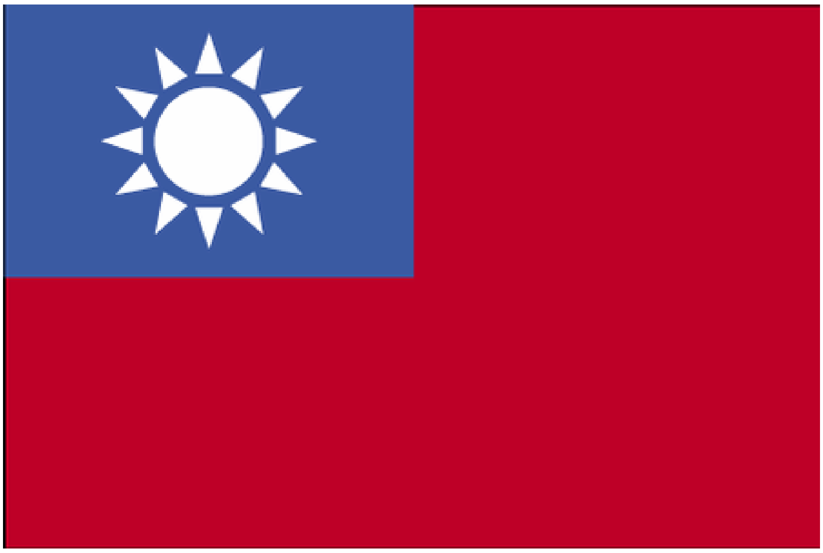
Country report **TAIWAN**



Summary

Taiwan's export growth is slowing, which is having a knock-on effect on investment growth and private demand as well. As a result, growth is estimated to slow to 1.3% this year, before rebounding to around 2.5% in 2013. Inflationary pressures are limited due to the relatively weak economy. The fiscal situation has improved following fiscal restraint, although public debt has risen following counter-cyclical policies in 2008-2010. Taiwan's banking sector is heavily exposed to the risky real estate and export sectors. A significant share of Taiwan's external debt is short-term debt, but the country has ample foreign exchange buffers to prevent liquidity problems.

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Taiwan

National facts			Social and governance indicators	rank / total
Type of government	Republic		Human Development Index (rank)	n.a.
Capital	Taipei		Ease of doing business (rank)	16 / 185
Surface area (thousand sq km)	36		Economic freedom index (rank)	18 / 179
Population (millions)	22.8		Corruption perceptions index (rank)	32 / 183
Main languages	Mandarin		Press freedom index (rank)	45 / 178
	Taiwanese		Gini index (income distribution)	n.a.
Main religions	Buddhism		Population below $1 per day (PPP)	n.a.
	Taoism			
	Christian			
Head of State (president)	Ma Ying-jeou			
Head of Government (prime-minister)	Sean C. Chen			
Monetary unit	New Taiwan dollar (TWD)			

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
China	29	Japan	19
Hong Kong	14	China	16
United States	12	United States	9
Japan	6	South Korea	6

Main export products (%)	
Electronic products	15
Basic metals	10
Information & communications products	9
Textiles	5
Main import products (%)	
Intermediate goods	76
Capital goods	15
Consumer goods	9
Openness of the economy	
Export value of G&S (% of GDP)	76
Import value of G&S (% of GDP)	69
Inward FDI (% of GDP)	-0.4

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	467	0.68
Nominal GDP at PPP	955	1.20
Export value of goods and services	353	1.60
IMF quotum (in mln SDR)	2117	0.97
Economic structure	*2011*	*5-year av.*
Real GDP growth	4.0	4.2
Agriculture (% of GDP)	2	2
Industry (% of GDP)	30	31
Services (% of GDP)	68	67
Standards of living	*USD*	*% world av.*
Nominal GDP per head	20235	187
Nominal GDP per head at PPP	41387	332
Real GDP per head	20134	246

