East Asia

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

People's Republic of China

An easing in domestic demand, compounded by weaknesses in exports, weighed on economic growth last year. The property boom cooled as a result of policy measures. Exports fell in the last 2 months of 2008 as global trade slumped. A concern early in the year, inflation ebbed later on as the global and domestic economies slowed. The authorities have switched to expansionary fiscal and monetary policies to support growth, including a large fiscal stimulus. These steps will moderate the slowdown that is forecast for 2009, before growth picks up in 2010. Generating jobs and protecting the growing number of unemployed is a pressing issue.

Economic performance

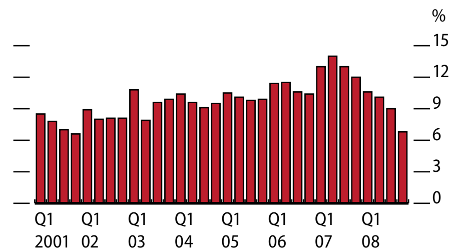
Growth pulled back from a rapid 13.0% in 2007 to 9.0% in 2008, the lowest rate since 2002, reflecting the combined effects of policy tightening to curb inflation, the global economic downturn, and natural disasters (severe snowstorms, floods, and May's Sichuan earthquake). GDP growth has decelerated since the second quarter of 2007, to 6.8% year on year in the fourth quarter of 2008 (Figure 3.9.1).

By sector, a sharp slowdown in industry, which makes up nearly 60% of GDP at constant prices, was the main cause of last year's overall deceleration: it slid to 9.3% from 14.7% in 2007. Industry still contributed an estimated 5.5 percentage points to total GDP growth. Services, accounting for 32% of GDP, followed a similar trend—its growth slowed to 9.5% from 13.8%. The contribution of services to GDP growth was about 3 percentage points. In contrast, agricultural production accelerated to 5.5% from 3.7%, but since agriculture now constitutes less than 10% of the economy, its contribution to total growth was just 0.5 percentage points (Figure 3.9.2).

On the demand side, investment continued to propel growth, contributing an estimated 3.9 percentage points. Consumption contributed an estimated 3.3 percentage points and net exports about 1.8 percentage points (Figure 3.9.3). On the basis of these estimates, the main cause of the GDP slowdown was a cooling in domestic demand that was exacerbated by weaknesses in exports as the year progressed.

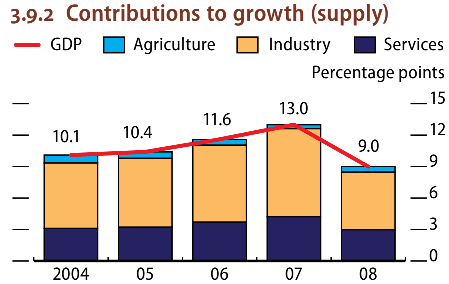
Nevertheless, external demand slowed more and more as the global economic downturn deepened. Export growth remained robust in the first three 3 quarters of the year as factories completed orders received earlier from abroad. However, in November and December 2008, merchandise exports turned down, by 2.2% and 2.8% (year on year) respectively, on a customs basis (Figure 3.9.4). This was the first such contraction in 7 years and the weakest pace since June 1999. Imports in those 2 months dropped by 18% and 21.3%, a consequence of weaker domestic and external demand and falling global commodity prices.

3.9.1 Quarterly GDP growth



Source: CEIC Data Company Ltd., downloaded 15 March 2009.

3.9.2 Contributions to growth (supply)



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

This chapter was written by Jian Zhuang of the People's Republic of China Resident Mission, ADB, Beijing.

As major industrialized economies slowed further in 2009, exports contracted by 17.5% in January and by 25.7% in February. Mechanical and electrical products, textiles, and toys were particularly hard hit by shriveling external demand. But because imports fell much faster than exports, the trade surplus surged from about $315 billion in 2007 to $351 billion in 2008.

Steps that the Government took from the second half of 2007 to cool a booming property market included credit quotas, curbs on land supply for project developers, and tighter lending conditions for second-home buyers. Consequently, a steep decline in property development last year contributed to a slowing of total real fixed asset investment growth from 20.2% in 2007 to 15.2% in 2008 (Figure 3.9.5).

The Government succeeded, perhaps more quickly than expected, in damping the property boom. Residential property sales went into a steep decline in 2008 and housing prices either stopped rising or fell in many cities. In December 2008, average prices for houses and apartments in 70 cities fell by 0.4% year on year, the first decline since July 2005, and the decline accelerated in the first 2 months of 2009. In addition, the contraction in property development depressed demand for building materials such as steel and cement (Figure 3.9.6), curtailing industrial output. Industrial investment held up well in 2008, expanding by 29%. However, slowing industrial output, falling profits, weaker exports, and overcapacity in some manufacturing industries strongly suggests that this rate of expansion cannot be sustained.

Consumption played an important role in maintaining GDP growth, although its contribution was slightly lower than in 2007 and much lower than that of investment. Growth in retail sales in real terms was around 15% (22% in nominal terms), speeding up from about 11% growth in 2007. Sales of motor vehicles rose by 25.3% in nominal terms and household appliances by 14.2%. This buoyant consumer demand was supported by rising incomes –urban incomes grew by about 8% in real terms last year—and slowing inflation, after a spurt early in the year.

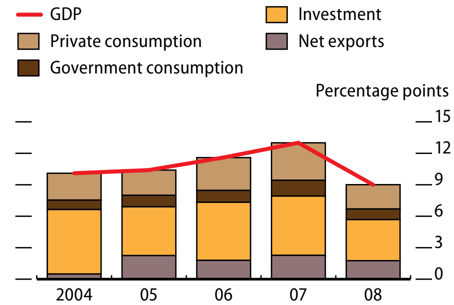
Inflation accelerated early in the year, driven by food. Once food prices stabilized, overall inflation was contained (Figure 3.9.7). On a year-on-year basis, inflation peaked in February 2008 at 8.7% year on year and eased to 1.2% in December, resulting in a 5.9% average, the highest in 12 years. The deceleration continued into this year—the consumer price index fell by 1.6% in February 2009 from February 2008. Producer price inflation moderated during the second half of 2008, reflecting declines in global prices for oil and other commodities. After inflation pressures receded, the Government ended some price controls introduced in early 2008.

Since July 2005, the authorities have determined the exchange rate with reference to a basket of major currencies. Its overall appreciation against the basket has slowed. The exchange rate in real effective terms gained 1.6% in the fourth quarter of 2008, after appreciating by 10.1% in the previous 9 months.

Maintaining exchange rate stability has become part of the Government's macroeconomic policies to support GDP growth in the face of weakening exports and volatile global financial conditions. Pressure on the yuan to appreciate eased considerably as capital inflows slowed.

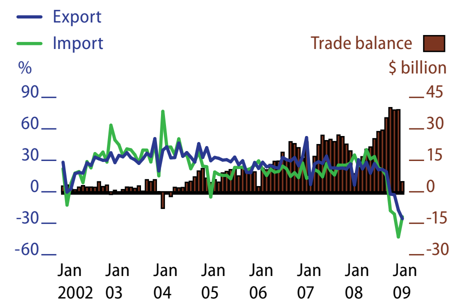
The current account surplus increased from $372 billion in 2007 to

3.9.3 Contributions to growth (demand)



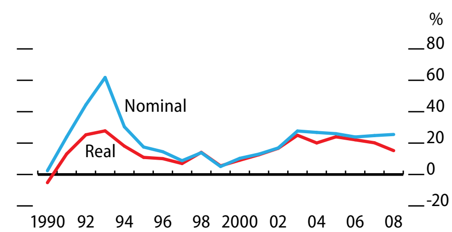
Sources: National Bureau of Statistics of China; staff estimates.

3.9.4 Trade indicators



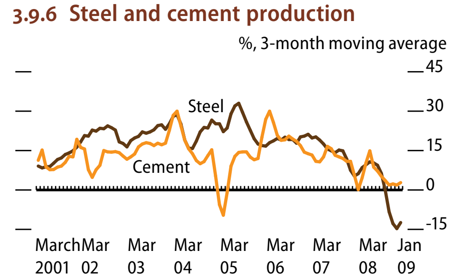
Source: CEIC Data Company Ltd., downloaded 15 March 2009.

3.9.5 Fixed asset investment growth



Source: CEIC Data Company Ltd., downloaded 15 March 2009.

3.9.6 Steel and cement production



Source: CEIC Data Company Ltd., downloaded 15 March 2009.

$440 billion in 2008, equivalent to 10.1% of GDP. Equity and debt inflows receded as the global financial crisis intensified and slowed the pace of the rise in official foreign exchange reserves, which still, however, ended the year $418 billion higher, at $1.95 trillion.

Domestic stock markets fell sharply in 2008, after soaring for most of 2006 and 2007. The Shanghai A-Share index plummeted by about 69% from its peak in October 2007 to December 2008 (Figure 3.9.8). The Government moved to stabilize stock markets with a 50% cut in the stamp duty on stock trading. It also prompted listed state-controlled companies to buy back their own shares.

The People's Bank of China, the central bank, tightened monetary policy through 2007 and well into 2008, when inflation and overheating were major concerns. It raised the reserve-requirement ratio for banks by 8.5 percentage points and its 1-year lending rate by 135 basis points between January 2007 and September 2008. These moves were coupled with guidance to banks to adopt informal credit quotas.

As the economy slowed and inflation eased in the fourth quarter of 2008, the central bank switched to an easing stance: it cut interest rates and reserve requirements and eliminated credit quotas. Between mid-September and end-December, it lowered the lending rate from 7.47% to 5.31%, the first reductions in 6 years, and the reserve-requirement ratio from 17.5% to 14.5% (Figure 3.9.9). Growth in M2 money supply picked up to 17.8% year on year in December and bank lending increased by 18.8% in that month. Both M2 and bank lending continued to accelerate in the first 2 months of 2009 (Figure 3.9.10).

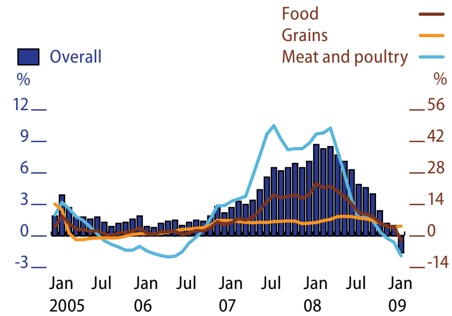
On the fiscal side, revenue growth was strong in the first half of 2008, but weakened late in the year owing to profit declines at state-owned enterprises and some tax concessions. Profits of state-owned enterprises administered by the central Government fell by 30% in 2008, the first decline on a yearly basis since 2002. As for tax breaks, the Government raised tax rebates to bolster exports, reduced taxes on house purchases, and cut the duty on stock trading in the second half of last year.

