EAST ASIA

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

People’s Republic of China

Strong investment, supported by an expansion of private consumption and net exports, powered a return to double-digit growth. The authorities ended the fiscal stimulus program and, with inflation pressures building, tightened monetary policy. GDP growth is forecast to moderate both this year and next. Inflation will rise in 2011, then likely decelerate in 2012. Going beyond the next 2 years, the new 5-year plan puts more emphasis on consumption and services as drivers of growth and on reducing both income inequality and pollution.

Economic performance

Brighter than expected economic growth in the second half of 2010 lifted the full-year rate of expansion in the People’s Republic of China (PRC) to 10.3% in a return to the pre–global recession double-digit pace. All sectors recorded solid growth, led by industry with a 12.2% increase that contributed about two-thirds of total GDP growth. Services expanded by 9.5% and agriculture by 4.3% (the grain harvest was good, despite harsh weather).

From the demand side, investment and consumption explained 92% of total growth, investment being the main contributor (Figure 3.9.1). Still, the winding back of the aggressive fiscal stimulus put through during the global recession slowed the growth of fixed asset investment in nominal terms from the very high 31.0% seen in 2009 to 24.4% in 2010.

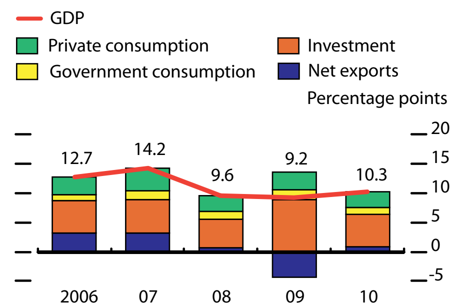
Private consumption grew by 11.0% in nominal terms (9.3% in real terms), supported by higher incomes. Sales of household appliances and furnishings benefited from heavy investment in housing, while sales of automobiles continued to surge. Despite several years of solid growth in private consumption, however, it remains low as a share of expenditure-based GDP at 34%.

Net exports contributed positively to GDP growth in 2010 (by 0.8 percentage points), unlike 2009 when net exports fell as global trade slumped.

Monetary policy supported growth, even as the authorities reined in the highly expansionary stance taken during the global recession. While broad money supply (M2) growth decelerated to 19.7% in 2010 from 27.7% in 2009, it was above the 17.0% target for 2010 of the People’s Bank of China (the central bank).

Growth in bank credit at CNY8 trillion also exceeded its target, by CNY0.5 trillion, although it was well below 2009’s outturn (Figure 3.9.2). This measure of credit is likely to understate the total as it excludes loans channeled through trust companies. Several

3.9.1 Contributions to growth (demand)



Sources: National Bureau of Statistics of China; ADB estimates.

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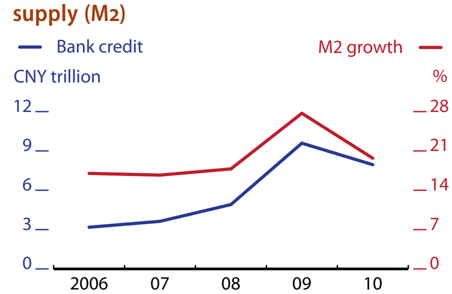
3.9.2 Growth in bank credit and money supply (M2)



Sources: CEIC Data Company (accessed 16 March 2011); ADB estimates.

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

estimates suggest that these off-balance-sheet loans amounted to about CNY3.8 trillion in 2010.

Abundant liquidity, rising food prices, and higher costs of imported oil and commodities pushed up consumer prices during 2010 (Figure 3.9.3), when inflation averaged 3.3%.

The government changed some of the weights in the consumer price index basket in early 2011, lowering that for food and raising the one for housing. Yet despite this, the index is still seen as understating inflation because its composition and weights have not been significantly adjusted to reflect the major changes in consumption patterns in the last decade.

Moving to stem inflation, the central bank raised the reserve requirement for banks six times in 2010 and three times in the first quarter of 2011 (to 20.0% for large banks). It also lifted the benchmark interest rate twice in 2010 and once in the first quarter of 2011 (by a total of 75 basis points to 6.06%—Figure 3.9.4). The government imposed price controls on some food items and increased subsidies for low-income earners.

Prices of residential property in cities rose strongly, propelled by rising incomes, investment demand, and the abundant liquidity. Overall property prices climbed by an average of 10.0% in 70 major cities. Real estate investment surged by 33.5% in nominal terms, outpacing overall investment growth. Government actions to curb house prices included raising both mortgage interest rates and down payments as well as directing banks not to lend for purchases of third (or more) homes. These changes damped the rate of increase during the year (Figure 3.9.5).

Fiscal policy was supportive of growth in 2010, although less so than in 2009 as the massive CNY4 trillion fiscal stimulus program launched in late 2008 came to an end. Fiscal revenue and expenditure rose by 21.3% and 17.4%, respectively, well above the government's traditionally conservative targets. The strong revenue performance was a consequence of the robust economic growth and higher prices. The budget deficit narrowed to the equivalent of 2.1% of GDP from 2.9% in 2009.

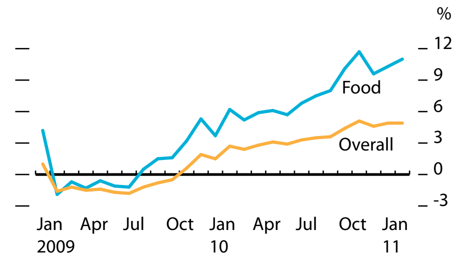
Global recovery in trade last year saw the country's trade flows soar by nearly 35% to about $3 trillion. Merchandise exports in nominal US dollar terms rebounded by 31%. Imports rose even faster (Figure 3.9.6), reflecting strong demand and higher prices for oil, other commodities, and capital goods. The trade surplus at $254 billion was little changed from 2009.

The PRC is diversifying its export markets in light of the slowdown in major industrial economies. It became Brazil's top trade partner in 2009 with bilateral trade showing a more than 12-fold increase in value since 2001. Some 85% of its exports to Brazil are manufactured products, while soybeans and minerals account for two-thirds of its imports.

Foreign direct investment (FDI) reached $105.7 billion in 2010, up by 12.4% from the previous year. By sector, manufacturing, real estate, and services attracted the most FDI. The leading sources of FDI were (in order) Hong Kong, China; Taipei,China; Singapore; Japan; the United States; the Republic of Korea; and the United Kingdom.

The PRC's direct investment abroad increased by 23.4% to $59 billion in 2010. It targeted energy, mining, and agriculture. Asia remained the top regional destination, although flows to South America and Africa

3.9.3 Monthly inflation



Source: CEIC Data Company (accessed 16 March 2011).

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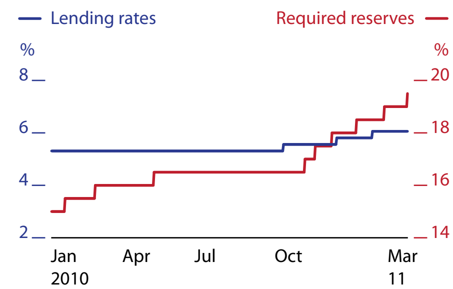
3.9.4 Monetary indicators



Source: CEIC Data Company (accessed 25 March 2011).

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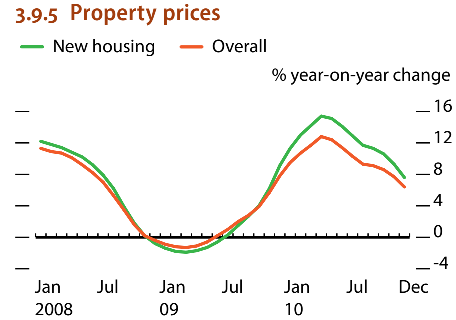
3.9.5 Property prices



Note: Overall are both residential and nonresidential.

Source: CEIC Data Company (accessed 16 March 2011).

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picked up. Large investments in energy-related projects in some Central Asian countries have turned the PRC into the second-largest investor there, after the Russian Federation.

The PRC is also gaining prominence as a lender to developing countries: its lending in the past 2 years exceeded that from the World Bank (excluding the International Development Association, which makes grants and low-interest loans). These operations included loan-for-oil deals with Brazil, the Russian Federation, and Venezuela; power-related projects in India; and infrastructure investments in Argentina and Ghana.

The current account surplus increased to $306.2 billion, but as a ratio to GDP it declined to 5.2%. This surplus, coupled with the FDI inflows and central bank purchases of foreign exchange to manage the exchange rate, pushed up foreign exchange reserves by 19% to $2.85 trillion. The yuan appreciated against the US dollar by 3% in nominal terms during the year (Figure 3.9.7), after the authorities indicated in June 2010 that they would gradually allow greater flexibility in the exchange rate. In real effective terms the yuan appreciated by 4.2% in 2010.

Efforts to internationalize the currency resulted in much higher levels of yuan-denominated trade, estimated at CNY70 billion in 2010 compared with just CNY0.5 billion in 2009.

About 11.7 million new jobs were generated in urban areas last year, above the official target but fewer than the average 24 million new job seekers who enter the labor market each year. Average minimum provincial wages rose by 24%, illustrating government efforts to raise living standards and foster consumption.

Economic prospects

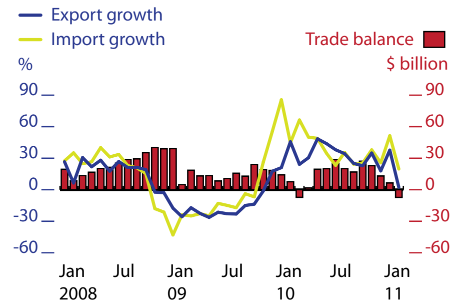
The 12th Five-Year Plan (2011–2015), approved in March 2011, seeks to rebalance the pattern of growth. Its targets indicate that the authorities are willing to forgo some speed of GDP growth to enhance its sustainability (see below).

