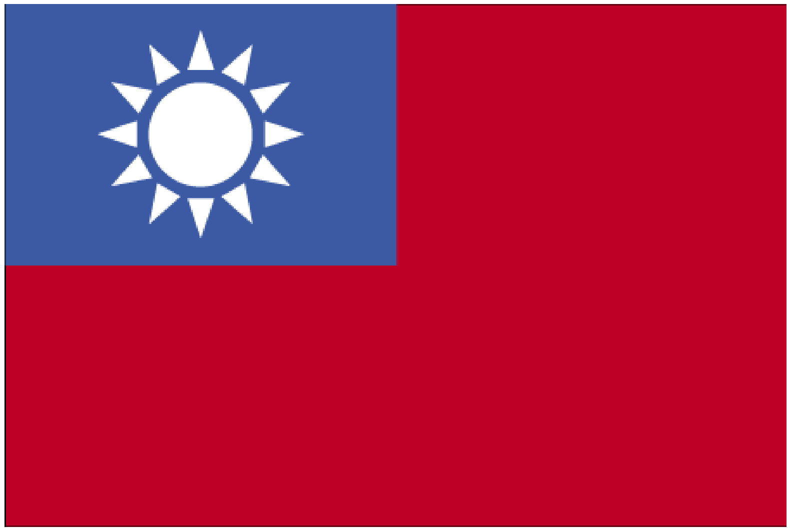
Rabobank

Country report

TAIWAN



Summary

The island of Taiwan has a dynamic, capitalist economy which has sharply rebounded from the effects of the global financial crisis. Economic activity will expand by over 9% yoy in 2010, a large improvement from the 1.9% contraction in 2009. As the economy is very open and export-oriented, it will remain highly susceptible to the global economic tide. Relations with China have improved in the last year, which is important for Taiwan's foreign trade relations. The political situation is stable, despite some internal conflicts. The external position is very healthy, as the economy has been posting large current account surpluses for years. Its FX-reserves are the fifth largest in the world and cover 16 months of imports.

Things to watch:

- Relationship with China
- Domestic political situation
- Sustainability of the global economic recovery

Author: **Ashwin Matabadal**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21- 61601
A.R.K.Matabadal@rn.rabobank.nl

Taiwan

National facts	
Type of government	Republic
Capital	Taipei
Surface area (thousand sq km)	36
Population (millions)	22.8
Main languages	Mandarin
Main religions	Buddhism
	Taoism
	Confucianism
Head of State (president)	Ma Ying-jeou
Head of Government (prime-minister)	Wu Den-yih
Monetary unit	New Taiwan Dollar (NTD)

Economy		2009
Economic size	*bn USD*	*% world total*
Nominal GDP	378	0.66
Nominal GDP at PPP	803	1.14
Export value of goods and services	235	1.51
IMF quotum (in mln SDR)	2117	0.97
Economic structure	*2009*	*5-year av.*
Real GDP growth	-1.9	4.6
Agriculture (% of GDP)	2	2
Industry (% of GDP)	30	26
Services (% of GDP)	69	70
Standards of living	*USD*	*% world av.*
Nominal GDP per head	16370	179
Nominal GDP per head at PPP	34713	311
Real GDP per head	17424	225

Social and governance indicators	rank / total
Human Development Index (rank)	n.a.
Ease of doing business (rank)	33 / 183
Economic freedom index (rank)	27 / 179
Corruption perceptions index (rank)	33 / 178
Press freedom index (rank)	48 / 178
Gini index (income distribution)	n.a.
Population below $1 per day (PPP)	na