In view of the fast-deteriorating external environment, the Government in November announced a 2-year fiscal stimulus package costing CNY4 trillion ($586 billion, or 16% of 2007 nominal GDP) to shore up domestic demand. The package includes social and infrastructure spending, earthquake reconstruction, and subsidies to farms and industries (Box 3.9.1). Some of the spending on projects was already planned, and has been brought forward. The package will be funded by the central Government, local governments, banks, and state-owned enterprises. The central Government committed a total of CNY1.18 trillion for 2009 and 2010, of which CNY230 billion was disbursed in the fourth quarter of 2008 and the first quarter of 2009. Large increases in expenditures in the fourth quarter of 2008 resulted in an estimated full-year fiscal deficit of 0.4% of GDP, compared with a surplus of 0.6% in 2007.

Economic prospects

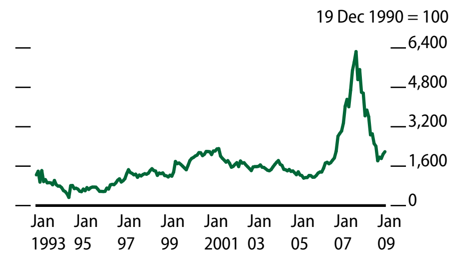
As the economic slowdown deepened, the Government continued to unveil new fiscal measures, including in January 2009 plans to spend

3.9.7 Monthly inflation



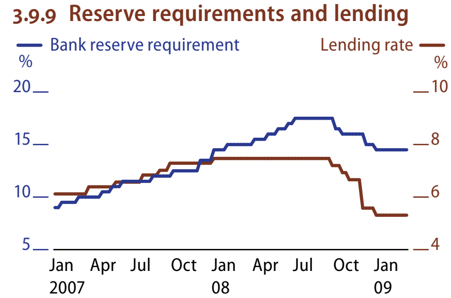
Source: CEIC Data Company Ltd., downloaded 15 March 2009.

3.9.8 Shanghai A-share index



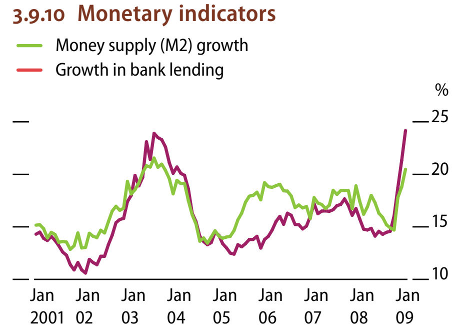
Source: CEIC Data Company Ltd., downloaded 15 March 2009.

3.9.9 Reserve requirements and lending



Sources: CEIC Data Company Ltd., downloaded 15 March 2009; People's Bank of China.

3.9.10 Monetary indicators



Source: CEIC Data Company Ltd., downloaded 15 March 2009.

3.9.1 The November 2008 fiscal stimulus package and its financing

The Government selected 10 areas for extra spending to provide a boost to the economy in 2009 and 2010.

- Housing—More affordable and low-rent housing, acceleration of slum demolition, launch of a pilot program to rebuild rural homes, and encouragement to nomads to move into permanent housing.
- Rural infrastructure—Improvement of roads and power grids in the countryside, and water supply projects, including a huge project to divert water from the south to the north. Additional efforts to reduce poverty.
- Transport—More rail links and routes for transporting coal. New airports in the west.
- Health and education—More hospitals in smaller towns and cities. More schools in the western and central regions, and for children with special needs countrywide.
- Environment—Focus on sewage and garbage treatment facilities and preventing water pollution. Accelerated green belt and natural forest–planting programs. More energy-conservation initiatives and pollution-control projects.
- Industry—Further subsidies for high-tech and service industries.
- Earthquake reconstruction—More funding to rebuild areas damaged by the Sichuan earthquake.
- Wealth creation—Increased grain purchases and farm subsidies to raise rural incomes. A boost in pension funds for a wide range of workers. More allowances for low-income city dwellers.
- Tax—Reforms to value-added tax, effective 1 January 2009. Reduction in corporate tax burden of CNY120 billion ($18 billion).
- Finance—Removal of loan quotas and ceilings for lenders. Increased bank credit for rural areas, small businesses, and companies involved in technology, iron, and cement.

On top of the central Government's pledge of CNY1.18 trillion for the stimulus package, the State Council will allow local governments to issue CNY200 billion in bonds through the Ministry of Finance (local governments are not usually allowed to issue bonds).

Other funding sources include long-term bank loans and corporate bonds issued by state-owned enterprises. If the entire CNY4 trillion were to be financed by debt issuance, total national debt would increase to 28% of GDP, which is still relatively moderate.

CNY850 billion during 2009–2011 to improve medical care, in February 2009 a planned CNY600 billion for research and technical innovation, and (the same month) a subsidy for farmers nationwide to buy household appliances. Specific industrial policies designed to support the adjustment and revival of key industries such as steel, automobiles, and textiles are being unfolded. Moreover, the monetary authorities have scope for more accommodative policies in view of low inflation at the start of 2009.

Still, the focus on public investment in the stimulus package suggests that it will take some months to gain traction. As a result, the economy is not expected to pick up until the second half of 2009, when more public investment is implemented. Growth should edge higher in 2010.

The dismal outlook for external demand suggests that merchandise exports are likely to fall by about 4% in 2009, before rebounding to 8% in 2010. Lower global oil prices and softer domestic demand for raw materials will reduce merchandise imports this year by about 7%. Next year, imports are forecast to rise by 10%. The merchandise trade surplus is expected to continue to rise. Weak global economic growth will reduce tourism receipts and contribute to a widening in the services trade deficit.

Capital inflows are likely to remain suppressed by the global financial crisis. The surplus on the income account will likely be maintained, reflecting earnings from the country's foreign exchange reserves and investments. In view of these developments, the current account is forecast to record substantial surpluses (8.4% of GDP in 2009 and 7.8% in 2010), coming down a little from just over 10% in the past 2 years. On this basis, foreign exchange reserves will rise to $2.2 trillion in 2009 and to $2.5 trillion in 2010.

3.9.1 Selected economic indicators (%)

	2009	2010
GDP growth	7.0	8.0
Inflation	0.8	1.0
Current account balance (share of GDP)	8.4	7.8

Source: Staff estimates.

Government investment will get a boost from the fiscal measures. Public consumption (about 30% of total consumption) will likely expand rapidly as the Government implements the package. The contribution to GDP growth of this investment and consumption is expected to be 3–4 percentage points in 2009, compared with less than 3 points in 2008.

Private sector investment is forecast to slow this year. Property development will likely be sluggish for as long as the housing market remains soft. The poor export outlook will curb investment in export-oriented industries, especially textiles, garments, footwear, and toys. Investment in domestic demand–driven industries should hold up relatively well, helped by the value-added tax change that reduces their tax costs. Still, profits in these industries too have been squeezed and some of them have excess production capacity.

A survey by the central bank suggests that the sharp slowdown in growth late in 2008 was in part a reflection of producers' inventory destocking, prompted by the slump in exports and in prices of many commodities. In the context of the Government's current policies to spur the economy and to revive major industries, producers are likely to end destocking and start to increase inventories in the second quarter of 2009.

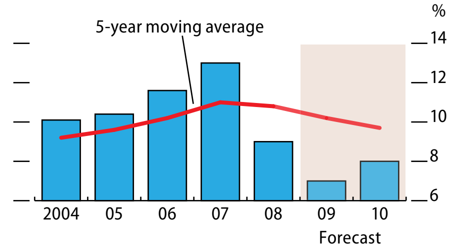
In contrast, private consumption growth is likely to remain buoyant at around 8–9% this year and next. The low level of inflation will benefit consumption, so will the subsidy for people in rural areas to buy household appliances and some of the stimulus package measures. Furthermore, the threshold for levying personal income tax might be raised this year, adding to disposable incomes. These positive factors will be offset to some degree by a weaker labor market. Growth in real retail sales grew at a solid rate in the first 2 months of 2009.

Based on these considerations, GDP growth is forecast at 7.0% in 2009. It should pick up to 8.0% in 2010 (Figure 3.9.11) as the global economy starts to recover, underpinned by a full year's impact of the domestic policy measures. Last year's high first-quarter base means that the year-on-year increase in GDP will probably ease to about 6% in the first 3 months of 2009, from 6.8% in the fourth quarter of 2008. Growth is expected to edge up from there, to about 8% in the second half of 2009.

Inflation is expected to average less than 1% in 2009 (Figure 3.9.12), suppressed by slackness in the economy, expanding supplies of food, and declining rents. Lower average prices for oil and other commodities will put downward pressure on producer prices, although the Government might raise administered utility charges as part of its reforms of energy pricing.

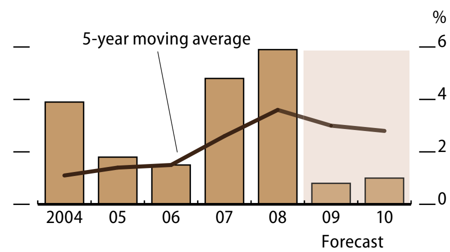
Downside risks to these forecasts stem from uncertainties in the global economy and a deeper than expected domestic property slump. On the upside, further domestic stimulus policies could spark an earlier recovery in the property market and faster growth in private sector investment.

3.9.11 GDP growth



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

3.9.12 Inflation



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

Development challenges

Unemployment is the most pressing issue. It worsened last year when external demand slumped, leading to layoffs in export-oriented industries. There have been more job losses in both the private and public sectors since then. The Government estimated in February 2009 that about 20 million migrant workers of the total of 130 million had at that date lost their jobs because of the economic slowdown. In December 2008, the Chinese Academy of Social Sciences, an academic research organization, estimated that 1.5 million of 5.6 million graduates from colleges last year could not find jobs by year-end. The Academy estimated that the total urban unemployment rate was 9.4% at end-2008, or more than twice the official urban unemployment figure of 4.2%, which excludes most migrant workers.

Investment projects in the stimulus package will generate jobs, but not enough to absorb the growing labor surplus. For one thing, infrastructure projects are generally less labor intensive than export-oriented manufacturing. Certainly, a rebound in economic growth can create large numbers of jobs—13.6 million nonfarm jobs were created each year from 2000 and 2007 when GDP growth averaged 10.2%. However, employment generation on this scale will be more difficult in the future because employment elasticity—the rate of employment growth to GDP growth—has declined in recent years.

