Taipei,China

Late last year external demand slumped for this economy's manufactured products, including its vital electronics exports. With domestic demand also contracting, GDP growth was minimal. Inflation accelerated to a 14-year high, then subsided by year-end. Even though substantial fiscal stimulus is being injected this year and interest rates have been lowered, the economy is forecast to shrink by 4.0% before resuming low-level growth next year.

Economic performance

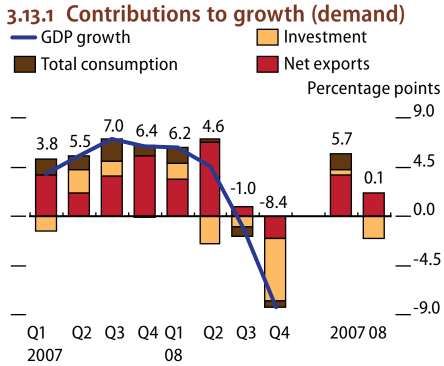
Heavily dependent on external trade, Taipei,China suffered more than most economies in the second half of 2008 as the global slowdown cut into world trade. After growing by an average of 5.4% in the first 2 quarters of the year, GDP contracted by 1.0% in the third and by a vertiginous 8.4% in the fourth. Growth for the full year was just 0.1% (Figure 3.13.1), the weakest outcome since a 2.2% contraction in 2001 when the global information technology bubble deflated.

The slowdown over the year stemmed from a slump in exports of machinery and electronics products and the depressing impact that had on fixed investment. Private investment contracted by 13.5% over the year (Figure 3.13.2) as the outlook deteriorated for manufacturing industries. Public investment declined as well, by about 1%. Investment overall subtracted 2.0 percentage points from total GDP growth in 2008. Against the background of weak consumer confidence and a sliding stock market, consumption was flat. The weakness in domestic demand was offset by some growth in net exports, and it was only that which enabled the marginal full-year expansion of GDP.

Industrial production started to slow in September and plunged by 32.0% in December (year on year). Manufacturers cut production of electronic parts and components, which account for nearly 10% of GDP, as global demand for these items shriveled. Industry as a whole contracted by 1.2% in 2008, a sharp turnaround from the 9.3% expansion in 2007. Moreover, agricultural production fell by 1.4% owing to cold weather in the first half of the year. Growth in services at 0.8% was the lowest since 2001, with particular weakness in wholesale trade and financial services. Still, it was only services that contributed any GDP growth on the supply side.

The economy has become increasingly reliant on external demand, with exports and imports of goods and services each equivalent to about 70% of GDP in 2008. This reflects the expansion of manufacturing production chains with neighboring economies, particularly the People's Republic of China (PRC). The United States (US) is the final destination of much of the production from these chains. Growth in merchandise exports to the PRC in 2008 slowed to 7.2% from 20.5% in 2007. Exports

3.13.1 Contributions to growth (demand)



Sources: Directorate General of Budget, Accounting and Statistics, available: http://eng.dgbas.gov.tw, downloaded 4 March 2009; staff estimates.

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This chapter was written by Akiko Terada-Hagiwara of the Economics and Research Department, ADB, Manila.

to the US fell in absolute terms by 4%, a second consecutive year of contraction in sales to this market.

Trade deteriorated rapidly in the fourth quarter: merchandise exports in nominal US dollar terms fell by 24.9% (Figure 3.13.3), reducing full-year growth to 3.4%. Likewise, merchandise imports fell by 22.3%, trimming full-year growth to 9.6%. The trade surplus in 2008 was about 40% below the prior-year level, and the current account surplus declined to 6.4% of GDP, from 8.6% in 2007.

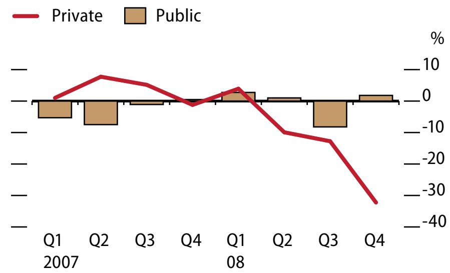
An outflow of portfolio investment in the first 3 quarters of 2008 was reversed in the fourth when residents, growing more risk averse as the global financial crisis deepened, redeemed investments abroad. As a result, lower net portfolio outflows for the year supported an overall balance-of-payments surplus of US$26.3 billion. Gross international reserves grew by 7.9% to US$291.7 billion, and the local currency in nominal average terms appreciated by 4.3% against the US dollar (it depreciated in real terms).

