crisis, financial institutions resumed lending, though low investment demand restrained credit expansion. A trend of financial deleveraging accelerated due to increased export profits. Reflecting the voluntary repayment of debt by medium-sized export companies, bank credits to corporations fell significantly from W30.5 trillion to W3.8 trillion in 2004.

The won substantially strengthened against the US dollar, to W1,035/$1 at end-2004 from W1,193/$1 at the previous year-end. A robust position on the balance of payments, as well as the global trend of dollar depreciation, were the main factors. The balance of payments was again in surplus; $38.7 billion was added to foreign exchange reserves in 2004. Bolstered by a record rise in merchandise exports, the current account surplus reached $27.6 billion. The capital account turned to a surplus of $8.3 billion, as foreign investors returned to the Korean stock market in the second half of the year. FDI was buoyant, with a net inflow of $3.4 billion in 2004. Portfolio investment remained a popular choice among foreign investors, with equity and bond purchases generating net capital inflows of $9.3 billion. On the other hand, Koreans also increased FDI abroad, amounting to $12.3 billion, with the majority directed to the PRC.

Figure 2.3 Household income growth and debt burden, Republic of Korea, 1995–2003



Sources: Bank of Korea; Datastream, downloaded 2 February 2005.

Macroeconomic policy developments

The lackluster growth performance in the second half of 2004 provided a political backdrop for bringing economic and development policies to the fore. In line with a firmer political consensus, the priority of economic policy is to create quality jobs and revive robust growth. To enhance growth fundamentals, the Government is emphasizing strengthening SMEs and the overall services sector, which remain labor intensive, thus having good potential to create jobs. The policy is also to create an investment-friendly environment and to reinforce the social safety net. Efforts will center on improving the competitiveness and productivity of SMEs by encouraging new entrants, nurturing technological innovation, and facilitating effective restructuring. Opening the services sector to international competition and related deregulation will bring about restructuring in services firms, thus heightening productivity. Meanwhile, a stronger social safety net will be put in place as increased competition causes some firms to reduce staff.

Macroeconomic policies will remain supportive of an emerging recovery at least in the first half of 2005. The consolidated central government budget has been expanded to W167.3 trillion for the full year, a 3.8% increase from W161.3 trillion in 2004. About 59% of the budget will be allocated during the first half to provide an immediate stimulus, while a planned public investment strategy—the Comprehensive Investment Initiative—will reinforce an investment revival in the second half. The initiative is expected to encourage private efforts and market incentives in public sector investment such as education, roads, energy, and other social overhead capital. However, the scope of the initiative remains vague, casting doubt on its effectiveness in boosting domestic demand in the near term, when the stimulus is required. There also is some concern that the initiative may mask

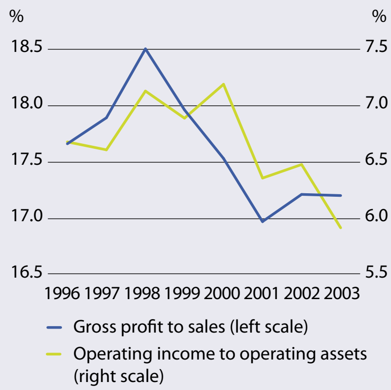
Box 2.2 Weakening small and medium enterprises pose a threat

Small and medium enterprises (SMEs)—the majority of which are small companies including micro businesses with fewer than five employees—accounted for 99.8% of Korea's companies and 86.7% of total employees in 2002. Any weakening among SMEs poses considerable impediment to a domestic demand recovery by directly affecting household income through poor job creation as well as by curbing a rebound in business spending.

Profitability and financial stability among SMEs are deteriorating, following a long delay in consumption recovery (see box figure). The ratio of gross profits to sales fell from 18.5% in 1998 to 17.2% in 2003, at the same time that operating income to operating assets declined from 7.1% to 5.9%. Capacity utilization in December 2004 remained below 70% for the 23rd consecutive month, constraining business spending. Such overcapacity is mainly attributable to a surge in SME credit during 2001–2003 following a venture capital boom and subsequent household credit contraction.

Although the current ratio (an indication of a company's ability to meet its short-term obligations) has been improving since the 1997 financial crisis, this appears to reflect a trend of financial deleveraging and low investment demand, which impairs SMEs' long-term competitiveness. Corroborating this view, declining profitability has left many SMEs in financial distress. Delinquency rates on bank loans to SMEs increased from 2.0% at end-2002 to 2.6% in September 2004. Such financial problems are particularly severe in the services sector.

