Taipei,China

On the back of stronger exports, economic growth accelerated in 2006. Domestic demand was subdued for most of the year, weighed down by a tightening of consumer credit. This year, consumption and investment demand are projected to pick up, cushioning the economy from an expected slowdown in external demand. That would leave GDP growth slightly below last year's pace. Structurally, higher performance levels require manufacturers to move further up the value chain and services firms to become more outward oriented.

Economic performance

Supported by strength in exports, the economy grew by nearly 5.0% in the first 3 quarters of 2006, but slowed to 4.0% in the fourth when the pace of exports decelerated sharply (Figure 2.12.1). For the year as a whole, exports of goods and services measured in US dollars expanded by 12.9%, up from 7.8% in 2005, led by optical equipment, electronics, and machinery. Growth in imports accelerated to 9.9.%, from 8.2%, driven by purchases of inputs needed for the expanding export industries and by a strengthening in domestic investment. As a result, net exports in national account terms jumped by 31.3%, contributing 3.5 percentage points of total 2006 GDP growth of 4.6% (Figure 2.12.2).

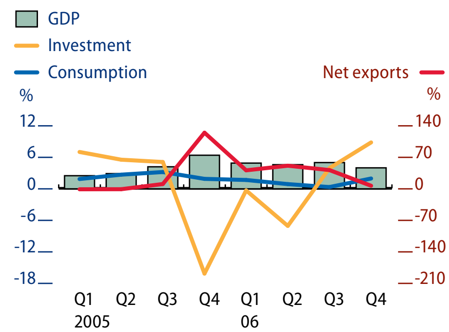
Private investment edged up by 2.1% in 2006, largely the result of a cyclical upturn in the second half, following 3 quarters of decline. The pickup was primarily seen in purchases of machinery and equipment prompted by strong exports of manufactures. Construction investment also continued to recover, as the property market strengthened. However, private investment growth was largely offset by a 4.9% contraction in public investment, due to the completion of some major projects. Overall, total fixed investment rose a paltry 0.3%, making little contribution to the overall outturn.

Private consumption decelerated to 1.5% from 2.7% a year earlier, weighed down by a tightening in consumer credit that followed the bursting of a credit-card bubble in late 2005. On a year-on-year basis, private consumption slowed to just 0.4% growth in the third quarter. It picked up in the fourth, in part because of a low-base effect from weak private consumption expansion in the last quarter of 2005. Government consumption slipped by 0.2%, reflecting efforts to tighten expenditures.

On the supply side, manufacturing grew by 7.1%, led by the subsectors of electronics components and computer and telecommunications products. Construction rose by 5.2% (from 0.5% in 2005). Services, which account for 73% of GDP, steadily progressed by 3.7% and were again the major contributor to GDP growth. Agriculture expanded by 5.4%, mostly a recovery from typhoons and floods in 2005.

Those natural disasters had hit vegetable and fruit production in 2005, pushing up the consumer price index by 2.3%. In 2006, as their

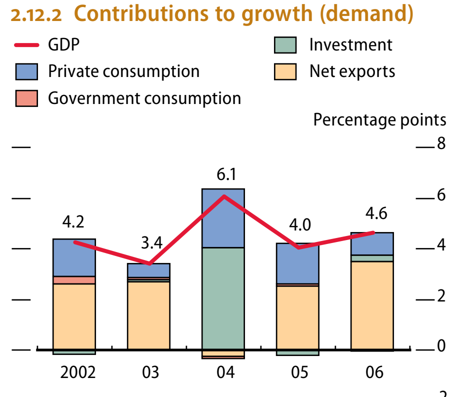
2.12.1 Growth of GDP and demand components



Source: Directorate General of Budget, Accounting and Statistics, available: http://eng.stat.gov.tw, downloaded 26 February 2007.

Click here for figure data

2.12.2 Contributions to growth (demand)



Source: Directorate General of Budget, Accounting and Statistics, available: http://eng.stat.gov.tw, downloaded 26 February 2007.