Fixed asset investment is expected to remain the main driver of growth in 2011 and 2012, decelerating to 22% in 2011 and to 20% in 2012 (Figure 3.9.8). The expiration of the fiscal stimulus package in 2010 will reduce such investment by CNY2 trillion this year (or 7% of the total in 2010). Monetary tightening under way will also damp the high rates of investment. Further, the central government is scrutinizing local government finances and investment more closely.

Fiscal policy will be broadly expansionary, with a higher priority on education, health care, low-cost housing, and research and development. The overall budget deficit is projected to be little changed at about 2% of GDP.

Inflation pressures are prompting the authorities to tighten monetary policy, but their stance is expected to remain supportive of growth. They have trimmed the target for growth in M2 money supply to 16% for 2011; a similar rate is assumed for next year. For new lending, the central bank has opted not to provide an annual target ceiling on new bank loans for 2011. It will instead target a new measure of total credit, "total social financing," which includes loans from trust companies, corporate bonds,

3.9.6 Trade indicators



Source: CEIC Data Company (accessed 16 March 2011).
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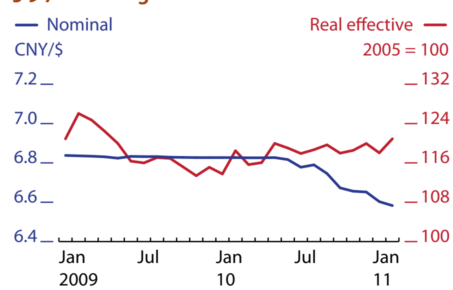
3.9.7 Exchange rates



Source: CEIC Data Company (accessed 16 March 2011).
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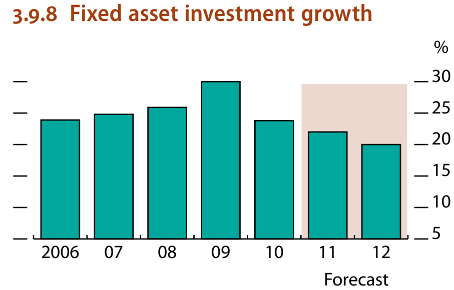
3.9.8 Fixed asset investment growth



Sources: CEIC Data Company (accessed 20 March 2011); ADB estimates.
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and equities of nonfinancial companies. It has not yet disclosed the numerical target.

Private consumption growth is expected to accelerate to 12.6% this year in nominal terms, a consequence of rising incomes and expanding state provision of education, health care, and pensions.

The contribution of net exports to GDP growth will moderate from 2010 owing to the base effect, still subdued demand from major export markets, and the expiry of tax rebates on some PRC exports. The increase in merchandise exports is forecast to slow to about 20% in nominal terms this year and 18% in 2012, below the near 30% average pace seen in the 5 years before the global recession.

Based on these projections, GDP is forecast to grow by 9.6% in 2011, easing to 9.2% in 2012 (Figure 3.9.9) on expectations that industrial production and fixed investment will continue to moderate.

Industrial production is expected to slow over the 2 years owing to relatively soft external demand, overcapacity in some manufacturing subsectors, and government efforts to reduce carbon emissions and other environmental damage. Nevertheless, in the first 2 months of this year, industrial output grew by 14.1%, slightly above the rate in December 2010.

In further signs of a solid start to 2011, fixed asset investment rose by about 25%, investment in real estate surged by 35%, and retail sales increased by 16% in the first 2 months (all in nominal terms).

Inflation is forecast to accelerate to 4.6% on average in 2011 (Figure 3.9.10), a result of higher global prices for food and oil, rising wages, and robust domestic demand. For the first 2 months of this year it averaged 4.9%, exceeding the full-year official target of 4.0%. The pace is expected to ease later in 2011 mainly because of the base effect.

In 2012, inflation is projected to ebb to 4.2% owing to the anticipated leveling off of global oil and commodity prices as well as tighter domestic monetary policy. Although the authorities are tightening to address inflation, they face difficulties in controlling bank liquidity and in managing inflation expectations without a nominal inflation anchor (Box 3.9.1).

Imports are expected to increase faster than exports during the forecast period, largely owing to high prices for imported energy and commodities. The current account surplus is projected to fall to 4.6% of GDP this year and 4.2% next, continuing a decline from a recent peak of 10.6% in 2007 (Figure 3.9.11) brought about mainly by faster growth in the value of imports than exports.

Downside risks to the economic outlook relate mainly to the fragility of external demand (exacerbated by the modest recovery in the United States), fiscal and debt concerns in the European Union (the PRC's largest trading partner), and now Japan. Although data are inadequate at present to assess the impact of the massive earthquake and tsunami on the PRC economy, they may have a short-term effect on bilateral trade, to a degree because Japanese companies in the PRC rely on spare parts and materials imported from Japan.

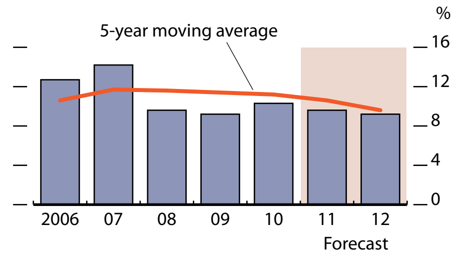
The rapid increase in local government debt to an estimated CNY7.6 trillion, stemming from the stimulus program begun in late 2008, is likely to lead to some rise in nonperforming loans at banks, given that about one-third of the debt is estimated to be at risk. This risk is, though,

3.9.1 Selected economic indicators (%)

	2011	2012
GDP growth	9.6	9.2
Inflation	4.6	4.2
Current account balance (share of GDP)	4.6	4.2

Source: ADB estimates.

3.9.9 GDP growth



Sources: National Bureau of Statistics of China; ADB estimates.

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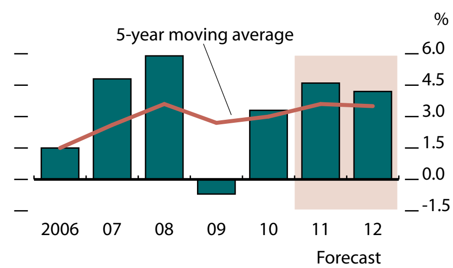
3.9.10 Inflation



Sources: National Bureau of Statistics of China; ADB estimates.

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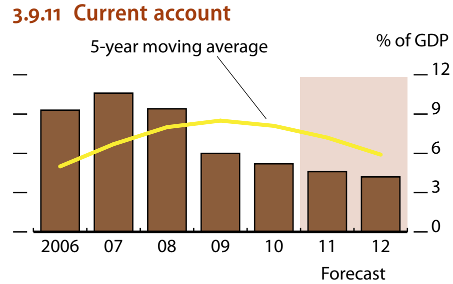
3.9.11 Current account



Sources: CEIC Data Company (accessed 16 March 2011); ADB estimates.

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mitigated by the current moderate level of nonperforming loans (1.1% of total lending), larger provisions for bad loans, and more stringent bank capital-adequacy requirements in recent years.

Failure to decisively implement the government's agenda to rebalance the economy risks jeopardizing the sustainability of growth in the longer term. Rapid growth over three decades has allowed for transition from a low- to a middle-income country, but has also generated imbalances such as heavy reliance on investment, relatively low levels of private consumption, underdeveloped services, widespread environmental damage, and expanding income gaps.

Development challenges

Implementing the 12th Five-Year Plan will be a major challenge. Its main policy directions include the following: a better balance in the drivers of growth among investment, consumption, and exports, with services playing a more important role; a stronger emphasis on improving living standards and narrowing income inequalities; newly designated strategic industries—a modern energy industry, a comprehensive transport system, information-based industries, and biotechnology—to promote innovation; and plans to combat global warming and reduce carbon intensity, including ambitious emission-reduction targets, a carbon tax, new indicators for pollutants, and carbon-trading programs.

The plan sets quantitative targets on key economic, social, and environmental indicators. It trims the GDP growth target of 7.0% for 2011–2015 from 7.5% in the previous plan, a move aimed to signal the government's willingness to sacrifice speed of growth for the sake of sustainability (actual GDP growth in the previous plan was 11.2%).

Critical among the objectives is changing the growth pattern toward a model oriented more to services and consumption from the past emphasis on industry and capital investment. Economic rebalancing was an objective in the previous plan, and indeed some progress was made in, for example, curbing energy consumption and pollutants and expanding the coverage of urban and rural health care.

Yet there was limited progress on major rebalancing targets. Consumption, for instance, substantially lagged investment (with average contributions of 41% and 54% to annual GDP growth in the past 5 years). On the production side, services' share of GDP is relatively low at about 43% (Figure 3.9.12).

The need to transform the pattern of economic growth is stronger now than in 2006 both because the external imbalances have become more pronounced, and because the recent global recession highlighted the risks of the export-led growth paradigm. Moreover, the implications of population aging in the PRC threaten the sustainability of growth and complicate the reform agenda.

Rebalancing is, however, unlikely to occur without significant policy adjustments, including shifting the emphasis of public spending from investment to public services, liberalizing the finance sector, developing capital markets to help small and medium-sized enterprises and the self-employed to access credit, and facilitating a greater role for private players in the economy.

3.9.1 Anchoring inflation expectations

Climbing consumer and asset prices in the country risk raising inflation expectations, and so encouraging new rounds of price increases that further heighten expectations. Such spirals have occurred in the past, leading to 20% inflation in 1988.

International experience suggests that the best way to control inflation expectations is to anchor them, preferably with inflation targeting rather than monetary targeting.

Inflation targeting allows the monetary authorities to use all available information, not just monetary variables, to determine monetary policy settings.

It is also transparent and readily understood by the public, increases central bank accountability (because its performance can be measured against a clearly defined target), and can help focus the political debate on the main role of the central bank in the long run (controlling inflation instead of boosting economic growth).

A central bank's credibility is indispensable in inflation targeting, so as to keep expectations well anchored.

