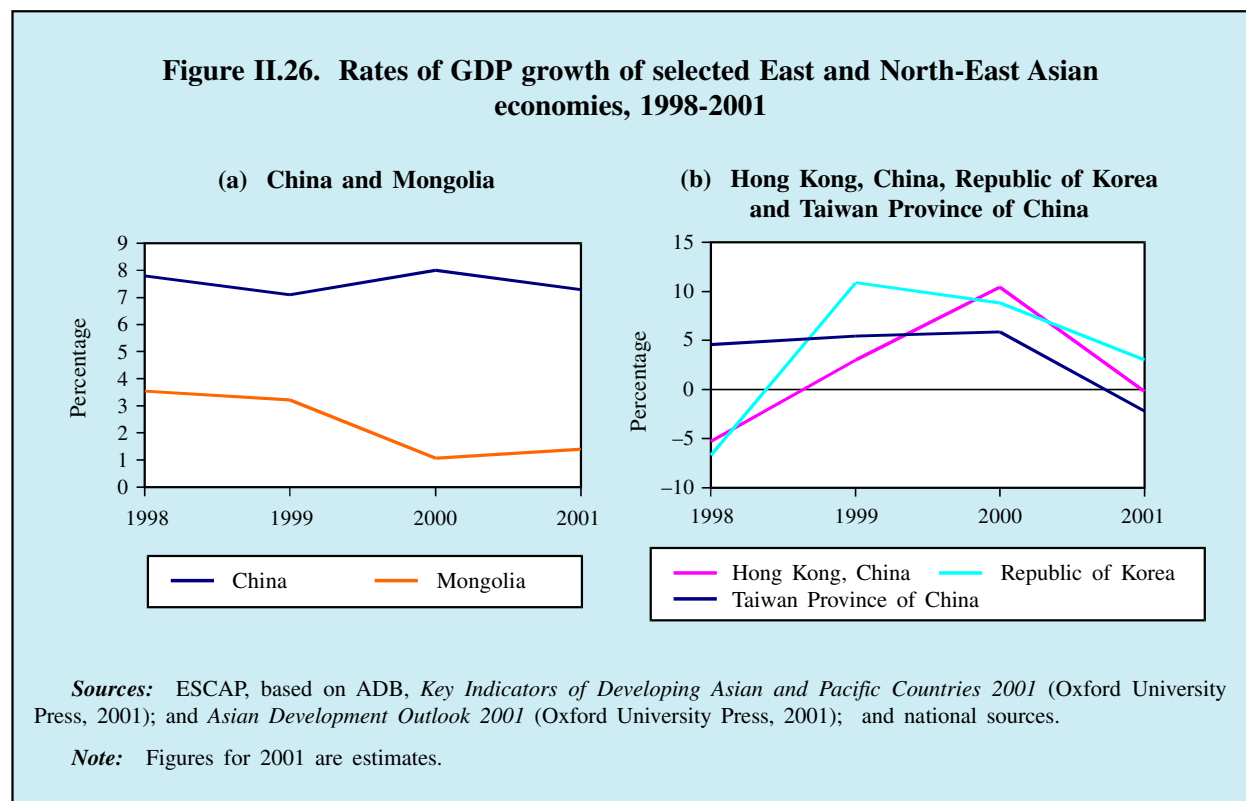


East and North-East Asia

Subregional overview and prospects

The newly industrialized economies in this subregion, the Republic of Korea and Hong Kong, China, experienced a sharp deterioration in GDP performance in 2001. The adverse external environment, caused by the synchronized global economic slowdown and compounded by the September 2001 terrorist attacks on the United States, reduced business confidence, and growth of consumer spending and exports. By and large, aggregate output remained stagnant in Mongolia. In sharp contrast, China again posted robust GDP growth, which, at 7.3 per cent for 2001, was the highest among economies of the ESCAP region, except those in North and Central Asia (figure II.26). In particular, both Hong Kong, China, and the Republic of Korea were hit hard by the sharp fall in external demand for high-technology products, especially ICT items, and this in turn, contributed, to a significant decline in industrial production and exports. The vibrant economic activities in China were largely driven by domestic factors which offset considerably the decline in export expansion in 2001. Nevertheless, the ongoing reform of State-owned enterprises in China and the current restructuring of the financial and corporate sector in the

The Republic of Korea and Hong Kong, China, hit by the global downturn but economic activities remained robust in China

