

Taipei, China

Growth accelerated in 2007, reflecting a recovery in domestic demand and continued strength in exports. Inflation quickened as global commodity prices rose. An expected slowdown in external demand will trim the expansion this year, although firm domestic demand is likely to support growth around the trend rate. The prospect of closer commercial ties with the People's Republic of China (PRC) is seen spurring growth in 2009.

Economic performance

Reflecting an improvement in domestic demand and strength in exports, GDP growth accelerated to 5.7% in 2007, 1 percentage point above the average for 2003–2006. Growth momentum was particularly strong in the second half of the year, supported by recovering private consumption and buoyant exports (Figure 3.13.1). For the year, net exports remained the primary demand-side driver. Merchandise exports, measured in nominal United States (US) dollars, decelerated to 10.1% from 12.9% in 2006. Although exports bound to the US fell by 0.9%, this was largely offset by strong demand from the PRC and other markets in Asia. Electrical machinery, chemicals, and basic metals led the growth of exports.

Import growth also moderated, to 8.2% from 11.0% a year earlier. Given that high global prices of food, oil, and raw materials lifted import prices relative to export prices, the growth of real imports was much more modest than for real exports. As a result, net exports expanded by 29.7% in 2007, contributing 3.7 percentage points to GDP growth.

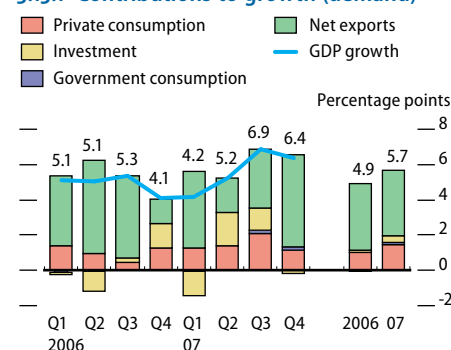
Private investment picked up to grow by 3.4%, largely thanks to a cyclical upturn in corporate spending on machinery and equipment that started in the third quarter of 2006. However, construction contracted by 0.4%. It was hit by two factors: first, concerns that a rapid rise in the price of houses might soon run out of steam; and second, soaring prices of building materials made construction investment more expensive.

The growth in total private investment was partly offset by a 3.9% decline in fiscal investment, which was dragged down by the authorities' efforts to rein in spending. Their encouragement of private participation in public projects has also contributed to a deceleration of public investment in recent years. Overall, total fixed investment rose by 2.4%, making a 0.5 percentage points contribution to GDP growth.

As the impact of a tightening in consumer credit, caused by the bursting of a credit-card bubble in late 2005, wore off, private consumption slowly recovered to grow by 2.6% in 2007. Employment rose and a buoyant stock market lent support to consumption growth.

Services grew by 4.3% and remained the main contributor to

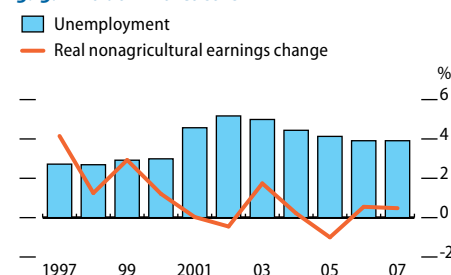
3.13.1 Contributions to growth (demand)



Source: Directorate General of Budget, Accounting and Statistics, available: <http://eng.dgbas.gov.tw>, downloaded 25 February 2008.

[Click here for figure data](#)

3.13.2 Labor indicators



Sources: CEIC Data Company Ltd., downloaded 17 March 2008; Directorate General of Budget, Accounting and Statistics, available: <http://eng.dgbas.gov.tw>, downloaded 7 February 2008.

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GDP growth on the supply side, underpinned by the consumption recovery, expansion of foreign trade, and brisk financial market activity. Manufacturing put in its best performance in more than a decade. It expanded by 10.1%, led by electronics components, telecommunications products, and chemical materials. Construction growth moderated to 3.4% in 2007 because of the caution over the property market. Agricultural production, hit by a severe typhoon in the fourth quarter, contracted by 2.9%.