Box figure Deterioration in SME profitability, 1996–2003



Source: www.nso.go.kr/eng.

For example, in wholesale and retail sales, the rate rose sharply from 2.3% to 4.6% over the same period. An SME survey by the Korean Federation of Small and Medium Business suggests that both operational and financial difficulties continue, with the index of small-business health falling to 68.5 in December 2004 from 71.0 in January that year (a reading below 100 suggests a deterioration in the SME business environment).

In response to the financial deterioration in SMEs, the Government has taken several steps to avoid a large number of defaults. SME financing is generally short term. With a large share of SME loans falling due within 12 months (72.8% of outstanding loans were due within 12 months as of July 2004), the Government has urged banks to roll over outstanding loans since the second half of 2004. It has also encouraged longer maturities on loans to SMEs, by providing guarantees through Korea Credit Guarantee Fund and Korea Technology Credit Guarantee. A substantial capital injection to these agencies has been made to expand SME credit guarantees from W39 trillion in 2004 to W42 trillion in 2005. However, the effects of this financing facility will only be for the short run; long-term reforms to strengthen the overall credit system are now required to provide stable SME funding. Along these lines, recent initiatives to establish a credit bureau for SMEs and diversify SME funding sources are welcome.

Korea's long-term economic growth fundamentals will be restrained without significant improvement among SMEs. Behind the lagging performance of SMEs has been the reluctance of both SMEs and the Government to push forward with forceful operational and financial restructuring. Not only were SMEs largely sheltered during the postcrisis reforms, but government support, including guarantees for SME credit, has also prevented the emergence of an effective market mechanism to force the exit of failing firms. A broad and in-depth restructuring is necessary among SMEs to sustain robust growth, by removing policy barriers to competition that hamper investment and by opening the services sector to foreign competition.

Source: Asian Development Bank staff.

fiscal liabilities that could stem from government guarantees to induce private investment in desired areas.

While a near-term fiscal stimulus is warranted to bolster weak investment demand, equally important is the establishment of an effective fiscal management system that is tightly anchored to long-term fiscal sustainability. The lack of comprehensive budget controls, together with inadequate fiscal management, often results in unintended fiscal tightening and repeated use of supplementary budgets, as seen in 2003 and 2004, which makes tax cuts a better choice than expansionary fiscal spending for short-term stimulus.

Against this background, more comprehensive fiscal reforms should follow the near-term fiscal stimulus to maximize the role of automatic stabilizers by increasing efficiency and transparency of expenditures and by minimizing distortionary effects of the tax system within a longer-term budget framework. To this end, the revenue structure should be streamlined through rationalization of different tax treatments of various income sources and the removal of earmarked and quasi-taxes with specific purposes (such as education, transportation, and a special tax for rural development), alongside a broadening of the tax base through limiting the use of allowances and personal income tax credits.

On the monetary front, an accommodative stance will prevail at least through 2005 given the below-potential economic performance. Although negative real interest rates limit the effectiveness of monetary policy, extended weakness in the financial position of households and SMEs will further weigh on policy decisions. While the mitigation of inflationary pressure late in 2004 provides a benign context, the Bank of Korea needs to monitor money and credit conditions to avoid any asset price booms arising from monetary easing and structural weaknesses in the financial system. Over the medium term, maintaining price stability should be the primary objective of the Bank of Korea. With the recovery likely to gain momentum later this year, monetary policy needs to gradually return to a neutral stance by adhering to the inflation target.

Alongside its strengthening of the financial system, the Government is continuing to facilitate restructuring of household debt, through rehabilitation of individual credit delinquents by court orders to reschedule debt payments, private debt workouts by financial institutions for defaulters, and the establishment in 2004 of a so-called "bad bank" that acquired distressed assets from banks and credit card companies. The credit card delinquency ratio of households fell to 9.6% in October 2004 from 10.5% in December 2003. The rate of overdue (1 month or longer) payments on credit cards also edged down to 7.3% from 7.8% over the same period.

In order to buttress a stable consumption recovery without a credit crisis recurring, further reforms need to ensure more efficient but prudent banking practices, including encouraging banks to diversify their lending services and to enhance their risk management through credit derivatives and hedging products.