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

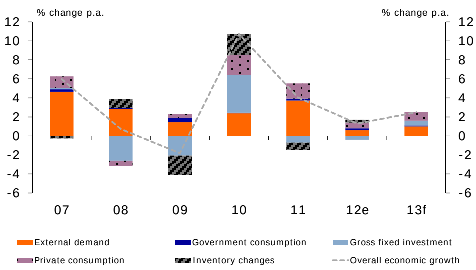
Taiwan, officially named the Republic of China, is a country comprising of several islands, located to the east of the People's Republic of China, across the Taiwan Strait. The largest island, the island of Taiwan, makes up 99% of Taiwan's total land area and houses the country's capital, Taipei. After the communist victory in mainland China in 1949, about 2 million Nationalists fled to Taiwan, established a government and incorporated the locals in the governing structure. In contrast to China, Taiwan enjoyed economic prosperity in the decades thereafter, resulting in GDP per capita rising from USD 2,400 (USD 3,500 in PPP terms) in 1980 to USD 20,235 in 2011 (41,387 in PPP terms). The economy is structured around the services sector, which contributes 68% to GDP. Industry accounts for 30% of the economy while the contribution of agriculture is negligible. The prosperity of this services-based, capitalist economy stems from the dynamic and entrepreneurial private sector, which employs over 90% of the working population.

The success of the private sector can be attributed to Taiwan's benign economic environment. The country scores very well on factors such as economic freedom (ranked 18th out of 179 countries) and ease of doing business (ranked 16th out of 185, up from 25th place last year). Internationally, Taiwan is highly competitive, ranking 13th out of 144 countries on the World Economic Forum's competitiveness index, particularly due to its efficient goods and labor markets and developed financial markets, as well as the country's sophisticated education and healthcare systems and sound infrastructure. As a result, in spite of its small size, Taiwan is home to some of the world's leading multinationals in the information technology (IT) sector, such as Acer and HTC. The country is an important supplier of intermediate IT goods worldwide and the export of IT products has boosted the performance of Taiwan's small and open economy.

However, Taiwan's high degree of openness, with total exports and imports of goods and services amounting to 145% of GDP, is the economy's main weakness as well. It makes the economy overly dependent on external demand, especially from its main trading partners China, Japan and the US. Roughly 10% of total exports are destined for the European Union (EU) and Taiwan is therefore, via direct and indirect trade channels, susceptible to the problems in the eurozone.

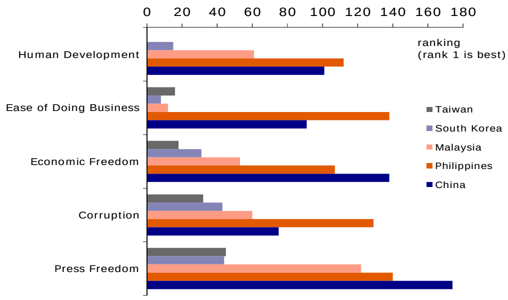
Taiwan's economic performance has weakened on the back of the weak global economy, as export growth turned negative in 2012. In Taiwan, a close link between exports and investments exists and, as a result, investments also contracted in 2012. Meanwhile, unemployment increased slowly and consumer confidence is at a low level, thereby limiting private consumption growth. Domestic demand, therefore, has also been weak, as only government consumption growth remained steady. In all, real GDP growth is estimated to slow to around 1.3% this year, down from 4% in 2011. Recently, some bright spots became visible, as, in September, industrial production growth accelerated somewhat and exports performed unexpectedly strong as well, on the back of strong growth of exports to China. Real GDP growth is expected to accelerate to 2.5% in 2013 on the back of a marginal improvement of the external environment, which will lead to stronger export and investment growth. Although demand from China is likely to increase (slightly), the situation in the eurozone remains difficult to predict while major downside risks are present. These translate to downside risks to Taiwan's economic outlook as well.

Figure 1: Growth performance



Source: EIU

Figure 2: Social indicators



Source: See factsheet

With private credit amounting to nearly 154% of GDP, Taiwan has a large financial sector. State-owned banks account for slightly over half of total deposits. State-owned banks' capitalization levels are worse than the 9.4% industry average, but they still meet Basel III requirements under a stress-scenario according to Fitch[1]. The non-performing loan ratio (NPL) stood at only 0.54% on average in June 2012. However, when impaired loans are used as a measure of asset quality, as has been argued in a recent report by Moody's[2], the situation is somewhat more fragile. The percentage of impaired loans to total loans stood at 2.3% mid-2012, considerably higher than the NPL ratio – although not all impaired loans will become non-performing loans. The banking sector's asset quality is particularly vulnerable to a sustained weakening of the real estate market and poor performance of the high-tech export industry. Some 34% of total loans were mortgages mid-2012 and an additional 7% has been extended to the real estate and construction sector. Although the real estate market is cooling down as a result of tightening measures introduced by the central bank to curb speculation and banks have become careful with extending mortgage loans, an unlikely strong and sustained price decline would be difficult to manage. Furthermore, the high-tech sector, which is vulnerable to weak external demand, accounts for about 11% of total loans.

