

and Pacific economies. The position of China as the most attractive FDI destination in the region is changing, yet the country has a vast reservoir of workers and huge internal market. Thus, these phenomena will pose new and challenging issues with which economies in the region will have to deal if the overall regional growth momentum is to be maintained.

Although the sum of FDI is not fixed, that is, more FDI for China does not necessarily mean less for others, China enjoys a huge competitive advantage over other producers and exporters of labour-intensive manufactured goods in the region. As described in the section on the East and North-East Asian subregion, China dominates the world in textile and clothing exports and it is developing prowess in the export of information and communication technology equipment. In the near future it might emerge as an important base for automobile exports. Several established producers of information and communication technology goods have already felt China's impact. Other industries are likely to be affected by China's growing competitiveness in industries that are not labour-intensive. These developments suggest that South-East Asia could experience sharply reduced inflows of FDI and of access to the technology and markets that FDI brings.

The restructuring experience of Singapore (see discussion in the section on the South-East Asian subregion) suggests some of the alternatives available to South-East Asian economies. These include a radical restructuring of the manufacturing sector in order to benefit from China's economic development by moving from labour-intensive to more technology- and capital-intensive production niches. Expanding the service sectors with information and communication technology is another option, but this would require major investment in human resources and cannot be done in just a few years. Moreover, investment in education is only one element in improving human resources. Better standards of governance in both the public and private sectors of the region's economies are also required in order to maximize total factor productivity. The way in which individual economies cope with the challenges posed by China will depend on a variety of considerations, involving a strong interaction between all stakeholders in pursuing a common vision and agenda for the future.

### ***North and Central Asia should expedite economic reforms***

Finally, greater economic diversification is needed in the economies in transition in North and Central Asia. The subregion is going through a sustained period of growth, with the energy sector, helped by high oil and gas prices, providing the main source of growth in many economies, especially Azerbaijan, Kazakhstan, the Russian Federation and Tajikistan. In Azerbaijan, where foreign capital inflows into the energy sector constitute an unusually high proportion of GDP, the need for broad-based growth is particularly strong in order to prevent the Dutch disease phenomenon in which the exchange rate appreciates and the economy loses competitiveness in the non-energy sectors. The Central Asian economies also need to expedite their economic reforms, particularly in the macro-economic arena, that have been going on since 1992. Only two countries, Kazakhstan and the Russian Federation, have achieved market-economy status thus far.

## **DEVELOPING COUNTRIES**

### **East and North-East Asia**

#### **Overview**

### ***Robust growth continues in the subregion***

The economies of the East and North-East Asian subregion differ greatly in size and level of development. China accounts for two thirds of subregional GDP. In purchasing power parity terms, however, that country's GDP per capita of \$4,500 is exceeded by a wide margin by that of Hong Kong, China, at \$27,000, and the Republic of Korea, at \$17,000. Those two economies also have a much higher ranking than China in the human development index of the United Nations Development Programme. Nonetheless, the economy of the subregion is hugely influenced by the increasing weight and power of China as a trading nation and its remarkable impact on the prices of manufactured goods, raw materials, exchange rates, financial flows, services and tourism.

Powered by the spectacular performance of the Chinese economy in 2005, the East and North-East Asian subregion forged ahead with strong growth in GDP and exports. Although the subregion's performance was a little less impressive in 2005 than in 2004, it continued on its robust growth path. Significantly, domestic demand appears to be replacing export demand as the primary source of growth, but Hong Kong, China, is likely to continue to depend mainly on trade, especially trade with China, including re-exports.

Several downside risks emerged during the year, as concerns heightened over rising global macroeconomic imbalances, steeply rising oil prices, the growing threat of an influenza pandemic and dollar interest rates trending upwards. The overall impact in 2005 was limited. Although dramatic change is not expected in 2006, investor sentiment may well be affected by the way in which the risks evolve and the measures that Governments of countries in the subregion take to deal with them.

Steep rises in oil and other commodity prices left an imprint on the economies of the East and North-East Asian subregion. China and the Republic of Korea performed better than others in coping with the upward pressure on prices, China doing so through a system of administrative controls on oil prices. In any event, price increases remained muted overall, although there was some modest upward pressure on prices in Taiwan Province of China.

On the positive side, global markets in information and communication technology began a cyclical recovery, affecting the Republic of Korea and Taiwan Province of China positively.

China became the largest destination for exports from the Republic of Korea and Taiwan Province of China in 2005, underpinning the growing interdependence in the subregion, but especially the crucial role that China plays in the region as a whole. The return to growth in Japan strengthened the subregion's prospects. In terms of global imbalances, in which the Chinese current account surplus features prominently, there was a 2.1 per cent appreciation in the trade-weighted exchange rate of the Chinese yuan in mid-2005. Indications of a further modest rise in the yuan's value in the coming months also emerged as the central bank of

China executed its first ever swap transaction in the domestic foreign exchange market. Indeed, of the likely scenarios of how the global imbalances could unwind, one could include a significant appreciation of Asian currencies, including the Republic of Korea won.

### **GDP growth performance**

#### ***China's economy maintains spectacular growth***

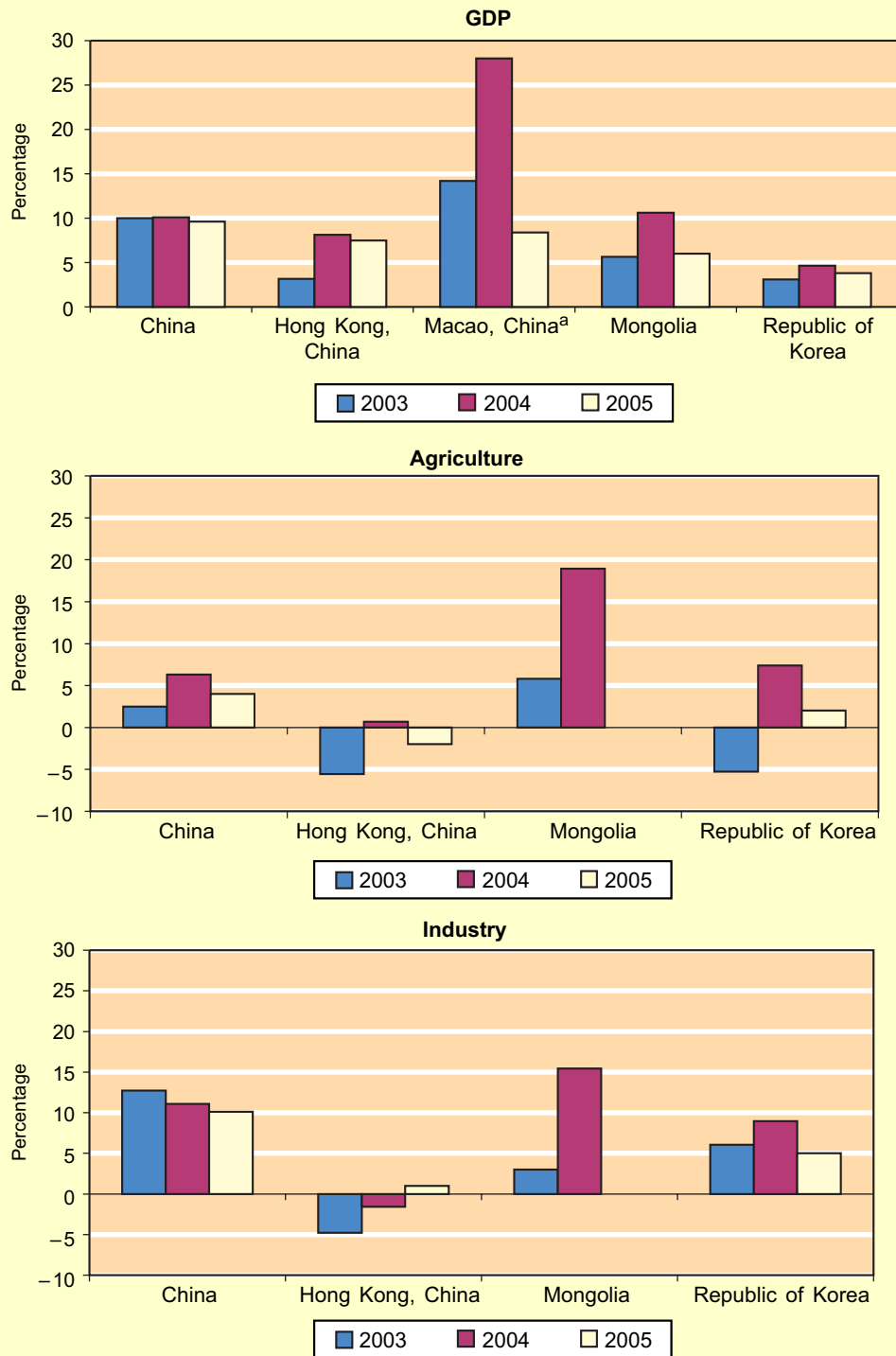
The East and North-East Asian subregion may be the most dynamic in Asia and the Pacific. Its economies specialize in high-technology industries and are increasingly developing new technologies in the information and communication technology field, particularly in semiconductors and telecommunications.