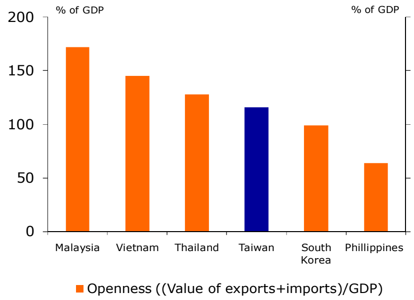
Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
China	28	Japan	21
Hong Kong	15	China	14
United States	12	United States	10
Japan	7	South Korea	6
Main export products (%)			
Electronic products			14
Basic metals			10
Information & communications products			7
Textiles			6
Main import products (%)			
Intermediate goods			76
Capital goods			15
Consumer goods			9
Openness of the economy			
Export value of G&S (% of GDP)			62
Import value of G&S (% of GDP)			54
Inward FDI (% of GDP)			0.7

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

Economic structure and growth

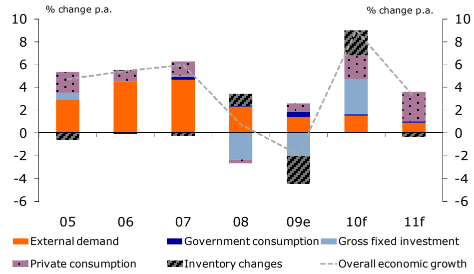
The country of Taiwan is located in South East Asia and is comprised of several islands, the largest of which houses the capital Taipei. This island is separated by the Taiwan Strait from the People's Republic of China, a country with which Taiwan has an intertwined history. In 1895, China was forced to cede Taiwan to Japan but regained control after WWII. After the Communist victory on mainland China in 1949, about 2 million Nationalists fled to Taiwan. They subsequently established a government and incorporated the locals in the governing structure. Over the next six decades, the country was gradually democratized and enjoyed economic prosperity. GDP per capita grew to USD 34,713 in 2009 from USD 22,960 in 2000. The economy is structured around the services sector, which contributes 69% to GDP. Industry accounts for 30% of the economy while 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. Even so, the public sector retains an important role through its control over key industries such as telecommunications, utilities and finance. The entrepreneurial spirit of the private sector is highlighted by the world-renowned multinationals the small island has generated in its key information technology sector. These include Acer, Asrock and HTC. Not surprisingly, this sector has been the backbone of economic growth in recent years. Especially the exports of electronics and information technology products have boosted the small and highly open economy. However, the high degree of openness is also the economy's main weakness. It makes the economy overly dependent on external demand. China and Japan are Taiwan's main trading partners, the US is a solid third. Besides electronics and ICT products, the country also exports basic metals and textiles.

Chart 1: Openness of the economy



Source: EIU

Chart 2: Growth performance



Source: EIU

The largest portion of its imports are intermediate goods with 76%.
Taiwan's dependence on foreign demand resulted in plummeting exports last year as the global financial crisis hit its export markets. Since external demand contributes 3-4 times more to GDP growth than domestic demand, the economy contracted by 1.9% in 2009. For 2010, it is the opposite story as the country experienced a very swift V-shaped recovery. Taiwan demonstrated an impressive start of the year by growing by a stunning 13.7% yoy in 1Q10, compared to a 9.1% contraction in 1Q09. While 2Q10 GDP growth was also strong with 12.5% yoy it is estimated full year growth will reach little over 9% yoy. This since the headline GDP figures in the third and fourth quarter will come out lower as the favorable base effects fade. Furthermore, the V-shaped recovery was primarily boosted by inventory restocking and the return of gross fixed investment by Taiwanese firms in anticipation of a revival in global demand. As these seem to have peaked, domestic and external demand need to carry the torch next year. Domestic demand seems well-placed as government spending continues and consumer confidence in the private sector is boosted by receding fears of high unemployment and possible real estate bubbles. However, the uncertainties of external demand remain as the US lingers with a jobless recovery and the effects of the European debt crisis on China and Japan. As such, the economy is forecasted to grow by only 3-4% in 2011, with downside risks especially against the currently uncertain global economic backdrop.
The Taiwanese financial sector is in reasonable shape, but very inefficient. It is fragmented, highly congested, and has a low profitability. The population of 23 million is served by no less than 37 local banks, 32 foreign lenders and more than 300 credit associations. It has weathered the global financial crisis relatively unscathed, despite the shock to the wider economy. The outlook is positive, not only given the economic recovery but also because of the signing of several agreements with China for investment in the Taiwan's financial sector.