Rebalancing the economic structure away from an emphasis on investment- and export-led growth and toward private consumption as a growth driver remains a challenge (Box 3.9.2). A better social safety net may well encourage private consumption by reducing people's precautionary saving (for education, medical care, and retirement). Maintaining the trend toward higher incomes is also important in this regard, as is addressing income inequality. The income ratio between urban and rural residents, for example, widened from 2.9:1 in 2001 to 3.31:1 in 2008 (Figure 3.9.13).

Pressing ahead with certain policies that have been announced but not yet implemented would also facilitate rebalancing. This means realizing reforms concerning rural land-use rights, while ensuring transparency and mechanisms to prevent exploitation of rural households, and finalizing a draft health reform package and a long-term plan for education.

At this time of rising unemployment, it will also be important to strengthen social protection programs, particularly for migrant workers who lose their jobs. Many of them are returning to the countryside where there is little work. Some have been offered assistance by the Government, such as vocational training and one-time cost-of-living subsidies.

The fall in global energy prices provides an opportunity to make more progress on reforming domestic pricing of energy and natural resources. These prices are generally much lower than world levels, reducing incentives to achieve energy efficiencies or to reduce emissions of major pollutants. Reforms have been implemented on the pricing and taxing of gasoline and diesel; the next step should be accelerating the pricing of natural gas, water, and electricity.

Box 3.9.2 Rebalancing the economy

The Government's midterm evaluation of implementation of the 11th Five-Year Plan (2006–2010), which set goals for rebalancing the economy, showed that progress is lagging in several areas.

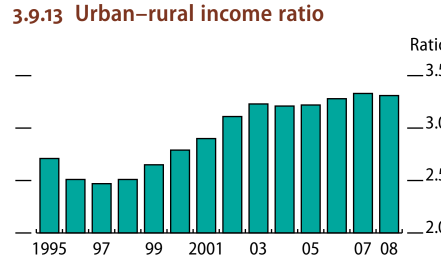
Among four key structural indicators used to measure rebalancing—share of the services sector's value added to GDP, share of employment in the services sector, share of research and development spending in GDP, and urbanization rate—only the urbanization rate met the target. Two other targets—on energy efficiency and pollution reduction—were not met.

Given that the CNY4 trillion stimulus package concentrates on investment projects rather than private consumption, the package is unlikely to help shift growth from an investment-led pattern to one driven more by consumption.

The economy has significant room to expand consumption. Household consumption as a share of GDP was 36.3% in 2007, one of the lowest ratios in the world.

There is much potential for greater public consumption, too, in view of the strong fiscal situation and low public debt. The Government has set up several social development programs such as *dibao* (a minimum living-standards guarantee) and basic health insurance for eligible urban and rural households whose annual incomes are below the *dibao* level.

3.9.13 Urban–rural income ratio



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

Hong Kong, China

Growth in this open economy was dealt a heavy blow toward the end of 2008 by the global financial crisis and trade slump. The important financial and real estate services industries contracted in the second half of 2008. For the year, consumption barely grew and fixed investment flattened. In 2009, exports are forecast to fall and both private consumption and investment will likely shrink. GDP is expected to contract, before growth resumes in 2010. Inflation has decelerated and is expected to remain low over the forecast period.

Economic performance

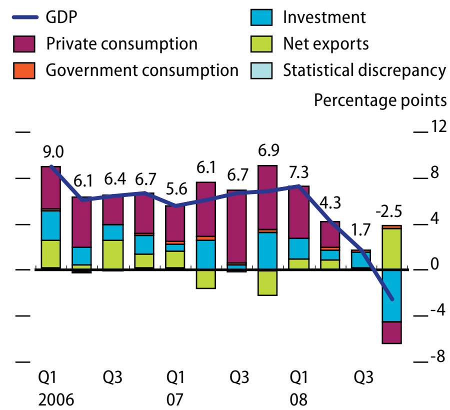
The economy opened 2008 with robust growth of 7.3% in the first quarter, year on year, slowed sharply in the second and third quarters, then contracted by 2.5% in the fourth (Figure 3.10.1). For the full year, growth decelerated to 2.5%, from 7.2% on average over 2004–2007. It was undermined by the global financial crisis, given the importance of financial services to this economy, and further eroded late in the year by the slump in world trade. Hong Kong, China is one of the most open economies in the world—the ratio of exports and imports to GDP was about 410% (including reexports) in 2008. The deteriorating external conditions severely dented consumer and business confidence.

Private consumption grew by a meager 1.8% in 2008, compared with buoyant growth of 8.5% in 2007. Spending was curtailed by the increasingly gloomy international outlook and its deleterious effect on employment and personal wealth. Unemployment rose from 3.4% in the first quarter to 4.1% in the fourth. As for asset markets, the share price index plunged by 48% in 2008 (Figure 3.10.2) and property prices turned down in the second half (Figure 3.10.3). Moreover, growth in visitor arrivals slowed to 4.7% from 11.6% in 2007, and the volume of retail sales slowed by about half, to 5.0%. Spending on services edged up by less than 1%. Consumption contributed about half of total GDP growth, much less than in 2007.

The deterioration in external and domestic demand caused businesses to cut back on investment in machinery and equipment in the fourth quarter. Fixed investment overall was flat in 2008 (it grew by 3.4% in 2007). When adjusted for changes in inventories, total investment contracted by 1.1% and subtracted 0.3 percentage points from GDP growth.

Growth in real exports of goods and services decelerated, especially in the second half of the year when the global downturn intensified. For the year, real exports decelerated to 2.7% from 8.3% growth in 2007. Growth in real imports decelerated even faster than that for exports, with the

3.10.1 Contributions to growth (demand)



Source: Census and Statistics Department, available: http://www.censtatd.gov.hk/, downloaded 2 March 2009.

3.10.2 Hang Seng index

Source: CEIC Data Company, Ltd., downloaded 15 March 2009.

This chapter was written by Juthathip Jongwanich of the Economics and Research Department, ADB, Manila.

result that net exports of goods and services contributed 1.5 percentage points to total GDP growth.

Reexports, mainly originating from the People's Republic of China (PRC) and accounting for 97% of total merchandise exports, rose by about 6% in nominal US dollar terms, the weakest result since 2001. Domestic merchandise exports fell. Financial services exports slowed as international capital market activity shriveled. Total services exports grew by 9.2% in nominal terms, another area whose growth slowed by around half. Still, a large surplus in services trade and a surplus in the income account more than compensated for a widening of the merchandise trade deficit (Figure 3.10.4). The current account surplus rose to the equivalent of 14.2% of GDP. After accounting for investment inflows, the overall balance of payments registered a surplus of 15.7% of GDP (Figure 3.10.5).

Services account for virtually all of GDP, and sector growth slowed to 2.5%, also the weakest since 2001. Wholesale and retail trading and transport and storage subsectors contracted in the fourth quarter year on year. The important finance, insurance, and real estate subsectors were hit harder: they contracted in both the third and fourth quarters. Nevertheless, the services sector was the only one to contribute to GDP growth. Production of the small manufacturing and agricultural sectors fell in 2008.

Slower economic growth and increases in government spending in FY2008 (ended 31 March 2009) resulted in a fiscal deficit estimated at 0.3% of GDP, compared with a surplus of more than 7% in FY2007. Fiscal concessions, largely aimed at cushioning the impact of rising prices in the first half, included temporary increases in welfare benefits, a one-time grant to subsidize household electricity costs, income tax rebates, and a waiver on property tax.

Inflation accelerated to 6.3% through July, driven by higher prices for imported food and fuel and rent increases (Figure 3.10.6). As global food and fuel prices declined and domestic demand weakened during the second half, inflation moderated to 2.1% by December. Year-average inflation was 4.3%. After adjusting for the fiscal concessions, which subdued some prices, underlying inflation was 5.6%.

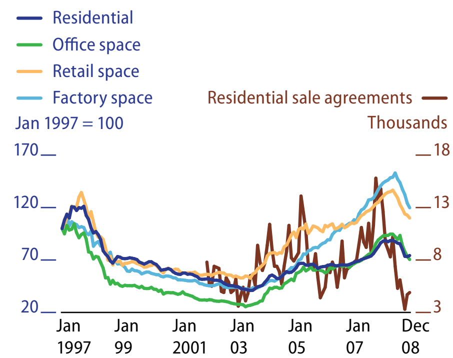
Given that the United States (US) and Hong Kong dollars are linked, interest rates in this economy broadly follow those in the US. The Hong Kong Monetary Authority lowered the base rate under its discount window throughout 2008, to 0.5% at year-end. Bank lending rates in real terms declined in 2008.

Economic prospects

Contracting economies in the eurozone, Japan, and US, coupled with the continuing global financial crisis, are particularly bad news for this trade- and services-dependent economy. The slowdown in the PRC economy—with which the Hong Kong, China economy has extensive trade, logistics, and services links—adds further gloom to the outlook. The forecasts assume that the yuan will appreciate slightly against the US dollar and that the Hong Kong's dollar link with the US dollar will be maintained.

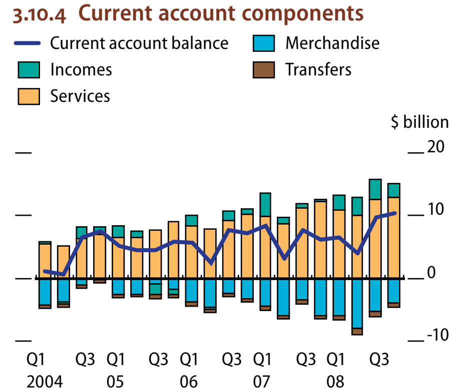
Slack external demand will further weaken the labor market in 2009,

3.10.3 Property price indexes and number of transactions



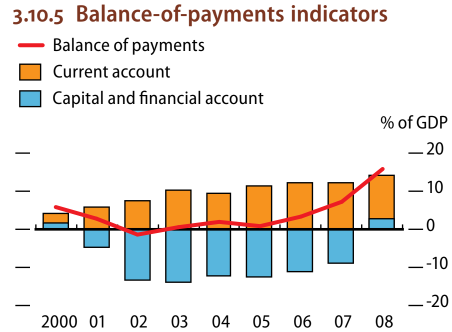
Source: Rating and Valuation Department, available: http://www.rvd.gov.hk, downloaded 15 March 2009.

3.10.4 Current account components



Source: Census and Statistics Department, available: http://www.censtatd.gov.hk/, downloaded 23 March 2009; Hong Kong Monetary Authority.

3.10.5 Balance-of-payments indicators



Sources: Census and Statistics Department, available: http://www.censtatd.gov.hk/, downloaded 23 March 2009; Hong Kong Monetary Authority.

pushing up unemployment and suppressing consumer confidence in 2009. Lower growth in tourist arrivals and the softening property market will also damp consumer spending. Investment will decline as a result of the somber outlook for both exports and demand for new buildings. Furthermore, banks have generally adopted a more guarded approach to lending. Both consumption and investment are forecast to contract this year. An expansionary fiscal stance (Box 3.10.1) will provide some support for domestic demand. So should low interest rates. But these positive influences cannot neutralize the powerful negative forces.