The subregion has one of the world's most sophisticated financial centres in Hong Kong, China, providing world-class services in commerce, financial intermediation and capital markets.

China continued its spectacular growth of the last two decades; average GDP growth was 10 per cent per year in the period 1987-1996 and 8.4 per cent in the period 1997-2005, making China the world's greatest economic success story in recent history. New official figures released by the National Bureau of Statistics resulted in an upward revision by almost 17 per cent of the 2004 GDP of China (equivalent to \$285 billion), with most of the increase in the service sector. This indicates that the economy of China is more diversified than previously thought. On the basis of the revised data the country's GDP is estimated to have grown by 9.6 per cent in 2005 (see figure II.2). On the social front, strong GDP growth was also manifested in a further reduction in income poverty in 2005 as growth in industrial production further reduced registered unemployment in urban areas.

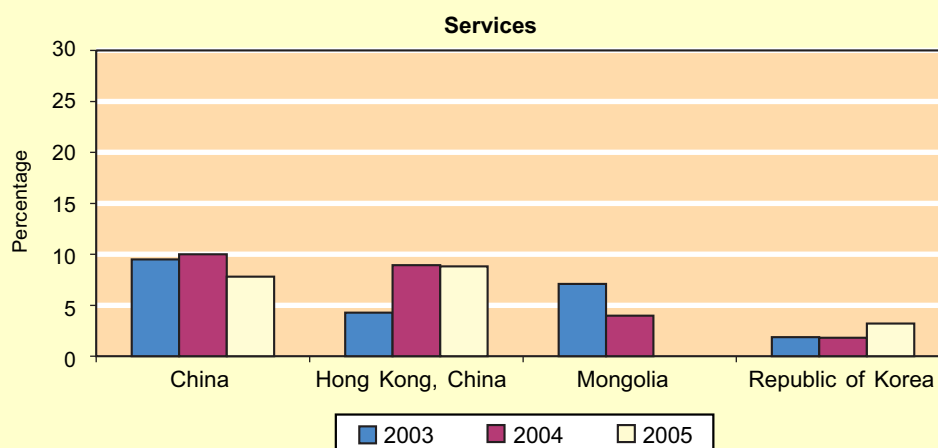
Robust growth in China has been sustained by three broad factors: surging net exports, domestic investment, especially in infrastructure and, increasingly, domestic consumption. Strong export demand propelled much of the growth, particularly in the second half of 2005. Based on current data and trends, exports

**Figure II.2. GDP and sectoral growth in selected East and North-East Asian economies, 2003-2005**



(Continued on next page)

Figure II.2 (continued)



Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on national sources; National Bureau of Statistics of China, *China Statistical Yearbook 2005* (Beijing, China Statistics Press, 2005); Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2005* (Manila, ADB, 2005); and Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2005 and 2006), various issues.

Notes: Growth rates for 2005 are estimates. Industry comprises mining and quarrying; manufacturing; electricity-generation, gas and power; and construction.

<sup>a</sup> Data (provisional) for 2005 refer to the period January-June of that year.

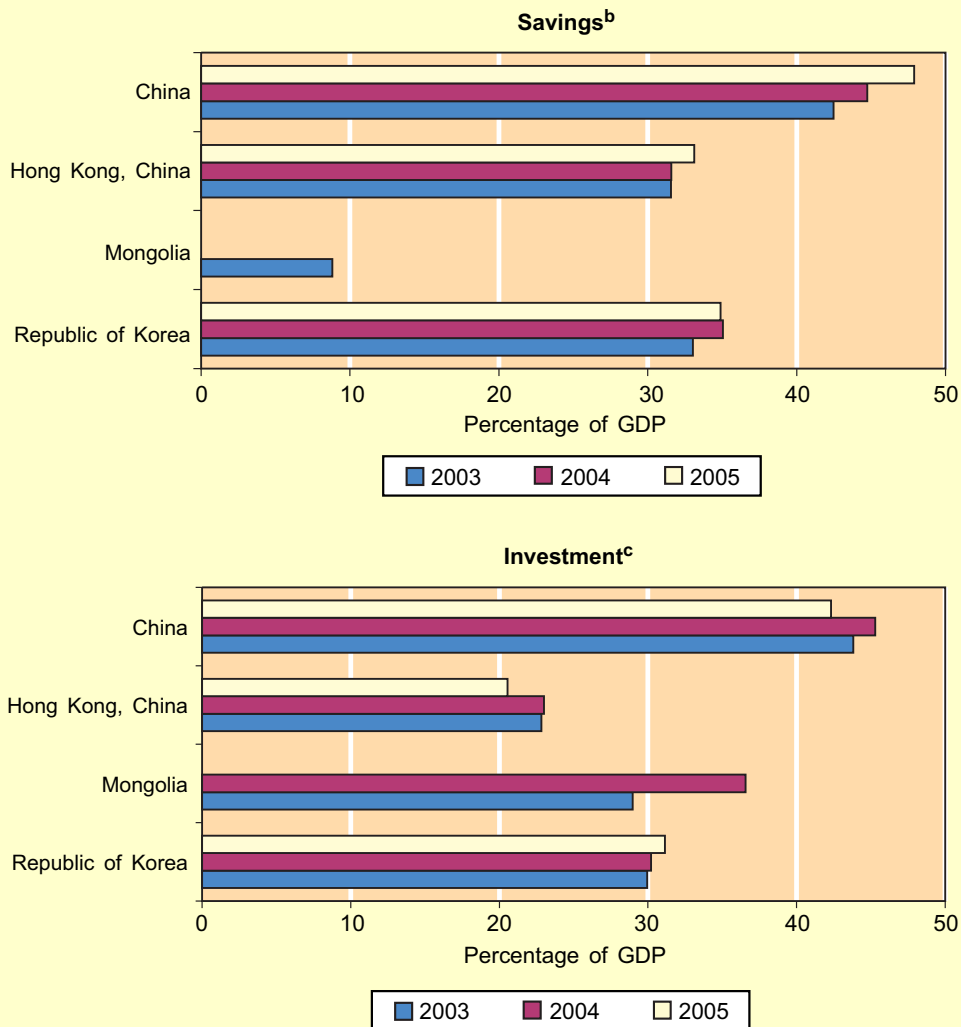
from China are expected to have exceeded \$760 billion in 2005, the third highest level in the world. In the last few years, the export of a wide spectrum of products has played the most important role in sustaining the recent growth momentum in China. Indeed, one of the striking features of 2004-2005 is that China has overtaken the United States in high-technology information and communication technology exports. In addition, the GDP growth rate held steady at nearly 10 per cent in 2005 because of continuing strong investment demand, aided by an increase in private consumption. Overall, the data suggest that China's economic growth could be shifting away from improvements in total factor productivity to capital accumulation, with large investments in physical infrastructure in the last few years, which traditionally have had relatively low financial rates of return.

