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THIS MONTH'S EXCLUSIVES ►►

HONG KONG – The Danger Of A Banking Collapse

Residential property prices in Hong Kong have dropped 65% since 1997, mortgage lending is falling and loan delinquency rates rising. **BMI View:** Hong Kong is in danger of falling into a period of shallow cyclical stagnation, with the property market accounting for most of the blame. The banking sector is vulnerable. The government has taken several wrong turns to boost the property market, and a long-term slump could prove to be the downfall of the banks.

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SOUTH KOREA – Why The North Must Reform

It is hard to gauge the true extent of economic reform going on in North Korea, but recent rumours do suggest the North is, at the very least, contemplating the idea of economic change. **BMI View:** Policymakers in Seoul must act to prevent a collapse of the North's economy, as the bill would land on the South. Foreign direct investment is the best way to achieve this outcome, but special economic zones present a more likely solution. Even this could prove tricky.

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REGIONAL INDICATORS

	2000	2001	2002f	2003f
Real GDP Growth, % y-o-y				
China	8.0	7.3	7.8	7.4
Hong Kong	10.2	0.7	1.4	2.4
Taiwan	5.9	-2.2	3.2	5.0
South Korea	9.3	3.0	5.2	6.8
Inflation, % y-o-y*				
China	0.3	0.3	-0.5	1.8
Hong Kong	-3.8	-1.4	-2.8	-0.1
Taiwan	1.3	0.0	0.1	2.0
South Korea	2.3	4.1	3.5	4.0
C/A Balance, % GDP				
China	1.9	1.5	1.9	0.9
Hong Kong	5.4	7.3	5.8	4.9
Taiwan	2.7	6.3	5.8	6.8
South Korea	2.7	2.0	1.2	0.5

f = BMI forecast. *consumer price inflation, for Hong Kong it is calculated from the composite CPI. Sources: National Central Banks/National Statistical Bureaux/BMI.

FEATURE ARTICLE

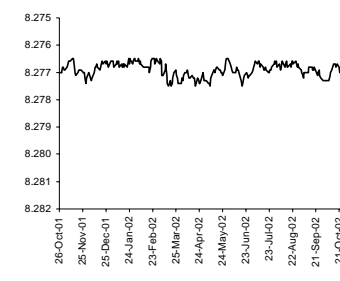
China's Leader Fêted In The US

President Jiang Zemin's visit to the US in October brought few surprises. **BMI View:** It did however, increase his political standing at home, possibly paving the way for him to hold on to his position as head of the Central Military Commission.

Chinese President Jiang Zemin travelled to the US in late October to attend a presidential summit with US President George W Bush at his ranch in Texas. The summit lasted only a few hours over lunch as several commercial contracts were finalised in the preceding days, and China appeared to make some progress on the sensitive issue of weapons proliferation. But while the summit was largely symbolic, a major conflict of interests still exists. Beijing made only a token attempt to improve its human rights record with the release of two political prisoners. This hardly signifies any improvement in Chinese policy. Moreover, the host of commercial deals signed in the run-up to the visit is nothing new. China has used similar tactics before previous presidential meetings, a fact the US is well

..... CHINA - CONTINUED ON PAGE 2

China: Offshore Trading But Tighter Control

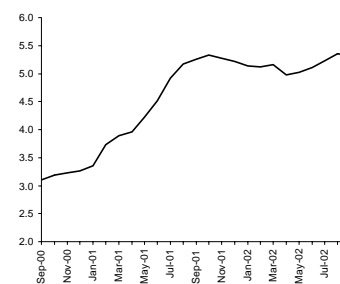


Exchange rate – CNY/US\$, inverted scale. Source: Reuters.

China has announced plans to allow offshore local-currency trading in neighbouring Hong Kong. This is, however, unlikely to signal an increased willingness to introduce capital-account liberalisation. Moreover, it may well allow China to exercise tighter control over the funds already known to leak out of the mainland.

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Taiwan: Unemployment Edges Down



Unemployment rate – %; Source: DGBAS.

Taiwan's unemployment rate edged down in September after reaching a high of 5.35% in August. The increase in GDP growth expected in H2 2002 should ensure unemployment continues to ease during the coming months. However, weak foreign investment may tempt employers to postpone hiring.

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Political Risk – Success In The US

- President Jiang Zemin's summit with US leader George W Bush at his ranch in Texas in late October brought few surprises. With terrorism firmly at the top of the US' current agenda, the issue of China's missile exports will remain a sticking point for some time ahead. China has made some effort to regulate and limit missile exports lately, but these have not been enough to satisfy the US. Nevertheless, the visit gave a significant boost to Jiang's domestic standing.

Our short-term political rating is static at 70.0 awaiting the outcome of the Communist Party congress scheduled to begin in November.

Economic Risk – Exports Fuel Growth

- China continues to be one of the fastest-growing economies in the world with real GDP up 8.1% year-on-year (y-o-y) in Q3 2002. Booming exports and strong state investment were once again the key drivers to growth. Although spending restrictions mean government investment must soon be reined in, the external boost looks set to continue. China is increasingly moving up the value-added ladder as massive

foreign investment leads to an improvement in technology. This should further increase China's export base. BMI has revised its 2002 real GDP forecast to 7.8% (from 7.5%).

Our short-term economic rating remains static at 83.0 despite the slight improvement in the outlook for this year.

Business Environment – Piracy Problems

- Comments by the staff of US software giant **Microsoft Corp** have put China's piracy laws back into the spotlight. In a piracy factsheet published by Microsoft in May 2002, China was cited as having the world's second highest piracy rate at 94%. More recent data compiled by industry watchdog **Business Software Alliance** suggest that global piracy is still rising with Asia as the main area of concern, according to Microsoft's senior corporate lawyer, Katherine Bostick. With US\$750mn committed to China's software industry earlier in the year, Microsoft will be keen to see tougher laws introduced. There is no guarantee this will happen.

Our business environment and composite ratings are static at 62.6 and 76.2 respectively.

All ratings are expressed as a number between 1 and 100. A high rating is an indicator of low risk. BMI's Risk Ratings source historical data and forecasts from BMI's Emerging Markets Online Service. For full access please contact Rob Anderson on +44 (0)20 7557 7171 or email randerson@businessmonitor.com, or see www.emerging-markets-online.com

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aware of. While the commercial deals are welcome, bringing new investment into China, the main benefit is a boost to Jiang's domestic political standing.

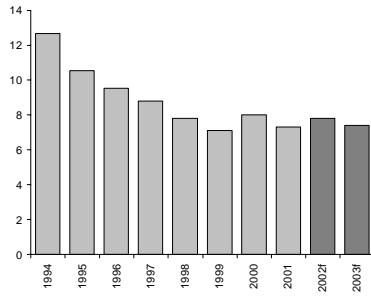
Telecommunications, oil, brewing and engineering were the main industries benefiting from commercial deals signed in the run-up to the presidential summit. The main deal was a framework agreement for a US\$3bn project between US **Exxon Mobil** and **China Petroleum and Chemical Corporation** (Sinopec). The deal should push forward joint projects in China's Fujian and Guangdong provinces to increase the nation's refining capacity. Another lucrative project was signed between US firms **Lucent Technologies** and **Motorola**, and **China United Telecommunications Corp**. While these contracts were largely part of earlier projects, and do not represent new deals as such, they are still being welcomed by both countries. The US is concerned with its increasing trade deficit with China. The US runs a larger trade deficit with China than any other nation, causing a huge outflow of US dollars into China. Nevertheless China provides low-cost goods and access to a cheap manufacturing base, both of which are important given the current weakness of the US economy. While Chinese exports to the US provide an important source of growth for the Chinese economy, it does leave China increasingly vulnerable to a slowdown in demand in the US. Stable economic relations are therefore important to both sides.