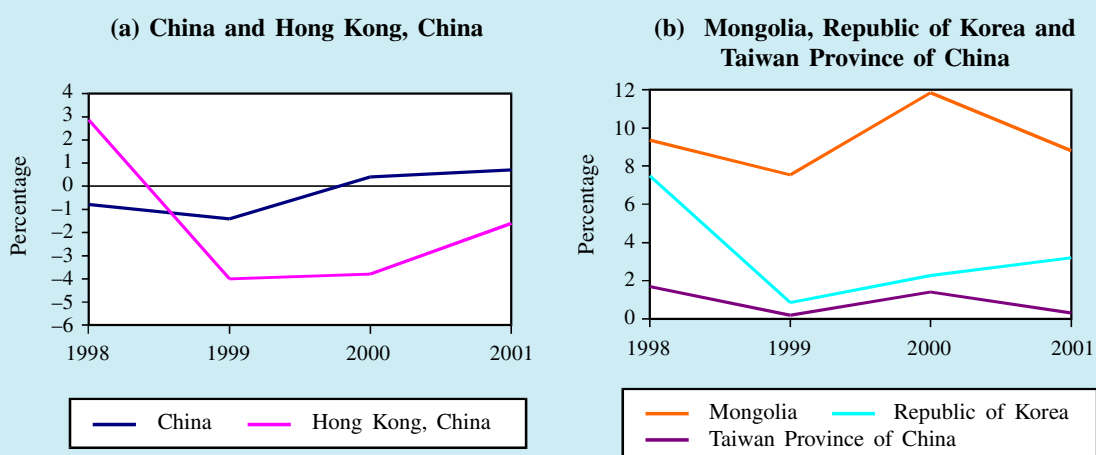


Republic of Korea put added pressure on the employment situation, with some adverse impact on consumer confidence and on domestic efforts to alleviate domestic poverty and protect social welfare.

Deflation pressures in Hong Kong, China, and low inflation in other economies, except Mongolia

Inflation in the subregion generally remained in check in 2001 (figure II.27). Hong Kong, China, continued to experience falling consumer prices, although at a slower pace. Inflation stayed at very low levels in China in 2000-2001. In the Republic of Korea, it rose slightly to about 3 per cent in 2001 because of the higher costs of utilities and a variety of services. In Mongolia, inflation went down to less than 9 per cent in 2001, compared with almost 12 per cent in the previous year, thanks in part to lower energy prices and stable meat prices. Only marginal changes, either way, are expected in the behaviour of consumer prices in the subregion in 2002.

Figure II.27. Inflation of selected East and North-East Asian economies, 1998-2001^a



Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2001* (Oxford University Press, 2001) and *Asian Development Outlook 2001* (Oxford University Press, 2001); IMF, *International Financial Statistics*, vol. LIV, No. 10 (October 2001); and national sources.

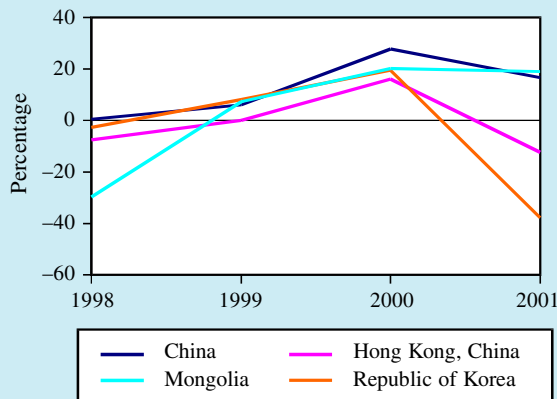
Note: Figures for 2001 are estimates.

^a Changes in the consumer price index.

Setback to trade in most parts of East and North-East Asia

Merchandise trade performance deteriorated virtually throughout the subregion in 2001. A high rate of export expansion continued in Mongolia, although merchandise imports fell by about half (figures II.28 and II.29). The Republic of Korea and Hong Kong, China, experienced the most severe setback in export earnings, from strong expansion in 2000 to a contraction during the first three quarters of the following

Figure II.28. Growth rates of merchandise export earnings of selected East and North-East Asian economies, 1998-2001



Source: IMF, *Direction of Trade Statistics* (CD-ROM), February 2002.

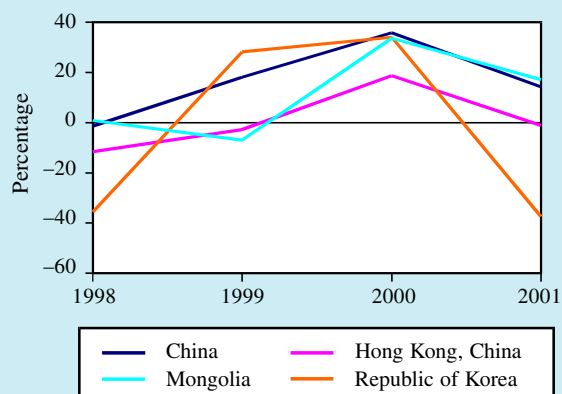
Note: Figures for 2001 refer to January-September.

year of 38 per cent in the Republic of Korea and 12 per cent in Hong Kong, China. As was the situation elsewhere in South-East Asia, ICT products were particularly hard hit by the lower external demand. China's export earnings continued to grow strongly, although at a slower pace of 17 per cent in the first nine months of 2001. Mongolia was able to sustain similarly vibrant growth in exports for both 2000 and three quarters of 2001; however, the growth rates of import spending went down sharply throughout the subregional economies. There was a surplus on the trade account of both China and the Republic of Korea. A surplus on the current account was achieved by China, Hong Kong, China, and the Republic of Korea. The foreign exchange reserves of those three economies totalled over \$420 billion as at October 2001.