In the People's Republic of China at the moment, accelerating inflation and difficulties of managing the high levels of bank liquidity suggest that some anchoring of expectations might now be appropriate. And although it would be premature for the central bank to adopt formal inflation targeting—given its limited independence and government controls on interest rates—it could consider some features of an anchoring system, such as announcing an explicit inflation objective or target range, and committing to achieve it for several years.

To increase the central bank's credibility, it would need full control over managing its reserves, more leeway to liberalize interest rates, and greater exchange rate flexibility. Managing inflation expectations would also require it to more clearly flag its monetary intentions to financial markets.

As the new plan reflects these reforms to some degree, the key challenge lies in how to successfully carry them out in a period of political transition to a new generation of leaders in 2012–2013. Moreover the intended reforms, although necessary, are not risk free, and might create or exacerbate policy-making trade-offs.

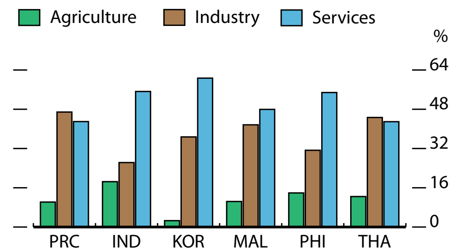
For instance, promoting services as a source of growth and employment may entail short-term side effects such as increased unemployment (until the full benefits unfold in the medium to longer term, when excess labor is absorbed through implementation of adequate supportive policy measures, including education and training).

Further, promoting consumption as a driver of growth would require larger salary increases, as supported in the plan, which could generate a wage-price spiral in the economy, trapping policy makers in a difficult choice between rebalancing and price stability.

Closing the income gaps is another major challenge. The benefits of rapid growth in the PRC have not been evenly distributed among regions, resulting in a skewed distribution of income in favor of coastal cities and urban citizens. The Gini coefficient, a measure of income inequality (zero indicates perfect equality and 1 absolute inequality) has worsened from 0.16 in 1978 to the current 0.47.

The PRC's rapid development has also come at a significant environmental cost. Heavy dependency on coal as an energy source has led to high levels of air and water pollution. The additional tens of millions of new automobiles on the roads in the past few years have taken carbon dioxide emissions to alarming levels. Against this background, government plans to accelerate urbanization—as stated in the new plan—require greater efforts to facilitate a sustainable process of urbanization in the framework of a low-carbon economy.

3.9.12 Sector shares in current GDP, 2010



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

Note: Data for India are based on advance estimates. Data for the Republic of Korea refer to 2009.

Source: Asian Development Outlook database.

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Hong Kong, China

Coming out of contraction the economy grew robustly in 2010, driven by recovery in goods and services trade that spurred growth in consumer spending and investment. Inflation rose from low levels, and is forecast to speed up in 2011. Economic growth will moderate this year and next. Low interest rates and abundant liquidity have contributed to a property-price spurt that the authorities are trying to damp with macroprudential measures and increased supply of land for housing.

Economic performance

This services-driven economy made a solid comeback in 2010 as it recovered from contraction in 2009. GDP picked up by 6.8%. From the demand side, consumption, investment, and net exports all contributed to growth (Figure 3.10.1).

Private consumption grew by 5.8% and was responsible for more than half the GDP growth. Consumption spending was supported by a pickup in employment and buoyant stock and property markets. Retail sales were boosted by a 22% jump in visitor arrivals to 36 million.

Government consumption made a small contribution to the expansion. Budget spending in FY2010 (ending 31 March 2011) came in below allocation, while revenue burgeoned alongside the recovery in economic activity and asset prices. The budget was in surplus to the tune of an estimated 4% of GDP.

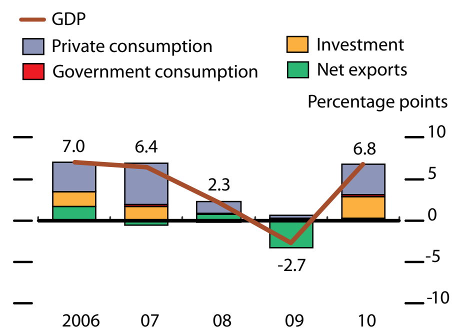
After 2 weak years, fixed investment rebounded by 8.1% in 2010, accounting for about one-quarter of GDP growth. Private investment in machinery, equipment, and computer software was strong, especially in the first half (reflecting the low base). Several large-scale projects boosted public construction, including the Guangzhou–Shenzhen–Hong Kong express rail and the Hong Kong–Zhuhai–Macao bridge.

With the revival of global trade, exports of goods bounced back to record 17.3% growth in real terms, from a double-digit contraction a year earlier. Exports to the People's Republic of China (PRC) and other major Asian markets (Japan; the Republic of Korea; Singapore; and Taipei,China) saw growth of 15%–23%. Exports to the United States and Europe also rose, but failed to scale 2008's precrisis peak. Imports of goods in real terms rose by 18.1%, reflecting growth in private consumption and the pickup in investment.

Services exports grew by 15.0% in real terms in 2010 as financial and professional services, trade services, transport, and tourism all benefited from the recovery in global trade and deepening integration with the rapidly growing PRC.

The important financial and insurance subsector grew by 7.5%

3.10.1 Contributions to growth (demand)



Source: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 14 March 2011).

Click here for figure data

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in 2010. Equity capital raised through initial public offerings rose to HK$449.5 billion (US$57.9 billion), making Hong Kong, China the world's biggest center for such capital raising last year. The subsector is benefiting from wider external use of the yuan. The number of authorized financial institutions participating in yuan business increased from 61 to 115 and their total deposits increased almost fivefold.

A resumption of employment gains in 2010 (after net job losses in 2009) lowered the seasonally adjusted unemployment rate to 4.0% in the fourth quarter (Figure 3.10.2). But real earnings grew by just 0.1% during the year.

Inflation quickened over the year to 3.1% in December 2010 owing to rising domestic demand, a softer US dollar, higher prices for imported food, and rising housing costs (Figure 3.10.3). It averaged 2.4% for the year.

Very low interest rates and abundant liquidity, coupled with strong underlying demand for housing, propelled prices of all categories of property in 2010. Residential property prices rose by 20.4% in the 12 months to December 2010, following a gain of 28.5% a year earlier. A housing affordability index shows that houses became more expensive in relation to incomes (Figure 3.10.4).

Concerned that the sharp runup in prices was spilling over from the high-end property sector to the broader residential market, the authorities directed banks to lower their loan-to-value ratios and raised stamp duty on high-end housing. As prices continued to trend up, the government in November 2010 imposed a special stamp duty on residential property resold within 24 months of acquisition. To add to the supply of housing in the medium term, it increased the land available for residential construction. By year-end, these measures appeared to damp speculation, as reflected in fewer transactions.

In the external accounts, a sharply wider merchandise trade deficit and lower surplus in the income account offset a larger services trade surplus in 2010. The current account surplus declined to US$14.8 billion (6.6% of GDP).

Economic prospects

In light of projected slower global trade and moderating PRC growth, Hong Kong, China will see its expansion ease this year and next.

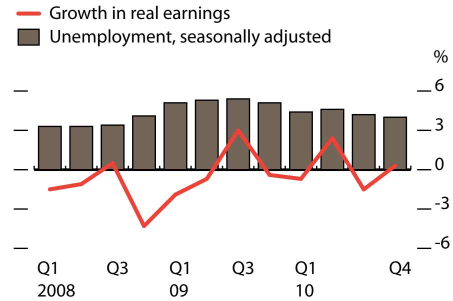
Private consumption is expected to remain healthy in 2011, based on growth in employment and incomes, and be the main contributor to growth in the economy. Retail sales in volume terms rose by 23.6% in the first month of 2011 (Figure 3.10.5) aided by inbound tourism.

Business investment will likely expand moderately this year, supported by low interest rates. Major public infrastructure projects begun in the past 2 years will continue contributing to growth in the forecast period.

Slower growth in world trade and the ending of the low-base effect on 2010's outturn are expected to bring down growth in merchandise exports to about 7.5% in nominal terms in 2011 from 22.4% in 2010. Robust growth is foreseen for services exports, particularly to the PRC.

The budget for FY2011 includes an increase in spending of nearly 25%, and projects a small budget deficit. Spending on capital works is budgeted to rise to US$7.5 billion this year and will likely exceed this amount in

3.10.2 Unemployment and earnings



Source: Census and Statistics Department. http://www.censtatd.gov.hk/ (accessed 28 March 2011).

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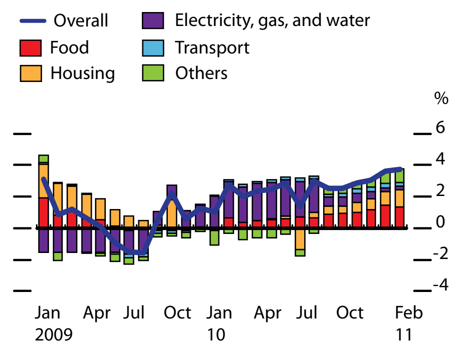
3.10.3 Sources of inflation



Source: CEIC Data Company (accessed 28 March 2011).

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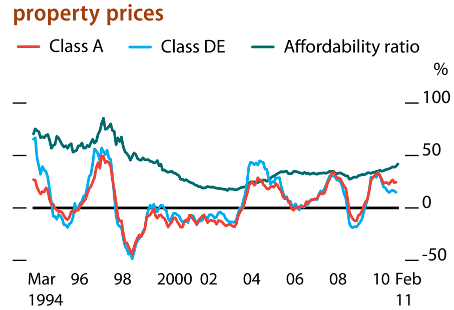
3.10.4 Affordability ratio and growth of property prices



Notes: Class A refers to residential properties less than 40 square meters in size. Class DE refers to residential properties above 100 square meters. Affordability ratio refers to the ratio of mortgage payments (for a 45 square meter apartment) to the median income of all households.

Source: CEIC Data Company (accessed 28 March 2011).