Despite these trade deals, US-China relations will continue to be plagued by the interrelated issues of Iraq, North Korea and weapons proliferation. China has made several attempts to curb its missile exports lately, although the US still remains sceptical about Chinese compliance on the issue. Prior to Jiang's visit to the US, China announced that major missile export projects would have to be approved by the cabinet and central military commission. This followed an announcement in August that set limits on exports of missile-related technologies. The US has slapped sanctions on several Chinese firms for supplying missiles to countries such as Iran in the past, and it will need concrete evidence of China's compliance before concessions (such as allowing US firms to launch satellites on Chinese rockets) are made. But China's growing requirement for imported energy poses a policy dilemma for the government. China imports around half of its oil from the Middle East, and Iran and Iraq are particularly important suppliers. Iran is now China's largest import source, accounting for around 30% of total Middle East imports, and China is eager to strengthen commercial links with Iraq. Chinese oil giant, Sinopec Corp, owns a 50% stake in an Iraqi oil field, although United Nations sanctions have prevented development and exports from this investment.

Despite little substantive development from the presidential summit, as only the fourth world leader to visit Bush's Texas ranch, Jiang's domestic political standing has been significantly heightened. With China's five-year Communist Party Congress scheduled to convene in early November, this is well-timed for Jiang. It is, however, unclear how he will use this to

Economic Outlook Improving

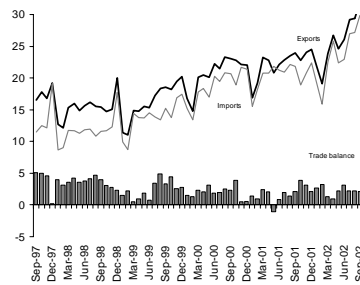
Real GDP – change, % y-o-y



Sources: State Statistical Bureau, BMI.

Exports Reach Record Levels

Merchandise trade – US\$bn



Source: State Statistical Bureau.

BMI FORECAST SCENARIO

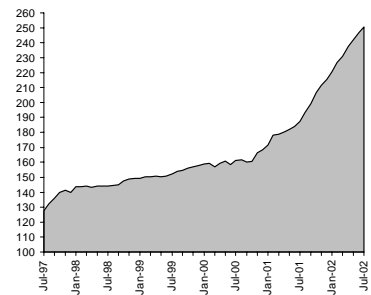
China's economy continues to soar. Booming exports and vast state spending are managing to offset the effects of rising unemployment. After rampant growth of 28.7% in Q3 2002, export growth should begin to slow. And imports are now outpacing exports, up 29.7% y-o-y in Q3 as the strong domestic economy sucks in raw materials. The benefits to growth from net trade are therefore likely to fall in 2003.

Consensus View: A poll of five western banks plus the Asian Development Bank and IMF gives a consensus forecast for real GDP growth of 7.6% and 7.3% for 2002 and 2003 respectively. BMI expects growth of 7.8% and 7.4% during the same period. Our slightly rosier outlook for 2003 is based on only a slight slowdown in growth in Q4 to 7.5%, as trade continues to prop up the economy for now.

Government View: The government is committed to maintaining growth above 7.0%. This target should easily be achieved during the forecast period.

Reserves Continue To Soar

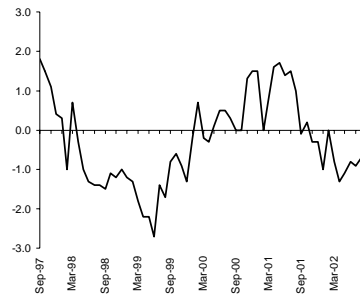
Foreign exchange reserves – US\$bn



Source: IMF.

Persistent Deflation

Consumer price index – change, % y-o-y



Sources: Reuters, State Statistical Bureau.

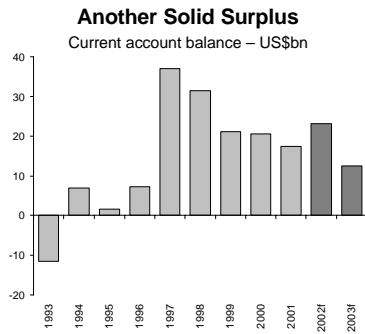
	1997	1998	1999	2000	2001e	2002 Latest period		2002f	2003f
Population (bn) ¹	1.24	1.25	1.26	1.27	1.27	-	-	1.29	1.30
Nominal GDP (US\$bn) ^{2,4}	903.5	964.5	991.2	1,080.0	1,162.2	-	-	1,247.1	1,358.0
GDP per capita (US\$) ^{1,2,4}	730.8	772.8	787.2	853.2	913.6	-	-	969.6	1,045.4
Real GDP growth (% y/y) ²	8.8	7.8	7.1	8.0	7.3	7.9	Jan-Sep	7.8	7.4
Oil production (mn b/d) ³	3.19	3.20	3.19	3.22	3.25	3.30	Mar	3.28	3.38
Fixed Asset Investment (% y/y) ¹	8.8	14.1	4.9	10.3	12.0	21.8	Jan-Sep	11.0	8.0
Industrial production (% y/y) ²	13.2	9.6	9.8	11.2	9.9	12.2	Jan-Sep	10.0	11.0
Consumer prices (% y/y, period avg) ¹	2.8	-0.8	-1.4	0.3	0.3	-0.8	Jan-Sep	-0.5	1.8
Consumer prices (% y/y, eop) ²	2.8	-1.0	-1.3	1.5	-0.3	-	-	1.8	1.8
Lending rate (% y/y, eop) ²	8.64	6.39	5.85	5.85	5.85	5.31	Jun	5.35	5.35
CNY/US\$ (eop) ²	8.30	8.28	8.28	8.28	8.28	8.28	28-Oct	8.28	8.45
CNY/US\$ (period avg) ²	8.29	8.28	8.28	8.28	8.28	-	-	8.28	8.30
Merchandise exports (US\$bn) ²	182.88	183.59	194.90	249.30	266.16	232.61	Jan-Sep	310.61	341.67
Merchandise imports (cif, US\$bn) ²	142.19	140.31	165.80	206.13	243.61	212.49	Jan-Sep	280.15	320.49
Trade balance (customs, US\$bn) ²	40.69	43.28	29.10	43.17	22.55	20.12	Jan-Sep	30.46	21.18
Current account (US\$bn) ²	36.96	31.47	21.12	20.52	17.42	13.63	Jan-Jun	23.15	12.52
Current account (% GDP) ^{2,4}	4.1	3.3	2.1	1.9	1.5	-	-	1.9	0.9
Foreign reserves (US\$bn) ^{* 2}	142.76	149.19	157.73	168.28	215.61	250.5	Jul	260.50	270.00
Import cover (mths) ^{** 2,4}	10.4	10.9	9.9	8.1	9.2	-	-	9.7	8.8
Government balance (US\$bn) ¹	-6.4	-7.0	-11.1	-21.1	-30.1	-	-	-37.4	-39.3
Government balance (% GDP) ^{1,4}	-0.8	-0.8	-1.2	-2.1	-2.8	-	-	-3.0	-2.9
External debt (US\$bn) ¹	130.96	146.04	151.83	145.73	170.10	-	-	180.00	190.00
External debt (% exports) ^{1,4}	60.0	67.1	64.7	48.7	53.4	-	-	49.1	47.1
External debt (% GDP) ^{1,4}	14.5	15.1	15.3	13.5	14.6	-	-	14.4	14.0

e/f = BMI estimates/forecasts (bold). eop = end of period; * excluding gold, ** no. of months imports covered by FX reserves. Sources: ¹ China Statistical Yearbook, ² IMF, ³ Petroleum Economist, ⁴ BMI Calculation.