Outlook for 2005–2007 and medium-term trends

The near-term outlook remains weak, with GDP growth projected to slow to 4.1% in 2005. Various adverse external factors, such as sustained high oil prices, softening global demand for high-tech products, and a likely moderation in the global recovery will weigh on export growth, not least because of the exceptional export performance in 2004. Meanwhile, consumption is picking up, but at a sluggish rate because of the weakness of household balance sheets and structural weakness in the labor market.

Still, evidence points to the end of the prolonged consumption slump that has dogged the economy since the credit card crisis. Household debts and the delinquency ratio on credit card loans have stabilized, although at a higher level than before that crisis, as a result of debt-restructuring efforts. A trend of financial deepening in the household balance structure based on increasing access to household credits and more assertive credit behavior by households also suggests that households should be able to manage debts more efficiently and soon resume spending. Meanwhile, expansionary macroeconomic policies and significant improvements in corporate balance sheets provide a favorable backdrop for investment. On the basis of a stronger recovery in domestic demand with lagged effects of policy stimuli, economic growth is projected to move up to 5.1% in 2006 and 4.9% in 2007.

While growth in merchandise exports will slow to an estimated 12% in 2005 from 31% in 2004, external demand will continue to provide a gentle push to growth. Trade and industrial production data in the last quarter of 2004 were surprisingly upbeat, which reflects the global competitiveness of many of Korea's exporting companies. Such resilience will help sustain industrial production and business spending, providing a firm foothold for an economic recovery.

The investment outlook is brighter than the immediate outlook for consumption, as many

firms that retained substantial export earnings and improved their financial status throughout 2004 appear to be in a promising position. Following years of conservative spending, exporters are also in need of aggressive business investment to maintain their global competitiveness. Operational and financial difficulties faced by the SME sector should gradually ease, as business spending driven by large firms will have an effect on overall domestic demand later in 2005.

A slowdown in the real estate market poses a significant near-term risk to a recovery in domestic demand. Policy measures to curb speculative activity in the housing market have started to have an impact. Amid uncertainty surrounding the implementation of new tax laws, real estate transactions have crumbled and housing prices have fallen, in turn helping weaken consumer sentiment and driving the near-term consumer expectation index down to a historical low at end-2004. Adding to the concern, construction investment growth fell sharply to 1.1% in 2004 from 7.9% in 2003. With its significant share (about 58%) in gross fixed capital formation and effects on overall economic activity, a further slowdown in such investment could impede a nascent recovery in domestic demand.

More important, unbalanced growth between the external and the domestic sector, manufacturing and services, and large and small firms—which highlights the disparities in competitiveness and productivity between these areas—remains a medium- and longer-term risk to sustainable high growth. To tackle this, the Government needs to focus urgently on linking the supply-side performance to domestic demand by creating a favorable investment climate to unlock domestic opportunities.

Over the long run, structural reforms to promote economic efficiency and competition across all sectors are key to sustaining stronger growth. The pace of comprehensive postcrisis reforms, which enhanced overall economic efficiency by promoting competition, has slowed in the past few years as the reform agenda moved into politically sensitive areas, such as labor markets, tax policy, and restructuring of social services. However, the economy's ability to sustain high growth will depend on the successful completion of comprehensive structural reforms that entail enhancing competition in SMEs and services, closing the gap between permanent and temporary workers, minimizing tax distortions, reducing inefficient regulatory interventions, and further strengthening governance in the corporate sector and risk management in the financial sector.

Mongolia

The economy surged in 2004 on the back of a stronger performance in agriculture, expanding mining output, and buoyant world copper prices. Rising corporate tax payments helped narrow the budget deficit to historical lows. Economic growth is expected to average 7% over the next 3 years, but sound monetary and fiscal policies as well as further private sector development are necessary to sustain growth and generate employment in order to fight persistent poverty.

Macroeconomic assessment of 2004

Surging world commodity prices and the positive effect of a milder winter on livestock nearly doubled GDP growth to 10.6% in 2004, in excess of projections and propelling it to the highest rate since Mongolia's economic transition began in 1991 (Figure 2.4). Agriculture grew by 18.9%, driven by rapid development of animal husbandry, though crop production declined. While the contribution of manufacturing was minimal, industry overall progressed by 15.4% as mining expanded with the start of operations of a new gold mine, which lifted gold production by half. Services—mainly wholesale and retail trade, telecommunications, and financial services—rose at a slower pace than in previous years, by 4.0%. Visitor arrivals rebounded by 67%, after being hit by the regional SARS outbreak in 2003.