Real exports of goods and services are forecast to weaken in 2009 compared with 2008. As a services-based economy, the prolonged global financial crisis and slump in both trade and tourism will further erode services exports, while merchandise reexports will remain sluggish. Imports in real terms will contract, given the decline in domestic demand.

On balance, GDP is forecast to fall by 2.0% in 2009, the first contraction since the economy shrank by 6.0% in 1998 during the Asian financial crisis. In 2010, growth is expected to resume at about 3% (Figure 3.10.7) as world trade picks up and financial markets rally. Growth in the PRC is projected to pick up by about 1 percentage point, which would support a recovery in Hong Kong, China. These influences are likely to feed through and boost consumer and business confidence next year.

Merchandise exports and imports in the first 2 months of 2009 slumped by 22% from prior-year levels on a customs basis, although this rate of decline is not expected to continue through the year. Exports for the whole year are projected to drop by about 5%, subject to substantial downside risks because of the uncertain global prospects. Imports will fall faster than exports owing to the sluggish domestic demand and lower prices of imported oil and other commodities compared with 2008. The merchandise trade deficit will likely narrow, but the services trade surplus will fall, reflecting weaknesses in financial services and tourism. The income account is expected to be in deficit as dividends from overseas investments decline in the context of lower global corporate profits. Consequently, the current account surplus will likely decline, but remain substantial at 9–10% of GDP in the forecast period.

Inflation pulled back to average 2.0% in the first 2 months of 2009. It is expected to be about 1.5% for the whole year, a result of subsiding domestic demand and lower prices for imported fuel and food than 2008. Against this, some fiscal concessions, such as waivers on public housing rents and grants to subsidize household electricity bills will expire this year so that the consumer price index will not fully reflect the weakness in domestic demand. In 2010, inflation is expected to edge higher as the recovery gets underway.

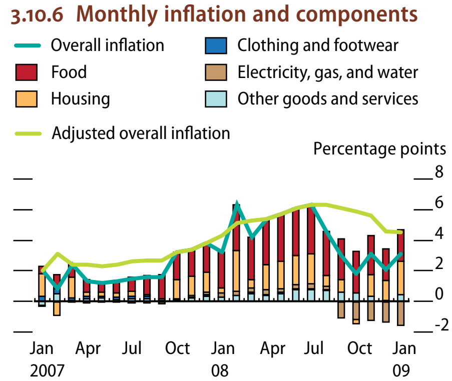
Risks to these forecasts stem mainly from external influences and are predominantly on the downside. Further jolts to the international financial system would quickly spill into domestic financial markets, causing further contraction in financial services, steeper declines in equity and property prices, and greater caution in lending. A deeper than expected slump in global trade would curtail growth in the PRC, with spillover effects to Hong Kong, China.

3.10.1 Selected economic indicators (%)

	2009	2010
GDP growth	-2.0	3.0
Inflation	1.5	2.0
Current account balance (share of GDP)	9.0	10.0

Source: Staff estimates.

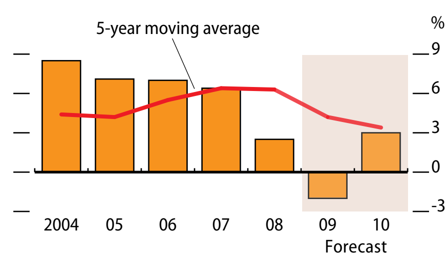
3.10.6 Monthly inflation and components



Note: Adjusted overall inflation refers to the rate after the effects of the Government's one-time relief measures are removed.

Sources: CEIC Data Company Ltd., downloaded 15 March 2009; Census and Statistics Department, *Monthly Report on the Consumer Price Index, January 2009*, Table B, available: http://www.censtatd.gov.hk.

3.10.7 GDP growth



Sources: Census and Statistics Department, available: http://www.censtatd.gov.hk/, downloaded 2 March 2009; staff estimates.

3.10.1 Global financial crisis and the economy

The Government and the Hong Kong Monetary Authority (HKMA) have taken a range of policy measures to support the economy and its financial institutions since mid-September 2008, when the global financial crisis intensified.

Monetary and financial policies

HKMA injected HK$179 billion (US$23 billion) into the banking system during September–December through market operations involving the purchase of US dollars for Hong Kong dollars, to address a squeeze in the interbank market and rising demand for Hong Kong dollars.

The monetary authority expanded acceptable collateral for borrowing under the discount window to include US Treasury securities, while maturities of liquidity assistance provided through its discount window were extended to up to 3 months. It reduced the base rate to 50 basis points above the prevailing US Federal Funds target rate and delinked the base rate from interbank rates. It took these temporary measures to enhance liquidity in the banking system.

The Government announced a blanket guarantee of all customer deposits held with all authorized institutions in Hong Kong, China, to end-2010. It also provided a facility to provide capital to locally incorporated banks, if they needed it.

HKMA offered banks foreign exchange swaps and a term lending facility to provide Hong Kong dollar liquidity against approved collateral for maturities of up to 3 months, until March 2009.

The People's Bank of China and HKMA signed an agreement for a CNY200 billion (US$29 billion) currency swap facility to provide short-term liquidity support to operations of Hong Kong banks in the PRC and vice versa.

Fiscal policies

The Government announced a HK$100 billion (US$12.8 billion) package of loan guarantees for small and medium-sized firms in December 2008.

A package of measures was outlined by the governments of the PRC and Hong Kong, China aimed at increasing cooperation on trade, financial, and infrastructure matters.

The budget unveiled in February targets a deficit equivalent to 2.4% of GDP for FY2009 and a deficit of 1.5% of GDP in FY2010. The budget includes spending of HK$1.6 billion aimed at generating 62,000 jobs and internships over 3 years, HK$39.3 billion in outlays on infrastructure, and several social support measures.

Economic and financial indicators

Key indicators of economic and financial health have generally strengthened in recent years. The current account surplus exceeded 10% of GDP and gross international reserves increased to US$182.5 billion at end-2008. Fiscal reserves also are substantial. The real exchange rate has closely tracked the long-run equilibrium real exchange rate, which implies that the Hong Kong dollar is valued broadly in line with economic fundamentals.

In the financial sector, the loan-to-deposit ratio in 2008 at about 54% indicates that bank funding is mainly through deposits rather than external sources. The capital-adequacy ratio of locally incorporated banks increased and the nonperforming loan ratio decreased in 2008. Some banks incurred losses on US "toxic" assets, but total exposure in relation to banking system assets is low.

There are concerns that banks will face pressure on profits from declining margins between funding costs and loan interest rates, as well as from reduced fee income, as a consequence of the slump in share offerings and in wealth management activity. As in other economies, nonperforming loans are likely to rise during the economic slowdown.

Economic and financial indicators

	2008
Fiscal reserves (% of GDP)	31.2
Loan-deposit ratio	54.0
Nonperforming loans (% of total)	1.2
Capital-adequacy ratio	14.8
Current account (% of GDP)	14.2
Gross international reserves (months of retained imports)	22.5

Sources: CEIC Data Company Ltd., downloaded 27 February 2009; staff estimates.

Development challenges

Hong Kong, China has extensive investment and trade with the Pearl River delta area of the PRC's Guangdong province. The delta is a major low-cost manufacturing and export base for products such as electronics, toys, clothing, and textiles. Investors from Hong Kong, China account for over 70% of the cumulative foreign direct investment there. Furthermore, Hong Kong, China has leveraged its comparative advantages to provide services such as logistics, shipping, and finance to firms in the delta.

Since global trade slumped in the second half of 2008, orders for products from factories in the delta fell sharply, and layoffs have been widespread. Even after world trade picks up, many low-end manufacturers are expected to relocate to other provinces or to other countries where labor and land costs are lower. The PRC Government, acting to bolster confidence, announced ambitious plans in December to deepen cooperation between Guangdong; Hong Kong, China; and Macau, China in an effort to achieve closer integration and to transform the delta into a center for high-technology industries and services. Early priorities are to extend road and rail links and accelerate construction of a long-planned US$5.5 billion bridge between the three places.

For Hong Kong, China to gain the full benefits of closer integration, it needs to further improve its infrastructure links with Guangdong and reduce bottlenecks in customs clearance. Also, it will be important to boost investment in tertiary education to build a larger base of professionals who can operate in both economies. Joint efforts to reduce air pollution caused by rapid development in both economies should be intensified. At the same time, Hong Kong, China needs to safeguard the reputation of its high-quality institutions that make it a predictable and stable services center.

Republic of Korea

Rocked by slumping external demand, the economy slowed sharply in the second half of 2008. The worsening global outlook combined with soft domestic demand to deliver the slowest GDP growth since the Asian financial crisis of 1997–98. Fiscal stimulus will to some extent offset the weakness in aggregate demand in 2009, but the economy will likely contract before growth resumes in 2010. A key longer-term policy challenge is to smooth domestic expenditure so as to cushion the impact of external fluctuations.

Economic performance

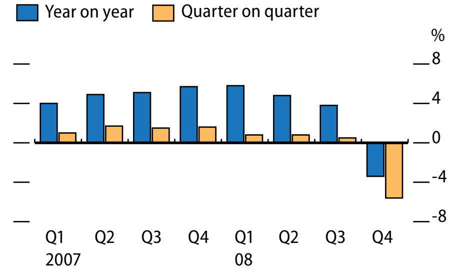
Severely affected by the global downturn and weakening domestic demand, GDP growth fell to 2.5% in the Republic of Korea (hereafter Korea) in 2008, well below the 5.0% of 2007 and the 2003–2007 average of 4.4%. The pattern of growth throughout the year mirrored the progressive intensification of the global financial crisis and the consequent deterioration of the world economy. GDP growth accelerated by a solid 5.8% in the first quarter, but then decelerated until output contracted by 3.4% in the fourth quarter on a year-on-year basis (Figure 3.11.1). Notwithstanding the softness of external demand, net exports still accounted for over 90% of total GDP growth, reflecting the even greater fragility of domestic demand. While the global downturn was the immediate catalyst of Korea's slowdown, sluggish private consumption and investment have amplified its effects.

Merchandise export growth (in nominal US dollar terms) held up well in the first 3 quarters of the year, before shipments contracted outright in the fourth, when the impact of the global downturn hit Korean exporters with full force (Figure 3.11.2). All major export products faced weaker demand in all major markets. Given the importance of the G3—United States (US), European Union (EU), and Japan—as export markets, the synchronized G3 recession has been a powerful drag on exports. Import demand from the People's Republic of China (PRC) and other major emerging markets has also cooled rapidly, and offers little respite from the collapse of G3 demand.