* (margin) Consensus forecasts based on data from the following institutions: Asian Development Bank, Deutsche Bank, Goldman Sachs, ING Barings, IMF, JP Morgan, Lehman Brothers.

ECONOMIC OUTLOOK

China has announced plans for an offshore trading centre for its local currency, probably in Hong Kong. **BMI View:** This could increase Beijing's control over currency outflows.



f = BMI forecast. Sources: IMF, BMI.

his advantage. Given earlier signs of reluctance to stand down from his position as number one in Chinese politics, Jiang may well use this international standing as reason to hold onto his position as head of the central military commission. This would give Jiang significant influence over future foreign policy.

More Restrictive Liberalisation

China has announced plans to allow offshore trading of its local currency, the yuan (or renminbi). Currently the yuan is convertible only on the current account, meaning that foreign currency can be exchanged for payment of goods and services only. Chinese officials have stated their willingness to allow exchange for financial transactions (capital-account liberalisation) and to widen the trading band of the yuan, although they appear in no hurry to do either. The yuan trades in a tight band against the US dollar of CNY8.276-8.280/US\$, a mechanism that has been in place since 1996. **BMI** expects China to widen the yuan's trading band by late-2003 at the earliest, although we expect only a 2% depreciation in 2003 (measured on an end-of-period basis). A token gesture towards greater currency flexibility, including allowing offshore trading in Hong Kong, is unlikely to speed up the process of capital-account liberalisation. The Chinese government will be able to keep a tight rein on foreign currency transactions as China's main state-owned bank, **Bank of China**, is well established in Hong Kong, and settlements would likely take place here. Moreover, the slow pace of banking reform is a significant hurdle in the way of capital account liberalisation. And a reversal of the recent trend of strong demand for local currency appears likely over the coming quarters, leaving officials fearful of a depreciation.

China recorded a current account surplus of US\$13.63bn in H1 2002, some 167.3% above the level in the same period a year ago, according to figures released by the State Administration of Foreign Exchange (SAFE) in late October. This leaves our full-year forecast of a US\$23.15bn surplus on track, a significant improvement from the US\$17.42bn in 2001. The H1 current account surplus was boosted by a visible surplus (goods) of US\$20.72bn, while services recorded a slight deficit of US\$4.33bn. This significant inflow of funds has boosted China's foreign-exchange reserves. Reserves increased by US\$30.60bn in H1, according to SAFE, and by another US\$15.84bn in Q3. While the merchandise trade performance in Q3 does suggest another healthy surplus on the goods account in H2, imports are beginning to outpace exports. Q3 merchandise exports expanded 28.7% year-on-year, slightly slower than the 29.7% growth in imports during the same period, and we expect this trend to continue into Q4 and 2003. **BMI** expects the current account surplus to narrow to US\$12.52bn in 2003, as imports outpace exports. This increased demand for dollars will exert downward pressure on the yuan.

A more open capital account could put even more downward pressure on the currency. China already attracts a huge amount of capital inflows but imposes strict restrictions on outflows, of both foreign and domestic funds. Given the lack of opportunities Chinese individuals have to invest their savings (other than as deposits at state-owned banks), capital account liberalisation would have to ensure that funds did not pour out of China in search of better returns elsewhere. China has the highest savings rate in the world after Japan, estimated at 30-40% of total GDP, but this huge quantity of savings is mainly invested in unprofitable state enterprises, leaving banks with little profits to enable them to offer higher returns. Currently the country's four state-owned banks hold around 70% of total deposits, and while China must allow foreign firms access to the industry by 2006, becoming a dominant firm in China's banking industry will be no easy task. Country-wide branch networks will be hard to establish given China's large rural population, and foreign banks will still face restrictions on the number of branches they are permitted to open. In addition, a significant capital base is required, excluding many banks from the outset. Apart from in the prosperous cities of Beijing, Shanghai and a few others, Chinese consumers will still have to invest their savings in state-owned banks for some time ahead. They would therefore have a great incentive to move their funds overseas after capital account liberalisation.

Despite the tight restrictions governing capital outflows currently in place, a significant amount of funds are known to leak out of China. Net errors and omissions on the balance of payments amounted to around US\$9bn in 2001, and although lower than the US\$12bn in 2000, this is still a vast amount of unaccounted outflows. By establishing an offshore trading centre in Hong Kong, China may in fact reduce this problem. Hong Kong is one of China's main trading partners and sources of foreign direct investment. As such, there is a large demand for Chinese currency there. Offshore trading in Hong Kong would mean the mainland may well be able to exercise tighter control of capital outflows, while appearing to liberalise.

China Telecom: Time To Engage?

With shares in China's dominant landline operator **China Telecom** due to start trading in Hong Kong and New York in early November, with the initial public offering (IPO) targeted to raise nearly US\$3.7bn, it is little surprise that the firm has taken the advice of underwriters, and increased its proposed dividend yield to 33% of profits, from 20%. Equally, a decision to reduce the flotation price to HKD1.48-1.71, from an initially envisaged HKD1.59-1.87, is sensible, given poor investor appetite for telecom stocks, which has seen mobile firms **China Mobile** and **China Unicom** lose 32% and 49% of their respective values this year.

Encouragingly, the more conservative plans for China Telecom mean that the lower share price will be below the 2003 forecast earning ratios for China Mobile and China Unicom. Meanwhile, in a further bid to improve the attractiveness of the offering, the authorities have pledged to maintain local telephone tariffs at current levels for at least the next three years. Given that over 70% of the operator's revenue is dependent upon the tariff policies of the government, this promise provides reassurance to potential investors, building confidence that a US\$1.99bn 2003 profit forecast is achievable, on the back of US\$1.03bn in H1 2002. Indeed, this projection appears reasonable given that landline connections are increasing rapidly, with the firm expecting to add another 8mn subscribers in 2002, and 7mn a year between 2003 and 2006.

Confidence is also bolstered by the mainland's rapid GDP growth which **BMI** expects to reach 7.8% this year, despite stagnation in the Eurozone and Japan, alongside the possibility of a further weakening of the US economy during the coming months. In fact, this may even force more cost-conscious multinational firms to relocate production facilities in China, given its low-cost labour force. Recent FDI figures lend weight to this assertion. While South Korea saw FDI nearly halve year on year to US\$589mn in September, inward investment to China is still rising, with **BMI** forecasting US\$52bn for 2002, after US\$46.8bn in 2001. Yet, while the all this adds up to a compelling fundamental long-term investment case for China Telecom's shares, the fact is that global equity markets remain stuck in a bear-trend, and, we would not reassess our negative overall outlook unless the Dow Jones improves decisively. As such, unless the current bounce can manifest itself into a more durable rally, the underwriters (which include **Morgan Stanley** and **Merrill Lynch**) may find themselves holding unwanted stock, in the same way as **Goldman Sachs** was forced to support **Bank of China's** IPO in September.