Although continuing economic growth is helping raise living standards, poverty remains persistent in both rural and urban areas: 36% of the population live below the national poverty line equivalent of $0.75 a day. In addition, income inequalities have widened—the Gini coefficient, a measure of income inequality, increased to 0.44 in 2002 (the latest data available) from 0.31 in 1995. Poverty in rural areas is the most severe, with western Mongolia the worst region. This is broadly consistent with changes in the composition of GDP in recent years, as industry and services have boosted their share of the economy while that of agriculture has shrunk, to 25% of GDP in 2004 from 34% in 2000. One result is a significant flow of people moving from the countryside to urban centers.

High unemployment—14.2% of the workforce in 2003 according to the National Statistical Office—and underemployment are the major causes of poverty. The services sector is the main source of employment in Mongolia, followed by agriculture and industry. But only 5% of the rural workforce is employed in services, compared with 75% in urban areas. The Government's strategy to reduce poverty consists in maintaining macroeconomic stability, further liberalizing the economy, and improving public services.

The fiscal deficit remained below the International Monetary Fund's Poverty Reduction and Growth Facility target (6.0% of GDP) for a fourth year in a row. Despite a fiscal loosening in the approach to June 2004's elections, the deficit narrowed to 1.2% of GDP from 4.2% in 2003, bolstered by higher corporate tax collection, particularly from the mining sector. This enabled the Government to repay $50 million borrowed in late 2003 from a Canadian mining company as part of a debt settlement with the Russian Federation.

Higher prices for locally produced food and oil more than doubled inflation to 10.6% in 2004. A tightening of monetary policy in the fourth

quarter of 2004 sharply decelerated growth in the money supply (M2) to 16.5% for the year, from 49.7% a year earlier. Lending rates were broadly stable and credit to the corporate sector continued to expand. The togrog depreciated by 3.9% in nominal terms against the dollar. FDI inflows, concentrated in mining, totaled $132 million, similar to 2003 levels.

Total trade leaped by 28.3% to $1.9 billion in 2004, on account of a 36.0% surge in exports—led by increases in shipments of copper concentrate, textiles, and precious metals—and a 22.4% upswing in imports—driven by purchases of oil, equipment, and machinery. The trade deficit narrowed to 10.4% of GDP from 15.7% the year before, and the current account deficit, including official transfers, narrowed to 0.3% of GDP from 7.8%. The overall balance of payments recorded a $42.5 million surplus, reflecting the inflow of external assistance and growing remittances from overseas workers.

At end-2004, foreign debt amounted to $1.3 billion, equal to 89.5% of GDP. Most foreign loans are on concessional terms, so the country's debt remains manageable. Gross international reserves stood at $205 million (10.3 weeks of imports), indicating a recovery after part of the reserves had been used to repay debt to the Russian Federation in December 2003.

Macroeconomic policy developments

The new Government of Mongolia, formed as a result of the parliamentary elections in June 2004, defined an Action Plan for the next 4 years, the main objectives of which are to upgrade the quality of public services, deepen legal reforms, sustain higher rates of private sector-led growth, improve living standards, and raise education standards.

On economic issues, the Action Plan sets various targets, including a minimum of 6% annual economic growth to be pursued through economic and financial stabilization, private sector-based structural reforms, and increased foreign investment and exports. The Government will pursue macroeconomic stability by maintaining inflation within single-digit levels, the budget deficit at 3% of GDP, and sufficient international reserves to cover 17 weeks of imports.

Table 2.4 Major economic indicators, Mongolia, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	10.6	7.0	6.3	7.5
GDI/GDP	27.0	27.0	28.0	28.0
Inflation (CPI)	10.6	5.0	5.0	5.0
Money supply (M2) growth	16.5	19.3	-	-
Fiscal balance/GDP	-1.2	-2.5	-	-
Merchandise export growth	36.0	-0.8	-	-
Merchandise import growth	22.4	2.5	-	-
Current account/GDP	-14.0	-13.5	-	-

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product.

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

The financial and banking subsector is to be strengthened through the development of financial markets and financial intermediation, introduction of long-term loans and mortgages, and progressive reduction in interest rates to facilitate wider access to credit and foster domestic investment.

Privatization will be continued and private investment in infrastructure will be encouraged. To stimulate private sector-led growth and exports, the Government will expand the policy of establishing free economic and trade zones and industrial technology parks. The Action Plan also calls for support to SMEs through better access to credit generally and microcredits in rural areas especially, and through promotion of intensive agricultural techniques and modern farming methods. To create a stable and attractive legal environment for investors, international standards and procedures will be extended and the stock exchange will be resuscitated.