Merchandise import growth accelerated in the first 3 quarters, before contracting in the fourth. The trade surplus fell sharply and the current accounted moved into deficit (estimated at a modest 0.7% of GDP) for the first time since 1997. In the fourth quarter, the current account shifted back into positive territory owing to import compression and the decline in oil and other commodity prices. Reflecting domestic financial institutions' repayment of foreign loans, the financial account deficit ballooned to $51 billion.

Private consumption rose by an anemic 0.5% in 2008, sharply down from a healthy 4.5% in 2007. As with exports, private consumption decelerated over the course of the year (Figure 3.11.3) and surveys pointed

3.11.1 Quarterly GDP



Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 9 March 2009.

3.11.2 Merchandise exports and imports

Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 6 March 2009.

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

to a steady deterioration of consumer sentiment (Figure 3.11.4). The impact of worsening consumer sentiment was most evident in stagnant sales of automobiles and household appliances. Inflation pressures in the first half of the year, together with a sluggish job market, dented consumption. The plunging stock market, which fell by 39.3% in local currency terms and 64.9% in US dollar terms, and depreciation of the won (Box 3.11.1) also damped consumption.

Fixed capital investment fell by 1.9% in 2008, compared with robust growth of 4.0% in 2007. Equipment investment, which plunged by 14% in the fourth quarter, fell by 2% for the year. Construction investment was in negative territory throughout the year, and fell by 2.7%. A surge in the price of imported capital goods and hence in the equipment investment deflator contributed to the decline of equipment investment in real terms. The decline in equipment investment was most pronounced in the information and communications technology industry. Business confidence fell throughout the year, with the decline accelerating in the fourth quarter. Also weighing on corporate investment, the average capacity utilization rate of manufacturing fell below 70% (Figure 3.11.5) for the first time in 10 years. The slump in construction investment was especially evident in residential construction, reflecting a weak housing market.

Although growth replaced inflation as the main macroeconomic concern as 2008 progressed, price pressures were also problematic. Year-average inflation accelerated to 4.7%, above the Bank of Korea's 2.5–3.5% target band. The weaker won and higher prices for oil and other commodities pushed up inflation until the fourth quarter, when pressures abated in response to the oil price collapse and slowing economy. In August, when inflation was a major concern, the Bank of Korea raised its policy interest rate by 0.25 percentage points to 5.25%. As the economy faltered and inflation eased, it switched to rapidly lowering the policy rate, in five steps to 2.0% by February this year.

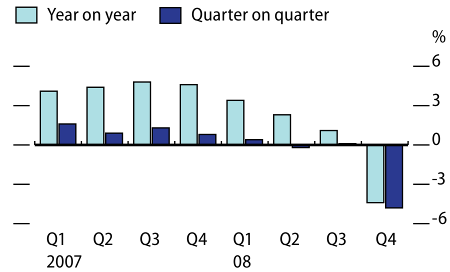
Reflecting the poor economic performance, labor market conditions deteriorated. Growth of employment was about half the increase in 2007. A surge in the number of workers who dropped out of the labor force contained the unemployment rate at 3.2%.

Economic prospects

The deceleration of the economy, which gathered pace in the fourth quarter of 2008, is expected to continue in the first half of 2009 and to level out in the second half. Early data on indicators such as exports, manufacturing output, and retail sales point to an intensification of output contraction in the first quarter of this year. The events of 2008 show that growth of the Korean economy, despite its large size, remains highly dependent on external demand. The gloomy global economic outlook for 2009 will therefore weigh on the country's export and growth prospects. The uncertainty surrounding the global downturn translates into a great deal of uncertainty for the country's performance, but the combination of a much worsened global outlook and feeble domestic demand clearly point to a very difficult year.

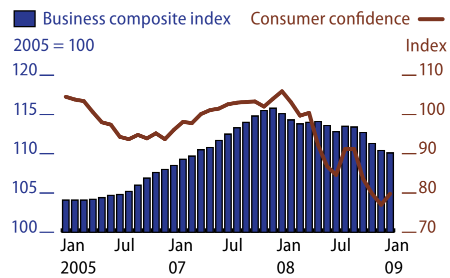
Due to the synchronized slowdown of demand both from industrialized countries and from emerging markets, exports will fall in

3.11.3 Private consumption



Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 9 March 2009.

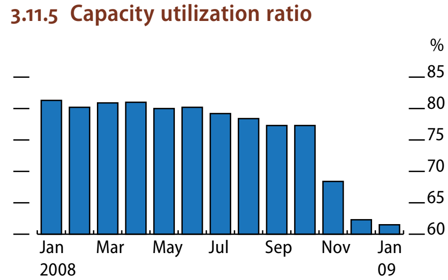
3.11.4 Confidence indicators



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

Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 9 March 2009.

3.11.5 Capacity utilization ratio



Source: Bank of Korea.

3.11.1 Selected economic indicators (%)

	2009	2010
GDP growth	-3.0	4.0
Inflation	2.0	2.0
Current account balance (share of GDP)	1.9	1.4

Source: Staff estimates.

3.11.1 The risks of capital account liberalization: Lessons from Korea's financial instability

During 2008, Korea suffered an unusually high degree of financial instability relative to other Asian countries. The instability reached its peak in October, when the Korean won fell sharply (Box figure 1) and the stock market plunged by one third. There was even speculation of a repeat of the Asian crisis, which had wrought havoc on the economy. The financial stress was puzzling in light of the country's relatively strong macroeconomic fundamentals—current account, fiscal, and international reserves—and microeconomic fundamentals, such as strong balance sheets at financial institutions and corporations. Other Asian countries with comparable fundamentals were largely spared such financial turbulence.

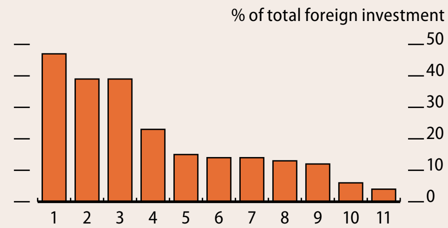
1 Exchange rate

Source: CEIC Data Company Ltd., downloaded 9 March 2009.

The most likely answer lies in Korea's exceptionally high degree of capital account liberalization. For example, there are almost no restrictions on foreign residents' purchase and sale of domestic equities, or domestic financial institutions' foreign borrowing. The large exposure of Korean banks to short-term foreign loans arose largely from their taking counterparty positions to the purchases of forward exchange contracts by Korean shipbuilders keen to hedge themselves against exchange rate risk. The rollover rate on those loans fell sharply as a result of the global credit crunch and the consequent repayment pressures precipitated a plunge in the won in October.

The share of equity investment in total foreign investment is the third highest among 30 Organisation for Economic Co-operation and Development economies, at 39.0% (Box figure 2). Hedge funds and other foreign residents withdrew from Korean equities to reinforce their balance sheets at home as the global financial crisis intensified. Total net sales of equities by foreign residents exceeded W43 trillion during 2008. Those sales were the main drivers of the year-long plunge of the equity market and contributed to the won plunge in October.

2 Equity investment, selected OECD countries



1 = Luxembourg; 2 = Japan; 3 = Rep. of Korea; 4 = Australia; 5 = United States; 6 = Germany; 7 = France; 8 = Spain; 9 = United Kingdom; 10 = Canada; 11 = Italy.

Source: Organisation for Economic Co-operation and Development, as cited in Samsung Economic Research Institute, CEO Forum, 24 December 2008.

Government actions, most notably currency swaps between the Bank of Korea and the central banks of the US, Japan, and the People's Republic of China, brought a measure of stability to the foreign exchange market in late 2008 and early 2009. However, the won fell sharply again in late February and early March.

What has happened in Korea suggests the need for a cautious and gradual approach for those developing countries embarking on capital account liberalization. Countries that are more open to cross-border capital flows will suffer disproportionately when foreign residents withdraw their funds from the local financial markets. Such risks are exacerbated if domestic banks are heavily exposed to short-term foreign loans.

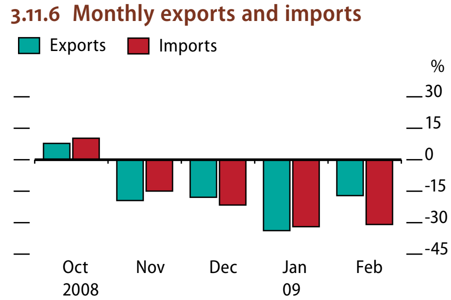
Although liberalization provides substantial benefits, for example by giving greater access to foreign savings, those benefits have to be weighed against the risk of financial contagion from financial center countries. This risk tends to be amplified during times of heightened global financial stress.

2009 for the first time since 2001. Worryingly, the contraction of exports that began in the last 2 months of 2008 gathered pace during the first 2 months of this year. Exports plunged by 33.8% in January from the same month in the previous year, and by 17.1% in February (Figure 3.11.6). Exports are expected to fall until at least the third quarter of 2009, and for the whole year they will likely be down by 15% relative to 2008.

Demand for Korea's major export items tends to be highly sensitive to the global business cycle. The recession and lower disposable incomes in the G3 presage poor sales there of the automobiles, electronics, and other durable goods that account for much of the country's consumer goods exports. The same goes for capital goods, which usually account for almost half of exports.

Global excess capacity in various industries, particularly information

3.11.6 Monthly exports and imports



Source: CEIC Data Company Ltd., downloaded 9 March 2009.

and communications technology, has combined with softening demand to discourage investment. Exports of petroleum products, chemicals, steel products, and machinery, which grew rapidly in recent years, will also be hard hit. Export unit prices are projected to fall for product groups whose prices are heavily influenced by the price of oil and other raw materials, such as petroleum products, petrochemicals, and steel. The fall in export unit prices of such major product groups will hit hard the total value of exports. Increasing protectionism might further dent export prospects, since protectionist pressures are most pronounced in major export markets and product groups.

The current account balance is expected to return to a surplus (Figure 3.11.7), of more than $10 billion in 2009, with trade surpluses for both goods and services. Weak domestic demand will cut imports, producing a trade surplus, and curtail foreign travel, reversing the chronic deficit in services.

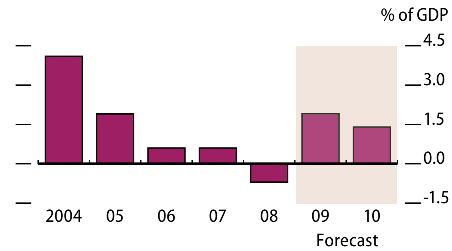
Although the economic contraction will be driven by the weakness of external demand, domestic demand is also projected to decline, foreshadowing a broad-based recession. The simultaneous softening of external and domestic demand began in the fourth quarter of 2008 and will persist until at least the third quarter of 2009.