Click here for figure data

2012. Major infrastructure projects to begin in 2011 include extensions of mass transit rail lines.

On the balance of these factors, GDP growth is forecast at 5.0% in 2011, easing to 4.7% in 2012, as the economy is expected to stabilize around its longer-term growth trend. Current account surpluses equivalent to 7.2%–7.5% of GDP are projected for the forecast period.

Inflation this year will be well above the average rate of just over 2% of the past 5 years. Hong Kong, China imports most of its food from the PRC, where food prices have been rising. Further, the yuan has steadily climbed against the Hong Kong dollar (Figure 3.10.6), raising the cost of all purchases from the mainland. Higher global fuel and food prices, rising housing costs, and a likely increase in wages add to inflation pressures. Inflation was 3.7% in February 2011 and is forecast to average 4.5% for the year.

In 2012, inflation is seen easing to 3.3% as global food prices decelerate and the housing market stabilizes, the latter aided by the policies introduced in 2010.

Development challenges

The Hong Kong dollar's link to the US dollar through a currency board framework constrains the authorities from using interest rates as a tool to curb property booms. Monetary policy is tied to that of the US Federal Reserve, which is not expected to tighten much during the next 2 years. The government is therefore relying on macroprudential measures to rein in speculation and to ensure prudent mortgage lending by banks, while it increases the supply of land for housing.

Acknowledging the risk of a property bubble, the financial secretary said in March 2011 that the government stands ready to take further action to calm the housing market.

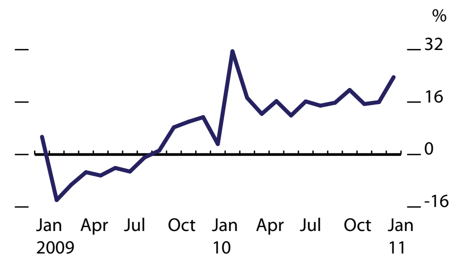
As for inflation more broadly, the FY2011 budget provides several one-time measures aimed at helping the population cope with rising costs of living. They include a subsidy for each residential electricity account capped at HK$1,800, waived rates (property taxes) up to HK$6,000, and 2 months' rent exemption for public housing tenants. The government also proposes to give a HK$6,000 cash payment to permanent residents aged 18 and above, and an income tax rebate up to a maximum of HK$6,000. These two measures will, however, add to domestic demand and, potentially, inflation.

3.10.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.0	4.7
Inflation	4.5	3.3
Current account balance (share of GDP)	7.2	7.5

Source: ADB estimates.

3.10.5 Retail sales volume growth



Source: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 14 March 2011).

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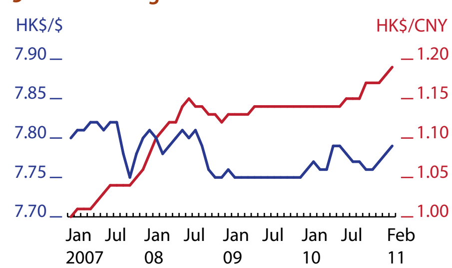
3.10.6 Exchange rates



Source: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 14 March 2011).

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Republic of Korea

Robust economic recovery continued through 2010, when a strong export performance and healthy domestic demand underpinned the steepest rise in GDP for nearly a decade. Growth is expected to moderate to a more sustainable pace in 2011. The paramount near-term challenge is to contain emerging inflation pressures. A key development challenge is to create more job opportunities for those seeking work.

Economic performance

Economic recovery gained traction in 2010 in the Republic of Korea, as GDP rose by 6.1%, the sharpest increase since 2002. The exceptional growth largely reflects a rebound from below-trend growth of 2.3% in 2008 and 0.2% in 2009. The recovery was broad-based and rested on both external and domestic drivers. Externally, exports surged in tandem with the rebound in the world economy and trade. Domestically, private demand replaced fiscal and monetary policy stimulus pushed through during the global recession. Figure 3.11.1 shows the trajectory of quarterly growth during 2008–2010.

Among the different sources of growth in 2010, robust investment played the dominant role, accounting for over two-thirds of the year's expansion (Figure 3.11.2). Surging exports of manufactured goods drove the sharp rise in investment. Private consumption accounted for the rest of GDP growth. Government consumption contributed less than a tenth, mirroring the transformation from policy-led recovery to growth based on private demand. The impact on GDP of the stronger total demand was partly offset by a surge in imports of goods and services.

As global trade volume swung from sharp contraction in 2009 to expansion in 2010, it propelled a 29.6% rise in merchandise exports in US dollar terms. Export performance was strong throughout the year (Figure 3.11.1). Information technology-related products such as semiconductors and liquid crystal displays performed particularly well. Exports of autos, auto parts, and general machinery also grew rapidly. In terms of export destinations, demand from the People's Republic of China (PRC) and Southeast Asia drove growth in the first half and held up well in the second. Demand from Japan and the United States also picked up last year from 2009.

Mirroring the strong recovery of demand, imports rose sharply by 31.9%. The merchandise trade surplus rose to about $42 billion, but the deficit in services trade nearly doubled to $11 billion. The current account surplus fell to 2.8% of GDP, from 3.9% in 2009.

An outstanding feature of growth in 2010 was the acceleration of equipment investment, which soared by 24.5%, though it partly reflects a base effect from 2009, when such investment fell by 9.1%. Companies

3.11.1 GDP and merchandise export growth

Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 11 March 2011).

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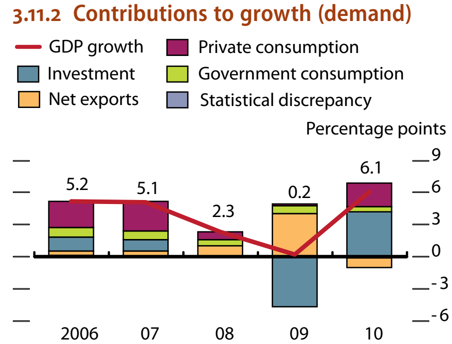
3.11.2 Contributions to growth (demand)



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 11 March 2011).

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

in export-oriented industries regained their appetite for investment as global demand for their products recovered. Companies were also spurred to expand facilities by a rise in manufacturing capacity utilization from an average of 74.6% in 2009 to 81.8% in 2010 (Figure 3.11.3). Further, an appreciating won against the US dollar in the second half of the year lowered the cost of imported capital goods. Imports of machinery rose sharply, although those of transport equipment grew much less quickly.

Construction investment contracted by 2.3% in 2010, after growing by 4.4% in 2009 on the back of public works. The weakness in construction reflected a sluggish housing market, where the inventory of unsold housing continued to build.

Private consumption bounced back (Figure 3.11.4) to grow by 4.1% in 2010, after feeble growth in 2009, supported by a stronger labor market. Employment rose by 323,000, even as the government scaled back job creation programs. Real wages increased by more than 3%, after contracting by 6% in 2009. Gross domestic income rose by 5.8%, the fastest pace in 8 years. An upturn in the stock market and appreciation of the won contributed to stronger consumer sentiment.

The unemployment rate nudged up to 3.7% from 3.6% in 2009, mainly a result of more Koreans looking for work in light of the improved outlook.

In terms of economic sectors, manufacturing stood out with a 14.6% increase in production last year, fueled by surging export demand. Services expanded by a healthy 3.5%.

Despite the strong economic growth, average inflation rose only slightly in 2010, to average 2.9%, within the Bank of Korea's target band of 2.0%–4.0%. As economic recovery gained traction, the central bank started to edge up its policy interest rate from the record low 2.0% set during the global recession. From July 2010 to March 2011, the Bank of Korea raised the rate in four steps to 3.0%.

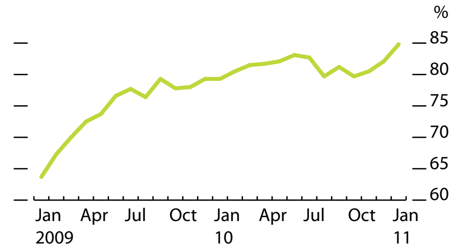
Economic prospects

Exceptionally strong growth in 2010 was based to a large extent on a one-time base effect due to weak performance of 2009. Consequently, the economy is expected to decelerate this year to more sustainable levels around the potential growth rate, estimated at 4.3%–4.9%. A generally benign global outlook will support exports and healthy private investment, and consumption will underpin growth. The consolidation of growth and the emergence of inflation pressures mean that inflation is set to replace growth as the priority of policy makers.

Merchandise exports are projected to grow by more than 10% in 2011. Demand from industrial economies will likely be subdued, but developing countries are forecast to grow rapidly and provide a more certain source of demand. The country has diversified its export markets in recent years, with the PRC in particular providing an important export market during the global recession (Figure 3.11.5).

Exports to the PRC have traditionally been dominated by high-tech parts and components for assembly and reexport to industrialized countries. Increasingly, however, the PRC is becoming a direct consumer of final goods, which helps to explain why the the Republic of Korea's exports to that market held up so well in 2009–2010.

3.11.3 Manufacturing capacity utilization



Source: CEIC Data Company (accessed 11 March 2011).
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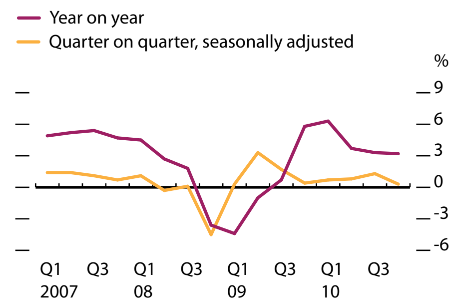
3.11.4 Private consumption growth



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 11 March 2011).
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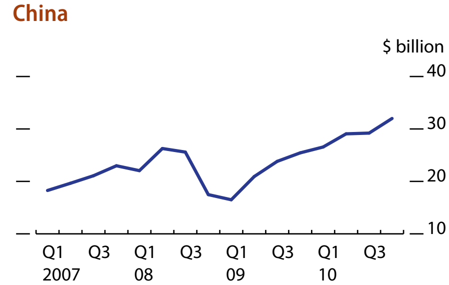
3.9.1 Selected economic indicators (%)

	2011	2012
GDP growth	4.6	4.6
Inflation	3.5	3.0
Current account balance (share of GDP)	1.8	1.7

Source: ADB estimates.