The 2005 budget, passed by Parliament in November 2004, aims for a budget deficit equivalent to 3.5% of GDP. It incorporates a new system of cash payments to children in families below the poverty line, fulfilling a promise made during the election campaign. This program will cost about $14 million a year. The budget allocates 20.8% of total expenditures to education and 10.8% for health. The president vetoed the excise tax provisions of the 2005 budget, which will reduce revenues by about $10 million, so a revision to the budget is required.

Late in 2004, the Bank of Mongolia raised the interest rate on its bills by 6 percentage points to 15.5% to damp inflationary pressures. This helped contain M2 growth to within relatively moderate levels for the first time since 2001. The slowing growth of the money aggregate indicates that demand for money and the monetization of the economy is decelerating after 3 years of fast growth in bank deposits and credit, a period when public confidence in the banking system improved. The central bank's guidelines for 2005 aim to contain the growth of money aggregates and bring down inflation to 5%.

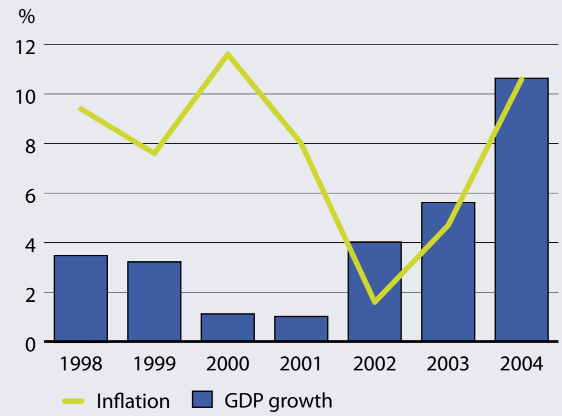
The Bank of Mongolia expects the exchange rate of the togrog to remain fairly stable, its policy having avoided sharp swings in the currency in the past 5 years. In other areas, it plans to strengthen regulation and surveillance of the financial subsector and to draw up laws to fight international money laundering and terrorism-financing practices. In order to project the expected effect of monetary policies on the overall economy, this year the central bank also plans to develop a general equilibrium model for the economy.

Outlook for 2005–2007 and medium-term trends

The economy depends heavily on the weather, which can seriously damage farm production; and on the performance of just three exports (minerals, cashmere, and textiles), which account for more than 80% of total exports. Hence, projections for the economy rest largely on assumptions in these two areas. The following outlook relies on assumptions that external demand will grow; prices of gold, copper, and cashmere will remain strong; weather conditions will be favorable; the PRC and the Russian Federation will continue to grow; and Mongolia itself will remain politically stable.

On this basis, economic growth is expected to average 7% in the forecast period. Milder winters and improved breeding techniques should continue to foster animal husbandry, although increases in crop production are less certain because the sector needs restructuring and investment. The boom in investment in mining and minerals is expected to continue, given good prospects for exploration in the Gobi desert and the PRC's voracious demand for minerals—particularly copper—and energy. Mongolia is affected by the phasing out of the Multifibre Arrangement and could lose garment-making jobs if it cannot upgrade to higher value-added products and compete in international markets, though prospects may brighten following a new bilateral trade agreement with the US. Construction and services, the latter accounting for about half of GDP, are projected to grow in line with rapid development of the capital city and growing demand for financial and telecommunications services. Tourism is likely to expand further because the country has attracted a growing number of visitors year after year, and the infrastructure for tourism is improving.

Figure 2.4 Inflation and GDP growth, Mongolia, 1998–2004



Source: National Statistical Office of Mongolia.

The budget deficit is likely to remain below 3.5% of GDP in the forecast period, with strong tax revenues from minerals and moves to discourage tax avoidance helping offset the increased costs of the new system of cash payments. Inflationary pressures caused by high oil prices may ease after the replacement of the agreement with a key oil supplier—the Russian company Yukos—with a new agreement to buy oil at lower prices from Kazakhstan. The lower oil prices and tighter monetary policy may be able to keep inflation at around 5% in the next 3 years.

Mongolia's dependence on a few commodities that are vulnerable to internationally volatile prices makes reliable projections on trade particularly difficult. There is potential for increased

exports to the PRC (especially oil and copper) and to the Russian Federation (animal products), though against this, the sharp increase in global copper prices seen in the past year or so is unlikely to be sustained.