The economic prospects in the subregion in 2002 are likely to improve because of a low initial base in 2001 or, in the case of China, to remain good. Certainly most subregional economies would gain from a solid recovery of the United States economy beginning in the second half of 2002; at present, an upturn is widely anticipated, although its strength remains uncertain. The impact will be both direct, including through improved export earnings and indirect, through a variety of positive spillover effects on consumer and business confidence, and through a stock market rebound as well. An additional push to the recovery process or to the pattern of sustained growth in the subregion is also

Modest recovery of growth and trade expected in 2002

Figure II.29. Growth rates of merchandise import spending of selected East and North-East Asian economies, 1998-2001



Source: IMF, *Direction of Trade Statistics* (CD-ROM), February 2002.

Note: Figures for 2001 refer to January-September.

expected from the ongoing effects of the expansionary policy in 2001. However, there are a number of downside risks associated with, among other things, the feeble performance of the Japanese economy and the volatility of financial markets and, in particular, the financial ripple effects emanating from economic problems in some emerging markets. All in all, aggregate output in Hong Kong, China is expected to expand by 1 percentage point and in the Republic of Korea by 4 percentage points while in China it is expected to go up by 7 per cent in 2002.

GDP performance

Strong growth in China and stagnation in Hong Kong, China

Economic growth in East and North-East Asia slowed in 2001 largely because of unfavourable external conditions; China constituted a striking exception, and GDP expansion was marginal in Mongolia. The Republic of Korea and Hong Kong, China, were among the newly industrialized economies severely hit by the global slowdown, especially the sharp decline in external demand for high-technology products. Only China maintained its steady, high growth path from the time of the 1997-1998 financial and economic crisis in East and South-East Asia through to the current slowdown. Its GDP expanded at a relatively stable rate of between 7 and 8 per cent during the period 1998-2001, giving an enviable annual increase of 7.6 per cent on average during this period (table II.31). Although China is less vulnerable to shocks in the high-technology sector,

Table II.31. Selected East and North-East Asian economies: growth rates, 1998-2001

(Percentage)

		Rates of growth			
		Gross domestic product	Agriculture	Industry	Services
China	1998	7.8	3.5	9.2	7.7
	1999	7.1	2.8	8.1	7.5
	2000	8.0	2.4	9.6	7.8
	2001	7.3	2.6	9.3	7.1
Hong Kong, China	1998	-5.3	..	..	..
	1999	3.0	..	..	..
	2000	10.5	..	..	..
	2001	-0.2	..	..	..
Mongolia	1998	3.5	6.4	3.9	0.3
	1999	3.2	4.2	0.9	3.5
	2000	1.1	-16.8	7.8	17.0
	2001	1.4	..	..	..
Republic of Korea	1998	-6.7	-6.6	-7.5	-6.0
	1999	10.9	5.4	12.8	9.9
	2000	8.8	0.1	11.3	7.6
	2001	3.0	0.7 ^a	2.2 ^a	3.3 ^a

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2001* (Oxford University Press, 2001) and *Asian Development Outlook 2001* (Oxford University Press, 2001); and national sources.

Notes: Figures for 2001 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

^a Growth rates for three quarters.

it was not totally immune to the slowdown in the industrialized countries. As demand contracted in China's top five export markets, the United States, Japan, the Republic of Korea, Germany, and Hong Kong, China, the growth of export earnings, although still strong, was on a declining course. Facing the deteriorating external environment, China implemented strong expansionary policies, including higher spending on infrastructure development projects and on property upgrading. Facilitated by housing policy reform and low interest rates on bank lending, investment in the property sector was soaring, thus contributing, in part, to rising domestic demand in 2001. Consumer and business confidence was also boosted with China's entry into WTO, the selection of China as the host of the 2008 Olympic Games and the granting of higher wages for civil servants.

All those factors contributed to sustained strong growth in output from both the industrial and service sectors. In fact, industrial value added went up consistently fast, by an annual average of just over 9 per cent during the period 1998-2001; the corresponding figure for the service sector was 7.5 per cent. Aggregate capital formation notched up another percentage point of GDP to 37.5 per cent in 2001, while the already high rate of savings was maintained at 39.5 per cent during the same year (table II.32). Nevertheless, one of the major challenges for China is to foster more private enterprises and to sustain the restructuring of State-owned enterprises. While the latter will enhance private sector participation and development, the trade-offs involved may be higher unemployment, at least in the short term, and lower private consumption. Inward FDI jumped in 1996 and remained at a high level, averaging almost \$42 billion annually during the period 1996-2000, and there is some evidence that foreign-funded enterprises have a better performance record than State-owned enterprises. Thus, greater job creation could be mediated through policy measures in support of the expansion of foreign-funded enterprises as part and parcel of the process of private sector development in China. Agricultural growth has been maintained at a respectable rate, averaging about 2.8 per cent annually during the period 1998-2001. The quality of agricultural products was also improving, and there have been large grain exports in recent years. With China as a WTO member, some market-oriented adjustments in agricultural protection will be necessary.