3.11.5 Exports to the People's Republic of China



Source: CEIC Data Company (accessed 11 March 2011).
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Still, several factors will damp growth in exports in 2011. First, the country's exports, especially durables and capital goods, are sensitive to the global business cycle, so the expected easing in world trade growth will act as a drag on exports. After past global downturns, exports initially responded elastically to the recovery of global growth, but lost some momentum as recovery moderated.

Other constraining factors for growth are an expected appreciation of the won and likely weakness in unit prices of exports. (Foreign competitors have expanded production capacity for semiconductors, liquid crystal displays, and other key items, which sets an upper bound to their prices.)

On the domestic front, strong consumer and business confidence will buttress growth in private consumption and investment (Figure 3.11.6). High corporate profits in 2010 and prospective foreign capital inflows have enabled firms to invest. However, as pent-up demand for investment postponed during the global slump was largely satisfied in 2010, equipment investment is likely to moderate to a more sustainable level of about 8% this year.

Construction investment will likely grow at the sluggish pace of about 3%. A significant inventory of unsold housing in the Seoul area will constrain construction, as will large debts of private housing companies and the government's Land & Housing Corporation. The corporation's debts are an example of a more general problem of high and growing debt burdens of state-owned firms (Box 3.11.1).

Private consumption is projected to expand by 4.0%–4.5% in 2011, bolstered by growth in incomes. The labor market looks set to remain strong (up to 250,000 jobs will likely be generated, down a bit from last year owing to the expected moderation in growth of exports industries). Softness in export unit prices will weigh on terms of trade and gross domestic income. But gains in corporate profitability in 2010 will pave the way for more robust wage growth. A decline in housing prices that bottomed out in the second half of 2010 should support consumer confidence.

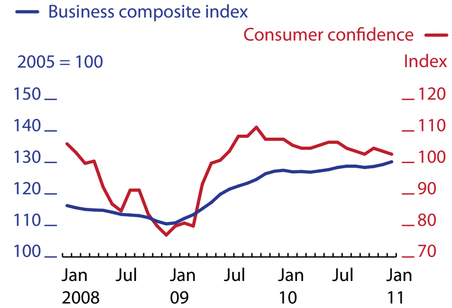
Inflation pressures surfaced toward end-2010 and are expected to intensify this year. Major price indicators are on the rise (Figure 3.11.7), with inflation breaching the central bank's target band in January and February this year. Inflation in 2011 is forecast at 3.5%. It is expected to ease a little in 2012, when monetary policy will be tighter and global prices for oil and food are expected to decelerate.

Cost-push factors such as higher global oil and food prices have contributed to the rise in inflation, though aggregate demand is also putting upward pressure on prices. Additionally, as actual output has surpassed potential output since the first quarter of 2010 (Figure 3.11.8), it is likely that monetary policy will be tightened further to contain inflation.

The authorities are also using administrative measures to control prices of specific items, especially food. Further, in February 2011 the government advised that it would minimize increases in public utility charges.

The fiscal stimulus has been withdrawn as the economic recovery gathered pace. The overall fiscal deficit was reined in last year to 2.3%

3.11.6 Confidence indicators



Note: Data for January 2008–August 2008 refer to the Consumer Expectations Index; values after that were derived from the Composite Consumer Sentiment Index.

Sources: CEIC Data Company; Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (both accessed 11 March 2011).

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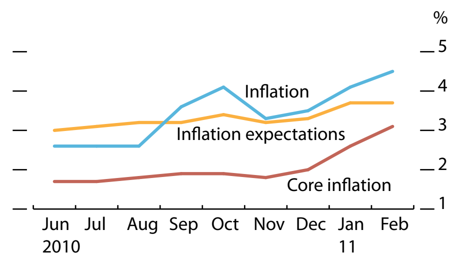
3.11.7 Inflation indicators



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 11 March 2011).

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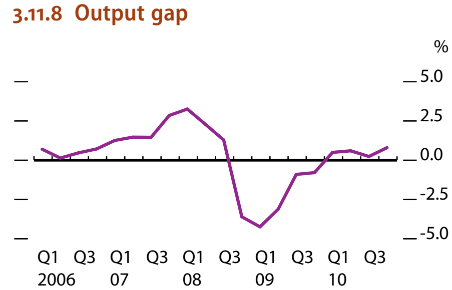
3.11.8 Output gap



Source: ADB estimates.

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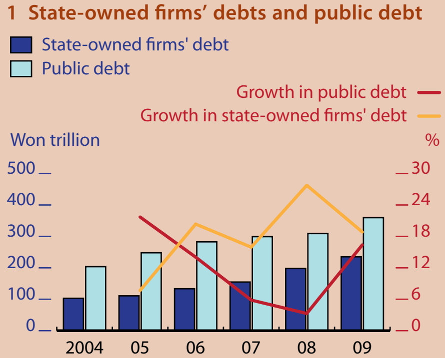
3.11.1 The rising debts of state-owned firms

The rapid increase in debt of state-owned firms may have damaging implications for future fiscal health. Public debt levels are low relative to Europe, Japan, and the United States, and public finances are generally in good shape.

This benign picture ignores, however, large and growing debts of 21 firms owned by the central government. Such debts are not part of the International Monetary Fund's definition of public debts, but still represent contingent liabilities for the government.

As at end-2009, these firms' total debt reached 235.1 trillion won ($201.4 billion), equivalent to 65.4% of public debt. Further, their debt grew by an average of 17.9% a year between 2004 and 2009, significantly faster than the growth in public debt (12.0%) (Box figure 1).

1 State-owned firms' debts and public debt



Source: Korea Development Institute.

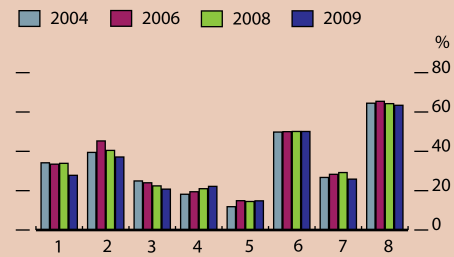
Click here for figure data

A study by the Korea Development Institute assessed the extent to which the debts of state-owned firms pose a risk to financial sustainability. The study was based on an analysis of six of the larger firms—in land and housing, gas, electricity, railways, highways, and petroleum—which together account for 87.5% of state-owned firms' total assets and 92.9% of their total debts. As much of their growth has been financed by borrowing, the weighted debt-to-capital ratio of the six rose from 106.3% in 2004 to 196.8% in 2009.

A high debt burden is not necessarily a concern, however, if there is enough liquidity to deal with short-term financial difficulties. Also, if profitability is high enough to allow for a gradual reduction of the debt burden, the risk that burden poses to fiscal sustainability is limited.

Critically, the ratio of short-term debt to total debt among state-owned firms is relatively low (Box figure 2) and the duration of borrowing is relatively long. They tend to have higher credit rating than private firms, facilitating their access to long-term credit, but few have "quick" assets that can be converted to cash at short notice. Their average ratio of current assets to short-term debt stood at 61.1% at end-2009, comparing unfavorably with the overall corporate average of 99.1%.

2 Short- to long-term debt ratio



1 = Land and housing; 2 = Gas; 3 = Electricity; 4 = Railways; 5 = Highways; 6 = Petroleum; 7 = Average of six state-owned firms; 8 = Average of private and 21 state-owned firms.

Source: Korea Development Institute.

Click here for figure data

State-owned firms generally have low profit rates, although with wide variations. Of the six, the highways and petroleum firms have low debt and high profits. Profitability of the other four has declined in recent years due to excessive business expansion and restrictions on public utility tariff increases.

Without a severe shock, the risk of liquidity problems or bankruptcy among the 21 firms owned by the government appears limited in the short run.

In the long run, however, they should strive to improve profitability so as to gradually reduce their debt burdens. While they are somewhat constrained from raising prices by public interest considerations, they should nevertheless operate along more commercial lines. (For political reasons the government is unlikely to be able to privatize them.)

It would therefore be helpful if the government allowed a gradual liberalization of public utility tariffs. Such firms should also become much more transparent about their financial health.

of GDP, from 5.1% in 2009. The government aims to further narrow the deficit in 2011 and it targets a balanced budget by 2014.

On the basis of the above factors, GDP growth for 2011 is projected to moderate to 4.6% (Figure 3.11.9), slightly exceeding the average of 4.3% during 2003–2007. Both exports and domestic demand will increase healthily, and contribute to broad-based growth. Year on year, the second

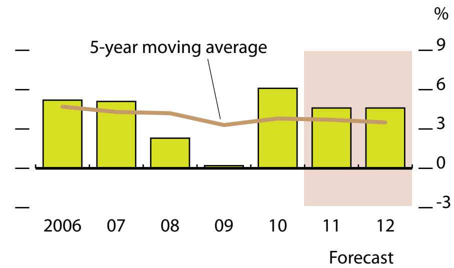
half will outperform the first, largely owing to the base effect. The outlook for 2012 is expected to be broadly similar to 2011's.

The primary source of uncertainty involves monetary policy. The cost of keeping interest rates low, in terms of the impact on inflation, is likely to be significantly higher than in 2010. The GDP outcome will therefore partly depend on how the central bank resolves the trade-off between growth and inflation.

The large size and volatility of capital inflows remain a risk, although macroprudential measures adopted by the authorities are mitigating it. For example, tax exemptions for foreign investors that were introduced in May 2009 to promote bond market development are being rolled back, and the government has set a ceiling on foreign exchange–related derivatives to limit banks' short-term foreign borrowing. External risks center on the trajectory of global commodity prices and recovery of industrialized countries.

