

## TAIPEI, CHINA

**W**ith exports and investment contracting sharply, Taipei, China experienced its weakest economic performance in two and a half decades in the second quarter of 2001 and faces its first recorded yearly contraction in GDP in 2001. A modest rebound is forecast for 2002.

Economic Indicator (percent)	1998	1999	2000	2001		2002	
				Current	ADO 2001	Current	ADO 2001
GDP growth	4.6	5.4	5.9	-2.0	5.1	2.0	5.8
Inflation rate	1.7	0.2	1.3	0.3	1.7	1.0	1.8
Current account/GDP	1.3	2.9	2.9	3.4	2.5	2.7	3.0

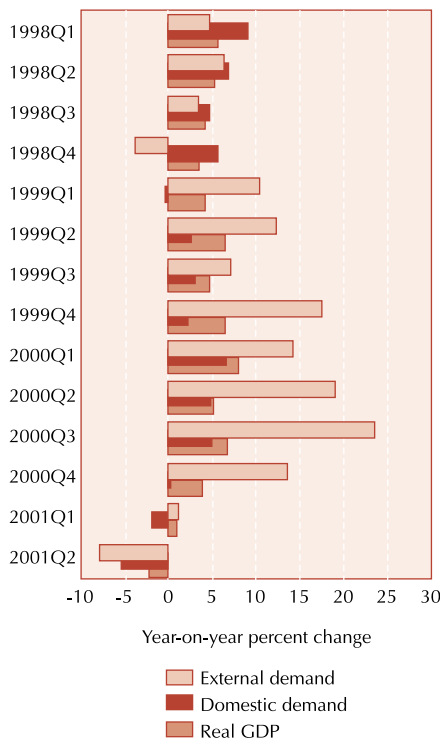
**Economic Assessment.** Economic performance was substantially weaker than expected in the first half of 2001: real GDP grew by less than 1.0 percent in the first quarter and shrank by 2.4 percent in the second quarter compared to the same quarters of the previous year. Domestic demand growth stalled in the fourth quarter of 2000 with a double-digit contraction in investment, and demand then began to shrink in the first quarter of 2001 as investment continued contracting and consumption growth decelerated to 0.6 percent. This deterioration in domestic demand worsened in the second quarter of the year, at a time when export demand, which had been growing for nine quarters, contracted by nearly 8 percent year on year. The collapse in domestic investment was partly the result of the falloff in worldwide demand for ICT products and partly the result of an accelerating trend in the relocation of manufacturing operations to the PRC to cut costs. Consumption growth slowed as the global economic downturn heightened uncertainty about the political and economic outlook, and rising unemployment eroded consumer confidence.

Growth of value added in services (services accounted for two thirds of GDP in 2000) slowed from 4.7 percent year on year in the fourth quarter of 2000 to 0.1 percent in the second quarter of 2001, with contractions in commerce and finance. Manufacturing, which expanded by 2.6 percent in the fourth quarter of 2000, shrank by over 2 percent in the first quarter of 2001 and by over 7 percent in the second quarter. The contraction in construction, ongoing since 1998, worsened to over 11 percent in the second quarter from 3.2 percent in the fourth quarter of 2000.

With the downturn in economic activity, unemployment worsened significantly from already historically high levels. The number of unemployed rose by 136,000 from end-December 2000 to end-July 2001, pushing up the seasonally adjusted rate from 3.3 percent to 4.7 percent. Average monthly earnings fell by 1.3 percent in the first half of 2001 compared with the same period in the previous year. Although employment picked up slightly in the services sector during these six months, this was more than offset by job

losses in manufacturing and other industry sectors. In the third quarter, labor market conditions continued to deteriorate as unemployment hit another record of 5.3 percent in September. With regard to inflation, consumer prices, which rose by 1.3 percent in 2000, were 0.1 percent higher in July 2001 than a year earlier, or 0.8 percent higher if food and energy are excluded. Import prices increased by 0.9 percent year on year in July 2001 as the New Taiwan dollar, which had declined by 4.8 percent against the US dollar in 2000, depreciated by another 5.1 percent through July 2001. With domestic demand continuing to weaken in the third quarter, consumer prices fell by 0.5 percent in September from a year earlier.