Other constraints include the dependence of some of the country's major growth industries on energy consumption, which poses a risk to sustainable development. The resulting air pollution and land and water degradation could hamper future growth. Furthermore, the country's competitiveness suffers from high transport costs, insufficient infrastructure, and limited access to credit.

The private sector's share in the economy has increased to 85%, but substantial challenges remain. A large body of legislation to improve the environment for private sector development has been enacted, but a lag remains between enactment and application. Interest rates remain high and terms for lending are short, which restricts investment to big borrowers and limits broad access to credit, hindering the development of SMEs.

Although investment remains strong, mobilization of savings is not progressing—indeed, the savings ratio is declining. The gap between saving and investment needs to be covered by foreign funds. Growth has picked up in recent years, but remains vulnerable to the economy's narrow base. Sound monetary and fiscal policy actions, a healthy financial sector, and further private sector development are crucial for sustaining growth and generating employment.

Taipei,China

The economy showed robust growth in 2004, marking a recovery from SARS in 2003 and supported by the cyclical rebound in the global high-tech sector, which boosted business investment. Growth will moderate this year before picking up in 2006–2007. Policy makers are grappling with ways to raise revenues in order to strengthen the fiscal position and upgrade technology, so that the economy can stay competitive.

Macroeconomic assessment of 2004

Growth picked up to its fastest rate since 2000, at 5.7%. After reaching a peak of 7.9% in the second quarter, momentum slowed in the second half, largely reflecting the higher second-half base in 2003, when the economy rebounded from the impact of SARS. The slowdown also stemmed from decelerating export growth in the second half of 2004, which was caused by higher global oil prices, an easing in global demand for high-tech products, and the PRC's macroeconomic tightening policy.

In contrast to previous years when the external sector lifted economic growth, domestic demand—particularly private consumption and investment—was the driver in 2004. Private consumption rose by 3.1% and contributed 1.9 percentage points to growth. The recovery of the information and communications technology (ICT) industry, which is a significant part of the economy, boosted business investment. Consequently, private fixed investment grew sharply by 28.2% and gross fixed capital formation contributed 2.6 percentage points to GDP growth. The external sector did not contribute to GDP growth, as strong export growth was offset by booming demand for imports (Figure 2.5).

From the production perspective, industry and services contributed fairly equally to GDP growth, with around 3 percentage points each. Growth in services of 4.8% was helped by the rebound from the 2003 SARS outbreak, which boosted tourism, travel, and retail trading. Industrial growth was led by manufacturing, which grew by 9.4%, supported by the ICT subsector. Construction, though, grew by a marginal 1.1%. Overall industry sector growth accelerated to 8.3%.

Agricultural production, in contrast, dropped by 7.1% as a typhoon and floods damaged output, though this hardly affected GDP because the sector's share of the economy is only 1.7%.

The recovery, combined with the Public Services Program to hire the unemployed, increased the number of people employed by 213,000, or 2.2%, in 2004. The average unemployment rate fell to 4.4% from 5.0% in 2003. Average earnings rose by just 0.1%.

The general government fiscal deficit, including the deficit of the central and local governments, has exceeded 3.0% of GDP since 2000, although the gap narrowed to an estimated 2.9% in 2004 from 3.6% in 2003. A major cause of the deficit is weak revenue mobilization. Various tax reductions and incentives over the years, as well as low economic growth rates in 2001–2003, eroded fiscal revenues to about 13.5% of GDP in 2004 from 20.6% in 1990. Government borrowing has increased instead, pushing up public debt to the equivalent of an estimated 38% of GDP in 2004, from 23% in 1998.

Inflation returned, after more than 2 years of deflation, to average 1.6% in 2004. Food prices rose in the third quarter because of the damage to food production by the typhoon and floods. The impact of higher global oil prices was limited because fuel makes up only 2.3% of the CPI and because the regulated transport and power industries did not pass on the higher costs to consumers. However, the wholesale price index rose by 7.1% on average, pushed by rising international oil and commodity prices.

Money supply (M2) growth picked up to 7.4%, reflecting the economic recovery. The New Taiwan dollar appreciated by nearly 3% against the US dollar to NT$33.4 on average for the year as the latter weakened. However, the domestic currency depreciated against the yen, to NT$0.309/¥1 from NT$0.297/¥1 in 2003.

