

Taipei,China

Economic Assessment

Economic growth came in at 6.7% in the first quarter of 2004, accelerating to 7.7% in the second, for a 7.2% expansion in the first half of the year, the fastest since 1992. The pickup was export led, fueled particularly by the rebound in the global high-technology sector, since information technology (IT) products account for nearly 40% of the economy's total shipments. Exports surged by 24.8% year on year in the second quarter of 2004, and by 22.4% in the first half (Figure 2.4). However, the contribution of net exports to GDP fell because imports grew by 25.8% in the first half, so that net exports contributed only 1.1 percentage points of total GDP growth in the first half of 2004, compared with 3.0 percentage points of the 3.3% GDP growth for all of 2003.

Strengthening imports reflected rising domestic demand after years of lackluster performance. Total domestic demand expanded by 7.0% in the first quarter and 6.7% in the second. In particular, private investment surged by 20.1% in the second quarter, after 14.1% growth in the first, contributing 3.7 percentage points to GDP expansion in the half. Investment was bolstered by buoyant exports, higher prices for electronics products, rising corporate profits, improvements in capacity utilization rates, and low interest rates. Industries such as semiconductors augmented production capacity, boosting investment in other industries. Imports of capital equipment boomed by about 30% in the first quarter and 48.2% in the second, the largest rise in 6 years.

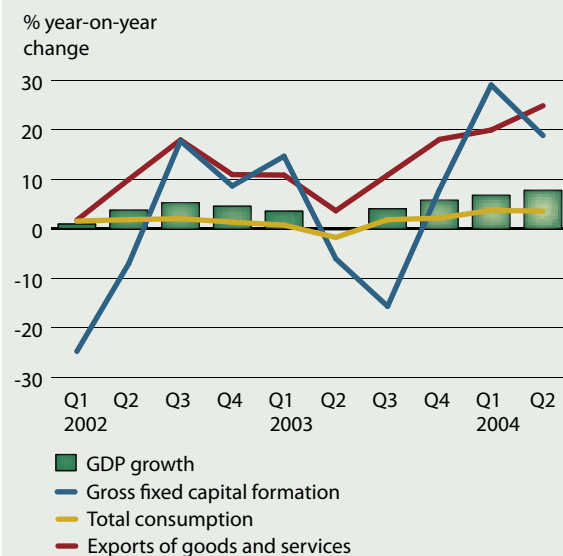
The pace of private consumption growth also picked up during the first half, from 3.2% in the first quarter to 4.1% in the second. As private consumption accounts for over 60% of GDP, this rise represented 2.4 percentage points of GDP growth in the first half. Taipei,China's consumption propensity has increased in line

with improving living standards and changing consumption patterns. Private consumption as a share of GDP rose from around 50% in 1980 to over 63% in 2003, while the savings ratio fell from 31% of GDP in 1989 to about 26% in 2003.

On the production side, growth was largely driven by manufacturing, which expanded by 11.8% in the first half of the year; overall industrial output rose by about 10%. The services sector grew by about 6%. Agricultural production declined by 7.2%, continuing a trend that has been reinforced by reduced domestic protection of farmers since Taipei,China joined WTO in 2001.

High growth rates in the second quarter were somewhat exaggerated by the low base of the previous year, when the economy was hit by the SARS outbreak, but strong momentum has continued since late 2003. The labor market has benefited from that momentum, with

Figure 2.4 GDP Growth by Expenditure Account, Taipei,China, Q1 2002–Q2 2004



Source: Directorate-General of Budget, Accounting, and Statistics, Executive Yuan, available: www.stat.gov.tw.

Table 2.4 Selected Economic Indicators, Taipei, China, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	5.4	6.0	4.7	4.8
Inflation (CPI)	0.8	1.5	1.2	2.0
Current account/GDP	6.9	6.8	6.0	6.0

Source: Staff estimates.

unemployment falling to 4.4% in April, before rising to 4.6% in July as job seekers graduating from school and university, and others, started looking for work as confidence in the recovery mounted. Real wages mirrored this development, with manufacturing earnings up by 5.8% in June from a year earlier (for all of 2003, they had risen by 2.9%).

Taipei, China's economic performance was hit hard by the bursting of the IT bubble and the global economic slowdown of recent years, and this flowed through to a decline in total government revenues from 22.7% of GDP in 1998 to just under 20% in 2003. The authorities responded by increasing spending to stimulate the economy, in the process widening the budget deficit to 4.0% of GDP. In recent months, the fiscal position appears to have been improving and the budget deficit narrowing.

Consumer price inflation, at just 0.9% in the first half, rose to 3.3% in July and 2.5% in August, due to strengthening domestic demand, higher global oil prices, and a weakening of the New Taiwan dollar against the US dollar. The property market revived, raising confidence among buyers and lenders, such that home mortgage and construction lending in May accelerated by 15.1% and 17.0%, respectively, from May 2003. Higher property prices increased household wealth and helped support private consumption expenditures. Share prices gained in the first quarter, then lost those gains in the following months, to show little change in September from the start of the year.