There are indications to suggest that the economy of China will lose momentum marginally, with GDP projected to grow at the rate of about 8 per cent in 2006. Export growth is expected to taper off slightly, but overall domestic demand with regard to investment and con-

sumption is expected to increase. Import growth, too, is expected to gather some momentum in 2006 over that in 2005.

Savings as a percentage of GDP continued to grow significantly, surpassing the high levels reached in the early years of the current decade (see figure II.3) and may soon exceed 50 per cent of GDP. Investment as a percentage of GDP, however, slowed to 42.3 per cent in 2005 from a high of 45.3 per cent in 2004. During the first eight months of 2005, investments in fixed assets increased by 27.4 per cent, down from 30.3 per cent during the same period in 2004.

The slowdown in investment growth was due largely to the introduction of administrative controls to curb investment growth in certain sectors, including the real estate sector that has seen explosive growth in demand virtually across all of China. The Government imposed a 5 per cent capital gains tax on the sale of houses owned for fewer than two years and raised mortgage rates and down payments. However, the ability to curb aggregate investment demand through administrative means has come under

**Figure II.3. Savings and investment in selected East and North-East Asian economies, 2003-2005<sup>a</sup>**

Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on national sources; Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2005* (Manila, ADB, 2005); Economist Intelligence Unit, *Country Forecasts* (London, 2005), various issues.

<sup>a</sup> Data for 2005 are estimates.

<sup>b</sup> Gross domestic savings.

<sup>c</sup> Gross domestic investment.

pressure as China has moved progressively towards a market-based financial system. The increased autonomy enjoyed by enterprises and local authorities is another factor that hampers efforts to curb demand, as these entities tend to be guided more by local considerations than by national policies. Against this background, the

considerable liquidity in the banking system indicates that investment demand, whether for real estate or manufacturing, could continue to increase the risk of overheating the economy.

In agriculture, production slowed to 4 per cent in 2005 from 6.3 per cent in 2004. Indus-

trial growth, also slowed down to 10.1 per cent from 12.7 per cent in 2003 and 11.1 per cent in 2004. Industrial growth was supported by a growth rate of 7.8 per cent in the service sector in 2005, slightly down from an average of just over 8 per cent since 2000.

### ***China's industrial scene undergoes massive transformation***

The industrial sector in China has undergone a massive transformation in the recent past. By some estimates, the number of manufacturing enterprises exceeded 250,000 by mid-2005, while the number of State-owned enterprises declined to about 29,000 as a significant number of units were privatized, merged or closed. Most of the privatized units were small and medium-sized enterprises. China is also expected over the near term to move away from traditional resource-based, energy-intensive manufacturing activities towards more knowledge-based industries with a greater emphasis on employment creation in urban areas and increasing space for the private sector. Improving the efficiency of capital is also high on the agenda, with more equitable sharing of the benefits of growth between the dynamic coastal belt and the interior and between the urban and rural areas generally.

One area in manufacturing, the growing importance of which became apparent towards the close of 2005, was the export of parts and components to Boeing and Airbus for the manufacture of civilian airliners. China has signaled its determination to develop its own technological base and industrial capacity in both the aircraft and aerospace industries, until now a preserve of developed countries. Apart from its well-publicized success in sending persons into space, China is rapidly developing its capacity in the area of launch technology for commercial satellites.

### ***Hong Kong, China, grows robustly***

The economy of Hong Kong, China, grew by 7.5 per cent in 2005 following its strong recovery in 2004 when it grew by 8.1 per cent. This slowdown was led by a moderate decline in consumer spending as interest rates rose, though this was offset somewhat by sustained growth in investments in machinery and equipment and a surge in exports propelled by import demand from China.

Savings as a percentage of GDP picked up, reaching 33.1 per cent in 2005. However, investment as a percentage of GDP slowed to 20.6 per cent from 23.0 per cent in 2004. Most of the growth in GDP came from the service sector, which grew by 8.8 per cent in 2005. Although growth was slightly less than in 2004, it was clear that services would continue to play a dominant role in the growth of the economy in Hong Kong, China, in 2006 and beyond.

### ***Sharp decline in Mongolia***

After growing at the rate of 10.6 per cent in 2004, the economy of Mongolia slowed sharply to 6 per cent in 2005, primarily as a result of higher energy prices. Before the slowdown, investment had surged to 36.6 per cent of GDP in 2004 from less than 30 per cent in 2003 as demand for metals and minerals stimulated new investments in the mining industry. Strong external demand, principally from China, had given a boost to the mining sector. Agricultural production picked up significantly in 2004 and this had a favourable impact on poverty reduction. Industry, after growing at a healthy rate of 15.4 per cent in 2004, a significant increase over the performance in 2003, slowed in 2005 in response to higher energy prices and other factors. The textile and garments industry suffered a heavy blow as Mongolia lost ground to other competitors with the expiration of the Multifibre Arrangement in January 2005. This led the Government to approach the United States and the European Union to secure bilateral treatment in order to safeguard its textile and garment exports to these two important markets. The service sector showed only modest growth in both 2004 and 2005 after having performed well in 2003.

### ***Domestic demand slows in the Republic of Korea***

GDP in the Republic of Korea grew by an estimated 3.8 per cent in 2005, down nearly 1 percentage point over that of 2004. The growth momentum was affected in recent years by the relatively slow growth in domestic demand, as credit card debt mounted rapidly and had to be curbed, although the slowdown was offset by buoyant exports. The country's economy is again becoming more reliant on external demand, primarily from China, which has emerged as the country's largest export market.



Overall, GDP is projected to grow at the rate of 4.9 per cent in 2006, as private consumption regains strength. Private consumption began to strengthen after the last quarter of 2004, and by August 2005 the real consumption sales index had grown by 6.0 per cent on a year-on-year basis, its healthiest growth rate since 2002. Consumption demand for semi-durable goods and services picked up further after the second quarter of 2005, a trend that was likely to be maintained as household debt burdens eased and an appreciating won meant lower prices for imported goods. Overall, the savings rate remained at around 35 per cent of GDP in 2005. Investment held steady at 31.2 per cent of GDP in 2005.

During the year, high oil prices blunted business confidence and may have been instrumental in the deferment of new investment in manufacturing. Moreover, the cyclical downswing in 2003-2004 in the global high-technology industry also adversely affected economic growth in the Republic of Korea, although the effect was short-lived as the economies of both Japan and the United States grew fairly strongly in 2005. A new and dynamic source of demand for the Korean economy in 2005 was import demand from China.

Agricultural growth declined by more than 5 percentage points in 2005 following declines of negative growth of more than 5.3 per cent and 3.5 per cent respectively in the two previous years. Industrial growth also fell to 5 per cent following a growth rate of 9 per cent in 2004. Textile exports declined as low-cost producers made inroads with the phasing out of the previously mentioned Multifibre Arrangement on 1 January 2005.