Table II.32. Selected East and North-East Asian economies: ratios of gross domestic savings and investment to GDP, 1998-2001

(Percentage)

	1998	1999	2000	2001
Savings as a percentage of GDP				
China	41.3	39.7	39.2	39.5
Hong Kong, China	30.8	32.2	33.0	32.7
Mongolia	18.5	20.0	19.0	21.0
Republic of Korea	34.4	33.5	32.5	32.6
Investment as a percentage of GDP				
China	37.7	37.2	36.9	37.5
Hong Kong, China	29.7	25.0	27.6	26.2
Mongolia	25.0	27.0	26.0	25.0
Republic of Korea	21.2	26.7	28.7	29.0

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2001* (Oxford University Press, 2001) and *Asian Development Outlook 2001* (Oxford University Press, 2001); and national sources.

Note: Figures for 2001 are estimates.

Hong Kong, China, was the worst affected by the global downturn among the subregional economies, with GDP remaining virtually unchanged in 2001 after strong expansion of over 10 per cent during the previous year. Sharp declines were recorded for both exports and domestic demand, despite a higher budget deficit amounting to 4.5 per cent of GDP in 2001, compared with less than 1 per cent the year before. In particular, lower private demand reflected falling consumer confidence, plunging tourist arrivals, weakening retail sales, rising unemployment and a faltering construction business. Furthermore, stagnant property and stock markets contributed to a decline (of about 1.4 percentage points) in total investment equivalent to 26.2 per cent of GDP in 2001. Capital formation is not likely to pick up in the near term, at least until exports of goods and services are on the upswing along with the global economic recovery expected towards the second half of 2002.

Economic activities in Mongolia were strong, with GDP growing by around 3.4 per cent a year in 1998-1999. However, total output slumped in 2000 and the recovery was subdued, with GDP expanding by just 1.4 per cent in the following year. Although agricultural production accounted for about a third of GDP, Mongolia is not self-sufficient in food, and agricultural activities are highly vulnerable to severe weather conditions and other shocks. The output of meat and meat products was adversely affected by severe weather conditions and foot-and-mouth disease in 2001.

In 2001, the Republic of Korea experienced the worst economic downturn since the financial and economic crisis of 1997-1998. The subsequent economic turnaround was speedy and significant; GDP expanded by almost 11 per cent in 1999 and economic activities were sustained at a relatively high level during the following year. However, total output went up by only about 3 per cent in 2001, when private consumption became stagnant and, along with a steep decline in export earnings, investment contracted during the first three quarters of the year. Weakened demand from the country's major export markets for such products as electronics and electrical machinery led to a drop in industrial production and dampened business confidence across the board until the third quarter of 2001. Instability in financial markets was another compounding factor; the collapse of several investment trust companies in the wake of the Daewoo group's bankruptcy heightened financial uncertainties and credit conditions became tight, further constraining investment. Government policies became strongly expansionary; interest rates were lower and the budget deficit went up to 2 per cent of GDP in 2001, compared with a surplus position of 1.3 per cent in the previous year (table II.33). The policy stimulus began to take effect at the beginning of the fourth quarter of 2001, when business confidence,

*Mongolia
experienced a
marginal
improvement in
output ...*

*... while the
Republic of Korea
suffered a steep
drop in GDP
growth*

Table II.33. Selected East and North-East Asian economies: budget and current account balance as a percentage of GDP, 1998-2001

	1998	1999	2000	2001
Budget balance^a as a percentage of GDP				
China	-1.2	-2.1	-2.8	-2.3
Hong Kong, China	-1.8	0.8	-0.9	-4.5
Mongolia	-14.3	-12.2	-6.8	-7.3
Republic of Korea	-4.2	-2.7	1.3	-2.0
Current account balance as a percentage of GDP				
China	3.1	1.6	1.5	1.0
Hong Kong, China	2.4	7.3	5.4	2.8
Mongolia	-13.2	-13.7	-17.2	-16.7
Republic of Korea	12.7	6.0	2.4	3.0
<p>Sources: ESCAP, based on ADB, <i>Key Indicators of Developing Asian and Pacific Countries 2001</i> (Oxford University Press, 2001) and <i>Asian Development Outlook 2001</i> (Oxford University Press, 2001); IMF, <i>International Financial Statistics</i>, vol. LIV, No. 10 (October 2001); Economist Intelligence Unit, <i>Country Forecast: South Korea</i> (London, December 2001); and national sources.</p> <p>Note: Figures for 2001 are estimates.</p> <p>^a Excluding grants.</p>				

retail sales and construction investment were revitalized and regained momentum. Other confidence-raising factors included the forthcoming 2002 World Cup Soccer games (co-hosted by Japan and the Republic of Korea) and the 14th Asian Games (hosted by the Republic of Korea). Some leading indicators are showing a mild recovery of economic activities in the Republic of Korea, although any sustained upturn in manufacturing and the associated investment in machinery and equipment necessary for regained strong growth, as was the pattern in 1999-2000, would depend heavily on a robust recovery in external economic conditions.