**The deterioration in domestic and external demand worsened in the second quarter of 2001**



Sources: Datastream, Global Economics Database; www.stat.gov.tw

Because external demand conditions deteriorated much more severely in the first half of 2001 than anticipated—despite the depreciating local currency—the US dollar value of exports (in f.o.b. terms) declined by 10.6 percent year on year from January to June. As in other NIEs, the drop in exports occurred in almost all sectors but was most severe in machinery and electrical equipment. Accounting for 55.7 percent of 2000 exports by value, exports from this subsector fell by 10.5 percent year on year in the first half of 2001. However, because of the rapid fall in import-intensive investment and export demand, the US dollar value of imports (in f.o.b. terms) declined more rapidly, by 17.0 percent over this period. Consequently, the current account surplus, at \$7.7 billion at end-June 2001, was three times higher than 12 months previously. However, with net financial inflows reversing from \$6.3 billion over the first half of 2000 to an outflow of \$2.0 billion over the first half of 2001, primarily because of net banking sector outflows, reserve accumulation slowed from \$9 billion to \$5.1 billion over these two periods. As external conditions deteriorated further in the third quarter of 2001, exports fell by 18.5 percent and imports by 23.7 percent in the first nine months from year-earlier levels, although this includes disruptions associated with the 11 September attacks and a severe typhoon on the island.

In line with regional trends, stock prices and interest rates fell, corporate debt levels rose, and bank lending slowed. Through end-July 2001, the Taiwan Stock Exchange Weighted Index declined by over 8 percent, after a 44 percent drop in 2000. After strengthening in August, the index fell by 19.3 percent in September as turbulence from the attacks on the US buffeted regional markets. The central bank lowered the discount rate from 4.63 percent in December 2000 to 2.50 percent in October 2001. Secondary market interest rates on 31-90 day commercial paper fell by an average of 174 basis points to 3.54 percent, three-year corporate bond rates fell by 206 basis points to 3.60 percent, and 10-year government bond rates dropped from 5.10 percent to 3.85 percent over the first eight months of 2001. The total value of bonds outstanding (covering government, corporate, and bank debentures) increased by 17.1 percent during the eight-month period. However, the prime lending rate declined only marginally from 7.7 percent to 7.6 percent, claims on the private sector contracted by 2.0 percent, while the past-due loan ratio of domestic banks rose from 5.3 percent to 6.5 percent during this period.

***Economic Management Issues.*** In response to weakening economic conditions and falling global interest rates, the central bank cut the discount rate eight times in the first nine months of the year. However, this has had little impact: while deposits at financial institutions grew by 6.3 percent year on year in August 2001, total loans showed no growth at all and portfolio investments of financial institutions expanded by 8.3 percent. The authorities have also adopted an expansionary fiscal policy. With the June 2001 passage of a supplementary budget of NT\$61.1 billion, expenditures are expected to grow from about 24 percent of GDP in 2000 to about 26 percent in 2001, accompanied by a higher budget deficit. This should provide some cushion to the impact of the downturn in economic activity by boosting public infrastructure investment and thus providing additional jobs in construction.

In addition to these short-term measures, the authorities are taking steps to ensure medium-term growth prospects and sustained long-term development. In June 2001, hoping to develop a more efficient finance sector, the Legislative Yuan passed measures to allow greater flexibility for financial firms both to merge and to provide a wider range of services. An NT\$140 billion resolution trust fund was also created to help restore to financial viability a group of credit cooperatives. Because this program covers only a small portion of the banking sector, many observers expect the authorities eventually to increase the size of the fund and to expand its scope. In August 2001, the Economic Development Advisory Committee made several policy recommendations intended to enhance Taipei, China's long-term development opportunities. Chief among them is the easing of restrictions on dealing with the PRC.

***Forecast.*** The deterioration of economic conditions in the first half of 2001 in Taipei, China, became even more pronounced in the third quarter. A significant worsening of external conditions, exacerbated by the September attacks and the typhoon, overshadowed Taipei, China's imminent WTO membership. The global economy and export demand are expected to remain weak through the rest of 2001. Hence, an unprecedented yearly contraction in GDP is expected for 2001. However, if the global economy slowly gathers momentum in 2002 and the authorities' economic stimulus packages and structural reforms provide a further boost, the economy should return to positive, although relatively modest, growth in 2002. With demand slack, inflation is likely to moderate for the whole of 2001 compared with 2000 but is expected to pick up in 2002 as demand starts to rise. Because imports are expected to remain weaker than exports, the current account surplus will probably widen in 2001 but begin to narrow again in 2002 as imports recover, reflecting a quickening pace of economic activity.