Political and social situation

The political situation is stable for the next two years as the Kuomintang Nationalist Party (KMT), led by President Ma Ying-jeou, won the 2008 elections by a landslide, giving it a decisive mandate. It gave the KMT control of both the executive and legislative branches of government, which has increased policy effectiveness. Ma has been most effective in improving relations with mainland China. The countries signed three memoranda of understanding concerning cross-strait investments in banking, brokerage and insurance. Direct flights were introduced as well as fast-track approvals for Taiwanese banks to provide Chinese Yuan services on the mainland. However, the signing of the Economic Cooperation Framework Agreement (ECFA), a loose bilateral free trade agreement (FTA), is the most significant achievement for Ma. Especially since the ECFA at first glance appears to be more beneficial for Taiwan than China. Its tariff concessions cover over 500

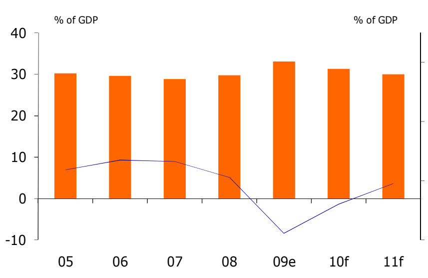
Taiwanese goods but only 267 Chinese goods. This is not the only benefit for Taiwan as Ma intends to restore good relations with the Chinese government and conclude further trade and transport agreements via the ECFA. He also hopes to win China's approval to increase Taiwan's trade diplomacy with other countries. China considers Taiwan a province of the People's Republic and does not recognize Taiwan's sovereignty. Other countries fear sanctions from China if they sign trade agreements with Taiwan, which in China's eyes would be a recognition of Taiwan's sovereignty. However, the fact that mainland China itself has signed a FTA with Taiwan might imply that other countries feel emboldened to engage in trade relations with Taiwan as well. Taiwan is already actively pursuing FTA's with other countries and if these bear fruit, the economic prospects of the export-dependent Taiwan will markedly improve.

While the KMT did achieve successes in improving international relations, it has not done so domestically. Firstly because of the inept government response to the Morakot typhoon which hit the country in August 2009, causing an estimated USD 3.3bn worth of damages and leaving over 400 people dead. The government was criticized for its slow relief efforts which led to more damage and casualties than necessary. Despite a cabinet reshuffle to form an "action cabinet", to speed up post-typhoon reconstruction, the KMT lost popularity. Another reason the KMT lost popularity was the rising unemployment rate at the end of 2009 when it recorded monthly historical highs of over 6%. This was a serious concern as the small country enjoys unfavorable demographics and rising unemployment would markedly increase the pension burden. While the unemployment rate has moderated to little over 5% in September 2010, the population's discontent is high, especially since Ma seemed more pre-occupied with improving foreign relations than addressing domestic issues.

And the relationship with China is at the core of the deep social and political divide in Taiwan: its re-approachment with China. While the population understands the economic benefits of better relations with China, it fears the threat to its sovereignty. This is a welcome rallying point for the main opposition party, the Democratic Progressive Party (DPP), led by Tsai Ing-wen, who opposes closer ties with China. The DPP and several pro-Taiwan groups prefer to keep the Beijing regime at arm's length for as long as possible. Whether or not the DPP can attract sufficient backing remains to be seen, as the party is seriously affected by internal conflicts concerning the special mayoral elections on November 27th. These elections will take place in the five largest cities and are seen as a barometer for national sentiment. Intra-party competition between potential DPP candidates is fierce and has resulted in two key members leaving the DPP to run independently.