Inflation

Consumer prices were muted in most parts of the subregion in 2000-2001 (table II.34). The exception was Mongolia, where inflation had been very high, averaging, for example, 50 per cent annually during the period 1995-1997. Tight fiscal and monetary policies helped to bring the rate of increase in consumer prices to the single-digit level in 1998 and 1999. Higher prices on energy and food products contributed to higher

Table II.34. Selected East and North-East Asian economies: inflation and money supply growth (M2), 1998-2001

	(Percentage)			
	1998	1999	2000	2001
Inflation^a				
China	-0.8	-1.4	0.4	0.7
Hong Kong, China	2.9	-4.0	-3.8	-1.6
Mongolia	9.4	7.5	11.8	8.8
Republic of Korea	7.5	0.8	2.3	3.2
Money supply growth (M2)				
China	15.3	14.7	12.3	13.8 ^b
Hong Kong, China	11.8	8.1	8.8	9.3
Mongolia	-1.7	31.6	17.6	23.0 ^c
Republic of Korea	27.0	27.4	25.4	14.5 ^c
<p>Sources: ESCAP, based on ADB, <i>Key Indicators of Developing Asian and Pacific Countries 2001</i> (Oxford University Press, 2001) and <i>Asian Development Outlook 2001</i> (Oxford University Press, 2001); IMF, <i>International Financial Statistics</i>, vol. LV, No. 1 (January 2002); and national sources.</p> <p>Note: Figures for 2001 are estimates.</p> <p>^a Changes in the consumer price index.</p> <p>^b January-September.</p> <p>^c January-June.</p>				

inflation, of almost 12 per cent, in 2000, although the trend was reversed with lower and more stable oil and meat prices in 2001. Inflation was again down to the single-digit level, at 9 per cent, during that year; it is expected to be lower (about 6 per cent) in 2002, but this will again depend very much on weather conditions, such as winter temperature and rainfall.

Consumer prices in China remained very stable, rising by less than 0.6 per cent on average in 2000-2001. China had experienced some deflation when prices fell by just over 1 per cent a year in 1998-1999, a reflection of oversupply of several consumer items, excess capacity, lower export growth and weak consumer demand; the latter was attributable in part to the fear of job loss. Some of these factors continued to operate over the years 2000-2001. Strong agricultural production over the past several years helped to keep food prices low. There were, however, higher charges for housing and services in 2001. All these cost-push pressures contributed to the positive, but highly marginal, increase in consumer prices during the year.

Muted consumer prices in China and Hong Kong, China, still under deflationary pressures

Consumer prices in Hong Kong, China, fell consecutively in recent years, although deflation levelled from 4 per cent in 1999 to 1.6 per cent two years later. Among the causal factors were lower property rentals as a result of the deteriorating housing market, a fall in retail prices caused by strong competition at the retail level, and cheaper costs of imports owing to the relatively strong local currency, which had a fixed peg to the strong United States dollar. Some mild deflation is expected in 2002, given the current economic downturn, the sharp contraction in current-year exports, the pegged exchange rate and the underlying trends in consumer prices over the last three years.

Prices edged upwards in the Republic of Korea

Inflation was well under control in the Republic of Korea after the 1997-1998 crisis, despite a high rate of money supply (M2) growth in 1999-2000. Consumer prices went up by less than 1 percentage point in 1999 and inflation was modest in absolute terms, although it was apparently on an upward trend in the following two years, amounting to just over 3 per cent in 2001. There were higher costs of utilities and medical services but demand-pull pressures were relatively weak, reflecting lower growth of wage rates, stable prices for raw and intermediate materials (such as crude oil and natural gas) and reduced economic activities more generally. The central banking authorities expect inflation to remain largely at the same level in the coming year.

Foreign trade and other external transactions

Falling export growth in the Republic of Korea

Merchandise trade performance deteriorated virtually throughout the subregion; only Mongolia was able to maintain a high rate of export expansion, although that of merchandise imports fell by about half (table II.35 and II.36). The Republic of Korea and Hong Kong, China, experienced the most severe setback in export earnings, from an expansion of one fifth (to \$171.8 billion) in 2000 to a contraction of 38 per cent during the first three quarters of the following year in the case of the Republic of Korea. ICT products, which accounted for about a fifth of the Republic of Korea's export value, were hard hit by lower external demand; in particular, lower receipts from semiconductors and personal computers were responsible for about 70 per cent of the export contraction in 2001. The decline would have been more serious without some offsetting gains in the so-called "traditional industry" export products, such as passenger cars and marine vessels, a development underpinned by an enhanced reputation and increased specialization in niche markets. There was an equally sharp contraction in import spending, by just over 37 per cent during the first three quarters of

Table II.35. Selected East and North-East Asian economies: merchandise exports and their rates of growth, 1998-2001

	Value (Millions of US dollars)	Exports (f.o.b.)			
		Annual rate of growth (Percentage)			
		1998	1999	2000	2001 Jan.-Sep.
China	249 195	0.5	6.1	27.8	16.6
Hong Kong, China	201 871	-7.5	0.1	16.2	-12.4
Republic of Korea	171 826	-2.7	8.2	19.6	-37.9
Mongolia	409	-29.8	7.4	20.3	19.0

Source: IMF, *Direction of Trade Statistics* (CD-ROM), February 2002.