The impact of the Japanese disaster will be limited and temporary. While exports that compete with Japan, such as autos and electronics, may benefit, disruptions to imports of capital goods will hurt manufacturers.

3.11.9 GDP growth



Sources: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 11 March 2011); ADB estimates.

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Development challenges

A key driver of private consumption growth in 2010 was the strong labor market. Growth of employment and wages is also expected to be a major positive factor in 2011, but paradoxically many job seekers cannot find work. A broad definition of work seekers includes the unemployed, those who work fewer than 36 hours a week and want to work more, and people who have never been employed or been out of the workforce for a long time but want to work. Their number shot up by 19.1% in 2009 to 1.8 million people, and rose by a further 5.4% in 2010, despite the economic recovery (Figure 3.11.10).

Several policy options can be considered. First, specialized skill training programs at small and medium-sized enterprises could be promoted for youths, especially high-school graduates, along with retraining for older individuals. This is important because youths and older people together accounted for around one fourth of work seekers in 2010, according to a study by Hyundai Research Institute.

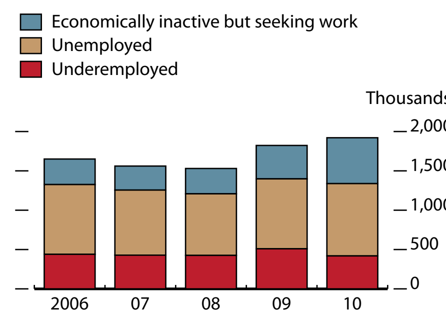
Second, an expansion of public child care facilities would enable more women with children to stay in work (the share of females in work seekers rose from 39% in 2009 to 43% in 2010).

Third, given that unemployment became more prevalent among those, especially females, with junior college or higher education, education must become better aligned with the needs of employers. Employment information, too, should be made more widely available at universities and colleges.

Fourth, efforts should be made to facilitate the employment of those work seekers formerly employed by public job-creation programs.

Fifth, internship programs in both public and private sectors should be expanded as they give valuable work experience to those who have never worked before (individuals unemployed for less than a year accounted for the largest share of work seekers).

3.11.10 Work seekers



Source: Hyundai Research Institute.

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Mongolia

Rising global prices of minerals and strong investment in mining contributed to a return of economic growth in 2010. These factors, coupled with a surge in fiscal spending, will spur higher GDP growth this year, too. Inflation accelerated to double-digit-levels in 2010 and is expected to be even higher this year. Rapidly rising prices and fiscal discipline are near-term challenges for policy makers.

Economic performance

A 6.1% recovery in GDP in 2010 was driven by growth in the minerals sector, high prices for mineral exports (Figure 3.12.1), and support from development partners. The outcome was a turnaround from a 1.3% contraction in the economy in 2009.

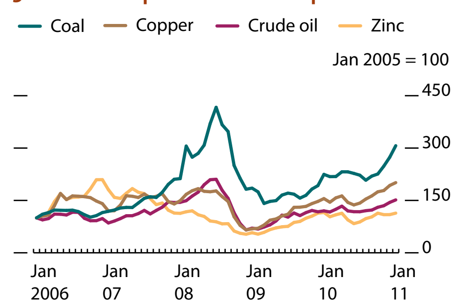
Mining benefited from a rebound in copper prices, strong external demand for coal and iron ore, and construction at Oyu Tolgoi, which will be one of the world's biggest copper and gold mines. Copper prices returned to 2008 levels early last year and rose to over $9,000 a ton in December 2010. Copper export volumes in 2010 were little changed from 2009, but their value jumped by more than 50%; export volumes of coal and iron ore more than doubled in 2010. Strong economic growth in the People's Republic of China (PRC), Mongolia's major trading partner, underpinned the increase in mineral exports.

Industry as a whole contributed nearly half the growth in GDP in 2010 (Figure 3.12.2) as construction and manufacturing expanded, along with mining. Services accounted for the rest of GDP growth: wholesale and retail trade recovered strongly as the economy bounced back.

Agriculture, however, which directly supports about one-third of the population of 2.8 million, was hit by severe winter conditions (a *dzud*) that reduced livestock numbers by about a quarter to 32.7 million. The sector's overall output contracted by nearly 17%. An estimated 10,000 households headed by livestock herders lost their livelihood and migrated to urban areas. The livestock losses also hurt the cashmere industry, reducing production of raw cashmere by 13.2% and output of cashmere sweaters by 20%.

Economic recovery was supported by an SDR 153.3 million (about $229 million) 18-month stand-by arrangement with the International Monetary Fund, completed in September 2010. Under this arrangement, Mongolia borrowed $185.4 million from the Fund and received commitments for $184 million for budget support from development partners. This financing, and associated policy actions taken by the government, bolstered both the budget and external positions and restored confidence in the currency (the togrog).

3.12.1 Global prices of main exports



Source: International Monetary Fund. International Financial Statistics online database (accessed 12 March 2011).

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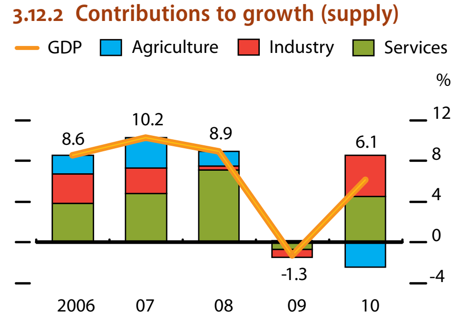
3.12.2 Contributions to growth (supply)



Source: National Statistical Office of Mongolia. 2010. *Monthly Statistical Bulletin*. December. http://www.nso.mn.

Click here for figure data

This chapter was written by Bayasgalan Rentsendorj of the Mongolia Resident Mission, ADB, Ulaanbaatar.

External trade rebounded last year from a sharp slump in 2009. Merchandise exports and imports in US dollar terms both jumped by about 53%, exports propelled by higher copper prices and increased coal and iron ore volumes and prices. Higher imports stemmed from the need for equipment in the mining industry, as well as rising prices of oil and food.

Deficits in trade in goods and services caused the current account gap to widen to 15.3% of GDP in 2010 (Figure 3.12.3). A surge in foreign direct investment to $1.6 billion, largely into mining, and in portfolio investment boosted gross international reserves to $2.2 billion at end-2010, equivalent to about 8 months of imports. (Reserves were just $637 million at end-2008.)

Inflation accelerated to nearly 13% by end-2010 (Figure 3.12.4), and averaged 10.1%. The loss of livestock during the *dzud*, coupled with an outbreak of hoof-and-mouth disease, caused a sharp runup in food prices. Strengthening domestic demand was reinforced in October when the government raised public sector wages by 30%. M2 money supply surged by nearly 63% over the year.

Inflation would have been higher had it not been for a 13% appreciation in the togrog against the US dollar in 2010 (the country has a managed floating exchange rate). As the economy recovered and inflation quickened, the Bank of Mongolia in May 2010 raised its policy interest rate from 10.0% to 11.0%.

Higher commodity prices and cash prepayments from the Oyu Tolgoi mine contributed to a 54.5% surge in government revenue in 2010. Government spending went up by 31.7%, largely the result of cash transfers and increases in public sector wages and pensions. The budget was roughly in balance (Figure 3.12.5).

Economic recovery generated jobs and lowered the unemployment rate, though it was still high at 8.6% at end-2010. Poverty remains widespread, with about one-third of the population living below the national poverty line. There has been progress on the Millennium Development Goals related to education and health, but achievements on the poverty, malnutrition, and environmental goals are trailing.

Improvements in business optimism and in public trust in banks encouraged a recovery in lending and strong gains in togrog deposits. Nonperforming loans and loans in arrears fell to about 15% of total loans. New banking and central bank laws were approved in February 2010 to improve bank regulation and supervision. A bank-restructuring strategy, drafted by the central bank, awaits approval by Parliament.

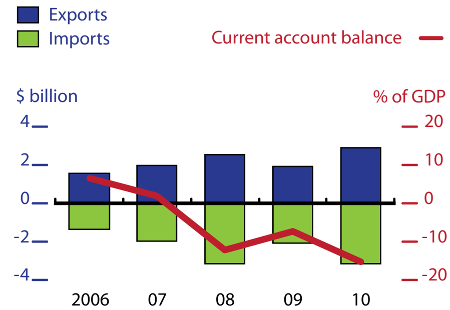
Economic prospects

Growth is expected to accelerate in 2011 and 2012, supported by high global mineral prices, development of new mines, and fiscal spending.

Mining is the key driver. Investment in the Oyu Tolgoi copper and gold mine is projected to total more than $4 billion over the next 2 years. The mine is scheduled to start production in 2013.

Preparations are being made to develop the coal deposits of one of the largest undeveloped coalfields in the world, Tavan Tolgoi. Like Oyu Tolgoi, these deposits are near the border with the PRC, a potential

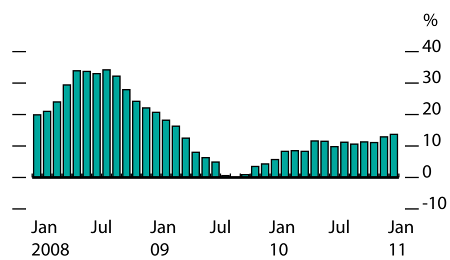
3.12.3 Current account and trade indicators



Sources: Bank of Mongolia. 2011. *Balance of Payments Report*. January. http://www.mongolbank.mn; ADB estimates.

Click here for figure data

3.12.4 Monthly inflation



Source: Bank of Mongolia. 2011. *Statistical Bulletin*. January. http://www.mongolbank.mn

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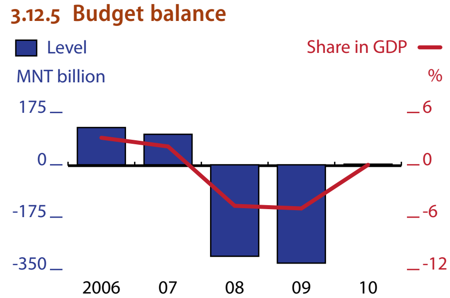
3.12.5 Budget balance



Source: Bank of Mongolia. 2011. *Statistical Bulletin*. January. http://www.mongolbank.mn

Click here for figure data

market for the minerals. At full capacity, Tavan Tolgoi could produce 15 million tons of coal a year. A state-owned company is expected to mine in one part of Tavan Tolgoi from this year, and international mining companies are bidding to develop another part.