[1] Fitch, Taiwan, Full rating report, September 2012.
[2] Moody's, Special Comment, Impaired loans better gauge of Taiwanese banks' asset quality than NPLs, October 2012.

Political and social situation

The Republic of China is commonly known as Taiwan. Its political institutions are relatively well developed, in spite of the fact that Taiwan is a young country, founded in 1949, and an even younger democracy – since the late 1980's and 1990's. Today, the country has a well-functioning multi-party democracy with universal suffrage.

Presidential elections were held early 2012 and were won by incumbent Ma Ying-jeou of the Kuomintang (KMT) party with 52% of the votes. The election campaign revolved around one decisive issue: Taiwan's relationship with mainland China, or Cross-Strait relationship. The KMT is in favor of closer ties with the People's Republic of China (PRC) and has actively pursued agreements and improved relations and linkages with mainland China while in office. The main opposition party, the Democratic Progressive Party (DPP), has historically been deeply distrustful of China's political intentions, while not ignoring its importance as Taiwan's main trade partner.

The Cross-Strait relationship remains a highly sensitive subject. Any unilateral adjustment to the current status quo could lead to an escalation. The risk of an escalation has, however, receded in recent years, as ties between Taiwan and the PRC became closer. In June 2010, both countries signed an Economic Cooperation Framework Agreement and trade relations were enhanced as a result. In addition, the Taiwanese population also seems to warm up to closer relations with China. With the KMT also holding a majority in the Legislative Yuan (Taiwan's parliament), and the DPP moderating its stance on the issue, Cross-Strait relations are not expected to deteriorate in the near-term. The PRC is itself also actively encouraging closer ties, enhancing protection for Taiwanese investors, easing employment policies for Taiwanese nationals. It has even been showing a more open stance towards the DPP recently. The DPP has moderated its stance on the Cross-Strait policy somewhat since the (lost) election, which made clear that the majority of the public judged the DPP's approach inadequate and even risky. However, this view is not shared by all Taiwanese and stiff opposition against closer ties with China remains present.

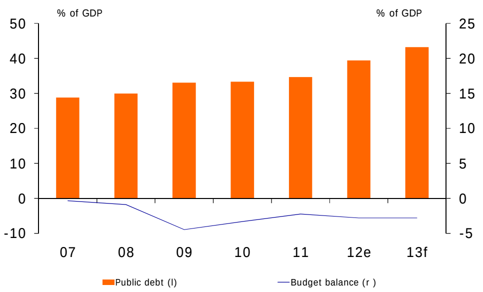
Other domestic political issues are also critical. Increasing inequality and the environmental problems continue to be issues of concern among the public. In addition, the economy has become a main topic of discontent among voters in the past months, as Taiwan's economic growth is slowing on the back of falling external demand and protests against the government's economic policies have erupted recently. Although the Taiwanese government can hardly be blamed for the lack of demand abroad, it has aggravated the dissatisfaction among the public by proposing an electricity subsidy reduction (which was not implemented in the end) and by lifting a ban on beef imports from the US. The KMT's choice to address the economic slowdown by reducing worker rights while putting an increase of the minimum wage on hold has particularly frustrated many. As a result, President Ma Ying-jeou's popularity has decreased significantly since the elections.

International relations of Taiwan have been suffering from the fact that, under pressure from the People's Republic of China that considers Taiwan to be part of its sovereign territory, the country is not recognized as a sovereign state by important international institutions, such as the United Nations and the International Monetary Fund, nor by the United States (US) or the European Union. As such, Taiwan's geopolitical role is relatively limited, although it enjoys strong international support from the US and relies on its support under the Taiwan Relations Act for its military. With the Cross-Strait relations being of overarching importance, Taiwan treads carefully – but is certainly not silent - with regard to regional geopolitical issues, such as sea borders in the South and East China seas, as it does not want to strain relations with China too much.