2001, compared with the previous year's expansion of 34 per cent. This contributed to a trade surplus for the year, while the current account surplus rose marginally from 2.4 per cent of GDP in 2000 to 3 per cent of GDP in 2001. Both the trade and current accounts were expected to be in surplus in 2002.

Table II.36. Selected East and North-East Asian economies: merchandise imports and their rates of growth, 1998-2001

	Value (Millions of US dollars)	Imports (c.i.f.)			
		Annual rate of growth (Percentage)			
		1998	1999	2000	2001 Jan.-Sep.
China	225 096	-1.3	18.0	35.8	14.2
Hong Kong, China	213 183	-11.5	-2.7	18.7	-1.0
Republic of Korea	160 479	-35.6	28.2	34.0	-37.5
Mongolia	588	0.9	-6.9	33.6	17.1

Source: IMF, *Direction of Trade Statistics* (CD-ROM), February 2002.

China's entry into WTO expected to boost trade and FDI in China and Hong Kong, China

Earnings on merchandise exports by Hong Kong, China, which had expanded by 16 per cent (to \$201.9 billion) in 2000, were also on the decline; the earnings were down by just over 12 per cent in the first nine months of 2001 owing to sharply reduced revenue from electrical appliances, office machinery and professional equipment. Import expenditure rose by almost 19 per cent (to \$213 billion) in 2000 but remained more or less stagnant during the first three quarters of the following year. The merchandise trade deficit widened somewhat but, owing to higher earnings on a wide range of services, the current account is expected to post a surplus of 2.8 per cent of GDP in 2001, or about half the figure for the previous year.

In China, the merchandise trade performance in 2000-2001 showed that both export earnings and import spending remained on a high trend, although at a declining rate. Export value went up substantially, by about 28 per cent (to \$249 billion) in 2000, and continued to grow by a considerable margin of 17 per cent in the first nine months of the following year. The value of foreign trade has expanded at the average rate of 15 per cent annually for the 22 years ending in 2000. In fact, China has become the seventh biggest trading country in the world, with a ratio of trade to GDP of just over 9 per cent in 1978 and 44 per cent in 2000. Its recent entry into WTO is expected to boost trade and investment activities, especially FDI and imports capital goods, as part and parcel of the ongoing process of global and regional integration. Indeed, the three most important export markets of China are the United States, Japan and Hong Kong, China, which together contributed about 55 per cent of China's export earnings. The top four export product groups, mechanical and electrical products, electric and electronic products, garments and clothing accessories, and computer and telecommunications equipment, accounted for almost nine tenths of the total export value as at September 2001.

Strong export earnings by Mongolia, but large trade and current account deficits

Mongolia's recent trade performance improved significantly, with merchandise export earnings expanding by almost a fifth annually 2000-2001. The main trading partners are China and the Russian Federation, and the main export items are copper and cashmere. However, total export value was comparatively modest, at \$409 million in 2000. Expenditure on imports ballooned in 2000, in part owing to higher oil prices, but moderated considerably to rise by about 17 percentage points during the first three quarters of 2001. Mongolia experienced considerable deficits in its trade and current accounts, the latter averaging about 17 per cent of GDP for both 2000 and 2001.

Along with the global economic slowdown, the level of net private capital flows to the emerging markets in the region, China, India, Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand,

fell by almost a third, from \$67 billion to just over \$44 billion, in 2000 and 2001. However, FDI flows to China in 2001 remained strong, reflecting in part such positive factors as the country's entry into WTO and the "Olympics 2008" effect. Net FDI inflows, which amounted to \$37.5 billion in 2000, are expected to reach some \$40 billion in the following year; this is equivalent to about 9 per cent of gross fixed investment in China. The country has been the largest FDI host for years and accounted for almost a fifth of all FDI flows among developing economies in 2000. China's savings rate is also among the highest in the world, hovering between 39 and 41 per cent during the period 1998-2001. Hong Kong, China, ranked second as an FDI recipient among developing economies in 2000, with a relative share of 16 per cent, although the flows have been rather volatile over the last few years. Net FDI is expected to rise to \$10 billion in 2001, equivalent to 24 per cent of the gross fixed investment in 2001, from \$1.4 billion in the previous year. Portfolio investment in Hong Kong, China, is expected to decline in 2001, reflecting the weakness of the economy.

FDI is expected to increase in China; Hong Kong, China; and Mongolia

FDI in Mongolia is on a rising trend, reaching \$40 million in 2000 compared with \$30 million in the previous year and \$19 million in 1998. However, the net FDI flows into the Republic of Korea are expected to decline to \$1.2 billion in 2001 (or about 1 per cent of gross fixed investment) from \$4.3 billion in 2000 (or just over 3 per cent). FDI had been promoted as a means to overcome the financial crisis of 1997-1998 and the net inflow had peaked at just over \$5.0 billion in 1999 from \$0.7 billion in 1998. The Republic of Korea was the sixth largest FDI host among the developing economies in 2000 (after China; Hong Kong, China; Brazil; Argentina and Mexico). The flow of portfolio investment to the Republic of Korea was volatile in 2001, reflecting the economic uncertainties in the economy. Its net amount was around \$12 billion in 2000, almost three times larger than the net FDI. Portfolio investment is expected to increase again along with the domestic economic recovery in 2002.