Private consumption is expected to contract by about 4% in the first half and about 2% in the second. The unfolding recession will constrain job creation and wage growth, and thus crimp the purchasing power of consumers. It will also give impetus to industrial restructuring, especially in shipbuilding and construction, and the associated layoffs will curtail spending. So will the decline in asset prices, especially the plunge in stock prices last year. Korea's ratio of household debt to GDP stands at about 73%, which is relatively high by international standards. Lower asset prices will encourage households to repair their balance sheets by repaying debt. In addition, financial institutions will likely cut back on household lending in response to lower collateral values.

Fixed capital investment is expected to fall by about 6% in the first half of 2009 and be flat in the second, for a decline of about 3% for the year. Business confidence indicators reveal an unusually high level of pessimism, which bodes ill for equipment investment. Machinery orders, a good indicator of equipment investment, dropped by 32% and 44% in November and December 2008 from a year earlier. A buildup of unsold houses will exacerbate the softness of the housing market (Figure 3.11.8) and act as a drag on construction. Still, massive planned public works will help offset weak private construction investment. The 2009 government budget has earmarked W24.7 trillion for infrastructure investment, a hefty increase of 27% from 2008.

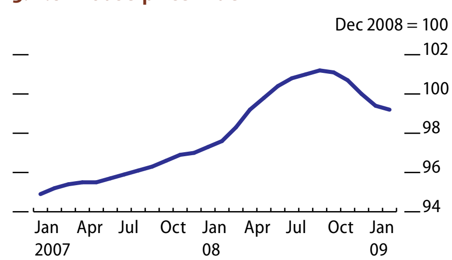
Inflation is projected at 2.0% for 2009, below the Bank of Korea's inflation target band but well above deflation. The widening gap between potential output and actual output in the face of softening external and domestic demand should choke off inflation pressures. The deflationary impact of lower oil prices and the inflationary impact of won depreciation will largely offset each other. Labor market conditions are set to deteriorate further: the unemployment rate is projected to rise to about 4%, reflecting a decline in hiring as well as the rise in job losses as industrial restructuring intensifies. A rise in the number of workers who drop out of the labor force

3.11.7 Current account balance



Sources: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 9 March 2009; staff estimates.

3.11.8 House price index



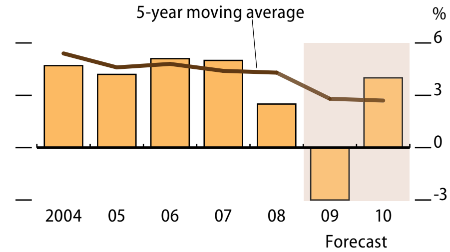
Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 9 March 2009.

will partly mask the extent of unemployment. There is limited scope for further monetary easing, given that interest rates have already dropped substantially and that additional currency depreciation is a risk.

Taking these factors into account, GDP is projected to fall by 3.0% in 2009 (Figure 3.11.9), which would be Korea's first contraction in output since 1998. Recovery is expected to be moderate and gradual, and take the form of an asymmetric U-shape in which the recovery is more drawn out than the sudden initial output decline. Korea's business cycle is expected to trough in the first half, when output falls by 5.0%, before experiencing a smaller output decline of 1.0% in the second. GDP growth is forecast to resume in 2010 at 4.0%. This will come from the expected recovery of both external and domestic demand and will reflect the effects of a lower base due to the contraction of 2009.

The main source of uncertainty—and of both the upside and downside risks—to these forecasts is the length and depth of the global downturn. The downside risks outweigh those on the upside, that is, a contraction deeper than 3% is more probable than a shallower one. The second major source of uncertainty is the effectiveness of countercyclical fiscal policy in limiting the contraction.

3.11.9 GDP growth



Sources: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 9 March 2009; staff estimates.

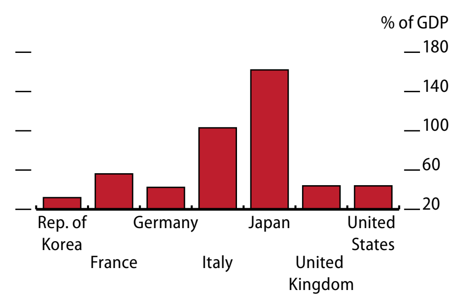
Development challenges

The large size of the Korean economy (between the 11th and 15th biggest in the world, depending on the measure) and its relative high per capita income suggest a sizable domestic demand base relative to most other Asian economies. Despite this advantage, the current global slowdown has severely affected national economic performance, which indicates that the economy remains hostage to the global business cycle.

In light of this, a key challenge for policy makers is to smooth domestic expenditure so as to cushion rather than amplify the impact of external fluctuations. Given the current low level of consumer and business confidence, the impact of monetary policy on aggregate demand will be limited. The burden of macroeconomic stabilization will therefore fall on fiscal policy. Fortunately, years of fiscal prudence (Figure 3.11.10) have left the Government with plenty of ammunition. It plans to implement a large fiscal stimulus package of W35.6 trillion, amounting to 4% of GDP. This includes W15.6 trillion of expenditures and W20 trillion of tax cuts. Further fiscal stimulus through supplementary budgets or off-budget measures may be adopted. An increase in public infrastructure investment will also boost aggregate demand.

The Korean experience suggests that the Government's role as a spender of last resort takes on added significance in the face of external fluctuations. This is all the more so since large parts of private domestic demand, such as investment in export-oriented industries, move in tandem with external demand. The need to secure adequate fiscal space to smooth domestic expenditures underlines the need for prudent fiscal policy. Put differently, an important additional benefit of fiscal prudence is that it gives the Government the capacity to limit the damage from externally induced downturns. Finally, volatility due to the global business cycle strengthens the case for automatic fiscal stabilizers, especially expenditure items that move against the cycle. For example, there is some scope for expanding unemployment benefits.

3.11.10 Government debt, 2007



Sources: International Monetary Fund, International Financial Statistics online database; Organisation for Economic Co-operation and Development, OECD Statistics Portal, available: http://www.oecd.org/statsportal; both downloaded 9 March 2009; staff estimates.

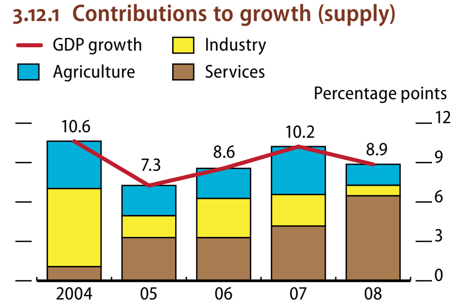
Mongolia

Buffeted by the slump in global prices for copper and other commodities, economic growth started to slow in 2008 and will decelerate sharply in 2009. The current account and fiscal positions have deteriorated, and inflation is at high levels. The Government has pledged to restore fiscal discipline and strengthen the banking system, while protecting the poor from the impact of the economic downturn. The severe impact of the global commodity slump highlights the need for a system to mitigate revenue volatility and to diversify sources of growth.

Economic performance

GDP grew by an estimated 8.9% in 2008, down from the previous year's double-digit rate but close to the average of the previous 5 years. Agriculture, which supports about 40% of the population, grew by 5.0%, aided by favorable weather and fiscal incentives to produce wheat. The wheat harvest itself surged by 85.5% and the livestock herd—mainly goats, sheep, and cattle—rose by 7.5% to 43.3 million. In contrast, prices of cashmere, a leading export, fell by about 45% during the year. Services output climbed by 15.9% and this was the source of most of the GDP growth last year (Figure 3.12.1). Growth in banking services was spurred by double-digit expansion in real estate services, wholesale and retail trade, and communications.

3.12.1 Contributions to growth (supply)

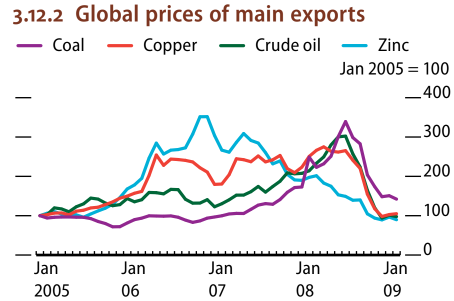


Source: Mongolian National Statistical Office.

Industrial growth came in below 1% for its lowest rate in a decade. Production of copper, the country's biggest export, was hurt by a fall in the metal's price of more than 60% on the London Metal Exchange between July 2008 and year-end (Figure 3.12.2). Among other important mineral exports, global prices of coal and zinc also dropped, although gold was firm. Extended delays in concluding agreements, between the Government and the holders of the mining licenses at the large Oyu Tolgoi copper and gold deposit and the Tavan Tolgoi coal seams, hampered development of mining.

Rapid expansion in public investment, fueled by a surge in government revenue from high commodity prices during the commodity boom, contributed to an upsurge in construction. During the boom, the Government also broadened social assistance and transfer payments to about half the population, and doubled public sector wages over a period of 2 years. These moves, coupled with growth in remittances (close to a fifth of the labor force worked abroad in 2008) bolstered consumption, particularly in the first half of last year. However, many of the factors that drove high growth in the first 3 quarters of 2008 triggered a sharp contraction in the fourth, when commodity prices slumped, remittances slowed, and spending on public investment and real estate projects declined.

3.12.2 Global prices of main exports



Source: International Monetary Fund, *International Financial Statistics* online database, available: http://www.imfstatistics.org/imf, downloaded 10 March 2009.

The hikes in government expenditure raised total public spending to the equivalent of 40.2% of GDP in 2008, from 27.5% in 2005. When mineral

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prices sank last year, revenue declined to an estimated 35.2% of GDP, and the budget slid into deficit (of about 5.0% of GDP), after 3 years of surpluses.

Mongolia imports much of its food and all its petroleum. Soaring global prices for these items in the first half of 2008, together with expansionary fiscal and monetary policies, propelled inflation to a year-on-year peak of 34.2% in August (Figure 3.12.3). In response, the Bank of Mongolia tightened monetary policy by raising the reserve ratio for commercial banks by 50 basis points to 5.5% and its policy interest rate by 185 basis points to 10.25%. Money supply (M2) growth slowed in the second half; during the same period, growth of commercial bank credit decelerated from 60% to about 28% year on year. Inflation eased to 22.1% by December, giving a year-average of 26.8%.