The government has ambitious plans for a new rail line linking into the Russian Federation's rail network and so through to its Pacific ports. It also plans to build an industrial complex, including a copper smelter, oil refinery, and facilities to process metals and produce construction materials. The aim is to reduce the country's dependence on exports of raw materials. The rail line and industrial complex would, however, require investment of more than $10 billion, and their economic viability and financing are uncertain.

Fiscal policy is highly expansionary this year. The 2011 budget, with a deficit equivalent to almost 10% of GDP, includes a 35% boost in spending. Cash allowances through the government's Human Development Fund are budgeted to almost double from 2010. Disbursements include a monthly cash allowance of MNT21,000 (about $16) for every citizen and partial tuition support for each college student. Government expenditure overall is projected to rise from 37.3% of GDP in 2010 to 52.0% in 2011, while revenue is set to climb from 37.3% to 42.0%.

Agriculture is expected to recover from the impact of last year's severe weather. The government is providing support for farm-based livestock husbandry, attempting to mitigate weather-related risks.

Taking these factors into account, GDP growth is forecast to grow by a rapid 10% in 2011. High rates of inflation and an increasingly negative real policy interest rate suggest that the central bank will tighten monetary policy. It raised the reserve requirement for banks from 5.0% to 9.0% in February 2011. Further tightening is likely to contribute to a moderation in GDP growth in 2012, projected at about 8.0%.

High food prices, hikes in government spending (notably the cash payments), and the increasing cost of imported fuel are likely to result in very high inflation in 2011, averaging 17%. On the assumption of further monetary tightening this year, inflation should decelerate in 2012, but is projected to remain elevated at 14.0% (Figure 3.12.6).

Robust mineral exports projected for 2011 will be offset by an increase in imports of supplies and equipment for mining, as well as the rising cost of imported food and fuel. The current account deficit is seen at about 15% through the forecast period. Its main sources of financing will be foreign direct investment and public and private sector borrowing from abroad.

The togrog could come under further upward pressure, undermining nonmineral industries, including cashmere and textiles.

Parliament last year enacted a fiscal stability law to improve the management of volatile revenue inflows from minerals and to help avoid the boom–bust instability that is common in mineral-based economies.

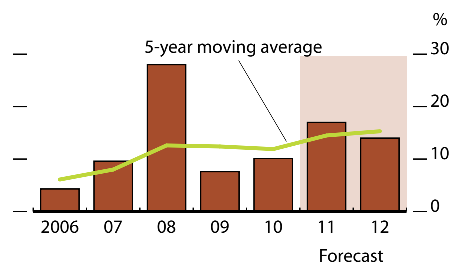
The law should foster budget discipline by effectively placing ceilings on spending growth, the fiscal deficit, and public debt. It also requires cost estimates for spending proposals to ensure consistency with the medium-term fiscal framework. A fiscal stability fund will be established to accumulate revenue saving, to be tapped during economic downturns. Most of the fiscal stability law's measures do not apply until 2013, however.

3.12.1 Selected economic indicators (%)

	2011	2012
GDP growth	10.0	8.0
Inflation	17.0	14.0
Current account balance (share of GDP)	-15.0	-14.0

Source: ADB estimates.

3.12.6 Average inflation



Sources: National Statistical Office of Mongolia. 2010. *Monthly Statistical Bulletin*. December. http://www.nso.mn; ADB estimates.

Click here for figure data

As for monetary policy, the new central bank law mandates the Bank of Mongolia to focus solely on price stability. Inflation targeting, coupled with a flexible exchange rate, should provide an appropriate monetary framework, which will take some time to establish. The monetary authorities have a tentative timetable to introduce inflation targeting in 2012.

Development challenges

The direction of fiscal policy is of increasing concern. Very high levels of government expenditure planned for 2011 are procyclical and may become a source of macroeconomic instability by fueling inflation, demand for imports, and exchange rate volatility.

Policies to develop minerals and promote economic diversification need to be balanced with sound macroeconomic management and prevention of boom–bust cycles. It is important to bring fiscal policy into line with the fiscal stability law and establish a sound medium-term budget framework.

Protecting the poor from the impact of rising prices and enabling their full inclusion in economic growth through greater employment are other objectives. Proposed measures to better target entitlement payments would mitigate the impact of high inflation.

Putting the banking system on a stronger foundation will require follow-through on the structural reforms proposed for the sector.

The "Dutch disease" risk common to mineral-based economies is likely to remain on the horizon. In this scenario, rapid increases in exports of minerals put upward pressure on the exchange rate and inflation, draw resources away from nonmineral sectors, and generate a stream of government revenue available for subsidies and handouts. The outcome can be uncompetitive nonmineral industries and overextended government budgets (particularly when global mineral prices turn down).

Taipei,China

A powerful recovery last year reflected a rebound in domestic demand and a surge in exports. Growth will moderate this year, owing to the high base set in 2010. Inflation has picked up, but is forecast at relatively modest levels. The outlook is improved by tariff reductions on exports to the People's Republic of China (PRC) and the opening of more industries to investment from there.

Economic performance

This trade-dependent economy rebounded vigorously from recession in 2009. Surging demand for its manufactured exports in 2010 drove a burst of investment and supported increased private consumption. The 10.8% rise in GDP—the fastest in almost a quarter century—was partly a result of the low-base effect from the contraction in the previous year.

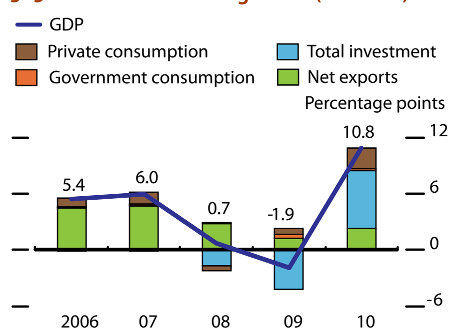
Private investment soared by nearly 33% in 2010, after contracting in 2009, with substantial increases in manufacturing, information and communications, and construction. Public investment also rose, albeit modestly, as the authorities continued with infrastructure spending, including reconstruction in areas hit by the severe Typhoon Morakot of August 2009. Overall, higher gross fixed capital formation contributed most of the boost to GDP in 2010 (6.1 percentage points of the total) (Figure 3.13.1).

Rebounding exports and manufacturing spurred employment and income growth, in turn buttressing private consumption. Unemployment declined to 4.7% by end-year, from 5.7% the previous year. Real average monthly earnings in manufacturing rose by 7.5% in 2010, after declines in the 2 previous years. The stronger labor market buoyed consumer confidence (Figure 3.13.2). Private consumption grew by 3.7% in 2010 and added 2.1 percentage points to GDP growth.

Sectorally, growth was dominated by manufacturing (constituting about 84% of industry), which surged by 26.8% and contributed 7.2 percentage points to GDP growth. Construction increased by 10.9%, though its contribution to GDP was slight, as it is a much smaller industry. Services grew by 4.8%, with wholesale and retail trading the major contributors to growth in this sector.

Strong global demand for manufactured goods drove growth of nearly 40% in exports of electronic products and chemicals, and increases of over 30% in metal products and plastics. Total exports shot up by nearly 35% in United States (US) dollar terms. The major markets were the PRC; Hong Kong, China; and the US, which collectively took 53% of total exports (Figure 3.13.3). Merchandise imports bounced back even more,

3.13.1 Contributions to growth (demand)



Source: Directorate-General of Budget, Accounting and Statistics. http://eng.dgbas.gov.tw (accessed 16 March 2011).
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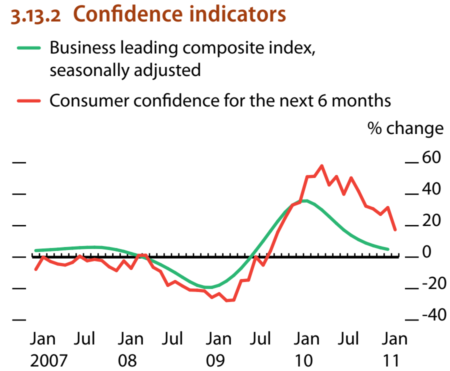
3.13.2 Confidence indicators



Source: CEIC Data Company (accessed 16 March 2011).
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This chapter was written by Akiko Terada-Hagiwara and Shiela Camingue of the Economics and Research Department, ADB, Manila.

by 43.2%, fueled by imported materials for manufacturing industries and capital goods required by the investment boom.

The merchandise trade surplus therefore fell by 12% to US$26.9 billion. After accounting for small surpluses in services and income, the current account surplus declined, to a still significant 9.4% of GDP. The overall balance of payments was in surplus and international reserves rose to US$382 billion by end-2010.

On the back of tighter economic links with the PRC through the Economic Cooperation Framework Agreement signed last year and abundant global liquidity, short-term portfolio inflows picked up and reached US$10 billion in the fourth quarter of 2010. A rapid increase in purchases of government bonds by foreign institutional investors, speculating on an appreciation of the NT dollar, prompted the monetary authorities in November 2010 to put limits on short-term debt that foreigners can hold. The local currency appreciated against the US dollar from NT$35.2 in March 2009 to NT$29.1 by end-2010.

After cutting interest rates in 2008 and 2009, the monetary authorities started to normalize rates as the economy rebounded. From June 2010, they raised the discount rate in three steps to 1.625% by year-end. Bank credit grew by 7.8% in 2010, after it had declined by 1.4% in 2009 (Figure 3.13.4). M2 money supply growth averaged 5.3% for the year, within the 2.5%–6.5% target range set by the central bank.

