Taipei,China

The upturn in the global electronics cycle lifted the economic growth rate in late 2005, after a soft first half to the year. Private investment contracted, weighed down by weak electronics exports in the first half, but private consumption continued to expand. Inflation picked up and, partly as a result, the authorities are nudging the discount rate higher. The likely continued upswing in the electronics cycle in 2006 will assist exports, investment, and growth, though growth may moderate later in the year.

Economic performance

Driven by the cyclical swing in global demand for electronic goods, year-on-year growth slowed through the first and second quarters of 2005 before edging up in the third and then picking up strongly in the fourth. For the year as a whole, the economy expanded by 4.1%, down 2 percentage points from 2004. The slowdown stemmed mainly from decelerating growth in merchandise exports, to 8.8% from 20.7% in 2004. Merchandise import growth fell even more sharply, to 8.5% from 32.5%, reflecting weak domestic investment demand. As a result, net exports in national accounts terms expanded by 27.6% and contributed 2.5 percentage points to gross domestic product (GDP) growth (Figure 2.12.1).

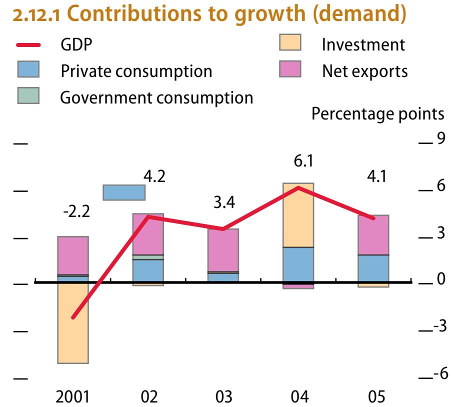
Private consumption, which accounts for 62% of GDP, grew by 3.0% in 2005, similar to its pace of growth in recent years, and contributed 1.8 percentage points of GDP growth. Consumer confidence has crept up on the back of continued improvement in employment. Rapid expansion of consumer credit over several years has also lifted consumer spending.

Government consumption and investment grew marginally by 0.7% and 0.3%, respectively, reflecting the authorities' efforts to tighten expenditure. Fixed investment by public enterprises grew robustly by 17.2%, but this was partly offset by a 1.3% fall in private investment, resulting in a modest 0.5% gain in total fixed investment.

Private investment usually tracks the export cycle, but this was not the case in 2005, when exports turned up in the second half and private investment fell (Figure 2.12.2). This may have been a consequence of a sharp expansion of production capacity in 2004, enabling manufacturers to meet higher export demand in the second half of 2005. Overall, total investment (including inventory investment) shaved 0.3 percentage points from GDP growth in 2005.

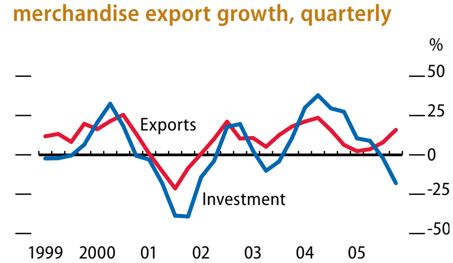
From the sector perspective, agriculture contracted by 4.1% in 2005 owing to severe typhoons and floods. Manufacturing grew by 5.8%. Electronics, despite weak performance in the first 2 quarters, remained the key driver of manufacturing expansion. Construction, which had expanded in 2004 after 6 years of decline due mainly to excess housing supply, was flat in 2005. Services, led by the wholesale and retail trading and restaurant subsectors, grew by 3.8%, a sign of the strength of consumption demand. Reflecting relatively rapid price increases in

2.12.1 Contributions to growth (demand)



Source: National Statistics statistical database, available: http://61.60.106.90/officialstat/dbmain.htm, downloaded 27 February 2006.

2.12.2 Private investment and merchandise export growth, quarterly



Source: National Statistics statistical database, available: http://61.60.106.90/officialstat/dbmain.htm, downloaded 27 February 2006.

the sector, the nominal growth of services continued to outpace that of industry, so that the share of services in GDP on this basis has in 20 years climbed to about 74% from 50%, while the share of industry has declined to about 25% from 40% (Figure 2.12.3). The relocation of some traditional manufacturing production in recent years to low-cost economies, such as the People's Republic of China (PRC), has contributed to the decline of industry.

Severe typhoons caused significant increases in food prices, pushing consumer inflation up to an average of 2.3% in 2005. However, core inflation remained tame at 0.7%. The direct effect of high global oil prices has been muted by appreciation of the New Taiwan dollar (NT$) and price regulation of transport services and power. Also, closer integration with the PRC economy has led to an inflow of lower-priced manufacturing imports, which has helped damp inflation in recent years. Employment rose by 1.6% and the unemployment rate fell to 4.1%, a 5-year low. However, average earnings of nonagricultural workers rose by just 1.4%, below the inflation rate.