Economic policy

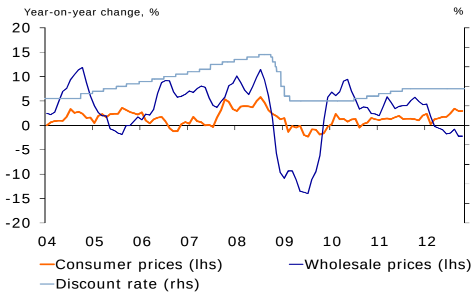
The Taiwanese government pursues business friendly economic policies, aimed towards maintaining a strong private sector and upholding Taiwan's internationally competitive position. Taiwan's public finances deteriorated markedly after the 2008/09 global financial crisis, as the government ramped up spending to counter the subsequent domestic economic slowdown. The budget deficit widened from an average of 2% of GDP in the period 2000-2008 to 4.5% of GDP in 2009. In the years thereafter, the budget deficit narrowed to 3.3% and 2.2% of GDP in 2010 and 2011, respectively, due a strong economic recovery and fiscal restraint. However, as the Taiwanese government is again faced with a domestic economic slowdown, it has planned a number of large projects that will be financed with public capital. Moreover, as social issues have to be addressed as well, the budget deficit is expected to increase to 2.8% of GDP in 2012 and 2013. Tax revenue continued to increase this year, by 6% in the first seven months of 2012, down from nearly 9% in 2011, but cannot keep up with expenditure growth. As a result, and due to financial deterioration of non-profit special funds that perform public functions such as education and public construction, government debt is increasing steadily. From 29% of GDP in 2007, central government debt increased to 33% of GDP in 2009, 35% of GDP in 2011 and will expectedly increase further to 43% of GDP in 2013. As such, public debt is relatively high, especially when taking into account the fact that Taiwan's access to financial markets is restrained as a result of the tense relationship with China, and most of the public debt is thus financed domestically.

Figure 3: Public finances



Source: EIU

Figure 4: Inflation and interest rates

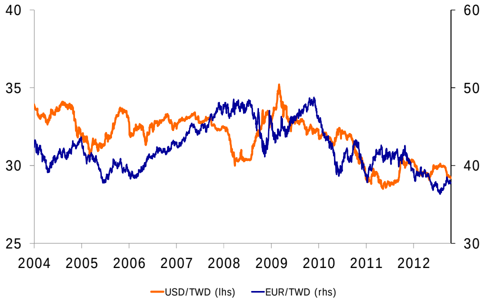


Source: Reuters EcoWin

In that respect, Taiwan's low interest rate environment benefits the government as well as the private sector. The Central Bank of Taiwan (CBOT) has kept its main policy interest rate, the discount rate, at a relatively low level in the post-global financial crisis period. After cutting the rate from 3.625% to 1.25% between September 2008 and February 2009, the CBOT has hiked it to 1.875% between mid-2010 and mid-2011 and kept it at that level since. In spite of the economic weakness, consumer prices have been picking up in the past months, in particular due to a hike of petrol prices in April. And while consumer prices increased by 3% year-on-year in September, wholesale prices decreased in recent months. On average, inflation is estimated at around 2% in 2012 and 2013. In spite of the weak economic environment, the CBOT has opted to keep interest rates steady so far and no major rate cuts are anticipated until end-2013.

The CBOT walks a fine line with regard to its exchange rate policy. On the one hand, it wants to allow the New Taiwan dollar (TWD) to strengthen against the US dollar, as this lowers imported inflation. However, in 2012, with exporters struggling, some depreciation has been welcomed to enhance international competitiveness. As a result, the TWD depreciated during 2012, until recently. Following the announcement of the third round of quantitative easing by the Federal Reserve in the US, the TWD appreciated again in the past months. Overall, Taiwan's large current account surpluses make it likely that the TWD will remain on its appreciating trend, while volatile capital flows will determine short-term fluctuations.