Buoyant domestic demand for much of the year and the higher prices of imported petroleum and food products in the first half pushed up merchandise imports by about 60% in 2008. Exports grew at about half that pace. The value of most commodity exports declined as world prices slumped, and the value of clothing shipments fell by 69% during the year. The trade deficit widened to an estimated $600 million. Inbound tourism, as well as remittance inflows, slowed in the second half. These developments contributed to a deficit on the current account of about 12.9% of GDP, the first deficit in 5 years (Figure 3.12.4).

The weakening current account put downward pressure on the togrog, prompting the Bank of Mongolia to sell foreign currency. That action contributed to a fall in international reserves from more than $1 billion in July to $657 million at the end of the year (and only 10 weeks of import cover). Late in 2008, the central bank eased its market intervention, and the togrog fell sharply. Speculative pressure on the exchange rate intensified early in 2009, taking the togrog down to MNT1,600/$1 in the first week of March, from MNT1,050/$1 in December 2008 (Figure 3.12.5).

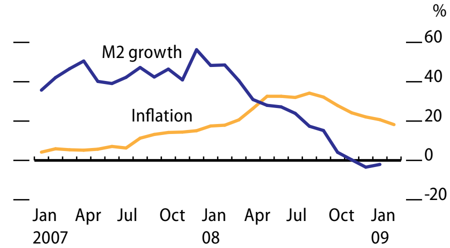
Banking also showed signs of stress. High inflation widened negative deposit interest rates which, combined with currency depreciation, led to withdrawals from togrog deposits and a liquidity squeeze among the banks. In December 2008, the Government took over the fourth-biggest bank (in terms of outstanding loans) when the bank foundered because of mismanagement and a run on deposits. In another move to stabilize the banking system, the authorities issued a blanket deposit guarantee, but the banks, concerned about the health of other financial institutions as well as borrowers, clamped down on their lending. Nonperforming loans more than doubled from 3.4% of total loans in 2007 to 7.2% in 2008 (including the assets of the government-rescued bank).

External debt has declined over several years, to an estimated 33% of GDP in 2008. The debt is largely on concessional terms. Fitch Ratings in January 2009 downgraded Mongolia's sovereign debt rating from B+ to B, with a negative outlook, citing weakness in the country's reserves, exchange rate, and banking system.

Economic prospects

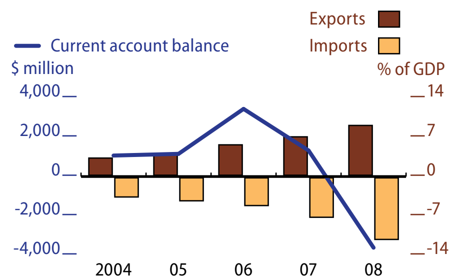
Economic growth will decelerate sharply in 2009, dragged down by the slump in prices for export commodities and by related fiscal weakness that will require cuts in government spending. The drop in prices for

3.12.3 Inflation and money supply



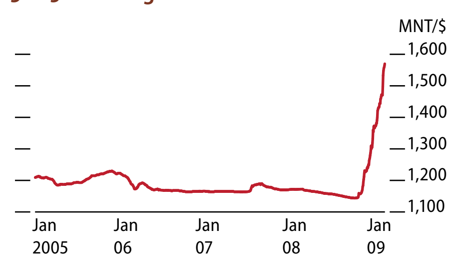
Source: Bank of Mongolia, available: www.mongolbank.mn., downloaded 13 March 2009.

3.12.4 External sector



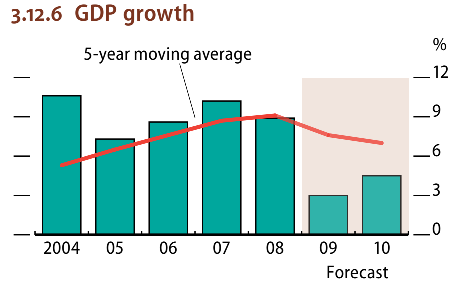
Source: Bank of Mongolia.

3.12.5 Exchange rate



Source: Bank of Mongolia, available: www.mongolbank.mn., downloaded 13 March 2009.

3.12.6 GDP growth



Sources: Mongolian National Statistical Office; staff estimates.

minerals and cashmere will suppress the output of these commodities and the incomes of their producers. The outturn for agriculture depends heavily on the weather, which has been favorable for several years. Construction activity will be hurt by the combined effects of the fall in property prices (which started in the second half of 2008), a likely decline in public investment, continued delays in mining-project agreements, and banks' caution. The outlook for services such as finance, domestic trade, and tourism is clouded by the banking system strains and the subdued global outlook for tourism.

Government revenue is expected to fall sharply in 2009, by as much as 11 percentage points of GDP. Unless the Government substantially curtails spending to match the decline in revenue, the fiscal deficit could reach an unsustainable level of above 10% of GDP.

Taking these factors into account, GDP growth is forecast to pull back to about 3.0% in 2009 (Figure 3.12.6). Growth is expected to pick up to about 4.5% in 2010, contingent on four factors: the global economic environment starts to recover as assumed; the Government concludes agreements for the two big mining projects and investment in them starts in 2010; the economy steadies in 2009, enabling a return to investment and employment growth next year; and the domestic financial system stabilizes, facilitating growth in banking and in domestic trade.

The decline in commodity prices, coupled with slower economic growth in the People's Republic of China, which takes nearly two thirds of Mongolia's exports, points to a fall in merchandise exports in 2009. Similarly, inflows from tourism and remittances are likely to contract. Imports, too, will decline, curtailed by the economic slowdown and lower average prices for imported food and fuel. Reflecting these influences, the current account will be in deficit by about 7.0% of GDP. Prospects for foreign direct investment in mining are clouded by substantially weaker global demand for minerals and much tighter international financial markets.

Inflation is expected to decelerate to 9.5% in 2009, and ease further in 2010, a net result of weaker domestic demand and the fall in prices of imported fuel and food on the one hand, offset partly by the impact of the currency's depreciation on the other.

In the context of weakening external and fiscal accounts, the Government agreed with the International Monetary Fund in early March 2009 on an economic program, to be supported by a $224 million loan under an 18-month standby arrangement. Under this, the Government pledged to restore the deficit to a sustainable range, in part through spending cuts, and to strengthen the institutional framework for fiscal policy to prevent a repeat of boom-bust spending cycles. It agreed to strengthen the banking system and follow monetary policies that safeguard its dwindling international reserves. It also committed to better targeting the social transfer programs and to raising the level of support for the very poor.

Economic recovery in the medium term will depend on implementing the economic program and on improving the legal and regulatory environment for mining.

Poverty incidence has declined steadily since 2003, but more than one third of the population lives below the poverty line. High inflation, falling remittances, and plunging prices for cashmere (an income source for herders), risk driving more of the near-poor households into poverty.

3.12.1 Selected economic indicators (%)

	2009	2010
GDP growth	3.0	4.5
Inflation	9.5	8.0
Current account balance (share of GDP)	-7.0	-6.0

Source: Staff estimates.

3.12.1 Development challenges

Addressing the immediate fiscal and banking strains requires bold measures to contain budget outlays, to restore confidence in the banking system and the currency, and to stimulate foreign direct investment. Yet crucially, vital antipoverty programs need to be protected and if possible strengthened given the potential rise in the number of poor people.

The country relies heavily on commodity prices that mirror global market swings, underscoring the need to mitigate the economic and social impact of this volatility by setting up new systems. These in turn require legal, administrative, and financial structures to manage windfall revenue during commodity booms so that sufficient financial reserves are in place during the ensuing bust. The Government set up the Mongolia Development Fund with this in mind, but drew down on its reserves even during the commodity boom. Improved standards of governance are a prerequisite for establishing a strong institutional framework for such a stabilization fund.

Diversification of the narrow base of the economy will involve substantial investment in the social and physical infrastructure and better conditions for development of the private sector. The latter is hampered by a cumbersome regulatory system, weak implementation of laws, shortages of skills, and lack of access to funding at reasonable costs for small and medium-sized enterprises.

The country is urbanizing rapidly, putting severe strains on the environment and on the state's ability to deliver services, which will only be eased by significant investments in urban infrastructure and services. Damage from mining-related toxic spills and desertification from overgrazing also need to be remedied.

Taipei,China

Late last year external demand slumped for this economy's manufactured products, including its vital electronics exports. With domestic demand also contracting, GDP growth was minimal. Inflation accelerated to a 14-year high, then subsided by year-end. Even though substantial fiscal stimulus is being injected this year and interest rates have been lowered, the economy is forecast to shrink by 4.0% before resuming low-level growth next year.

Economic performance

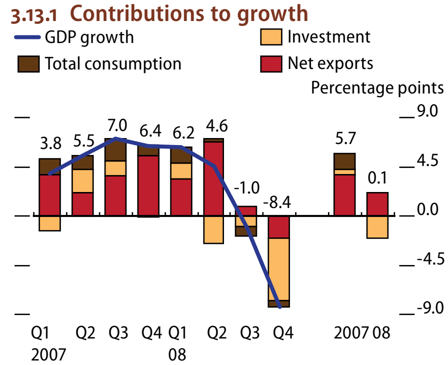
Heavily dependent on external trade, Taipei,China suffered more than most economies in the second half of 2008 as the global slowdown cut into world trade. After growing by an average of 5.4% in the first 2 quarters of the year, GDP contracted by 1.0% in the third and by a vertiginous 8.4% in the fourth. Growth for the full year was just 0.1% (Figure 3.13.1), the weakest outcome since a 2.2% contraction in 2001 when the global information technology bubble deflated.

The slowdown over the year stemmed from a slump in exports of machinery and electronics products and the depressing impact that had on fixed investment. Private investment contracted by 13.5% over the year (Figure 3.13.2) as the outlook deteriorated for manufacturing industries. Public investment declined as well, by about 1%. Investment overall subtracted 2.0 percentage points from total GDP growth in 2008. Against the background of weak consumer confidence and a sliding stock market, consumption was flat. The weakness in domestic demand was offset by some growth in net exports, and it was only that which enabled the marginal full-year expansion of GDP.

Industrial production started to slow in September and plunged by 32.0% in December (year on year). Manufacturers cut production of electronic parts and components, which account for nearly 10% of GDP, as global demand for these items shriveled. Industry as a whole contracted by 1.2% in 2008, a sharp turnaround from the 9.3% expansion in 2007. Moreover, agricultural production fell by 1.4% owing to cold weather in the first half of the year. Growth in services at 0.8% was the lowest since 2001, with particular weakness in wholesale trade and financial services. Still, it was only services that contributed any GDP growth on the supply side.

The economy has become increasingly reliant on external demand, with exports and imports of goods and services each equivalent to about 70% of GDP in 2008. This reflects the expansion of manufacturing production chains with neighboring economies, particularly the People's Republic of China (PRC). The United States (US) is the final destination of much of the production from these chains. Growth in merchandise exports to the PRC in 2008 slowed to 7.2% from 20.5% in 2007. Exports

3.13.1 Contributions to growth



Sources: Directorate General of Budget, Accounting and Statistics, available: http://eng.dgbas.gov.tw, downloaded 4 March 2009; staff estimates.