Inflation sped up in the first half of 2008, driven by rising world prices for energy and food. It peaked at 5.8% year on year in July, the highest rate in 14 years. Global energy and food prices pulled back from their highs later in the year, and the domestic economy slowed, bringing inflation down to 1.3% in December.

The monetary authorities, having edged up the policy interest rate continually since mid-2004, switched to an expansionary stance in September 2008 as economic activity slowed. From September to February 2009, they lowered the policy rate by a total of 238 basis points, to 1.25%. Broad money supply (M2) grew by a sluggish 3.0% on average in 2008, although it picked up a little in the fourth quarter. In October, when the global financial crisis worsened, the authorities guaranteed bank deposits in full through end-2009.

Layoffs during the second half of 2008 lifted the unemployment rate to a 5-year high of 5.0% in December, when the number of unemployed hit a record 549,000. Concerns about these job losses, and more broadly about the sharp deceleration of the economy, reversed the authorities' fiscal consolidation efforts of recent years that had reined in the fiscal deficit to 0.4% of GDP by 2007. Increases in public expenditure, at a time of marginal growth in revenue brought about by weakness in tax income, widened the fiscal deficit 2.3% of GDP in 2008.

3.13.2 Investment growth



Source: CEIC Data Company Ltd., downloaded 15 March 2009.

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Economic prospects

The slump in global demand for machinery and electronics products (about half all merchandise exports), and the knock-on effects to consumption and investment, will cause the economy to contract in 2009. Most of the world's laptop computers and liquid crystal display panels are manufactured in Taipei,China—the type of durable goods that face particularly weak demand worldwide. Early trade and production figures for 2009 were bleak: merchandise exports plunged by an average 36.3% year on year in the first 2 months. (Shipments to the PRC dropped by 48% in this period.) Industrial production fell by 43.1% in January.

The authorities, from September 2008 to February 2009, announced several fiscal stimulus measures to support consumer and business

3.13.1 Selected economic indicators (%)

	2009	2010
GDP growth	-4.0	2.4
Inflation	0.6	1.2
Current account balance (share of GDP)	8.4	8.3

Source: Staff estimates.

spending and generate jobs. These measures included tax breaks for new investment by businesses, discounted sales of industrial land, and increased financial support for small and medium-sized firms. Investment in public infrastructure of about US$15 billion is planned over the next several years, with about 30% of it (1% of GDP) allocated for this year.

Nevertheless, private fixed investment is expected to decline further in 2009. Fixed investment is strongly correlated with the performance of merchandise exports (Figure 3.13.4), so it is unlikely to pick up significantly until manufactured exports rise, which will be some time, given that export orders have dived. Moreover, inventories of manufactured products have mounted steadily in recent months. Permits for construction, too, have trended lower. Consequently, private fixed investment is projected to fall by 6.3% in 2009, before picking up in 2010.

Measures to spur sluggish consumption have involved cash transfers equivalent to about US$200 to low-income families and subsidies for consumers to buy energy-saving products, such as solar water heating systems and low-emission vehicles. Shopping vouchers valued at NT$3,600 (about US$100) were handed out to all citizens, including children, starting in January 2009. These transfers seemed to have an impact: sales at department stores and supermarkets rose by about 20% year on year in January. Some department stores reported their highest-ever one-day sales in the days after the vouchers were passed out.

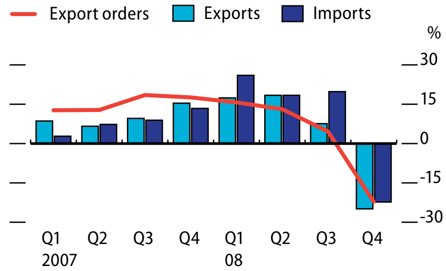
But from a multi-month perspective, consumer confidence has continued to decline since mid-2008 (Figure 3.13.5). Consumption is forecast to contract by about 2% in 2009, against the backdrop of the weak labor market and reduced household wealth. Taking these influences into account, GDP is projected to shrink by 4.0% this year (Figure 3.13.6). Growth is forecast to resume at a low level (2.4%) in 2010, on the expectation that the global economic environment improves next year and that stimulus measures in both Taipei,China and the PRC have an appreciable impact. An expected gradual recovery in manufacturing in 2010 will bolster the labor market, which, coupled with low inflation, is expected to support a moderate pickup in consumption.

With global trade seen contracting in 2009, merchandise exports are forecast to fall by 3.5%. Imports will fall even faster than this, by about 6.3%, on lower prices for imported commodities compared with 2008, weaker domestic demand, and fewer imports of raw materials for export industries. The current account surplus is forecast to increase to about 8.4% of GDP in the forecast period.