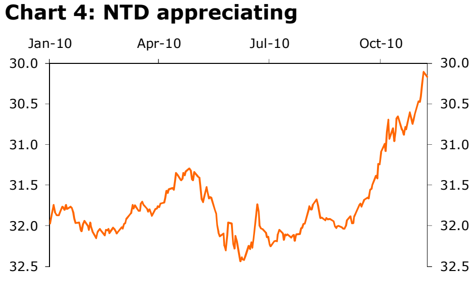
Thus, while the KMT has lost popularity according to the mayoral election polls, the largest opposition party is too weak itself to form a major threat. As such, we consider the political situation stable at least until the 2012 presidential elections.

Chart 3: Public finances



Source: EIU

Chart 4: NTD appreciating



Source: Bloomberg

Economic policy

Public finances have deteriorated last year, but not as much as expected. The budget deficit amounted to only 2.8% of GDP, whereas a 5% of GDP deficit was expected. This has mostly been the result of double counting. A large part of the stimulus package of USD 15.5bn included public works projects such as expanding metro systems, rebuilding bridges renovating schools, hospitals, railway and sewage systems. However, when the new KMT government came into power it had already approved a USD 126bn program in May 2008 to be implemented in the coming eight years. As this program involves many of the same infrastructure programs as announced in the stimulus packages, it is highly likely double counting has occurred.

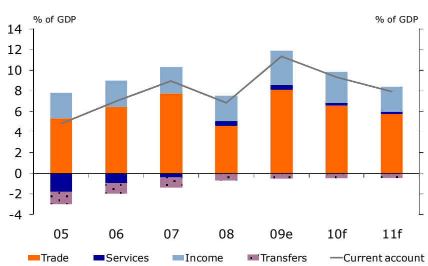
Even so, the shopping voucher scheme, which involved every citizen to receive USD 104 in coupons, and the lowering of the corporate and personal income tax rates did increase government expenditure. For 2010, it is expected that the budget will remain in deficit, but only by 1.8% of GDP. A deficit is likely to persist in 2011 as well as the government is considering another round of tax reductions to upgrade the country's industrial base. This should improve Taiwan's tax competitiveness with Singapore and other regional peers. It implies a corporate tax reduction to 17% from 20% and preferential treatment for key industrial segments. However, several of these new tax breaks are expected to replace parts of the stimulus package which have already expired. Thus, while aggregate tax revenues have increased in line with the impressive economic recovery, revenues are partially offset by the lowered tax rates.

The contingent liabilities are substantial but have decreased with the expiration of public deposit and interbank loan guarantees at the end of 2009. One large liability remains the high speed railway company, which amounts to 2.5% of GDP. The company negotiated a substantial loan in exchange for shares from an 8-bank consortium but the board of directors and several bankers are under investigation for fraud.

Public debt is estimated at a moderate 31% of GDP and unlikely to improve quickly. Taiwan's access to international capital markets is also very limited due to cross strait issues. As a result, the Taiwanese government resorts to domestic financing of its debt which does profit from a low interest rate environment and therefore a low interest burden on its debt service.

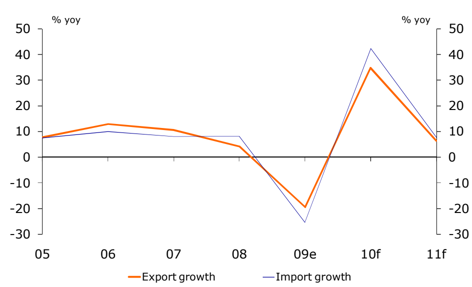
The Central Bank of Taiwan (CBOT), has been able to maintain this low interest rate environment this year as consumer prices were at a record low in 2009, averaging -0.9% yoy and expected to post an average of 1.3% in 2010. Inflation has historically been low in Taiwan, as the CBOT has an effective and timely monetary policy. As such, it has built a good reputation and credibility. The main policy rate currently stands at a low 1.5%, up from the record low of 1.25% in June 2009. While inflation is not expected to be a problem this year, rising asset prices and currency appreciation are sources of concern. The low interest rates have fueled speculation on the Taiwanese housing market. House prices have increased in Taipei in particular, and currently stand at a two-decade high relative to incomes. The CBOT has already strengthened oversight on lending