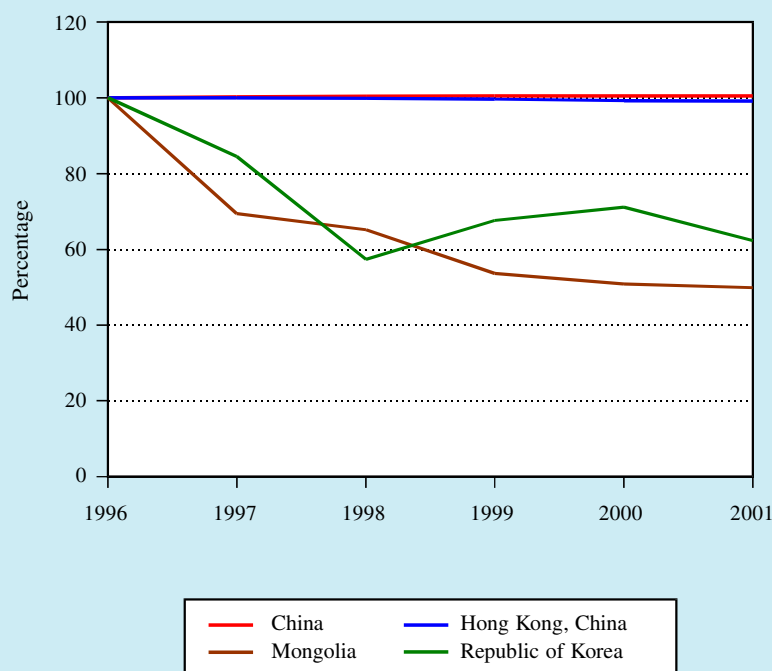
As a whole, the foreign reserve position of the three largest subregional economies was reasonably comfortable. As at October 2001, China is estimated to have accumulated foreign reserves totalling more than \$206.5 billion, or about 1.5 times the level of its external debt; such debt had declined steadily, from 15 per cent of GDP in 1999 to an estimated 12 per cent in 2001. The amount of foreign exchange reserves was also equivalent to about 10 months of import spending. The level of reserves in Hong Kong, China, was \$113.1 as at October 2001 and in the Republic of Korea, it was \$101.6. The external debt of the Republic of

Substantial foreign reserves among the major subregional economies

Korea has been on a declining trend since the 1997-1998 financial crisis, amounting to \$120.3 billion as at November 2001 compared with \$131.7 billion at the end of 2000. The ratio of short-term external debt to foreign exchange reserves, which had been as high as 63.3 per cent in 1998, went down to just under 50 per cent as at December 2000 and 40 per cent as at November 2001. The local currencies in both Mongolia and the Republic of Korea depreciated somewhat against the United States dollar, the won reflecting in part weakened domestic economic conditions and the weakening Japanese yen in 2001. However, China, and Hong Kong, China, maintained their pegged rate of foreign exchange with the dollar (figure II.30).

Figure II.30. Index of exchange rates against the United States dollar of selected East and North-East Asian economies, 1996-2001

(1996=100)



Sources: IMF, *International Financial Statistics*, vol. LV, No. 1 (January 2002); and *Far Eastern Economic Review*, various issues.

Note: Figures for 2001 are estimates.

Key policy issues

The economies in East and North-East Asia share a number of common policy issues in economic reform and restructuring. A key issue in China is the reform of State-owned enterprises and the financial sector as many of those enterprises were highly indebted and operating at a loss thus adding NPLs to the domestic banking system. Among the policy responses were debt-for-equity swaps, privatization, reducing the workforce of the enterprises and the closure of non-viable enterprises. Although the profitability of State-owned enterprises as a whole improved somewhat in the first half of 2001, concerns about rising unemployment and the adverse external environment were among the constraints on the restructuring process. Furthermore, the State banks' financial situation is still heavily dependent on the performance of the State-owned enterprises and progress in financial sector reform is also dependent on the pace of enterprise restructuring. In the process of financial and State-owned enterprise sector restructuring, a considerable number of NPLs have been transferred to asset management companies thus lowering the NPL ratio to 29 per cent at the end of 2000, from 39 per cent at the end of 1999. However, the comparatively high NPL ratio is another constraint on the financial situation of the banking sector. In addition, the possible areas for strengthening of the legal infrastructure include a framework that can handle speedily defaults or delays on payment, bankruptcy procedures, manipulation of stock prices, false financial reporting and breaches of contract.