The expansionary fiscal policy is projected to widen the fiscal deficit to 5.0% of GDP in 2009. Domestic bond issuance will be the main funding source for the stimulus measures. Fitch Ratings in January 2009 cited deteriorating public finances when it lowered its outlook on the AA long-term local-currency rating to negative from stable. Next year, the fiscal position is expected to improve, if external demand picks up and the stimulus measures lift domestic demand, in the process strengthening tax receipts.

Inflation is expected to average 0.6% this year before edging up to 1.2% in 2010. The consumer price index rose by 1.5% in January, but fell by 1.3% in February. Given concerns about possible deflation, monetary policy is expected to remain expansionary.

3.13.3 Merchandise trade growth



Source: CEIC Data Company Ltd., downloaded 15 March 2009.

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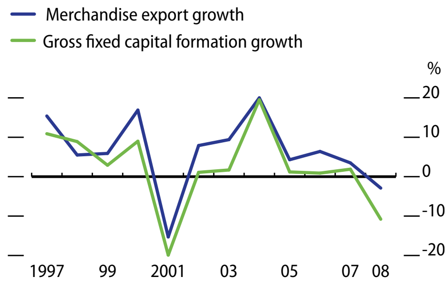
3.13.4 Investment and exports



Source: Directorate General of Budget, Accounting and Statistics, available: http://eng.dgbas.gov.tw, downloaded 2 March 2009.

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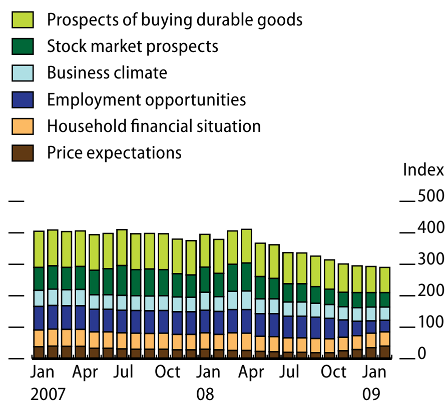
3.13.5 Consumer confidence for the next 6 months



Source: CEIC Data Company Ltd., downloaded 15 March 2009.

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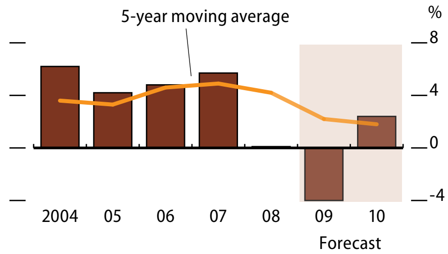
To help spur growth in the longer term, the authorities are establishing closer economic ties with the PRC. Four agreements aimed at expanding trade across the strait were signed in November 2008. They cover air and shipping routes, postal exchange, and greater cooperation on food safety relating to imports from the PRC. The near-term impact on growth is likely to be slight though, given the economic slowdown in both economies

The main domestic risk to the forecasts is that the fiscal stimulus fails to have a significant impact, in which case the economy would contract more than forecast and the slowdown could be extended. Fiscal strains would also intensify, as the recovery in tax revenue would be delayed.

3.13.6 GDP growth



Sources: Directorate General of Budget, Accounting and Statistics, available: http://eng.dgbas.gov.tw, downloaded 4 March 2009; staff estimates.

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Development challenges

An aging population and inadequate state pensions are inducing high household saving in Taipei,China. Households are the source of more than half of all national saving, compared with about 20% in the Republic of Korea.

The high household saving rate largely stems from workers' concerns about the adequacy of the state retirement pension, which is funded by contributions from employers and employees. However, enforcement of employers' contributions is weak. Furthermore, given that a growing proportion of the population will draw on this pension system for basic needs as the average age rises, many are concerned that the system might not have sufficient funding to meet even the current low pension payments. The old-age dependency ratio, the share of people aged 65 and older as a proportion of the working population, is projected to more than double between 2001 and 2036, to above 30%.

Some steps have, though, been taken to strengthen the pension system. A reform that came into effect in October 2008 allows workers to switch jobs without losing their accumulated contributions—that is, the pensions have become portable. This has improved labor market flexibility and increased the number of people eligible for a pension in retirement. However, until the pension system is enhanced, workers are likely to maintain high precautionary saving rates.

Until about 10 years ago, the need to save for medical treatment was another reason for the high saving rate. A national health insurance system that was launched in 1995 has had a significant impact in reducing individuals' precautionary saving for medical expenses, particularly those on low incomes.