Stability In China

In line with its more defensive regional strategy, **JP Morgan** has upped China to overweight from marketweight in the JP Morgan Asia Credit Index, expressing this view by increasing exposure to the sovereign US\$ '11 bond. Indeed, a strong domestic bid from onshore financial institutions has shielded China's dollar bonds from the worst of the recent market volatility, whilst improving macroeconomic fundamentals, in contrast with elsewhere in the region, are giving underlying support. Furthermore, Chia-Liang Lian, Asia sovereign strategist for Morgan, in Singapore, remains optimistic that the pragmatic approach towards policymaking will continue with a new political leadership, which is expected to be announced at the forthcoming National Congress of the Chinese Communist Party (CCP) on November 8. Even so, there is still much uncertainty surrounding the succession process. Chia-Liang Lian points out that the President's future political role is very much in question. "Reports, from both local and foreign sources, have so far sent conflicting signals as to whether Jiang will indeed relinquish all three influential leadership positions he currently holds: as the country's President, Chairman of the Central Military Commission (CMC), and General Secretary of the CCP." That said, Chia-Liang stresses that, despite the often-opaque political manoeuvrings, he still sees a high likelihood of an outcome that leads to a relatively smooth transition with a minimal de-stabilising impact on the market.

Chia-Liang believes that Jiang will relinquish the presidency and secretariat of the CCP, but will probably stay on for at least one year as Chairman of the CMC. **BMI** agrees. Chia-Liang also stated that "His (Jiang's) continued tenure will offer a critical link between the CCP and the military, suggesting that the President's continued political presence may in fact be interpreted as an anchor of socio-political stability." As a result, major changes in overall economic policy are unlikely going forward. With Vice President Hu Jintao anticipated to take over as General Secretary of the CCP, it would seem that preserving social stability will remain high on the transition agenda. Isolated reports of labour unrest reinforce the need to balance the twin objectives of liberalising markets and providing a social safety net for those displaced in the process, concludes Chia-Liang.

CAPITAL MARKETS

Underwriters are doing all that they can to make the planned listing of China Telecom attractive to investors. **BMI View:** With global stock markets still largely stuck in bear-trends, they may still wish that the listing was taking place rather later than November.

CAPITAL MARKETS

Investment banks are giving the all-clear for investors to increase their holding of Chinese debt. **BMI View:** This stamp of approval has much to do with greater certainty about political stability in China.

Political Risk – A Tougher China

- Hong Kong is at risk, at least in concept, of suffering a sudden political squeeze from China. In November China will get a new leader: most likely the low-profile Hu Jintao. Little is known about his political leanings. He may decide to ditch China's policy of allowing Hong Kong a high degree of freedom. He may even scrap the part of Hong Kong's constitution that says the city can aim for universal suffrage in elections after 2007. But this is unlikely.

Elections in China are unlikely to produce a big shift in policy on Hong Kong, hence our short-term political rating remains at 80.0.

Economic Risk – A Bankrupt Recovery

- Hong Kong shows few signs of emerging from its cyclical economic slump. In October the government announced that more than 17,000 people declared bankruptcy in the first nine months of 2002, nearly three times as many as the same period last year. Deflation is rife and unemployment remains near a record high. The saving grace is exports. They are rising healthily thanks to Hong Kong's re-export

trade with China's booming economy. This trade is one of the few things preventing Hong Kong from tipping into recession. Direct links between China and Taiwan, which are becoming an increasing possibility could, however, cut this trade boom short.

Exports are blunting the worst of Hong Kong's economic problems for now, hence our short-term economic rating stays at 62.0.

Business Environment – Borrowing Costs

- Hong Kong companies are at risk of seeing their borrowing costs jump higher. In October **Standard & Poor's**, an international rating agency, said the chances were growing that it would have to downgrade Hong Kong's long-term local-currency credit rating. It said it was worried about Hong Kong's widening budget deficit and about declining confidence in the city's pegged exchange rate. A downgrade would make it more expensive for Hong Kong's government, as well as firms, to borrow money.

Our business environment rating stays at 84.2, while our short-term composite rating remains at 70.4.

All ratings are expressed as a number between 1 and 100. A high rating is an indicator of low risk. BMI's Risk Ratings source historical data and forecasts from BMI's Emerging Markets Online Service. For full access please contact Rob Anderson on +44 (0)20 7557 7171 or email randerson@businessmonitor.com, or see www.emerging-markets-online.com

ECONOMIC OUTLOOK

Hong Kong's slumping property market remains a fairly painless problem for local banks. **BMI View:** This cannot last. The property market is structurally flawed and as time goes on these flaws will pose ever-bigger financial problems.

The Next Big Threat To Banks: Property

There can be little doubt that Hong Kong's property market is in a bad way. Residential property prices have slumped 65% since 1997. In August, mortgage lending for new homes dropped 16%. Property prices are likely to fall another 5-10% during the next 12 months and office rentals are likely to plunge 10-20%, says **Standard & Poor's**, an international credit-rating agency. Things could hardly be worse. The odd thing is that Hong Kong's banks seem unharmed. The drop in lending and rise in mortgage delinquencies have had little effect.

Banks are not only flush with cash, but savings are high and capital-adequacy ratios (used across the world as a measure of the strength of the safety nets that banks build to protect themselves against credit crunches) are more than double the usual prudential minimum of 8%. Predictions of a banking crisis are given short shrift. But they should not be. **BMI** believes problems for the banking sector will mount. The property market is unlikely to recover for at least another year. Banks are not prepared for a long-term slump.

Hong Kong banks are familiar only with short, sharp swings in the property market. In the past two decades there have been at least three episodes of annual property-price rises of more than 20% and two episodes of drops of a similar size. Elsewhere, most economies during the same period have experienced just one period of rising prices followed by one period of falling prices. Hong Kong is clearly different. It experiences booms and busts with dramatic frequency. No surprise, then, that many banks are expecting an early end to the current downturn. The same was true of Japanese banks in the early 1990s when faced with a post-bubble drop in house prices. Banks expected a sharp turnaround. Japan has now suffered average annual price declines of 10% for more than a decade.

Hong Kong is unlikely, according to **BMI** analysis, to sink into the same structural economic quagmire that has kept Japan in or near recession for the past 12 years. But a long, shallow period of cyclical stagnation in Hong Kong is a real possibility. Much of the blame for this stagnation will go to the housing market. It suffers from long-term problems that the government is failing to address and that will, without change, become only worse.

Bad loans are one reason why the real-estate market will stay on its sickbed. Non-performing loans as a share of total loans are low (about 5%) but not low enough. Quicker corporate restructuring and dispersal of bad loans would improve liquidity in the property market. As would stricter loan classification by banks. A better help to revitalising the housing sector would, however, be provided by opening up the structure of the real-estate industry. At present it is one big cartel. New entrants face prohibitively high land costs, financing problems (since they have no track record in the business), and less bargaining power in hiring professionals and contractors. These barriers to entry need to be lowered. Hong Kong needs to encourage new methods of real-estate securitisation similar, perhaps, to the real-estate

investment trusts, or REITS, that exist in the US. The result would be to attract new investment into the property industry.

Regulatory limitations on land use are, like bad loans, doing little to encourage recovery in the property market. Land use remains under tight government control (until 1985 the government had sole control the supply of new land for development). But there is still a considerable amount of undeveloped and inadequately used land. Zoning regulations and building codes should, for a start, be further liberalised.

The government has so far taken many wrong steps. It has capped the supply of public housing and suspended land sales. These will, if they work at all, have no more than a temporary effect on the property market. A longer-term strategy is needed in order to save Hong Kong's banking sector from a fall.