The lower farm production and increased pass-through of international commodity price increases pushed up inflation from 1.0% (year on year) in the first quarter of 2007 to 4.5% in the fourth. For the year as a whole, the consumer price index rose by an average 1.8%, compared with just 0.6% a year earlier. Excluding certain food and energy prices, core inflation rose to a decade-high 1.4%, suggesting some increase in domestic cost pressures. The pickup in economic growth bolstered the labor market: employment expanded by 1.8% and annual average unemployment remained at 3.9%. Average earnings of nonagricultural workers rose by 2.3%, slightly above the inflation rate (Figure 3.13.2 above).

Alongside a rising trade surplus, the current account surplus swelled to US\$31.7 billion in 2007, equivalent to 8.3% of GDP. Against this, the capital and financial account posted a record deficit of US\$39.0 billion owing to a sharp decline in portfolio capital inflow, as foreign investors sold shares in the local stock market during the US liquidity crunch (Figure 3.13.3). The balance of payments deficit contributed to weakness in the currency. Over 2007, the NT dollar depreciated on average by 0.9% against the US dollar (Figure 3.13.4), and its real effective exchange rate depreciated by 0.8%.

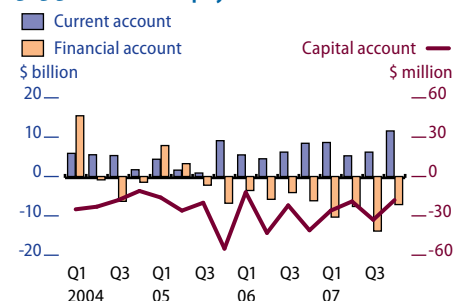
The monetary authorities, prompted by concerns over cost-push inflation and low real interest rates (they were negative in the fourth quarter), raised the benchmark discount rate in each quarter of 2007, by an aggregate 62.5 basis points to 3.375% at the end of the year. Given an abundance of loanable funds in the banking system, the cost of borrowing remained low. The base lending rate rose by 19.8 basis points to 4.31% over the year. The growth of broad money (M2) eased to average just 4.3% from 6.2% in 2006, largely reflecting the effects of net capital outflows and reduced public sector borrowing from domestic banks.

Solid economic growth and the authorities' fiscal consolidation effort strengthened the budget position. Tax revenues rose by 8.3%, driven by high corporate profits, the buoyant stock market, and implementation of an alternative minimum tax, which brings firms and individuals who had exemptions from income tax into the tax net. Revenue growth exceeded the pace of public spending, reining in the fiscal deficit to 0.2% of GDP.

Economic prospects

This economy is heavily dependent on external trade. The expected slowdown in the US and other major industrial countries and the impact on Asian economies is likely to damp demand for its exports. Consequently, economic growth is expected to decelerate to 4.2% in 2008 (Figure 3.13.5). Momentum is projected to pick up again in 2009, with growth of 5.6% that year, on the assumptions that domestic business

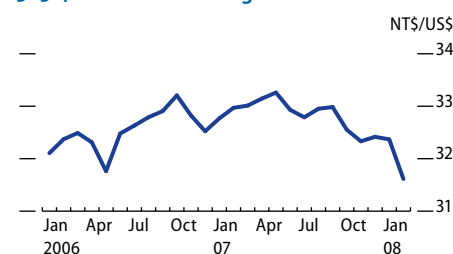
3.13.3 Balance-of-payments indicators



Sources: Data downloaded from <http://www.cbc.gov.tw/>, 13 March 2008; CEIC Data Company Ltd., downloaded 17 March 2008.

[Click here for figure data](#)

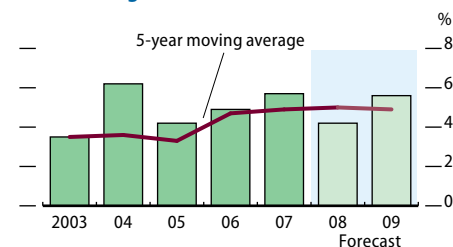
3.13.4 Nominal exchange rate



Source: Data downloaded from <http://www.cbc.gov.tw/>, 15 March 2008.