Chart 5: Current account



Source: EIU

Chart 6: External trade



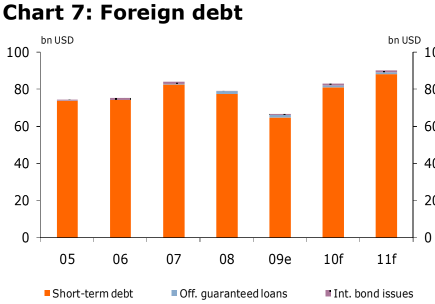
Source: EIU

and tightened restrictions on mortgage issuances. If property prices continue their rise, we expect more prudential measures to follow. The CBOT is intervening in the currency markets to curb any appreciation of the domestic currency, the New Taiwanese Dollar (NTD). It intends to counter short-term capital flows to weaken the NTD to the USD to support the export sector. As other Asian countries have also been seen to actively manage their exchange rates, Taiwan seems to be engaged in a "currency war" in popular terms. However, we do not expect a real currency war or competitive devaluation. We expect only continued intervention to slow the pace of any unwanted rapid appreciation.

Balance of Payments

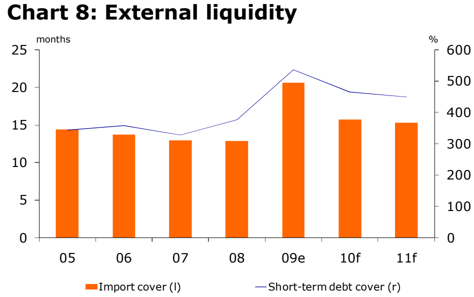
The current account balance is very healthy as it has posted large continuous surpluses, averaging 7.8% of GDP in the past five years. For 2010, the current account is estimated to post a 9.3% of GDP surplus. The trade balance is the main driver of these surpluses, the result of high exports of electronic products and basic metals. After an impressive surge in the first seven months of the year, when export orders grew by a monthly average of 48% yoy, they have slowed. The growth in export orders was 16% yoy in September, lower than the 23% yoy expansion in August. While this is partly a result of unfavorable base effects, it is also due to the sluggish economic recovery in the west as export orders from the US declined. Export orders from China did pick up and are expected to continue since Taiwan and China signed the EFCA. Imports have shown a similar trend as exports, since 79% of the country's imports are intermediate goods. September imports grew by 25% yoy. Besides the trade balance, the income balance is also a positive contributor to the current account. It will post a surplus of 3% of GDP in 2010 as Taiwanese multinational electronics and ICT companies repatriate profits from abroad. The transfer and services balance offset the positive contributions from the trade and income balance with rather small deficits.
Overall, the current account has posted healthy surpluses which means no external financing via the capital account is required. It has also resulted in a large accumulation of FX-reserves. These are expected to be USD 377bn at end-2010, the fifth largest in the world.

Chart 7: Foreign debt



Source: EIU

Chart 8: External liquidity



Source: EIU

External position

The external position of Taiwan is very healthy. Foreign debt stands at USD 91bn, equivalent to a modest 22% of GDP. The portion of short-term debt is with 89%, rather high. It is held largely by the private sector, as the Taiwanese government has very limited access to international capital markets due to cross strait tensions. The foreign debt is mostly held in bank deposits and trade credit by the private sector. Even though the portion of short-term debt is high, it is well-covered by the FX-reserves. The short-term debt cover stands at an ample 465%. The high level of FX-reserves also cover imports by 16 months, which reflects a very sound external liquidity position.