Medium-Term Threat To Currency Increases

It will be difficult to reverse the current lack of confidence in the peg, especially with deflationary pressure continuing. Any speculative attack on the currency would likely be defeated, but the longer-term decline in domestic confidence will pose a greater threat. The possibility of a cut in US interest rates will offer support, although competitiveness has weakened due to a decline in regional currencies. The HKD7.80/US\$ peg should survive in the short term.

Peg Confidence Weakens Significantly – Confidence in Hong Kong's currency peg has continued to decline. Deflation remains entrenched, with consumer prices falling 3.3% in the year to August. Prices have fallen for the past 46 months and property prices are also declining. Speculation over a policy change was also fuelled by rumours of an official report into alternatives, causing temporary pressure on the peg. The Hong Kong Monetary Authority (HKMA) has issued a strong defence of the peg although its strident tone appeared to indicate underlying vulnerability.

HKMA Still In A Strong Position – Foreign exchange reserves fell to US\$111.2bn at the end of September from US\$112.3bn in August. Despite this there is still a relatively low risk of heavy speculation as the HKMA can easily defend the peg and speculators will find it difficult to pursue an attack for long. Reserves are still substantially higher than the monetary base which will provide strong protection to the currency regime. The greater risk is that domestic individuals and companies will start to hedge more aggressively against currency risk.

Pressure For Improved Competitiveness – There has been a slight deterioration in the competitive position, with the Hong Kong dollar strengthening against regional currencies since the middle of 2002. Studies suggest that the currency is probably overvalued by around 20% although estimates vary widely. Any move by the Chinese authorities to float the yuan would also increase the pressure for Hong Kong dollar flexibility. A widening of the yuan's trading band is not expected by end-2003 at the earliest.

	2000	2001	2001-02 Latest Period		2002f	2003f
Population (mn) ¹	6.67	6.76	-	-	6.79	6.85
Nominal GDP (US\$bn) ¹	165.17	172.47	39.42	Apr-Jun	166.27	163.95
GDP per capita (US\$) ^{1,2}	24,782	25,645	-	-	24,505	23,935
Real GDP growth (% y/y) ^{1,2}	10.2	0.7	0.5	Apr-Jun	1.4	2.4
Retail Sales Value (% y/y) ³	3.8	-1.2	-4.2	Aug	-2.6	0.8
Retail Sales Volume (% y/y) ³	8.1	1.2	-2.9	Aug	0.2	0.9
Annual inflation (CPI, %, period avg)* ³	-3.8	-1.4	-3.0	Jan-Sep	-2.8	-0.1
Unemployment (3mma, %) ³	4.9	5.1	7.4	Jul-Sep	7.9	7.2
Prime rate (% pa) ³	10.0	7.0	5.125	28-Oct	6.0	6.5
HK\$/US\$ (eop) ¹	7.80	7.80	7.80	28-Oct	7.80	8.30
Exports (fob, US\$bn)** ¹	201.86	189.90	145.57	Jan-Sep	199.00	215.00
Imports (cif, US\$bn) ¹	212.81	203.00	151.83	Jan-Sep	213.00	231.00
Trade balance (US\$bn) ¹	-10.95	-14.00	-6.26	Jan-Sep	-14.00	-16.00
Foreign reserves (US\$bn, eop)*** ¹	107.54	111.16	112.49	Jul	115.00	110.00

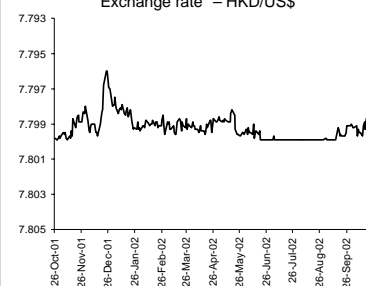
f = BMI forecast (bold). *composite index; **exports comprise re-exports and domestically produced exports; ***excluding gold. Sources: ¹ IMF, ² BMI, ³ Census and Statistics Department.

CURRENCY OUTLOOK

Confidence in Hong Kong's currency peg has continued to deteriorate. **BMI View:** This is unlikely to ease until deflationary pressures subside. Even then, longer-term policy may still be on the cards.

No Change In The Short Term

Exchange rate* – HKD/US\$



*inverted scale. Source: Reuters.

BMI FORECAST SCENARIO

Hong Kong is suffering many of the symptoms associated with a structural economic downturn. Deflation is rife, unemployment is at a record high and growth appears to be no more than negligible. But these problems are not, according to BMI analysis, structural. They are mostly cyclical, and as such will disappear once Hong Kong enters a more solid phase of recovery. Admittedly, speculation will continue to mount about Hong Kong being forced to ditch its currency peg. This is only natural. The government is under pressure to increase spending. The worry is that if spending is raised the government will not be able to afford to prop up the peg. But BMI believes the peg is sustainable. Spending is unlikely to soar. And in any case, Hong Kong has the reserves to defend its currency.



Political Risk – A Change Of Semantics

- A recent move by Beijing to de-politicise the issue of re-establishing direct links between China and Taiwan does mark an improvement in cross-strait relations. While the “one China” hurdle (the acceptance of eventual reunification with the mainland) will likely remain in place for the foreseeable future, cross-strait business may well move up a gear. Negotiations with Taiwan’s pro-independence government and business are, however, likely to remain on the sidelines. Until this political impasse is resolved, progress will be limited.

Our short-term political rating is static at 75.0 as official cross-strait relations will likely remain closed for the time being.

Economic Risk – Strong Export Orders

- Despite fears of a slowdown in exports, a key engine of growth in the Taiwanese economy, orders have continued to grow. September orders expanded 22% year-on-year to reach, US\$12.8bn. This should ensure export growth remains on track, albeit with an expected slowing as growth

rates return to more normal levels, after the bounce back from the slump in late 2001 and early 2002. A robust export performance will boost industrial output given the largely export-orientated nature of the manufacturing sector. It could also push real GDP growth above our 2002 forecast of 3.2%.

Our short-term economic rating is static at 78.0 as activity is expected to slow in Q4, and our GDP forecast remains on target.

Business Environment – Chipmakers Face Uncertain Profits

- Taiwan’s leading contract chipmaker **Taiwan Semiconductor Manufacturing Co** reported Q3 2002 profits of TWD\$3.16bn (US\$90.5mn), down from TWD\$9.31bn in Q2. The fall in profits from Q2 was attributed to a drop in capacity utilisation and average chip prices. This drop in profits will likely be felt across Taiwan’s electronics industry, bringing the possibility of cutbacks in production during the coming months.

Our business environment and composite ratings are static at 72.1 and 76.5 respectively.

All ratings are expressed as a number between 1 and 100. A high rating is an indicator of low risk. BMI’s Risk Ratings source historical data and forecasts from BMI’s Emerging Markets Online Service. For full access please contact Rob Anderson on +44 (0)20 7557 7171 or email randerson@businessmonitor.com, or see www.emerging-markets-online.com

ECONOMIC OUTLOOK

Taiwan has yet to regain its status as a key centre for foreign investment in electronics. **BMI View:** Investment in the electronics sector will undoubtedly continue to lose out to the expanding Chinese market, but services may provide the lifeline that Taiwan needs.