Despite the overall recovery of the economy, investment spending remained hesitant as small and medium-sized enterprises rebuilt their balance sheets. Corporate profits suffered as oil prices soared and the exchange rate appreciated in 2005. Although the leading indicators for equipment investment showed moderate improvement, monthly indicators failed to exhibit signs of a lasting recovery. Investment growth in construction turned positive in the second quarter of 2005, after recording negative growth rates in the preceding three quarters.

Growth in the service sector improved, growing at the rate of 3.2 per cent in 2005 compared with only 1.8 per cent in 2004. Financial sector performance improved considerably. The ratio of non-performing bank loans fell across the board. The major credit card service providers increased their profitability as the average delinquency ratio continued to decline. The stock market displayed remarkable strength in 2005 with the Korean Composite Stock Price Index rising nearly 50 per cent, the best performance by a stock market in the region.

### **Key macroeconomic policy developments**

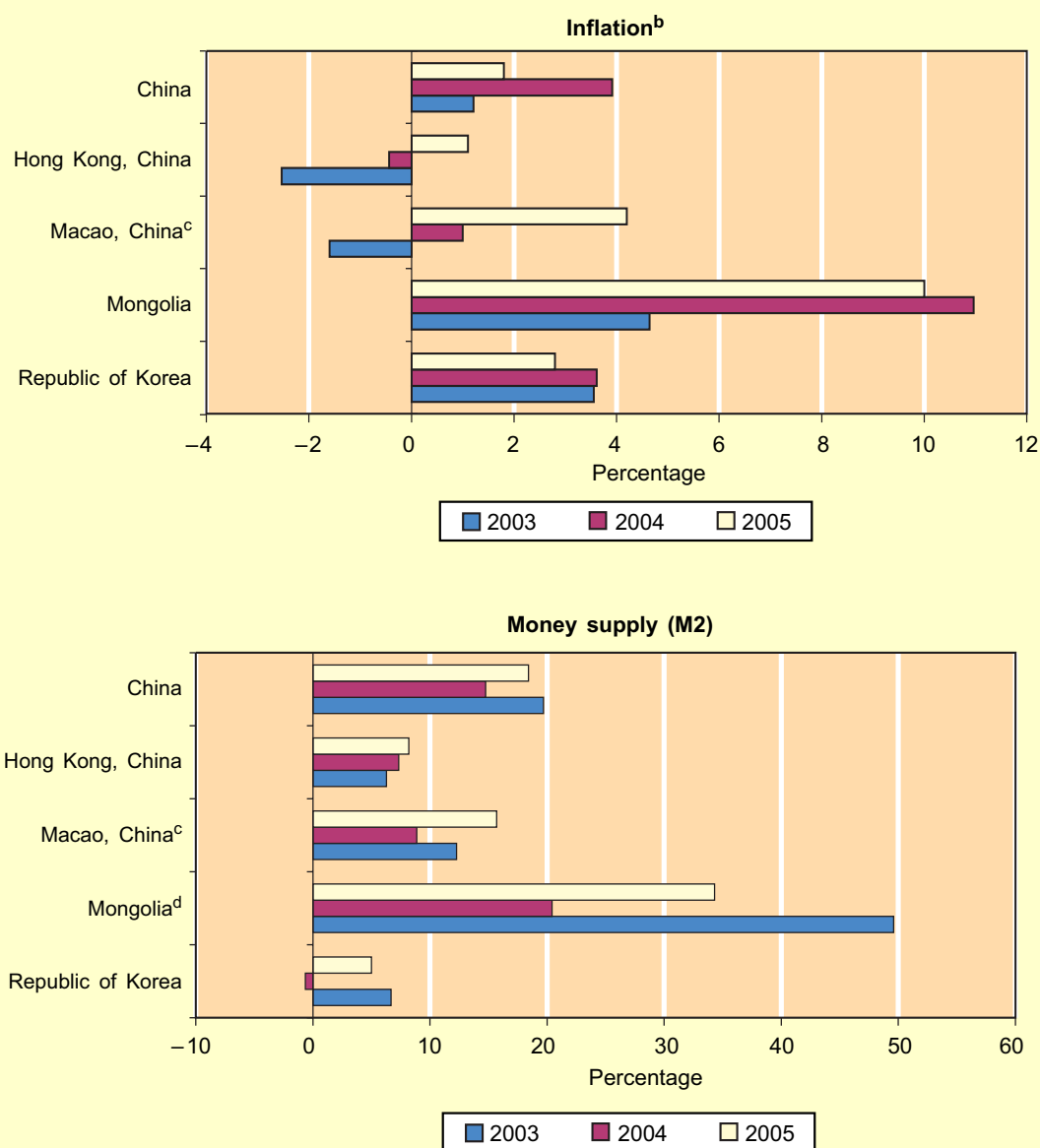
#### **Price pressures moderate**

Inflation remains benign in the subregion despite higher oil prices. Headline inflation in China fell to around 2.0 per cent in 2005, a significant reduction from the level of 2004, largely as a result of falling food prices (see figure II.4). Food prices are expected to remain low following a series of good harvests, improving yields, and the Government's efforts to reduce the tax burden on the farming community. Prices of raw materials, fuel and power rose more slowly than in the previous year as lower investment demand relieved pressure on their supply.

On the fiscal side, the budget deficits in all economies of the subregion except Hong Kong, China, widened in 2005 after having contracted in 2004 (see figure II.5). Higher fiscal deficits were occasioned primarily by increased government spending rather than lower tax revenues. Although the fiscal situation deteriorated in 2005, this is not a cause for concern as the deficits remained below 3 per cent of GDP in all the economies except Mongolia.

The Chinese central bank has undertaken several measures to tighten monetary conditions and to slow growth in lending. The more rapid pace of reserve accumulation in late 2004 and the first half of 2005 led to a substantial spike in the money supply and ample liquidity remained in the banking system. However, inflationary pressure remained moderate as global commodity prices fell and grain production rose. Increasing competition among manufacturers kept prices low on a wide range of goods, such as consumer durables.

**Figure II.4. Inflation and growth of money supply in selected East and North-East Asian economies, 2003-2005<sup>a</sup>**



Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on national sources; Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2005* (Manila, ADB, 2005); International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, September 2005), and *Mongolia: Selected Issues and Statistical Appendix*, IMF Country Report No. 05/400, November 2005; and Economist Intelligence Unit, *Country Forecasts* (London, 2005), various issues.

<sup>a</sup> Data for 2005 are estimates.

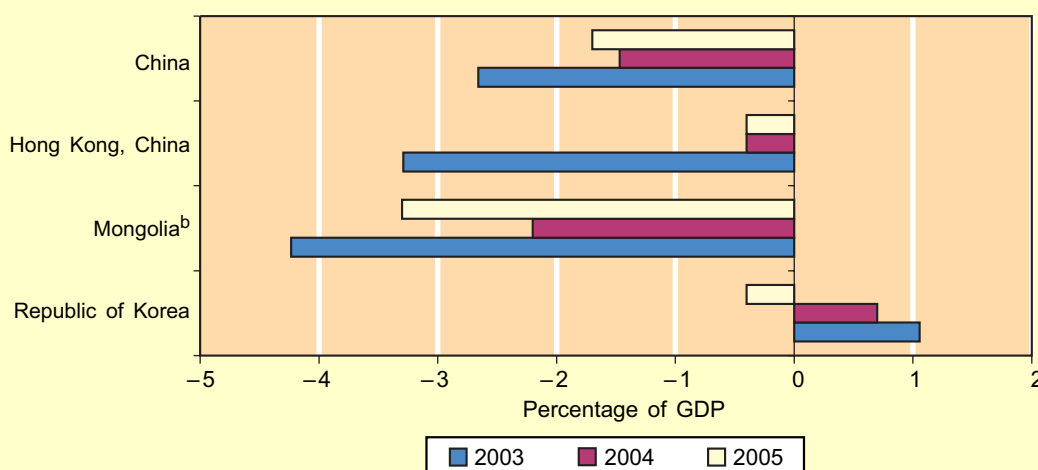
<sup>b</sup> Inflation refers to changes in the consumer price index.