On the external side, merchandise exports climbed steeply by 20.7% in 2004, with exports to Asian nations up by about 25% and accounting for more than half of total exports. A large portion of this export volume to Asian economies is reexported to the US and Europe.

Imports shot up by 32.2%. Sharp increases in imports of capital and consumption goods, reflecting strong domestic demand, were largely responsible. The burst of imports caused the trade surplus to shrink to US$16.5 billion in 2004 from US$24.9 billion in 2003, and the current account surplus narrowed to 6.2% of GDP from 10.2%. Foreign reserves rose by a further US$35.1 billion to US$241.7 billion at end-2004, for two main reasons: increased portfolio investment, driven by the opening of the capital market in October 2003 that allowed foreign investors to trade on the stock market; and an appreciation against the US dollar of the reserves denominated in euros and yen.

Table 2.5 Major economic indicators, Taipei,China, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	5.7	4.2	4.5	4.6
GDI/GDP	20.7	20.8	20.9	21.5
Inflation (CPI)	1.6	1.7	1.5	1.5
Money supply (M2) growth	7.4	6.1	5.5	5.5
Fiscal balance/GDP	-3.4	-4.9	-4.5	-4.6
Merchandise export growth	20.7	12.1	8.2	9.5
Merchandise import growth	32.2	18.2	12.6	8.9
Current account/GDP	6.2	6.8	6.7	6.3

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product.

Sources: Central Bank of China, available: www.cbc.gov.tw/EngHome, downloaded 4 March 2005; Directorate-General of Budget, Accounting and Statistics, available: www.stat.gov.tw, downloaded 4 March 2005; staff estimates.

Macroeconomic policy developments

The fiscal deficit and rising government debt are among areas receiving attention from policy makers. The tax system has become distorted by concessions and incentives that have seriously eroded the tax base. The authorities have stated that it could take 5–10 years to balance the budget, and they plan to do this by reducing government employment, enlarging the tax base, raising tax rates, and selling some SOEs. In February 2005, they proposed a new minimum business income tax on local and foreign enterprises. However, no time frame for implementation was presented.

Privatization of SOEs has fallen behind schedule because of resistance within Parliament, from labor unions, and sometimes from the companies themselves. The authorities own large stakes in many companies, including those in the airline, banking, petroleum, and telecommunications industries. In an effort to facilitate privatization, it is planned to group 43 of the companies under one (or more) holding company. However, for unprofitable enterprises such as the power monopoly Taipower, the authorities also need to allow market pricing of power before the company is likely to be attractive to investors.

In 2005, the authorities intend to issue up to NT$500 billion of bonds, among other things, to cover a budget deficit of nearly NT$300 billion. Some of the bonds will be exchangeable into shares of SOEs. Although international rating agencies have expressed concern over the fiscal position and rising public debt, running into serious debt problems in the medium term is unlikely.

In the area of monetary policy, the Central Bank of China raised the official discount rate by 25 basis points to 1.625% in September 2004, the first increase since mid-2000, and lifted the

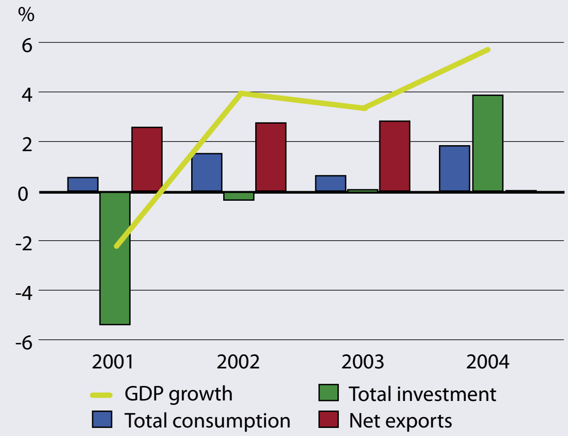
rate further to 1.75% in December. The rises were prompted by concerns about inflation, a widening spread between domestic and US rates, and the desire to maintain positive real domestic rates.

Consolidation in the banking industry is progressing slowly; the economy still has about 50 banks and a large number of small lenders. Fourteen financial holding companies were formed in 2001 to amalgamate banking, insurance, and securities operations. A number of financial-sector mergers and acquisitions were finalized in 2004, though the authorities hope to reduce further the number of financial institutions and increase the size and market share of several key domestic players. In addition, the resolution of problems that emerged during the Asian financial crisis continued in 2004. Some weak financial institutions were liquidated or acquired, and NPLs at domestic banks fell to 2.8% at end-2004 from 7.5% in 2001. The improvement in the soundness of the institutions helped spur lending to businesses.