An Investment Bright Spot In Services

Foreign direct investment (FDI) in Taiwan is plunging. Overseas investment approvals dropped 43.3% year-on-year (y-o-y) during the January-September period to US\$2.27bn, according to Taiwan’s Ministry of Economic Affairs. However, local investment in the mainland rose 26.4% y-o-y during the same period with more than 40% of this directed towards the electronic and electrical goods industries. Taiwan (along with several other economies in Southeast Asia) is increasingly worried about losing out to China in terms of investment, as low labour costs and a gloomy global economy force producers to outsource to China. The trade and investment liberalisation taking place thanks to China’s entry to the World Trade Organisation (WTO) in late-2001 has also enticed many foreign firms to the mainland in the hope that previously sheltered industries will soon be open. While Taiwan joined the WTO in January 2002, the huge size of the Chinese market place is a major advantage over Taiwan in attracting foreign investment. There is no immediate end in sight to this loss of business to China. Foreign investment into China is still soaring, and foreign producers are well aware that gaining access to the Chinese market will be a very slow process. A recent move by Beijing to de-politicise the process of cross-strait links between Taiwan and China will also make this worse. Beijing has now suggested that negotiations could be conducted using the term “cross-strait” rather than “domestic”, allowing Taiwan to maintain its identity while moving forward to re-establish direct trade, transport and communication links between the two nations. The issue of preconditions will likely remain a stumbling block (China insists that Taiwan accept the idea of eventual reunification before any negotiations begin) but the latest move does indicate a real possibility of an acceleration in the process. Direct links would likely result in a surge in investment.

In a global context Taiwan’s investment performance is not actually that poor. Global FDI flows fell 51% in 2001 as slower global growth reduced investor appetite for cross-border mergers and acquisitions. In Taiwan FDI dropped only 16.1% during the same period. The drop in real investment also appears to be easing. Real investment fell 20.6% in 2001 but decelerated to a drop of 8.1% in H1 2002. Real investment is on track to return to 2000 levels by 2003. In contrast, real investment in Southeast Asian economies hit by the financial crisis in 1997-98 is still well below pre-crisis levels. Moreover, by promoting the service sector, Taiwan could well make up for the loss in manufacturing investment.

Although the manufacturing sector is a key driver of Taiwan’s economy through its largely export-orientated nature, services is by far the biggest sector accounting for almost 70% of total GDP. Taiwan’s ability to increase services investment should, therefore, be able to offset some of the losses from lower manufacturing investment. While Taiwan’s service sector is not without its problems, particularly with the high level of non-performing loans within the

banking industry, it is much more developed than in China. In addition, prior to WTO entry, investment into Taiwan's service sector was fairly restricted, unlike the largely open manufacturing sector. New opportunities should therefore attract foreign firms into Taiwan's service sector. An example of this is Taiwan's recent attempts to bolster investment in biotechnology. In late October a conference held by China External Trade Development Council earmarked around TWD1bn of public and private funds towards investment in the biotechnology industry. While this alone is unlikely to provide much of a catch up for investment lost to China, it is a much-needed step in the right direction.

Taiex On The Bounce

Taiwan's tech-heavy Taiex equity index has shown signs of life over the last couple of weeks. The surge reflects improved sentiment toward US stocks, with **International Business Machines** (IBM) and **Microsoft** reporting better-than-expected profits in Q3 2002. Moving forward, with the Nasdaq and the Dow Jones having risen lately, improved foreign equity inflows could see the Taiex move up during the near-term. Yet, we would reserve judgement as to whether the much-fabled bottoming out in global sentiment has finally arrived. The probability is that we are merely experiencing an extended bounce from short-term oversold territory. It would take a further improvement on the Nasdaq technology composite to signal a significant turnaround in appetite toward global tech stocks.

Underpinning our cautious stance are persisting concerns about the global geopolitical risk outlook, with a war between Iraq and the US still very much on the cards. America's recent decision to toe the UN's line and allow Iraq one more chance to admit weapons inspectors, will merely mean a postponement of an attack against Iraq. Prolonged uncertainty is perhaps a more negative medium-term scenario for global stock markets. Ultimately, the US is determined to disarm Iraq, and until this prevails, equities (and particularly volatile tech stocks) will struggle to match the lustre of more defensive assets.

Meanwhile, there are industry-specific reasons to remain cautious about the outlook for the technology sector, and particularly chipmakers, such as **Taiwan Semiconductor Manufacturing Company** and **United Microelectronics**. There is a pressing need for sectoral consolidation, as technological upgrades exacerbate cyclically-generated over capacity. Unfortunately, there has been scant evidence of mergers and acquisitions activity over the last couple of months. "There seems little point in buying under-utilised assets at a time when demand is weak," says Jeffrey Toder, Taiwan equity strategist for **SG Securities**, in Taipei. In this regard, semiconductor stocks are best avoided, especially with 128-megabit DRAM chip prices at around US\$1.60 (from around US\$2.70 in early August), and capacity utilisation rates in US foundries at only 68%. Clearly, excess capacity within the industry still needs to be eliminated, and the depressed mobile telecom sector – the second largest end-user of semiconductors, behind computer hardware manufacturers – will curb output for some time yet. Toder believes the safest strategy would be to focus on notebook-producers **Compal** and **Quanta**, and motherboard-markers **Asustek** and **Gigabyte**. These companies should benefit from the seasonal up-tick in PC demand caused by the Christmas shopping season.

	2000	2001	2002 Latest Period		2002f	2003f
Population (mn, eop) ¹	22.25	22.44	-	-	22.63	22.63
Nominal GDP (US\$bn) ^{1,4}	319.36	295.66	-	-	306.05	301.21
GDP per capita (US\$) ^{1,4}	14,353	13,175	-	-	13,524	13,310
Real GDP growth (% y/y) ¹	5.9	-2.2	4.0	Apr-Jun	3.2	5.0
Industrial Output (% y/y) ¹	7.4	-7.5	6.5	Jan-Sep	6.0	7.5
Inflation (% y/y, an avg) ¹	1.3	0.0	-0.1	Jan-Sep	0.1	2.0
30 Day C. P. rate (% eop) ³	5.00	2.13	1.96	29-Oct	2.05	3.75
TWD/US\$ (eop) ²	32.99	35.00	34.72	29-Oct	33.80	34.30
Exports (fob, US\$bn) ¹	148.32	123.10	95.72	Jan-Sep	129.00	140.00
Imports (cif, US\$bn) ¹	140.01	107.40	83.23	Jan-Sep	112.23	132.00
Trade balance (US\$bn) ¹	8.31	15.70	12.49	Jan-Sep	16.77	8.00
Current account balance (US\$bn) ²	8.9	18.9	13.3	Jan-Jun	18.2	20.7
Current account balance (% GDP) ^{2,4}	2.7	6.3	-	-	5.8	6.8
Foreign reserves (US\$bn, eop)* ²	106.7	112.0	157.03	Sep	129.0	134.0
Import cover (mths)** ^{2,4}	8.0	10.6	-	-	11.6	11.0

f = BMI forecasts (bold). *excluding gold, ** number of months imports covered by FX reserves. Sources: ¹ DGBAS, ² Central Bank of China, Taiwan, ³ Reuters, ⁴ BMI Calculation.

CAPITAL MARKETS

Taiwan's tech-heavy stock index, the Taiex, has rallied during recent weeks. **BMI View:** The rally is unlikely to be anything other than bear-market bounce. Those investors brave enough to up exposure may look to downstream tech plays such as **Compal** and **Quanta**, to benefit from a seasonal up-tick in demand.