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prices fell or steadied, inflation was marked down to 0.6%. Wholesale prices, in contrast, rose steeply by 5.6%, pushed up by rising international oil and commodity prices and a weakening of the New Taiwan dollar (Figure 2.12.3). The divergent trend between consumer and wholesale prices indicates limited pass-through from increased production costs into retail inflation, partly a consequence of firms having limited pricing power.

Labor market conditions improved with the faster pace of economic growth. Total employment expanded by 1.7% and the annual average unemployment rate fell to a 6-year low of 3.9%. Job creation was broad based, with construction growing strongest, by 3.3%. The reduction in labor market slack and lower inflation lifted real wages. Real average earnings of nonagricultural workers rose by 0.5%, a switch from a 0.9% decline in 2005.

Concerned about negative real interest rates and inflationary pressures from rising prices of imported oil and commodities, the monetary authorities raised the benchmark discount rate by 12.5 basis points in each quarter of 2006, to 2.75%. The policy rate is still below those of most other regional economies, however.

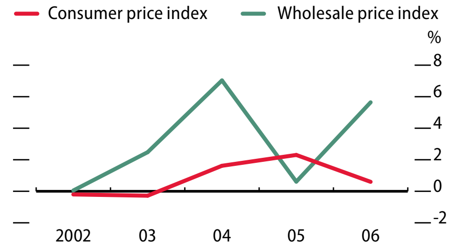
With an abundance of funds in the banking system, the cost of borrowing stayed low. The base lending rate rose by just 27 basis points over the year to 4.12%. However, the pace of domestic loan growth slowed markedly to 2.5% at end-2006 from 8.1% a year earlier, mainly due to the weakness in consumer lending. After 2 years of rising at double-digit levels, lending to consumers nudged up by 1% in 2006 as banks imposed more stringent lending standards after a surge in credit-card defaults. Banks wrote off US$5.1 billion in bad cash-card and credit-card loans last year, more than double the amount in 2005.

On the back of the property market upturn, construction lending rebounded by 26.8%, which partly offset the impact of the consumer credit crunch (Figure 2.12.4). Despite weak credit expansion, broad money (M2) grew by an average of 6.2% in 2006, similar to that recorded in 2005, as financial institutions increased their portfolio investments.

The strong rise in exports pushed the trade surplus up by 30% and this followed through into the current account surplus, which reached $25.2 billion in 2006, equivalent to 7.1% of GDP. This was partly offset by an upsurge in capital outflows channeled to overseas securities markets, and by a reduction in portfolio investment inflows. A widening gap between local interest rates and the US Federal Funds rate was the major factor driving capital outflows, though some domestic reasons apparently contributed, such as the gradual lifting of a cap on overseas investment by insurance companies. Gross international reserves rose to $266.1 billion at end-2006. The capital outflows also contributed to weakness in the currency. Over the year, the New Taiwan dollar depreciated on average by 1.1% against the US dollar, and its real effective exchange rate by 0.4%.

In fiscal matters, the faster pace of economic growth was not reflected in tax revenues, which rose modestly by 1.8%. The tax-to-GDP ratio declined to 14.3% in 2006 from 14.6% a year earlier. Corporate income tax receipts fell by 5.3%, possibly a result of tax exemptions and tax preferences for certain investment and industries. The Government trimmed spending and ended the year in the black, reversing a run of deficits. The ratio of central government outstanding debt to GDP rose

2.12.3 Inflation



Source: Directorate General of Budget, Accounting and Statistics, available: http://eng.stat.gov.tw, downloaded 13 March 2007.

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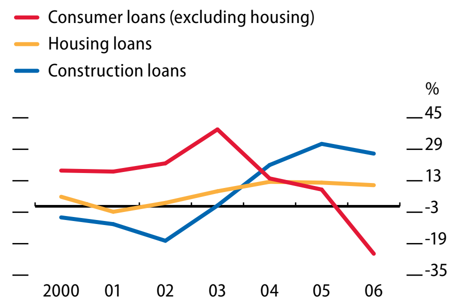
2.12.4 Loan growth



Source: Central Bank of the Republic of China, available: http://www.cbc.gov.tw, downloaded 14 March 2007.