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

to the US fell in absolute terms by 4%, a second consecutive year of contraction in sales to this market.

Trade deteriorated rapidly in the fourth quarter: merchandise exports in nominal US dollar terms fell by 24.9% (Figure 3.13.3), reducing full-year growth to 3.4%. Likewise, merchandise imports fell by 22.3%, trimming full-year growth to 9.6%. The trade surplus in 2008 was about 40% below the prior-year level, and the current account surplus declined to 6.4% of GDP, from 8.6% in 2007.

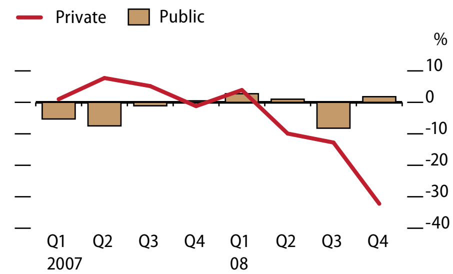
An outflow of portfolio investment in the first 3 quarters of 2008 was reversed in the fourth when residents, growing more risk averse as the global financial crisis deepened, redeemed investments abroad. As a result, lower net portfolio outflows for the year supported an overall balance-of-payments surplus of US$26.3 billion. Gross international reserves grew by 7.9% to US$291.7 billion, and the local currency in nominal average terms appreciated by 4.3% against the US dollar (it depreciated in real terms).

Inflation sped up in the first half of 2008, driven by rising world prices for energy and food. It peaked at 5.8% year on year in July, the highest rate in 14 years. Global energy and food prices pulled back from their highs later in the year, and the domestic economy slowed, bringing inflation down to 1.3% in December.

The monetary authorities, having edged up the policy interest rate continually since mid-2004, switched to an expansionary stance in September 2008 as economic activity slowed. From September to February 2009, they lowered the policy rate by a total of 238 basis points, to 1.25%. Broad money supply (M2) grew by a sluggish 3.0% on average in 2008, although it picked up a little in the fourth quarter. In October, when the global financial crisis worsened, the authorities guaranteed bank deposits in full through end-2009.

Layoffs during the second half of 2008 lifted the unemployment rate to a 5-year high of 5.0% in December, when the number of unemployed hit a record 549,000. Concerns about these job losses, and more broadly about the sharp deceleration of the economy, reversed the authorities' fiscal consolidation efforts of recent years that had reined in the fiscal deficit to 0.4% of GDP by 2007. Increases in public expenditure, at a time of marginal growth in revenue brought about by weakness in tax income, widened the fiscal deficit 2.3% of GDP in 2008.

3.13.2 Investment growth



Source: CEIC Data Company Ltd., downloaded 15 March 2009.

Economic prospects

The slump in global demand for machinery and electronics products (about half all merchandise exports), and the knock-on effects to consumption and investment, will cause the economy to contract in 2009. Most of the world's laptop computers and liquid crystal display panels are manufactured in Taipei,China—the type of durable goods that face particularly weak demand worldwide. Early trade and production figures for 2009 were bleak: merchandise exports plunged by an average 36.3% year on year in the first 2 months. (Shipments to the PRC dropped by 48% in this period.) Industrial production fell by 43.1% in January.

The authorities, from September 2008 to February 2009, announced several fiscal stimulus measures to support consumer and business

3.13.1 Selected economic indicators (%)

	2009	2010
GDP growth	-4.0	2.4
Inflation	0.6	1.2
Current account balance (share of GDP)	8.4	8.3

Source: Staff estimates.

spending and generate jobs. These measures included tax breaks for new investment by businesses, discounted sales of industrial land, and increased financial support for small and medium-sized firms. Investment in public infrastructure of about US$15 billion is planned over the next several years, with about 30% of it (1% of GDP) allocated for this year.

Nevertheless, private fixed investment is expected to decline further in 2009. Fixed investment is strongly correlated with the performance of merchandise exports (Figure 3.13.4), so it is unlikely to pick up significantly until manufactured exports rise. That is unlikely to happen for some time, given that export orders have dived. Moreover, inventories of manufactured products have mounted steadily in recent months. Permits for construction, too, have trended lower. Consequently, private fixed investment is projected to fall, by 6.3% in 2009, before picking up in 2010.

Measures to spur sluggish consumption have involved cash transfers equivalent to about US$200 to low-income families and subsidies for consumers to buy energy-saving products, such as solar water heating systems and low-emission vehicles. Shopping vouchers valued at NT$3,600 (about US$100) were handed out to all citizens, including children, starting in January 2009. These transfers seemed to have an impact: sales at department stores and supermarkets rose by about 20% year on year in January. Some department stores reported their highest-ever one-day sales in the days after the vouchers were passed out.

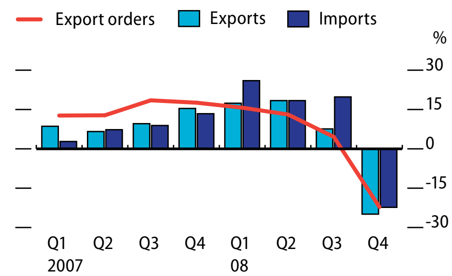
But from a multi-month perspective, consumer confidence has continued to decline since mid-2008 (Figure 3.13.5). Consumption is forecast to contract by about 2% in 2009, against the backdrop of the weak labor market and reduced household wealth. Taking these influences into account, GDP is projected to shrink by 4.0% this year (Figure 3.13.6). Growth is forecast to resume at a low level (2.4%) in 2010, on the expectation that the global economic environment improves next year and that stimulus measures in both Taipei,China and the PRC have an appreciable impact. An expected gradual recovery in manufacturing in 2010 will bolster the labor market, which, coupled with low inflation, is expected to support a moderate pickup in consumption.

With global trade seen contracting in 2009, merchandise exports are forecast to fall by 3.5%. Imports will fall even faster than this, by about 6.3%, on lower prices for imported commodities compared with 2008, weaker domestic demand, and fewer imports of raw materials for export industries. The current account surplus is forecast to increase to about 8.4% of GDP in the forecast period.

The expansionary fiscal policy is projected to widen the fiscal deficit to 5.0% of GDP in 2009. Domestic bond issuance will be the main funding source for the stimulus measures. Fitch Ratings in January 2009 cited deteriorating public finances when it lowered its outlook on the AA long-term local-currency rating to negative from stable. Next year, the fiscal position is expected to improve, if external demand picks up and the stimulus measures lift domestic demand, in the process strengthening tax receipts.

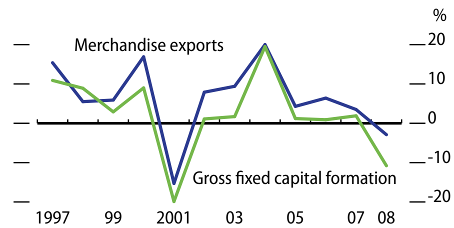
Inflation is expected to average 0.6% this year before edging up to 1.2% in 2010. The consumer price index rose by 1.5% in January, but fell by 1.3% in February. Given concerns about possible deflation, monetary policy is expected to remain expansionary.

3.13.3 Exports and imports



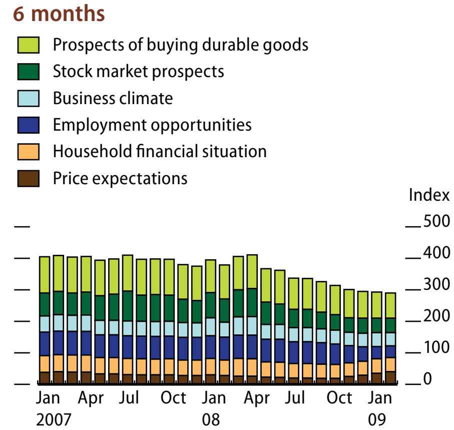
Source: CEIC Data Company Ltd., downloaded 15 March 2009.

3.13.4 Investment and exports



Source: Directorate General of Budget, Accounting and Statistics, available: http://eng.dgbas.gov.tw, downloaded 2 March 2009.

3.13.5 Consumer confidence for the next 6 months

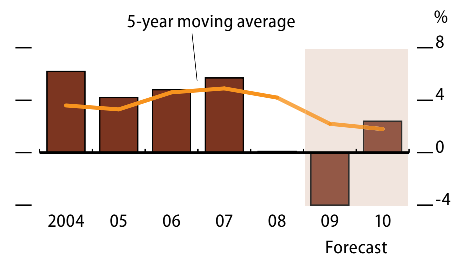


Source: CEIC Data Company Ltd., downloaded 15 March 2009.

To help spur growth in the longer term, the authorities are establishing closer economic ties with the PRC. Four agreements aimed at expanding trade across the strait were signed in November 2008. They cover air and shipping routes, postal exchange, and greater cooperation on food safety relating to imports from the PRC. The near-term impact on growth is likely to be slight though, given the economic slowdown in both economies

The main domestic risk to the forecasts is that the fiscal stimulus fails to have a significant impact, in which case the economy would contract more than forecast and the slowdown could be extended. Fiscal strains would also intensify, as the recovery in tax revenue would be delayed.

3.13.6 GDP growth



Sources: Directorate General of Budget, Accounting and Statistics, available: http://eng.dgbas.gov.tw, downloaded 4 March 2009; staff estimates.

Development challenges

An aging population and inadequate state pensions are inducing high household saving in Taipei,China. Households are the source of more than half of all national saving, compared with about 20% in the Republic of Korea.

The high household saving rate largely stems from workers' concerns about the adequacy of the state retirement pension, which is funded by contributions from employers and employees. However, enforcement of employers' contributions is weak. Furthermore, given that a growing proportion of the population will draw on this pension system for basic needs as the average age rises, many are concerned that the system might not have sufficient funding to meet even the current low pension payments. The old-age dependency ratio, the share of people aged 65 and older as a proportion of the working population, is projected to more than double between 2001 and 2036, to above 30%.

Some steps have, though, been taken to strengthen the pension system. A reform that came into effect in October 2008 allows workers to switch jobs without losing their accumulated contributions—that is, the pensions have become portable. This has improved labor market flexibility and increased the number of people eligible for a pension in retirement. However, until the pension system is enhanced, workers are likely to maintain high precautionary saving rates.

Until about 10 years ago, the need to save for medical treatment was another reason for the high saving rate. A national health insurance system that was launched in 1995 has had a significant impact in reducing individuals' precautionary saving for medical expenses, particularly those on low incomes.