BMI FORECAST SCENARIO

Taiwan's unemployment rate edged back down in September after reaching a record high of 5.35% in August. September unemployment dropped back to 5.32% as the influx of new graduates into the labour market began to slow. New job seekers dropped by 11,000 in September, after increasing by almost 30,000 during the two previous months. With industrial output still strong and GDP on target to meet our forecast of 3.2% this year, unemployment should begin to ease back. Nevertheless, unemployment is no longer expected to meet our forecast of 5% in 2002. **BMI** now expects a rate of 5.2% for 2002, although this does imply a slowing in Q4. Taiwan's drop in foreign direct investment this year may, however, tempt employers to postpone hiring, citing increased uncertainty for domestic industries (particularly electronics) and the ongoing weakness in the US economy, one of Taiwan's major trading partners.


SOUTH KOREA

Political Risk – Nuclear North

- The stakes are once again rising to nuclear levels in South Korea's dealings with North Korea. In October the US announced that North Korea had admitted to having a secret nuclear weapons programme. This followed some angry diplomatic brinkmanship. South Korea demanded that the North accept earlier agreements to give up its nuclear weapons. The North, meanwhile, has blamed US hostility for its action. Thankfully, there now seems a real commitment to calmer dialogue.

Tensions have risen, but not by much, hence our short-term political rating stays at 58.0.

Economic Risk – Burst Bubbles

- South Korea continues to fret about the dangers of its credit bubble and overheated housing market. One of the few real safety nets, Korea's propensity to save, is looking threadbare. Savings as a share of income dropped to 26.9% during the first half of the year, down from 40.5% in 1998, according to Korea's central bank. This is a worry.

Policymakers are, however, taking action. In October the government raised the requirements for loan-loss provisions at financial institutions and put a ceiling on mortgage loans across the country.

The government's actions will help cool Korea's red-hot economy, hence our short-term economic rating remains at 85.0.

Business Environment – Reform Progress

- South Korea seems to have waved goodbye to the weakest of the banks that plunged the country into crisis in 1997. The government recovered US\$586mn of funds in September in its efforts to recoup US\$127bn spent rescuing financial institutions hurt by the Asian financial crisis. Policymakers have stepped up efforts to sell the banks that were nationalised at the end of the 1990s. This is welcome. Nonetheless, Korea retains many of the systemic corporate weaknesses that helped bring down the economy five years ago.

Our business environment rating stays at 65.8, while our short-term composite rating remains at 70.2.

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ECONOMIC OUTLOOK

South Korea's northern neighbour, the hermit kingdom of North Korea, is suddenly looking more open to the idea of economic co-operation. **BMI View:** South Korea should now, for its own health, be urging the North to create special economic zones.

Why Korea Needs The North To Reform

Rarely in the past has South Korea's communist neighbour, North Korea, looked so willing to countenance economic reform. In recent months there have been murmurs of sweeping changes in the North. Rice prices have been liberalised, wages have been raised, north-south rail links have been approved and the government has given the nod to the creation of special, free-trading economic zones. All this is, of course, no more than hearsay. It remains notoriously hard to gauge what is happening in North Korea. Even foreign aid workers are denied access to large parts of the country. Nonetheless, it seems clear that the North is, at the very least, toying with the notion of economic change. South Korea needs to encourage this process. As a first step the South should increase pressure for special economic zones.

South Korea needs desperately for the North to reform its economy. Without reform, North Korea is, very simply, a giant-sized economic threat. The North does not generate enough output to sustain its population and there is little sign of it being able to do so in the future. The North Korean economy is in persistent danger of collapsing into a mess that would cost trillions of dollars to clean up. The bill would go to South Korea.

Policymakers in Seoul need to act to prevent such a collapse. More specifically, they need to engineer economic policies that promote structural change in the North. Any form of economic interaction will promote change to some extent. But a cross-border railway will, **BMI** believes, have only limited impact. The railway, plans for which were revived in August, seems likely to be used for the most part to transport goods from South Korea to China and to Russia's Far East. North Korea will extract royalties. The railway may be fenced off and economic interaction between South and North is liable to be negligible. Proposed foreign mining concessions would have a better chance of spurring change in the North. But these concessions are in danger, like many classic enclave economies, of being intentionally isolated from the rest of the country.

Special economic zones are at present South Korea's best and most realistic chance of promoting economic integration. In September North Korea announced plans to construct a special economic zone in Sinuiju, a port city near the border with China. The zone would have its own flag, its own currency (the US dollar), and would be leased for 50 years. All this is startlingly radical for North Korea. Perhaps too radical. In October the Chinese-born man in charge of the zone was arrested for tax evasion. There remains, however, momentum towards some kind of economic zone. South Korea needs to encourage this momentum. In China, a country that many people see as North Korea's mentor on the slow march towards economic liberalisation, special economic zones have played a major part in promoting change. Since the 1980s they have acted not only as laboratories for experimental reform but also as windows for economic exchange with the outside world. They have been places where goods,

people, money and information can be introduced from other countries. Where reforms were successful, they were disseminated to other parts of the country. This dissemination is exactly what is needed, as far as the South is concerned, in North Korea.

Much more than just special economic zones would, admittedly, be desirable. Foreign direct investment is perhaps the best way South Korea can engage with the North. Contact between North Koreans and outsiders would be more extensive. Competition between regions of the North to attract investment from the South would carry the benefits of raising productivity, of spreading new skills, and of helping to reverse North Korea's economic backwardness. All this would do much to reduce the risk to South Korea of the North imploding. But at the moment direct investment into the North remains curtailed to the point of exclusion. Special zones are the South's best bet for integration.

Poor Investment Outlook May Hamper Won

A deterioration in the balance of payments position will increase the won's vulnerability to portfolio capital outflows. Regional currency weakness will also put downward pressure on the won. The combination of a possible US rate cut and domestic tightening, should provide a boost. However, the won is liable to weaken back to at least KRW1250/US\$ from around the current level of KRW1220/US\$, although temporary gains to or beyond KRW1200/US\$ are feasible in six months.

Investment Inflows Weaken – The current account recorded a US\$151mn surplus in August compared with a US\$143.4mn deficit the previous year, but the overall trend is towards deterioration as strong domestic demand will boost imports during the coming months. The services-account deficit will likely widen due to lower shipping income and a rising tourism deficit. Direct investment remains weak with inflows down 30% year-on-year in September. Manufacturing investment is also contracting and a sustained decline would raise fears over the longer-term competitiveness of the industrial sector. This expected narrowing of the surplus will further weigh down on the won in the coming months.

Monetary Pressures Will Continue – The central bank remains concerned over property-sector inflation and will still consider a rate increase despite a dip in consumer confidence and potentially strong opposition from the government. There remains the possibility of a US rate cut this year, despite the recent financial market rally, although yields will remain strongly in the won's favour even if interest rates are left unchanged. The won should be well placed to attract deposit inflows although policy divisions would weaken confidence.