Taiwan

Selection of economic indicators	2005	2006	2007	2008	2009	2010e	2011f
Key country risk indicators							
GDP (% real change pa)	4.7	5.4	6.0	0.7	-1.9	9.0	3.2
Consumer prices (average % change pa)	2.3	0.6	1.8	3.5	-0.9	1.3	1.6
Current account balance (% of GDP)	4.8	7.0	8.9	6.8	11.3	9.3	7.9
Total foreign exchange reserves (mln USD)	253290	266148	270311	291707	348198	377780	395440
Economic growth							
GDP (% real change pa)	4.7	5.4	6.0	0.7	-1.9	9.0	3.2
Gross fixed investment (% real change pa)	2.7	0.1	0.6	-11.2	-11.1	18.4	-0.1
Private consumption (real % change pa)	2.9	1.5	2.1	-0.6	1.4	3.6	4.7
Government consumption (% real change pa)	0.2	-0.7	2.1	0.7	3.7	1.2	1.1
Exports of G&S (% real change pa)	7.8	11.4	9.6	0.6	-9.1	23.5	3.8
Imports of G&S (% real change pa)	3.2	4.6	3.0	-3.1	-13.4	27.1	3.2
Economic policy							
Budget balance (% of GDP)	-0.6	-0.3	-0.4	-0.9	-2.8	-1.8	-1.1
Public debt (% of GDP)	30	30	29	30	33	31	30
Money market interest rate (%)	1.3	1.5	1.9	1.9	0.2	0.4	0.9
M2 growth (% change pa)	7	5	1	7	6	3	5
Consumer prices (average % change pa)	2.3	0.6	1.8	3.5	-0.9	1.3	1.6
Exchange rate LCU to USD (average)	32.2	32.5	32.8	31.5	33.1	31.9	31.1
Recorded unemployment (%)	4.1	3.9	3.9	4.1	5.9	5.2	4.7
Balance of payments (mln USD)							
Current account balance	17578	26300	35154	27505	42916	39000	35050
Trade balance	19456	24197	30445	18478	30553	27450	25270
Export value of goods	198456	223789	246500	254897	203399	277640	294210
Import value of goods	179000	199592	216055	236419	172846	250200	268930
Services balance	-6653	-3543	-1640	1847	1915	1010	1050
Income balance	9039	9581	10132	9978	12511	12570	10780
Transfer balance	-4264	-3935	-3783	-2798	-2063	-2020	-2050
Net direct investment flows	-4403	25	-3338	-4855	-3072	-5000	-3900
Net portfolio investment flows	3244	-17818	-39383	-10810	-9337	-8050	-7970
Net debt flows	5901	-765	7941	-5547	-13966	16070	6940
Other capital flows (negative is flight)	-10928	5146	3813	15069	40037	-12190	-12360
Change in international reserves	11392	12888	4187	21362	56578	29820	17760
External position (mln USD)							
Total foreign debt	86789	85838	93942	89031	75303	91410	98210
Short-term debt	73747	74247	82700	77444	65003	81260	88090
Total debt service due, incl. short-term debt	74508	82595	82747	91968	87307	72740	90140
Total foreign exchange reserves	253290	266148	270311	291707	348198	377780	395440
International investment position	3132	21258	21809	34386	57736	n.a.	n.a.
Total assets	154673	165855	177996	206103	210651	n.a.	n.a.
Total liabilities	151541	144597	156187	171717	152915	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	5.3	6.4	7.7	4.6	8.1	6.6	5.7
Current account balance (% of GDP)	4.8	7.0	8.9	6.8	11.3	9.3	7.9
Inward FDI (% of GDP)	0.4	2.0	2.0	1.3	0.7	1.1	1.4
Foreign debt (% of GDP)	24	23	24	22	20	22	22
Foreign debt (% of XGSIT)	35	31	31	28	29	27	27
International investment position (% of GDP)	0.9	5.6	5.5	8.5	15.3	n.a.	n.a.
Debt service ratio (% of XGSIT)	30	30	27	29	34	21	25
Interest service ratio incl. arrears (% of XGSIT)	2	2	2	2	2	2	2
FX-reserves import cover (months)	14.4	13.7	12.9	12.9	20.6	15.7	15.3
FX-reserves debt service cover (%)	340	322	327	317	399	519	439
Liquidity ratio	188	186	187	188	238	218	206

Source: EIU