<sup>c</sup> Inflation for 2005 refer to January-October in that year; money supply for 2005 refers to January-August in that year.

<sup>d</sup> Data for 2005 refer to January-September.



**Figure II.5. Budget balance in selected East and North-East Asian economies, 2003-2005<sup>a</sup>**



Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on national sources; Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2005* (Manila, ADB, 2005); International Monetary Fund, *Mongolia: Selected Issues and Statistical Appendix*, IMF Country Report No. 05/400 (2005); and Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2006), various issues.

<sup>a</sup> Data for 2005 are estimates.

<sup>b</sup> Budget balance including grants.

### **Hong Kong, China, emerges from deflation**

In Hong Kong, China, inflation edged up to the rate of 1.1 per cent in 2005 after several years of deflation. A buoyant economic upturn, progressive feed-through from the earlier rental rebound and the modest impact of higher fuel costs added to upward pressure on headline inflation in the economy. The persistent downward pressure on prices over the past several years was halted by the third quarter of 2005. However, the inflationary environment was expected to remain benign as productivity and productive capacity increased. Growth in the money supply was held at 8.2 per cent in 2005, an increase from that of the previous year. Overall, inflation was expected to remain at under 2.0 per cent in 2006.

In Mongolia, inflation more than doubled to 11.0 per cent per year in 2004 from 4.6 per

cent in 2003. This was despite a sharp contraction in the growth of money supply from 49.6 per cent in 2003 to 20.4 per cent in 2004. Steep increases in oil prices and adjustment of domestic heating and electricity prices contributed to the inflationary pressure. Some easing of the monetary policy also contributed to the price rise. The latest data for 2005 suggest that price pressures have eased somewhat but remain close to 10 per cent. More stable energy prices should remove some of the pressure on prices in the remainder of 2005.

### **Appreciation of the won moderates price pressures in the Republic of Korea**

Headline inflation fell to 2.4 per cent in the Republic of Korea in November 2005 on a year-on-year basis, although the money supply grew by 5.0 per cent from negative growth of 0.6 per cent in 2004. This was despite the steep

increase in oil prices. The appreciation of the won in early 2005 also helped to keep inflation low. House prices came under significant pressure in the first half of 2005, reflecting a prolonged shortage of housing and speculative transactions fueled by the low interest rates that had prevailed in the country in the recent past. A variety of tax measures were introduced to contain the upward pressure on housing prices. The overnight call rate went up to 3.5 per cent in October, the first rise in more than three years, and interest rates were increased again in December 2005 to 3.75 per cent in order to pre-empt a more generalized rise in the price level.

### ***Developments in the external sector***

#### *Foreign trade and other external transactions*

#### ***China's foreign trade maintains robust growth***

The subregion accounts for more than 60 per cent of the region's foreign trade with the rest of the world and more than two thirds of the trade within the region. China is a major trading power of global importance in a wide range of both low- and high-technology goods, the Republic of Korea and Taiwan Province of China are at the forefront of high-technology production and export, while Hong Kong, China, apart from its role as an entrepôt for China, is a substantial exporter of goods and services in its own right. As such, the subregion exercises a large and growing influence in both trade and output in the development of technology in the region as a whole.

Exports from China declined to 31 per cent in 2005 after an increasing trend since 2002 (figure II.6). This slight easing in the export growth rate was caused by slower growth in electronic exports to the United States and the European Union in the earlier part of 2005. The export of textiles and clothing took up some of the slack, showing a strong increase subsequent to the ending of the Multifibre Arrangement through the WTO Agreement on Textiles and Clothing in January 2005; however, this provoked protectionist measures

by both the United States and the European Union. China's large and modern textile and garment industry expanded rapidly as its exports to the European Union increased by 40 per cent in value during the first six months of 2005.

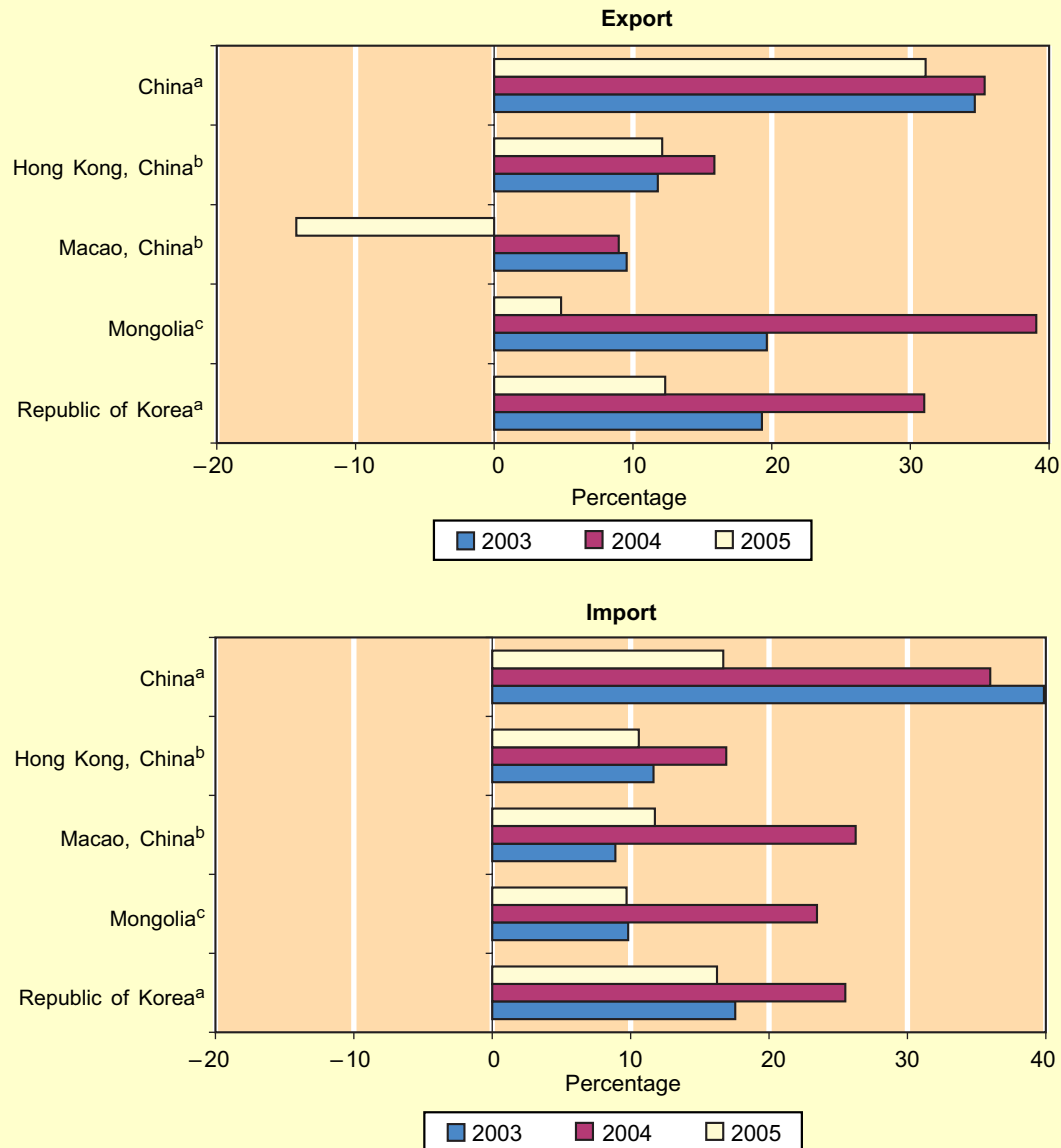
Export growth has been more durable than in other countries owing to China's diversified manufacturing base. The economy continues to expand capacity in a wide range of areas, such as steel, cement and automobiles. Remarkably, exports of automobiles exceeded imports for the first time in 2005. Automobile production reached record levels as new plants opened. Steel production, already exceeding 330 million tons, was 27 per cent higher in the first nine months of 2005 than in the previous year, with exports reaching 21.7 million tons.