	2000	2001	2001-02 Latest period		2002f	2003f
Population (mn) ¹	47.31	47.76	-	-	48.30	48.30
Nominal GDP (US\$bn) ¹	461.70	422.17	-	-	464.74	535.79
GDP per capita (US\$) ^{1,2}	9,759	8,840	-	-	9,622	11,093
Real GDP growth (%) ^{1,2}	9.3	3.0	6.3	Apr-Jun	5.2	6.8
Industrial output (% y/y, period avg) ¹	16.9	1.0	7.0	Jan-Jun	7.0	11.0
Unemployment rate (% y/y, period avg) ³	4.1	3.7	3.0	Jan-Sep	3.0	2.5
Inflation (% y/y, period avg) ^{2,4}	2.3	4.1	2.7	Jan-Sep	3.5	4.0
Av. Interbank call rate (% p.a.) ¹	5.06	4.00	4.27	28-Oct	4.25	5.50
KRW/US\$ (avg) ^{2,3}	1131.0	1291.0	1251.2	Jan-Sep	1275.0	1225.0
KRW/US\$ (eop) ^{2,3}	1264.5	1313.5	1222.4	28-Oct	1250.0	1200.0
Exports (US\$bn, fob) ¹	172.27	150.60	76.02	Jan-Jun	164.00	180.00
Imports (US\$bn, cif) ¹	160.48	141.10	70.87	Jan-Jun	156.00	174.00
Trade balance (US\$bn) ¹	11.79	9.50	5.15	Jan-Jun	8.00	6.00
Current account balance (US\$bn) ¹	12.24	8.62	1.81	Apr-Jun	5.40	2.49
Current account balance (% GDP) ^{1,2}	2.7	2.0	-	-	1.2	0.5
Foreign reserves (US\$bn, eop) ^{* 1}	96.13	102.75	116.47	Aug	110.05	113.80
Import cover (mths) ^{** 2}	6.0	7.2	-	-	7.2	6.7
External debt (US\$bn, eop) ³	131.70	119.9	129.6	Aug	114.00	106.00
External debt (% exports) ²	76.5	79.6	-	-	69.5	58.9

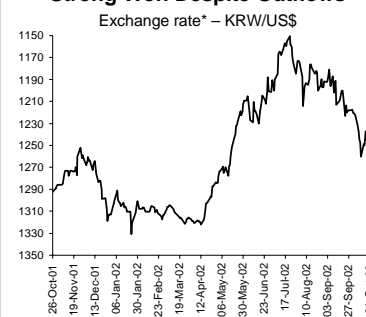
f = BMI forecasts (bold); eop = end of period; * excluding gold; ** no of months imports covered by FX reserves plus gold; Sources: ¹ IMF, ² BMI, ³ Bank of Korea, ⁴ Ministry of Finance. Consensus forecast based on data from the following institutions: ABN-Amro, Merrill Lynch, Goldman Sachs, JP Morgan, ING Barings, Deutsche Bank, Lehman Brothers.

^{*} (margin) Consensus forecasts based on data from the following institutions: ABN Amro, Deutsche Bank, Goldman Sachs, HSBC, ING Barings, Lehman Brothers, JP Morgan, Merrill Lynch, OECD, Salomon Smith Barney.

CURRENCY OUTLOOK

Weak investment flows will tend to weaken support for the won. **BMI View:** This should not cause serious difficulties during the next few months.

Strong Won Despite Outflows



^{*}inverted scale. Source: Reuters.

BMI FORECAST SCENARIO

BMI View: Policymakers are putting the brakes on South Korea's runaway economy. In October they imposed stiff conditions on mortgage lending, raised the requirements for loss provisions at banks and proposed an increase in property taxation. All this will help slow the economy. We predict real GDP growth of 5.2% this year.

Consensus View*: Real GDP will rise 6.0% this year, according to an average forecast taken from a straw poll of 9 investment banks, plus the OECD. Korea's economy will, common wisdom has it, continue to expand at a breakneck pace. **BMI** disagrees. A rise in interest rates next year, if not this year, will slow the economy.

Government View: Korea's central bank has forecast economic growth of more than 6.0% this year, boosted by resilient consumer demand and a boom in spending. This forecast does not, however, incorporate the possibility of higher interest rates.



Political Risk – US Manipulates Nuclear Issue

- The revelation that North Korea had flouted the Framework Accord and continued with a uranium enrichment programme as part of a weapons development policy has caused shock and outrage. Regional condemnation has been strong and, through close coordination with South Korea, Japan and China, the US is now seeking to push North Korea to the negotiating table.
- The ball is now in Pyongyang's court. Given strong economic and political pressure, a deal is perhaps more likely than a lingering crisis but substantive concessions, centring on international inspections and the end of the nuclear programme will be needed.

Economic Risk – Aid In Jeopardy

- A high-powered North Korean delegation arrived in Seoul on October 26 to conduct a nine-day economic survey of the South, clearly underlining the North's continued commitment to its new policy of spurring economic development, using outside assistance. Yet there is a definite risk that vital foreign support will be lost unless North Korea falls into line over the nuclear issue. Japan has already stated this to be the case.

Business Risk – Investment Stalemate

- The admission of its nuclear programme means that much-needed foreign investment is off the agenda for now. An ambitious special economic zone is no further forward after the arrest of its proposed governor in October, although the need to attract foreign funds into the North is urgent.

POLITICAL OUTLOOK

The US announced that North Korea had admitted to developing a nuclear weapons programme. **BMI View:** There are risks and opportunities from this admission. The North may ultimately prove more ready to strike a verifiable deal to end its nuclear programme if, as is likely to be the case, regional aid comes under threat.

Risks And Opportunities In New Situation

The US announced on October 16 that, confronted with compelling intelligence evidence, North Korea had acknowledged that it has a secret uranium-enrichment programme as part of a nuclear-weapons development policy. This violates several international agreements signed by Pyongyang, notably the 1994 Framework Agreement under which it agreed to freeze its nuclear programme. The US had apparently had strong evidence of the existence of the enrichment process for at least three months. Although the admission therefore does no more than confirm what was virtually a known fact, it does significantly change matters. It makes it impossible for other countries to ignore the fact that North Korea has broken agreements it entered into, and is indeed a real and present threat to regional security. In the wake of the revelation, North Korea rather lamely sought to shift blame to the US for undermining the Agreed Framework by not fulfilling its side of the bargain, but on the whole the rhetoric from both sides was constrained. Japan and South Korea did not back off from steps aimed at improving diplomatic and economic relations, notably the return visit to Japan by five Japanese individuals abducted by North Korea in the 1970s and 1980s. Practical issues such as working-level talks on anti-flood cooperation should continue. North Korea indicated that it still wants talks with the US and intimated that a deal on nuclear weapons might be possible on condition that the US signs a non-aggression pact with Pyongyang and gives a guarantee of the sovereignty for the state. The US will not negotiate on substantive issues while the North maintains its nuclear programme, although contacts do look set to continue.

The US used the Asia Pacific Economic Cooperation (APEC) forum in Mexico in late October to firm up a common stance with Japan and South Korea, making a joint call on Pyongyang to dismantle its nuclear weapons program "in a prompt and verifiable manner". The three did not spell out the consequences of inaction but in a rare joint political statement APEC itself stated "the potential for the Democratic People's Republic of Korea to benefit economically from greater participation as a member of the Asia-Pacific community ... will rest upon a nuclear weapons-free status on the Korean Peninsula". Japan then emphasised the point stating that it would press Pyongyang to abandon its programme in normalisation talks due to resume shortly in Kuala Lumpur or "face the possibility of not receiving economic aid". A general withdrawal of aid would be a blow to the North's tentative economic reform programme. The potential for increased friction also exists in the political sphere, especially if the North launches one of its periodic provocations. The changed situation after the nuclear revelation thus carries a tangible risk of deteriorating into a real crisis, with blockades and the like, albeit outright conflict remains most unlikely.

In practice there is a much greater chance that the North will continue to seek increasing foreign contacts and aid. Yet, if the allies maintain a common stance, the North should now find fewer benefits from engagement. On this basis, there may even be an increased possibility, that the North will at some point agree to full weapons inspections and a verifiable end to its nuclear weapons programme in return for economic and diplomatic benefits, with perhaps a "peace treaty" with the US on the distant horizon.