Since 1997 the Government of China has pursued a policy of "reducing employment and increasing efficiency" and the number of employees of State-owned enterprises decreased by 26 per cent, from 110 million in 1997 to 81 million in 2000. The unemployment rate, based on registered unemployment in the urban areas, is estimated to be 3.6 per cent in 2001, compared with 3.1 per cent in 2000. Concerted efforts have been made to provide laid-off workers from the enterprise sector with alternative employment opportunities in labour-intensive activities, including through the development of more service business and non-State firms. The very high savings rate in China, noted earlier, and the low levels of public debt (under 12 per cent of GNP) can help to facilitate the process, especially if the financial sector can be both deepened and widened to ensure effective and flexible resource mobilization and intermediation. However, the unemployment problem is expected to remain a key issue for policy attention at least in the short to medium terms, especially with more intensifying competition from external producers in the wake of China's entry into WTO. In this context, the social safety nets needs to be strengthened, although programmes for the unemployed already exist.

***China needs to
improve the
efficiency of its
State-owned
enterprises***

The current pension system only covers urban workers, and adequate provisions would need to be made to cater for the growing ageing population in the country.

***Rising
unemployment in
Hong Kong, China***

Unemployment in Hong Kong, China, fell steadily in 2000 but, as is the case elsewhere in the subregion, the unemployment rate has been rising since early 2001, with the seasonally adjusted rate standing at 5.3 per cent in September 2001, compared with 4.5 per cent in the first quarter of the year. This trend is expected to continue until the first half of 2002, especially as the new graduates start to enter the workforce. The economy of Hong Kong, China, would need to be even more flexible, knowledge-based and focused on high value added activities through continuous education, training and skills upgrading, especially with China's entry into WTO. The sudden economic downturn and the associated revenue shortfalls, and increased public expenditure, resulted in a considerable increase in the budget deficit, to 4.5 per cent of GDP during fiscal year 2001 compared with less than 1 percentage point in the previous year. In this context, the needs of an ageing population and the associated demand for greater public spending on health care and on social welfare and safety nets will put added pressure on government resources in the longer term. Facing an increasingly competitive financial industry, Hong Kong, China, also needs to upgrade its infrastructure in order to sustain an efficient and secure financial environment, strengthen financial risk management and monitoring capabilities, develop new products and services, such as a credit reference service, and introduce deposit insurance schemes that involve minimum moral hazard risks.

***Mongolia in
transition towards a
market economy***

Mongolia, which has been in transition towards a market-based economy, has made remarkable progress in reducing fiscal deficits and bringing down inflation in recent years. For example, inflation averaged 50 per cent annually during the period 1995-1997, compared with an average of less than 10 per cent a year in the following four years. The budget shortfall was also contained at around 6-7 per cent of GDP in 2000-2001 relative to over 12 per cent a year during the previous biennium. The current account deficit, however, remained at a high and rising level in 2000-2001. Larger inflows of ODA and FDI would relieve the pressures from this deficit, as would better export performance and diversification in combination with more streamlined import spending. There is also no sustainable substitute for greater domestic resource mobilization, again in combination with concerted efforts to rationalize and streamline public expenditure so as to further improve its relevance and impact in line with national development priorities. In this context, the granting of subsidies to public enterprises would need to be

carefully reviewed along with policy measures to speed up the privatization process and encourage greater private sector participation in economic activities.

The Republic of Korea has made considerable progress in financial sector restructuring, including strengthened profitability, improved recapitalization and lower NPL ratios. Most of the needed improvements were made within the “hardware” institutional and regulator framework, while several elements in the “software” of the financial system, such as risk management, credit analysis, lending practices and financial system monitoring, require further development and strengthening for greater resilience and efficiency. The base of skilled human resources and managerial expertise needs to be both deepened and widened in order to maximize the potential within the reformed and reinforced financial industry. The privatization and sale of Government-owned banks and investment and trust companies will be a challenging task for the Republic of Korea in 2002.

Considerable progress in financial sector restructuring in the Republic of Korea

The corporate sector of the Republic of Korea is still highly vulnerable to external shocks; its exports are heavily concentrated in ICT products such as semiconductors and consumer and office electronics equipment. Although the overall level of corporate debt has declined and corporate profitability risen, a large segment of the corporate sector is still not able to cover and service borrowing costs from its own cash flows. Many firms therefore have to engage in operational restructuring, that is, closing non-profitable operations and concentrating on their core business activities in order to sharpen their international and domestic competitiveness and maintain their financial stability. However, the promotion of greater market discipline, improved corporate governance (including enhanced accountability and transparency in management, and better protection of minority shareholders’ rights), and revamped insolvency laws and bankruptcy procedures would contribute to the corporate restructuring and strengthening processes. The successful sale of Daewoo Motor Co. and Hynix Semiconductor Inc. are expected to reduce market uncertainties, thus facilitating progress in corporate restructuring; Daewoo used to be one of the “Big Three” car manufacturers and Hynix the world’s third largest computer-chip manufacturer.

The corporate sector needs to improve its competitiveness and profitability

The elderly dependency ratio is rising relatively rapidly in the Republic of Korea relative to other OECD countries. This has long-term implications for social welfare and social protection since the current National Pension Scheme is projected to be financially inadequate to meet future (funding) commitments. The current health care system also requires major revamping to enable it to meet future financial needs and provide better service.