Going forward, electronics exports are likely to maintain their recovery, which began late in 2005. However, textile and clothing exports will be constrained by limits agreed with both the United States and the European Union.

Import growth also slowed in 2005 from its very high pace during the previous three years. This was the result of slightly lower investment growth in the economy as well as new factories becoming operational, which allowed for greater substitution of imports. Weaker investment led to slower growth in imports of intermediate goods, which have been important in the past, such as chemicals, raw materials, equipment components and plastics.

The investment slowdown can also be seen in lower foreign investment in 2005 and reflects the Government's moves to cool the economy. Policies to temper growth have been in place since mid-2004, through monetary, fiscal and administrative measures in the steel, cement, aluminium, automobile and real estate subsectors. Once China implements all its current expansion plans in the steel industry, its imports are likely to decline drastically. This could have major repercussions for the global steel industry, which could be faced with large overcapacity and persistent weaker prices in the future.

**Figure II.6. Growth rates in merchandise export earnings and import spending in selected East and North-East Asian economies, 2003-2005**



Sources: National Bureau of Statistics of China website <www.stats.gov.cn>, accessed on 21 October 2005; Ministry of Commerce of the People's Republic of China website <http://english.mofcom.gov.cn>, accessed on 12 January 2006; Hong Kong Census and Statistics Department website <www.info.gov.hk>, accessed on 7 September 2005; Macao Special Administrative Region Government website <www.gov.mo>, accessed on 13 January 2006; Monetary Authority of Macao website <www.amcm.gov.mo>, accessed on 13 January 2006; Macao Special Administrative Region Economic Services website <www.economia.gov.mo>, accessed on 13 January 2006; Korea Development Institute website <www.kdi.re.kr>, accessed on 28 December 2005; and International Monetary Fund, *IMF Executive Board Concludes 2005 Article IV Consultation with Mongolia*, Public Information Notice (PIN) No. 05/140 (6 October 2005).

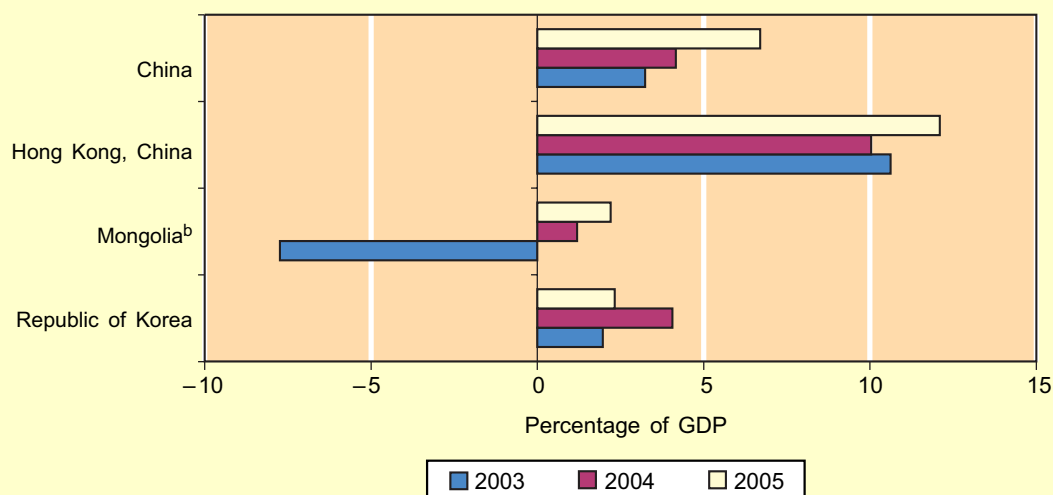
- <sup>a</sup> Growth rates for 2005 refer to January-October of that year.  
<sup>b</sup> Growth rates for 2005 refer to January-November of that year.  
<sup>c</sup> Growth rate for 2004 is an estimate and for 2005 is a projection.

The merchandise exports of Hong Kong, China, suffered a downturn in the first few months of 2005, with slower growth in the United States and in neighbouring Asian countries, though the pace subsequently improved. This led to an overall reduction in export growth for the year, from 15.9 to 12.1 per cent of 2005. Slower expected export growth for China in 2006 could have parallel effects on Hong Kong, China, which handles the bulk of China's re-exports. Textile and clothing exports, which declined with the expiration of the Multifibre Arrangement quotas in January 2005 (see box II.1), have now expanded owing to the re-export of finished Chinese goods to overcome the limits imposed on mainland companies by the European Union and the United States. A boost to export services came from implementation of the

Individual Visitor Scheme and the opening of Disneyland in September 2005, helping to attract record numbers of visitors from the mainland. The number of tourists from China to Hong Kong, China, has tripled over the past five years.

Import growth slowed in 2005, from 16.9 to 10.6 per cent. The merchandise trade deficit shrank in 2005 as export growth outstripped import growth. The deficit is expected to increase if exports improve less in the year ahead. Imports should remain strong because of robust consumption and investment in the economy. The current account surplus increased as the merchandise trade deficit was offset by the large and growing services surplus (figure II.7).

**Figure II.7. Current account balance in selected East and North-East Asian economies, 2003-2005<sup>a</sup>**



Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on national sources; Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2005* (Manila, ADB, 2005); International Monetary Fund, *Mongolia: Selected Issues and Statistical Appendix*, IMF Country Report No. 05/400 (2005); and Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2005), various issues.

<sup>a</sup> Data for 2005 are estimates.

<sup>b</sup> Current account balance includes official transfers.

### Box II.1. The new scenario for textile and clothing exports from China

The end of the Multifibre Arrangement in January 2005 had a dramatic impact on Chinese exports to developed countries. The United States saw a 60 per cent increase in Chinese textile and clothing exports and a 180 per cent increase in the newly liberalized categories, in the first three months of 2005 alone.<sup>a</sup> The European Union witnessed a 40 per cent increase in the value of Chinese textile and clothing exports in the first six months of 2005, with a 95 per cent increase in the liberalized categories.<sup>b</sup>

The size and rapidity of these changes provoked protectionist reactions in these markets. The European Union in June 2005 and the United States in November 2005 set limits with China on annual textile export growth in a number of categories. The agreement with the European Union covers "mass market" items likely to cause major disruption to European producers: pullovers, men's trousers, blouses, T-shirts, dresses, brassieres, flax yarn, cotton fabrics, bedlinen and table and kitchen linen. Growth in exports in these areas was limited to 8-12.5 per cent a year in 2005, 2006 and 2007. The limits affect a large portion of textile exports to both the United States and the European Union.