Consumer prices also turned up last year, although average inflation was just 1.0%. Of greater concern was a surge in residential property prices (Figure 3.13.5) caused mainly by speculative buying. The authorities moved to curb bank lending for second homes and directed banks to reduce loan-to-valuation ratios for such properties, which helped to damp speculation.

Government expenditure fell by 0.8% in 2010 from 2009, as the authorities gradually withdrew 2009's fiscal stimulus measures. Revenue also declined, by 0.4%, and the budget deficit narrowed only slightly in terms of the ratio to GDP, to 3.2% from 3.5% in 2009. Outstanding government debt rose to 33.6% of GDP, though still below a 40% limit set by law.

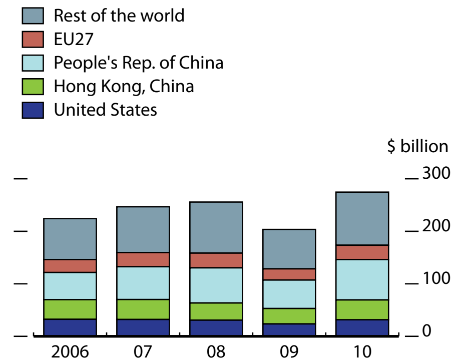
Economic prospects

Further growth in world trade in 2011 (though moderating from 2010's sharp rebound) and continuing expansion of the PRC economy will underpin growth in 2011. The pace will be around trend, however, as the base effect from the 2009 recession that propelled the 2010 outturn dissipates. Growth is expected to be broad-based, with contributions from both domestic and external demand.

The Economic Cooperation Framework Agreement with the PRC will support growth. (The PRC and Hong Kong, China together account for about 40% of Taipei,China's exports.) The first set of tariff reductions under the agreement came into effect in January 2011. Nearly 2,000 certificates of origin valued at over US$400 million, about 5% of merchandise exports to the PRC, were issued in January–February 2011 for Taipei,China products that receive preferential duties from the PRC.

The number of visitors from across the strait surged by 68% in 2010,

3.13.3 Total exports, by major trading partners



Source: Department of Statistics, Ministry of Economic Affairs. http://2k3dmz2.moea.gov.tw/gnweb/English (accessed 1 March 2011).

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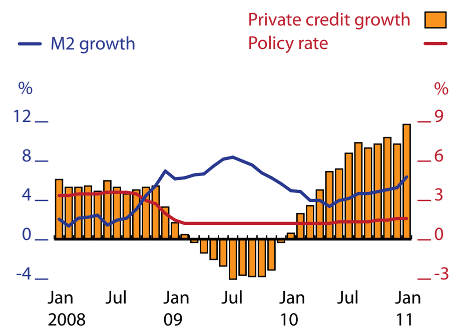
3.13.4 Credit indicators



Source: CEIC Data Company (accessed 16 March 2011).

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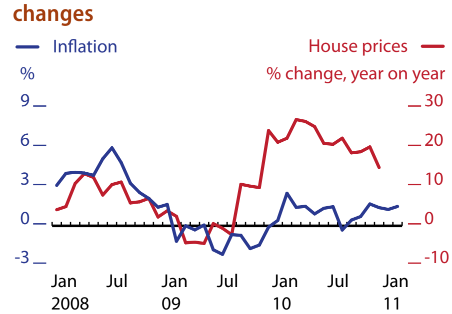
3.13.5 Monthly inflation and house price changes



Source: CEIC Data Company (accessed 16 March 2011).

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3.13.1 Selected economic indicators (%)

	2011	2012
GDP growth	4.8	5.0
Inflation	2.8	2.9
Current account balance (share of GDP)	6.9	7.0

Source: ADB estimates.

and further growth in inbound travel is expected as more tourist groups from the PRC are allowed to visit this year.

Further, the authorities in March 2011 opened up more industries to PRC investors, including the semiconductor and flat-panel subsectors, which were excluded in the first round of investment liberalization last year. PRC investment in these subsectors is expected to lead to increases in exports to the mainland.

Growth in export orders for manufactured goods (such as mobile telephones and tablet computers) moderated to about 5% in the first 2 months of 2011 compared with the prior-year period (Figure 3.13.6). Merchandise exports increased by about 21% in January–February 2011, year on year.

Private consumption is expected to grow by 1.2% in 2011, against the background of a firm labor market. Businesses in sectors with strong external demand—semiconductors and telecommunications equipment for example—are likely to increase investment, but private investment overall is projected to contract by 2.3% this year from the high base set in 2010.

On the balance of these influences, GDP is forecast to grow by 4.8% in 2011 and about 5.0% in 2012 (Figure 3.13.7). Downside risks to this outlook come from higher than expected global oil and commodity prices, any significant slowdown in the PRC, and a prolonged supply disruption to manufactured components from plants in Japan affected by the earthquake and tsunami.

Global price increases for commodities, food, and oil will likely mean that the value of imports rises faster than exports in 2011. (The import bill rose by 25.0% year on year in the first 2 months.) The trade surplus is forecast to fall and the current account surplus decline to 6.9% of GDP.

The higher costs of imports will put upward pressure on inflation, which is projected at around 2.8% in the forecast period (Figure 3.13.8). The NT dollar appreciated by 2.7% against the US dollar from the start of 2011 to mid-March, and is expected to remain firm. Given that forecast GDP growth is broadly in line with trend potential, the monetary authorities are expected to edge up interest rates to contain inflation.

Public investment will play a smaller role in the next 2 years. About US$3.6 billion is allocated for public infrastructure this year, compared with US$5.1 billion in 2010. General government revenue is expected to outpace expenditure, narrowing the fiscal deficit.

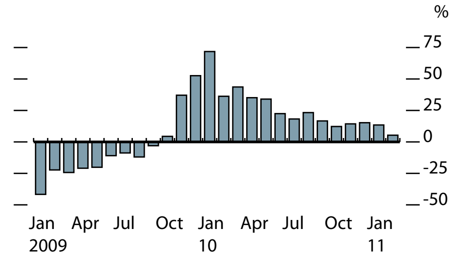
Development challenges

Longer-term growth potential is constrained by an aging, and shrinking, labor force.

The ranking of sources of GDP growth, in terms of production factors, in the decades of fast growth in the 1980s and 1990s put growth of the capital stock first, followed by total factor productivity, labor, and education. In 2000–2007, the capital stock was still the largest growth contributor; labor and education were equal second.

The labor force is projected to decline to below 10 million workers by 2030, from 11.1 million in 2010, and the age-dependency ratio could triple in that period.

3.13.6 Growth in export orders



Source: CEIC Data Company (accessed 16 March 2011).
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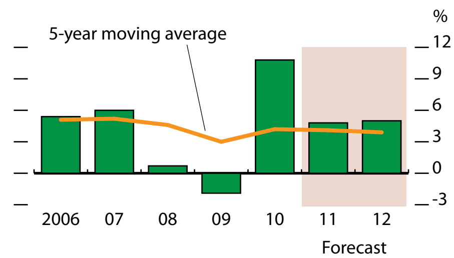
3.13.7 GDP growth



Sources: Directorate-General of Budget, Accounting and Statistics. http://eng.dgbas.gov.tw (accessed 16 March 2011); ADB estimates.
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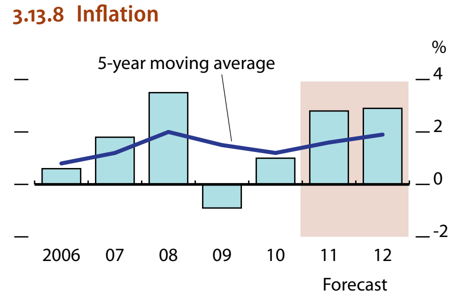
3.13.8 Inflation



Sources: Directorate-General of Budget, Accounting and Statistics. http://eng.dgbas.gov.tw (accessed 16 March 2011); ADB estimates.
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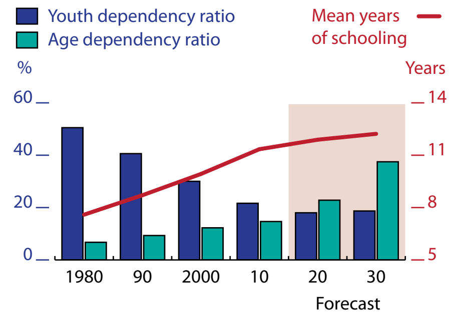
Taipei,China's labor force participation rate, at 58% of the working-age population, is the lowest among newly industrialized economies and almost 10 percentage points lower than Singapore's. The population in Singapore is aging faster, but an active immigration policy there means that labor is projected to add to its growth in the long term, while the reduction in the Taipei,China labor force will lower its growth.

To address this issue, some local authorities, such as Taipei city, are providing conditional cash transfers to households with pre-school-age children to encourage women, in particular, not to quit work when they have children. Such measures could be rolled out more widely to raise labor force participation.

With regard to education, the average number of years of schooling in Taipei,China is expected to reach developed-country levels of 12 years by 2030 (Figure 3.13.9). Hence, there is probably greater room to enhance growth potential by focusing on policies that raise the labor force participation rate, stimulate investment, and foster advanced technology.

The reductions in tariffs on exports to the PRC may well encourage some of the manufacturers that relocated factories to the PRC to bring back some production to the island. Further, the eased tariffs, proximity to the PRC, and a cut in the corporate tax rate to 17% last year all improve the odds of broadening the investor base by attracting firms from rapidly developing countries, such as India, that aim to produce for the large PRC market.

3.13.9 Dependency ratios and years of schooling



Sources: J.-W. Lee and R. Francisco. 2010. Human Capital Accumulation in Emerging Asia 1970–2030. *ADB Economics Working Paper Series* No. 216. Asian Development Bank, Manila; Population Division of the Department of Economics and Social Affairs of the United Nations Secretariat, *World Population Prospects: The 2008 Revision*. http://esa.un.org/unpp (accessed 28 April 2010).

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