Exports of goods and services have grown at double-digit rates since mid-2003, boosted by particularly robust demand from Hong Kong, China and from the PRC. IT exports have been especially vigorous: electronics exports, for example, rose by around 40% in the first 7 months of 2004 from the same period a year earlier.

Imports of goods and services have also risen strongly, outpacing exports in recent months. The trade surplus contracted in the first 3 months of 2004, after widening for about 3 years. In June, the trade balance switched from surplus to deficit due to rising oil prices and the purchase of three civil aircraft, although the overall trade balance for the first half of 2004 is a US\$6.9 billion surplus. A continued trade surplus and inflows of foreign portfolio investment saw foreign reserves reach US\$230.1 billion at end-June 2004, the third largest in the world.

Policy Developments

The deterioration in the fiscal position during the years of weak economic performance—caused in part by a decline in tax revenues to 19.8% in 2003 from over 20% before 1999 and by demands for more social safety net payments—prompted calls from policy makers to raise tax revenues and simplify the tax system. In response, a Ministry of Finance tax reform committee has proposed increasing VAT from 5% to 7%, although a change is unlikely until after Legislative Yuan elections in December 2004. The authorities have also announced their intention to improve nonwage benefits for workers.

The period of weak performance also exposed the need for improvements to the social security system, and an aging of the population reinforces this. In June, the authorities passed a pension reform package that will require private sector companies to pay the equivalent of 6% of every employee's monthly salary into a centrally managed investment fund with individual accounts for retirement savings, effective 1 July 2005. Employees may voluntarily contribute up to an additional 6% of pretax salary into these interest-earning accounts. Employees' individual retirement funds are transferable if they change jobs. (Currently, companies are required to pay employees who retire between 2% and 15% of their monthly wage for each month worked, capped at a total of 45 months of benefits, but this benefit is not paid if an employee is not retiring but moving to another employer.) One result of the new pension plan will be to build up a large pool of investment funds that will deepen the local capital market.

However, business groups are concerned about the additional costs of the pension plan and they warn that they could accelerate the migration of manufacturing production to the PRC. Many of Taipei,China's traditional, labor-intensive manufacturing industries moved production to the PRC in the 1990s to reduce labor costs. Some high-technology firms have followed suit, so that manufacturing's share of GDP has fallen by half since the mid-1980s. The authorities are weighing options to keep their remaining traditional industries competitive and encourage the growth of high-technology and services-oriented industries while, at the same time, establishing a modern social safety net.

In the area of monetary policy, the Central Bank of China has not given any sign that it plans to raise interest rates in the near term. In June, it decided to keep the discount rate at 1.375%, after concluding that inflation risks are still low. There is, though, a longer-term risk that the Government's continued domestic bond issuance (public debt is now at about 30% of GDP) will increase the debt burden and put upward pressure on interest rates.

Outlook for 2004–2005

Growth is likely to moderate over the second half of 2004 from the first half's strong pace. The leading composite indicator, which gauges future economic conditions, supports this view: it fell in both May and June. Still, GDP is forecast to grow by 6.0% in 2004, well above the *ADO 2004* projection of 5.4%, and by 4.8% in 2005, revised up marginally from 4.7%.

Merchandise exports are forecast to rise by 16.2% in 2004 and 9.2% in 2005. Growth in imports will outpace that in exports, strengthening by 19.6% and 10.5% over these 2 years. The momentum in exports will continue to propel domestic demand as companies that are benefiting from exports raise their capital

expenditures. Imports are also projected to be strong, such that the contribution of net exports to GDP growth in the forecast period will be only about 0.4 percentage points. The trade surplus will decline, and the current account surplus will narrow to 6.8% of GDP in 2004 and 6.0% in 2005.

Private investment is expected to rise by 17.0% in 2004 and 9.8% in 2005 as exports and corporate profits improve and as interest rates stay low. Improved conditions in the labor and property markets will see private consumption rise by 3.9% over the whole of 2004 and by 3.7% in 2005. Private investment growth will account for 2.8 and 1.8 percentage points of GDP growth in 2004 and 2005, respectively, while private consumption growth will translate into 2.8 and 2.6 percentage points of the total.

Unemployment is projected to average 4.2% over 2004 and 4.0% in 2005, down from 5.0% in 2003. It will be difficult for the economy to return to the pre-1995 unemployment rates below 2%, despite the robust GDP upturn. Retraining programs and a stronger social safety net are required to help people move from declining into expanding industries.

Inflation looks likely to stay mild over the next 2 years. Upward price pressures come from the firm domestic demand and higher global oil prices, though the continued opening of the economy to greater competition, partly as a result of WTO membership, will offset some of these pressures. Consumer prices are forecast to rise by 1.5% in 2004 and 2.0% in 2005. The central bank may tighten its monetary stance a little from late 2004, but the favorable inflation outlook and the need to stimulate employment make significant rate rises unlikely.

A prolonged period of high oil prices poses a risk for Taipei,China because it is heavily dependent on energy imports. It is also vulnerable to any major slowdowns in its main export markets.