The Financial Supervisory Commission was established in July 2004 to consolidate multiple layers of financial supervision for insurance, securities, and banking. This move is expected to lead to more transparency and accountability in the financial sector.

Of broader concern to policy makers is the decline in Taipei,China's economic growth rate to an average of 2.7% in the past 4 years, from 6.3% in the 1990s and 8.1% in the 1980s. Slow population growth and an outflow of FDI, partly caused by manufacturers relocating to lower-cost economies, are two of the main causes. The authorities consider that upgrading technology and a general increase in productivity is the way to achieve longer-term sustainable growth. To spur the development of a knowledge-based economy, they initiated the Challenge 2008: National Development Plan, which involves mobilizing around US$15 billion of government investment and encouraging the private sector to invest US$6 billion by 2008. Other goals for 2008 include achieving economic growth of more than 5% a year, raising spending on research and development, making the economy the world leader in 15 products or technologies, and connecting more than 6 million households to broadband telecommunications.

Figure 2.5 Contribution to GDP growth by expenditure account, Taipei,China, 2001–2004



Source: Directorate-General of Budget, Accounting and Statistics, available: www.stat.gov.tw, downloaded 1 March 2005.

Outlook for 2005–2007 and medium-term trends

The GDP growth rate is expected to moderate to 4.2% in 2005 as external demand eases. Supporting this forecast, the composite index of leading economic indicators—a gauge of economic activity 3–6 months ahead—fell for several months in a row in late 2004 and its rate of decline accelerated in January. Private consumption will continue to grow, by around 3% annually in the forecast period. Private fixed investment growth will remain relatively strong and government investment in infrastructure is likely to increase.

Growth in exports of goods and services will slow to 10.2% in 2005 because of softening global demand, and will decelerate to below 8% in 2006–2007. Imports of goods and services are expected to grow by 8.4% in 2005.

Per capita gross national product (GNP) is set to rise to US$15,600 this year from US$14,717 in 2004, reflecting the appreciation of the local currency against the US dollar, moderate growth in GDP, and net factor foreign income flows. This milestone could be significant because the experience of other economies suggests that technology upgrades are facilitated when per capita GNP exceeds US$15,000. It has taken

Taipei,China 8 years to increase its per capita GNP from US$13,500 to above US$15,000 because of slow economic growth and a weakening of the currency during the period.

GDP growth is forecast to edge higher to 4.5% in 2006 and to 4.6% in 2007, based on expectations of an upturn in the global technology cycle, a greater focus on economic issues by the new cabinet, and reasonably smooth relations with the PRC. If plans to increase tax revenues gain legislative approval and further progress is made in strengthening the domestic financial system, investment and growth could be greater than forecast.

CPI inflation is expected to rise to 1.7% in 2005. Regulated transport services and public utilities could well receive approval to raise prices following increases in their costs, though this should be largely offset because the appreciating currency will limit imported inflation. The CPI rose by 1.2% in the first 2 months of 2005 from the year-earlier period and the wholesale price index rose by 3.3%. Inflation is expected to be below 2% in 2006–2007, depending in large part on movements in international commodities and the exchange rate. This is expected to appreciate to average about NT$31.7 to the US dollar and strengthen further in the following 2 years. Interest rates will be on a gradual upward trend from the low levels of recent years.

In March 2005, the central bank again raised the official discount rate, to 1.875%, the third increase in 6 months. It pointed to rising inflationary expectations, high capacity utilization in manufacturing (80.3% in January), a stronger labor market (unemployment averaged 4.2% in the first 2 months of the year), and low real interest rates.

In this context and with economic growth on track, the central bank said that monetary policy would gradually return to a neutral stance to help maintain price stability and prevent negative real interest rates from hampering fund allocation and long-term financial stability. It added that the rate rise would cause only a small increase in nominal costs for firms, given that the banking sector has ample liquidity to accommodate funding needs

Downside risks to this outlook include a larger than expected rise in oil prices; a sharp appreciation in the New Taiwan dollar, reducing the economy's export competitiveness; and any serious heightening of tensions with the PRC. Also, there is a risk that Taipei,China could be left out of closer regional economic integration, which would reduce its economic opportunities.