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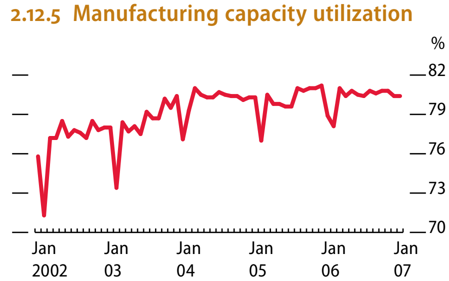
2.12.5 Manufacturing capacity utilization



Source: Business Indicators DataBase, available: http://index.cepd.gov.tw, downloaded 11 March 2007.

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2.12.1 Selected economic indicators

	2007	2008
GDP growth	4.3	4.5
Inflation	1.6	1.5
Current account balance (% of GDP)	6.7	6.5

Source: Staff estimates.

slightly to 33.2% at end-2006, within a 40% ceiling stipulated by the Public Debt Law.

Economic prospects

External conditions will be benign in 2007, despite the expected deceleration in the global economy and a softening in demand for some electronics. Resilient intra-Asian trade and robust demand from the People's Republic of China (PRC) will likely provide a buffer against the slowdown in other world markets. Export growth is expected to slow by about 4 percentage points to a still-solid 8.8%. An upturn in the global electronics cycle, starting in the second half of this year, is projected to take export growth back up in 2008, to 9.4%.

Domestic demand is forecast to recover gradually, bolstered by the modest upturn in investment that started in 2006 and a strengthening in consumer spending. The cyclical rebound in machinery and equipment investment will likely be prolonged by a high manufacturing capacity utilization rate (Figure 2.12.5) and by solid exports. Construction investment growth will ease because the buoyant property market is expected to slow. Public investment will increase owing to new public infrastructure projects in energy, water supply, and railways. Private consumption is expected to accelerate back to 3.0% in 2007 as the credit-card debt problems are resolved. Also, spending is underpinned by positive wealth effects from last year's gains in housing and equity prices as well as the strengthening of the labor market.

Based on the above factors, economic growth is projected to moderate to 4.3% in 2007, then inch up to 4.5% in 2008 as the global economy gains momentum. Inflation will creep up to around 1.6% in the forecast period from last year's low levels. Low inflation, a reduced risk of imported inflation, and the expected end of US interest rate rises suggest that the monetary authorities could adopt an accommodative monetary policy stance and keep interest rates steady over this year. Import growth measured in nominal terms is projected to outpace export growth, largely because of the imports needed for investment projects. The current account surplus is forecast to decline to 6.7% of GDP in 2007 and 6.5% in 2008.

These projections are subject to both downside and upside risks. Political uncertainties ahead of legislative elections in December 2007 and presidential elections in March 2008 could unnerve investors, as would any deterioration in cross-strait relations. On the upside, a possible move to liberalize economic relations with the PRC, such as relaxing limits on investment there or restrictions on tourists visiting the island from across the strait, would boost confidence in the economy.

2.12.1 Development challenges

Two important medium-term challenges face the authorities: to nurture new sources of growth and to redress income inequalities. The growth engine of recent decades—electronics—has faced significant competition from low-cost producers. Most of its labor-intensive production has relocated to the PRC.

Firms in Taipei,China still make some high-value products and play a dominant role in regional supply-chain management, but profit margins have been squeezed and their linkages to the domestic economy weakened. This is reflected in a reduction in manufacturing to 21.4% of GDP in 2006 from 37.6 % in 1986.

Services, which accounted for 73% of GDP last year, are mainly oriented toward the domestic market and are dominated by small and medium enterprises, so are unlikely to expand at much faster rates than they do now. New growth sources would be fostered if manufacturers moved further up the value chain and services firms tapped into regional markets.

Although the economy has a relatively equal income distribution, income disparities have widened over the past decade. Only the highest-earning 20% of households enjoyed gains in income in 2001–2005, partly because corporate and investment income outpaced wage income, helped by corporate tax breaks. Incomes for other groups stagnated or declined. Unskilled workers were the major losers as manufacturers relocated abroad. Some middle-income earners also suffered because of subdued growth in real wages and a disproportionate tax burden on salaried employees.

The widening income gap will restrain expansion in consumption, make it more difficult to win public support for further economic liberalization, and could even induce social tensions.