The agreement with the United States, following tougher unilateral limits in mid-year, will limit the export growth of most Chinese textile and clothing goods to 8-10 per cent in 2006, 12.5 per cent in 2007 and 15-16 per cent in 2008. The agreement also restricts growth in Chinese exports of 14 "core" apparel products by more than any quotas that could have been imposed under WTO safeguards. The limits are 5.5 per cent in 2006, 7.8 per cent in 2007 and 10.3 per cent in 2008, compared with 7.5 per cent annually under the safeguard mechanism. Products classified as core apparel include cotton knit shirts, synthetic fibre knit shirts, woven shirts, cotton trousers, brassieres and underwear.

The effects of these restrictions on the composition and direction of Chinese exports will depend on how Chinese textile producers react. They could divert production into the non-limited categories or move production bases to countries in the region in order to avoid quotas. Other textile-exporting countries in Asia have had to react to the new scenario without quotas. Some are trying to upgrade to higher value-added products. Others have asked for special consideration from the United States and the European Union. The United States has reduced tariffs by granting normal trade relations status to the Lao People's Democratic Republic and Viet Nam. The European Union has removed tariffs and duties on nearly all exports from the least developed countries.

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Sources: European Commission, "EU-China textile agreement 10 June 2005", press release dated 12 June 2005; and Office of the United States Trade Representative, "Benefits from establishing quotas on certain Chinese apparel exports to the United States", *Policy Brief*, November 2005.

<sup>a</sup> International Monetary Fund, *IMF Survey*, 23 May 2005, vol. 34, No. 9.

<sup>b</sup> European Commission, "Evolution of EU textile imports from China 2004-2005", 28 November 2005.

The export growth rate of Mongolia dropped from 39.1 per cent in 2004 to 4.8 per cent in 2005. The main negative impact was due to lower textile and clothing sales following the end of quotas under the Multifibre Arrangement. This problem is likely to persist, although there should be some improvement in exports owing to the mid-2005 Generalized System of Preferences Plus scheme with the European Union, which allowed approximately 7,200

goods to be exported to the European Union at a preferential rate. High copper and gold prices, strong tourism flows and private transfers also had a positive effect on exports. Copper exports should continue to benefit from strong demand in China, the country's main export market. However, there may be a sharp downturn in export growth going forward if the copper price falls significantly from its record levels during the year.

The value of imports increased by 9.7 per cent, mainly as a result of higher oil prices. Oil products account for about a quarter of imports. The current account may worsen in 2006 if the copper price falls or demand from China slackens, but there could also be a positive effect if oil prices stabilize or fall.

***Export growth slows in the Republic of Korea but exports of information and communication technology pick up***

The export growth rate sharply declined in the Republic of Korea, from 31.0 per cent in 2004 to 12.3 per cent in 2005. Export growth in the third quarter of 2005 marked the first upturn in five quarters. The earlier poor performance was caused primarily by low international demand for information and communication technology-related products. Those products, including semiconductors, electronic components and telecommunications equipment, account for 40 per cent of merchandise exports. Textile and clothing exports have also declined sharply following the end of the international quota system. A positive factor has been the continuing rapid increase in exports to China. The recovery in Japan could further aid exports in the future.

Despite the rise in oil prices the country saw a large drop in the import growth rate from 25.5 to 16.2 per cent. The current account balance has a surplus of about \$17 billion, but it is showing a tendency to decline. In 2006 high oil prices should continue to erode the current account balance, in view of the country's nearly total dependence on imported oil. Domestic demand, which has begun to recover, could also lead to higher imports.

*Capital flows and external debt*

***China is becoming a source of foreign direct investment***

Although China remains one of the largest destinations in the world for inflows of foreign direct investment, FDI growth into China was close to zero in 2005. This was essentially a reaction to the large quantities of investment that entered the country following the accession of

China to the World Trade Organization in 2001. The Government is also attempting to cool investment in several overheated sectors, which is making foreign investors more circumspect. FDI is likely to grow moderately in coming years. The pace could even slow further as profit opportunities diminish somewhat with greater competition and increasing labour costs. On the other hand, China is emerging as a significant outward investor, with Chinese FDI stock abroad standing at \$39 billion in 2004. The Government has provided encouragement by relaxing sector controls, streamlining procedures and easing foreign exchange restrictions.

An important investment objective for China has been to secure long-term access to foreign energy and mining assets to satisfy the country's growing demand for natural resources. Since India shares the same need, there has been cooperation in several cases between State-owned companies from the two countries in natural resource investments abroad. China is also displaying greater interest in developed country corporate acquisitions to secure new markets and acquire technologies and skills. A notable example was the takeover of the personal computer business of IBM by Lenovo. Portfolio inflows also increased during 2005 on speculation of a revaluation of the yuan. A 2.1 per cent revaluation of the currency in July was not large enough to substantially affect the real economy, although inflows of speculative funds appear to have eased as is evident in the slower growth in reserves in the second half of 2005. The country's external debt continues to be relatively small, mainly long term and easily covered by its reserves.

Hong Kong, China, in addition to its large current account surplus, experienced a strong inflow of FDI during the year. The expansion of the Closer Economic Partnership Arrangement with the mainland in January 2005, which provides tariff-free access and preferential treatment for service providers, helped to attract FDI. There has been increasing entry of mainland investors into the Special Administrative Region with many establishing regional or global headquarters. There were both large gross outflows and inflows of portfolio investment in keeping with Hong Kong, China's role as a financial



centre. The exchange rate maintained its dollar peg after the yuan's revaluation, the only remaining currency in the region to do so after Malaysia adopted a managed float in July 2005.

The balance of payments of Mongolia saw strong remittances from overseas workers, FDI in mining and continued aid flows. Studies have upgraded mineral prospects, and large mining multinationals are displaying investment interest in mineral development. Privatization of a number of companies will also help to attract FDI. External debt remains high, at around 90 per cent of GDP, but it is manageable, with most of it being concessional public sector borrowing. A prudent monetary policy is helping to maintain a stable exchange rate and prevent debt-servicing from becoming a concern.

***Portfolio inflows taper off; outward foreign direct investment from the Republic of Korea increases***

Inward direct foreign investment in the Republic of Korea was down from the previous year's unusually high level. Outward direct investment increased substantially. Inward flows were affected by energy prices, global overcapacity, and Chinese competition in key sectors such as steel, automobiles and ship-building. Outward investment has been stimulated by the increasingly globalized enterprises in the Republic of Korea and has been directed primarily towards the United States and China. Portfolio investment recorded a net deficit by mid-2005, compared with a surplus in 2004, with such investment abroad increasing steadily because of low interest rates at home. There was increased borrowing from abroad as foreigners were prepared to increase their exposure to Korean debt. Continued surpluses on the current and capital accounts led to a sharp increase in reserves to \$210 billion in December 2005, more than three times the short-term debt. In response, the Government set up an investment company in July 2005 to place some of the reserves in overseas stocks and bonds. The exchange rate strengthened against the dollar during 2005, leading to pressure on profit margins for exporters (see figure II. 8).