Figure 5: Exchange rate



Source: Reuters EcoWin

Figure 6: Current account

Source: EIU

Balance of Payments

Taiwan's current account is strong, showing a healthy surplus on the back of significant surpluses on the trade and income balances. The weak global economic environment is having a negative impact on Taiwan's export performance, especially regarding IT-related products. As a result, exports are contracting, with total exports amounting to an estimated 288bn in 2012, down from 307bn in 2011. Imports declined as well, partly because a large share of imports serves as inputs for the export sector and partly because domestic demand weakened. As a result, the trade balance surplus narrowed slightly from 6% of GDP in 2011 to an estimated 5.6% of GDP this year. Export growth will pick up again in 2013, but import growth will increase as well, which is forecast to lead to small further deterioration of the trade balance to around 5.5% of GDP next year.

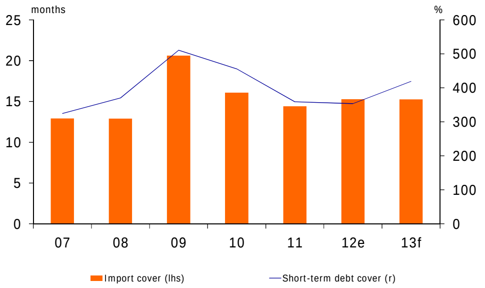
The current account surplus will also narrow this year, as aside from the lower trade surplus, the surplus on the income balance is also estimated to decrease; by roughly USD 3bn in 2013 and a further 2.5bn in 2013. The services surplus has risen rapidly from around USD 2bn in 2008 and 2009 to an estimated USD 8bn this year and nearly USD 11bn in 2013 on the back of increased tourism earnings from visitors from mainland China. This will partly make up for the deterioration of the trade and income balances. The transfers balance is expected to remain steady. In all, Taiwan's current account surplus is comfortable at an average of 8% in the period 2005-2011. However, a narrowing trend has set in, with the current account surplus falling from around 11% of GDP in 2009, to an estimated 8.6% in 2012 and 8.4% in 2013.

Foreign direct investment (FDI) inflows took a major hit in 2008, as a result of the global financial crisis. While FDI inflows amounted to some 7.5bn in 2006 and 2007, only one-third of that was received in post-crisis years 2009 and 2010. Following a short negative inflow in 2011, FDI inflows turned positive again, with an estimated inflow of USD 2.2bn this year and USD 3bn in 2013. As FDI outflows are much larger than inflows, a substantial net FDI outflow exists. Portfolio outflows also outpaced inflows, although by a lesser degree than is the case with FDI flows. The net FDI and portfolio outflows are due to Taiwanese investments, both fixed and liquid, abroad. The net debt inflow is the result of the large amount of short-term debt, a large part of which is refinanced each year and trade related.

External position

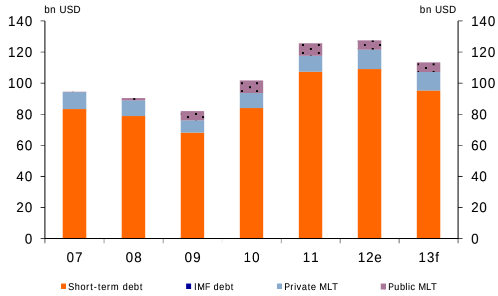
Taiwan's external position is in good shape. Total foreign debt amounts to USD 127bn in 2012, or 27% of GDP and 35% of total current account receipts. However, a very substantial 85% of total external debt is short-term, which is largely trade related. As a result, Taiwan's debt service ratio is high at 35% of total current account receipts. However, Taiwan's external liquidity position is sound nonetheless. Foreign exchange (FX) reserves amount to around USD 385bn, which equals 15 months of imports. Moreover, FX reserves cover over 300% of debt service and Taiwan's liquidity ratio is high at around 200%.

Figure 7: External liquidity



Source: EIU

Figure 8: External debt decomposition



Source: EIU

As trade will be relatively subdued next year, with only a slight improvement of the global economic environment expected, less trade related short-term debt will be required. This will translate into a decrease of total foreign debt to USD 113bn next year on the back of a decline of short-term debt from around USD 109bn in 2012 to around USD 95bn in 2013. However, the positive effect on the debt service ratio will only be seen from 2014 onwards, forecasted at 28% and 24% of total current account receipts in 2014 and 2015 respectively. Next year, FX reserves are expected to increase to nearly USD 400bn, which will lead to slight improvement of the debt service cover ratio to 312%.