[Click here for figure data](#)

3.13.5 GDP growth



Sources: Directorate General of Budget, Accounting and Statistics, available: <http://eng.dgbas.gov.tw/>, downloaded 25 February 2008; staff estimates.

[Click here for figure data](#)

3.13.1 Selected economic indicators

	2008	2009
GDP growth	4.2	5.6
Inflation	2.3	1.6
Current account balance (% of GDP)	7.3	6.6

Source: Staff estimates.

sentiment receives a lift from a likely greater emphasis on growth and from closer commercial ties with the PRC, once the new administration takes office in May this year; also that the external environment turns more favorable with the global downturn bottoming late this year.

Resilient domestic demand will cushion the economy from the global economic slowdown. Private consumption is expected to continue to recover this year, against the background of a firm labor market, and grow by 3%. In regard to investment, businesses are likely to be cautious amid moderating external demand and volatile financial markets. Still, there are projects in the pipeline to expand production of liquid crystal display panels that should support growth in manufacturing investment. The buoyant property market is likely to ease because of higher interest rates and concerns over possible oversupply in some areas, acting as a drag on house construction. On the other hand, a push by the authorities for urban regeneration will support some types of construction. Overall, investment is projected to grow by 2.5% this year, similar to 2007.

Export growth is expected to slow by 4 percentage points to 6.0% this year. Import growth, driven by higher international commodity prices, is forecast to outpace export growth, rising by 6.5%. As a result, the current account surplus is forecast to decline to 7.3% of GDP. Taking the price effects into account, the contribution of net exports to GDP growth is forecast to fall by about 2 percentage points, to 1.6 percentage points.

A lag in the pass-through of rises in wholesale prices in 2007 and low base effects in the consumer price index will cause inflation to edge up to 2.3% in 2008. Currency appreciation will help to limit imported inflation. The NT dollar appreciated by 5.6% against the US dollar between January and mid-March 2008, partly a result of slower portfolio capital outflows, and is expected to remain firm. Given that forecast GDP growth is broadly in line with trend potential, the monetary authorities are expected to continue to raise interest rates at a modest pace in 2008 to contain inflation and bring interest rates to a neutral level.

The new administration is expected to ease controls somewhat on economic ties with the PRC, primarily in the areas of investment, trade, tourism, and transportation. Such changes would likely stimulate growth in these services, in part by reducing costs, and raise business and consumer sentiment. Extra public investment in infrastructure is also possible in the medium term. Going into 2009, therefore, firmer domestic demand, coupled with some recovery in external demand, is projected to support a robust economic expansion.

The main external risk is a sharper than expected slump in the US. On the domestic front, there is a risk that implementing the forecast improved links with the PRC will take longer than expected.

3.13.1 Development challenges

The most immediate challenge is to improve the policy environment to facilitate closer cross-strait economic integration. The PRC already accounts for 40% of Taipei,China's exports and 70% of its outbound investment. However, as there are no direct cross-strait transportation links, passengers and cargos transit Hong Kong, China or Macau, China. This raises business costs and hurts development of vertical integration of production and just-in-time supply lines. Direct transportation links with the PRC would facilitate the growth of the island as a research and development, logistics, and financial center.

Similarly, the authorities in Taipei,China prohibit banks based there from setting up branches in the PRC; these banks have only recently been allowed to invest in PRC banks. Limits on investment in PRC companies have led some firms to delist from the local stock exchange and pursue an overseas listing. A concrete policy framework toward broad cross-strait economic integration could help reduce the operating costs of local firms and facilitate their participation in regional and global production networks.

Longer term, industrial diversification is important. The economy relies heavily on electronics, the performance of which hinges on demand conditions in the US and on costs in the PRC, where much electronics production has been relocated. With production costs rising in the PRC and other lower-cost countries entering the industry, producers in Taipei,China are being squeezed.

The economy needs to diversify into high-end manufacturing and into services. Given the relatively small scale of the economy, progress in upgrading industry and services is likely to require closer ties with other economies.