***Medium-term prospects and key policy issues***

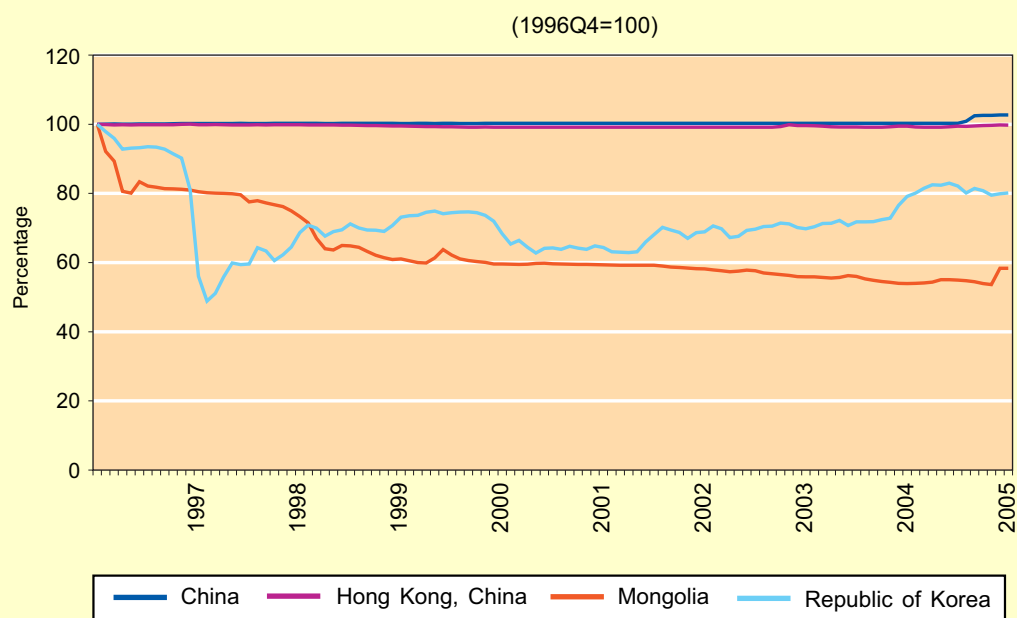
***Growth in China will moderate***

There is little doubt that the pace of economic growth and development in China will be the preponderant factor regarding medium-term prospects for the subregion as a whole. On that basis, there is a consensus that the economy of China will grow somewhat slower than it did over the last 8-10 years. Along with a slower pace of growth in investment and a shift towards services, some moderation in the growth of the country's international trade is also likely, with the growth rate of exports and imports slowing to about 15-16 per cent a year, down from average growth rates of close to 30 per cent in the last five years. These changes will have a direct impact not just on the East and North-East Asian subregion but on the entire Asian and Pacific region and on the global economy. Reacting and adjusting to what happens in China thus poses the main challenge for the other economies in the subregion in terms of trade and investment flows and financial market developments and the domestic policy issues that arise as a result.

Achieving greater flexibility in exchange rates emerged as a key policy issue in 2005. The yuan was revalued against the United States dollar by 2.1 per cent in July. This meant that the yuan would no longer be pegged to the dollar but would move in keeping with market demand and supply with reference to a basket of foreign currencies, and be allowed to fluctuate within a band of plus or minus 0.3 per cent around a predetermined exchange rate target. In the short run, the revaluation could theoretically hurt exports, employment and GDP growth but any negative impact is likely to be negligible in view of the strong competitive advantage China enjoys. Most analysts agree that in the long run an exchange rate more in line with market conditions could benefit the Chinese economy by producing a positive impact on China's terms of trade, export pattern and allocation of resources. In addition, it would provide the authorities with another instrument for policy transmission.



**Figure II.8. Index of exchange rates against the United States dollar in selected East and North-East Asian economies, 1996-2005<sup>a</sup>**



Sources: International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2005); and *The Economist*, various issues.

<sup>a</sup> Data for 2005 are estimates.

Combined with its spectacular economic growth, China has managed to drastically reduce the incidence of income poverty from 33 per cent in 1990 to 17 per cent in 2001. More than 160 million people have been taken out of poverty. Thus, China has continued to make steady progress in reducing poverty, indicating that it is well on its way to achieving this important Millennium Development Goal. In recent years, however, concerns about growing income inequality and regional disparities have mounted as the country's economy has become technologically more sophisticated and earnings in manufacturing have risen rapidly, especially for those possessing useful skills. As a result, the bottom 25 per cent of the population accounted for only 4.7 per cent of total consumption in 2001.

### ***China plans to create a more harmonious society***

Policy attention has accordingly shifted towards a more balanced model of economic

growth so that groups and regions left behind by the rapid growth of the Chinese economy would enjoy more benefits from the country's progress in coming years. The draft eleventh five-year plan for economic development, approved by the National People's Congress in October 2005, set the stage for the most important national economic and social development blueprint for the next five years (2006-2010). The plan focuses on improving the quality of growth to create a more harmonious society. Three broad areas are identified for policy attention: improving efficiency, raising technological standards and narrowing the income gap between the rich and the poor and between cities and the countryside.<sup>1</sup> Public spending on social protection and rural

<sup>1</sup> International Monetary Fund, *People's Republic of China: 2005 Article IV Consultation – Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion*, IMF Country Report No. 05/411 (Washington, D.C., IMF, 2005).

areas has begun to rise, but major initiatives are needed in the short term.

For Hong Kong, China, several policy issues seem to be gaining importance. Maintaining investor confidence is the key as the economy is the premier financial centre in the region and its prosperity is strongly linked to how investors and users of its services perceive policy changes and the functioning of the Government, particularly moves towards greater democratization and popular participation in decision-making. The fiscal deficit and the accumulation of public debt need attention as they conflict with the low tax regime that Hong Kong, China, has traditionally enjoyed. The Hong Kong, China, government expects to restore fiscal balance in 2008-2009.

Another issue concerns administrative changes and policy continuity. Under the "Strong governance for the people" policy, the Chief Executive announced several administrative changes on 12 October 2005, including the reorganization of the Chief Executive's Office to increase its effectiveness. The size of the civil service would continue to be reduced in order to maintain a small government. Plans have been announced to recruit more talented professionals from the mainland and abroad. Professionals would be allowed to stay in Hong Kong, China, without having to have a prior job offer. The Hong Kong, China authorities expect to sustain the pre-eminent position of the economy as a regional financial and commercial centre through these means.

Significant challenges faced by Mongolia are to increase the value added in its mining sector and to diversify into new export areas. Greater value added domestically in mining would provide increased employment opportunities. Moving up the value chain from raw material exports, such as through the establishment of smelters and refineries, would require investment in capital and technology. This may be achieved by greater foreign investment in the sector. The country relies on a narrow range of export products, with minerals, cashmere and textiles accounting for more than 80 per cent of exports. Further development of tourism services could diversify foreign earnings. There has been growth in the sector over the past few years, although visitor numbers are still low. The coun-

try possesses attractive adventure and cultural opportunities. To fully benefit from these advantages, the general tourism infrastructure needs improvement.

***Oil prices and appreciation of the won  
are the main policy issues***

After successfully negotiating post-Asian financial crisis-related challenges and regaining strong growth momentum in the last two to three years, the economy of the Republic of Korea is expected to face two broad policy issues as it enters 2006. First, as an energy importer, high and volatile global oil prices pose considerable risks for the economy. High oil prices could cause aggregate demand in the economy to contract, with possibly severe implications for GDP growth. High oil prices could also affect global demand for exports from the country, adversely affecting its growth prospects. Second, dollar interest rates are on the rise; this could put upward pressure on Korean interest rates, putting downward pressure on housing prices. Higher interest rates could lead to a sharp contraction in new construction activity, with significant downstream effects. The large current account imbalances in the global economy suggest that significant exchange realignments should take place over the medium term. The won already appreciated by nearly 5 per cent against the dollar in 2005. Any further appreciation could undermine export competitiveness, particularly in the information and communication technology industry.

## **North and Central Asia**

### **Overview**

***The subregion enjoyed the seventh  
successive year of GDP growth***

The countries of North and Central Asia experienced the seventh successive year of GDP growth in 2005, the longest sustained expansion since the beginning of their transition to a market-based system in 1992. Positive GDP growth was recorded virtually across the subregion in 2005. The growth performance of the countries, with the exception of Kyrgyzstan, remained strong as a result of high export com-