Taiwan

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	6.0	0.7	-1.8	10.7	4.0	1.3	2.7
Consumer prices (average % change pa)	1.8	3.5	-0.9	1.0	1.4	2.1	2.0
Current account balance (% of GDP)	8.9	6.9	11.4	9.3	8.9	9.5	8.8
Total foreign exchange reserves (m USD)	270311	291707	348198	382005	385547	393900	409030
Economic growth							
GDP (% real change pa)	6.0	0.7	-1.8	10.7	4.0	1.3	2.7
Gross fixed investment (% real change pa)	0.6	-12.4	-11.2	24.0	-3.8	-2.4	3.3
Private consumption (real % change pa)	2.1	-0.9	0.8	3.7	3.0	1.2	2.0
Government consumption (% real change pa)	2.1	0.8	4.0	0.6	1.9	2.0	1.3
Exports of G&S (% real change pa)	9.6	0.9	-8.7	25.6	4.5	-1.2	3.8
Imports of G&S (% real change pa)	3.0	-3.7	-13.1	28.2	-0.6	-2.7	3.5
Economic policy							
Budget balance (% of GDP)	-0.4	-0.9	-4.5	-3.3	-2.2	-2.8	-2.8
Public debt (% of GDP)	29	30	33	33	35	39	43
Money market interest rate (%)	1.9	1.9	0.2	0.4	0.7	0.8	1.1
M2 growth (% change pa)	1	7	6	5	5	2	3
Consumer prices (average % change pa)	1.8	3.5	-0.9	1.0	1.4	2.1	2.0
Exchange rate LCU to USD (average)	32.8	31.5	33.1	31.6	29.5	29.6	29.3
Recorded unemployment (%)	3.9	4.1	5.9	5.2	4.4	4.3	4.5
Balance of payments (m USD)							
Current account balance	35154	27505	42923	39873	41600	44900	42970
Trade balance	30445	18478	30553	26513	27848	30560	28120
Export value of goods	246500	254897	203399	273823	307030	297570	305860
Import value of goods	216055	236419	172846	247310	279182	267010	277740
Services balance	-1640	1847	1991	2493	4265	7500	10620
Income balance	10132	9978	12524	13577	13178	10800	8110
Transfer balance	-3783	-2798	-2145	-2710	-3691	-3960	-3880
Net direct investment flows	-3338	-4855	-3072	-9082	-14723	-5440	-5250
Net portfolio investment flows	-39376	-10814	-9868	-23095	-34924	-28450	-4750
Net debt flows	8522	-4797	-8640	19474	20236	100	-1570
Other capital flows (negative is flight)	3226	14323	35235	7069	-8806	-2690	-16390
Change in international reserves	4187	21362	56578	34240	3384	8430	15020
External position (m USD)							
Total foreign debt	94525	90361	81963	101581	122528	122370	120530
Short-term debt	83283	78773	68178	83670	104159	104020	102460
Total debt service due, incl. short-term debt	82742	92595	89680	81936	100535	124200	122360
Total foreign exchange reserves	270311	291707	348198	382005	385547	393900	409030
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	7.7	4.6	8.1	6.2	6.0	6.5	5.7
Current account balance (% of GDP)	8.9	6.9	11.4	9.3	8.9	9.5	8.8
Inward FDI (% of GDP)	2.0	1.4	0.7	0.6	-0.4	0.5	0.6
Foreign debt (% of GDP)	24	23	22	24	26	26	25
Foreign debt (% of XGSIT)	31	28	31	30	32	33	31
Debt service ratio (% of XGSIT)	27	29	34	24	26	33	32
Interest service ratio incl. arrears (% of XGSIT)	2	2	3	2	2	2	2
FX-reserves import cover (months)	12.9	12.9	20.6	16.1	14.4	15.3	15.3
FX-reserves debt service cover (%)	327	315	388	466	383	317	334
Liquidity ratio	187	188	236	217	201	197	198

Source: EIU