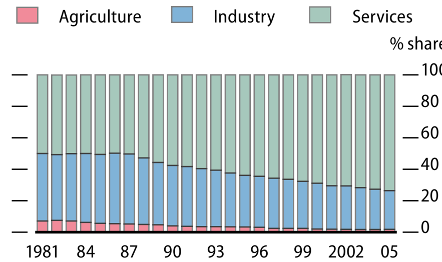
In the context of low and negative real interest rates, and the pickup in inflation, the monetary authorities gradually shifted to a more neutral policy stance to help achieve price stability and prevent capital misallocation. The Central Bank of China raised its benchmark discount rate by 12.5 basis points in each quarter of 2005, bringing this key rate to 2.25% from 1.75% at end-2004 (Figure 2.12.4). Given an abundance of funds in the banking system, monetary conditions were hardly affected by these mild rate rises. The interbank call loan rate rose by 25 basis points, while the base lending rate of the banking system rose by 33 basis points. Growth in broad money (M2) slowed from 7.4% in 2004 to 6.5%, still near the high end of the central bank's 3.5–7.5% target range.

Domestic credit expanded by 8.0%, underpinned by increased lending both to businesses and to individuals. Outstanding consumer loans at year-end were up by 12.8% from 12 months earlier. Banks tightened lending policies during the year on concerns of a rise in nonperforming credit card loans, following a significant increase in the number of credit cards issued.

The merchandise trade surplus rose to $18.0 billion in 2005, but the current account surplus narrowed to $16.4 billion, equivalent to 4.7% of GDP, due mainly to increased outward remittances of investment income. A surge in net inflows of portfolio investment was more than offset by increased loans to foreign banks, resulting in a reduced financial account surplus. Gross international reserves rose to $253.3 billion. A heavy volume of foreign funds into stocks, driven by an improvement in international investor sentiment (investors were underweight the Taipei,China stock market compared with others in Asia) and speculation on revaluation of the PRC yuan contributed to an abundance of liquidity and strength in the currency. The New Taiwan dollar appreciated by 3.9% against the United States dollar in 2005 in year-average terms, and its real effective exchange rate appreciated by 0.2%.

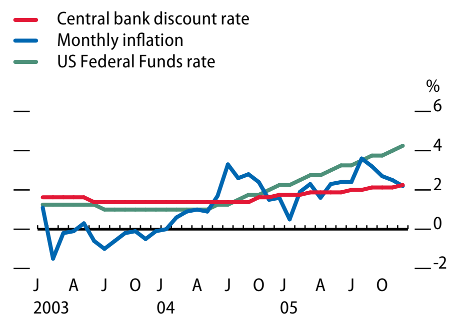
Fiscal consolidation efforts, combined with the impact on revenues of economic expansion over the past 4 years, lifted general government revenue by an estimated 8.5% in 2005, while total expenditure declined by 1.0%. As a result, the budget deficit continued to shrink (Figure 2.12.5),

2.12.3 Sector structure of GDP



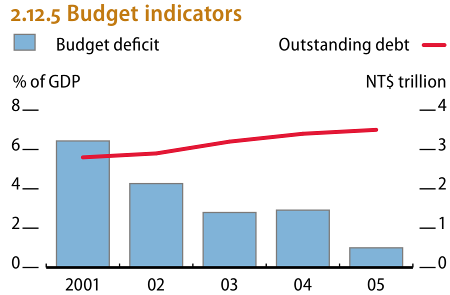
Source: National Statistics statistical database, available: http://61.60.106.90/officialstat/dbmain.htm, downloaded 27 February 2006.

2.12.4 Central bank discount rate, monthly inflation, and US Federal Funds rate



Sources: Central Bank of China, available: http://www.cbc.gov.tw/EngHome/Eeconomic/Statistics/FS/history/EINTEREST-H.xls; National Statistics, available: http://eng.stat.gov.tw/public/data/dgbas03/bs3/english/cpiidxc.xls, downloaded 20 March 2006; Datastream, downloaded 18 March 2006.

2.12.5 Budget indicators



Sources: Directorate General of Budget, Accounting and Statistics, available: http://eng.stat.gov.tw/public/Attachment/5122010301471.XLS, downloaded 27 February 2006; Central Bank of China, *The Central Bank of China Annual Report 2004*, available: http://www.cbc.gov.tw/EngHome/Eeconomic/Publications/year2004/developments-26-28.pdf, downloaded 22 March 2006; staff estimates.

to 1.0% of GDP. The ratio of outstanding central government debt to GDP stood at 32.1% at end-2005, marking recent years' financing of budget deficits.

Economic outlook

The economy relies heavily on the world market, especially for electronics. External conditions in 2006 are expected to be favorable, with the current buoyancy in consumer electronics likely to continue over most of the year. On the domestic front, fiscal policy in 2006–2007 is expected to tighten further to check the rise in government debt. The introduction this year of the "alternative minimum tax" (Box 2.12.1) is likely to lift revenue in 2007 and beyond. The Central Bank of China is expected to raise interest rates at a modest pace in 2006 to contain inflationary pressure and to narrow the interest rate gap with the United States. (It raised the discount rate by 12.5 basis points in March.)

Based on these assumptions, economic growth is forecast to strengthen to 4.4% in 2006 (Figure 2.12.6) on the back of sustained world economic expansion, a continued upswing of the global electronics cycle, and a pickup in domestic investment. Growth momentum may ease to 4.0% in 2007, largely reflecting a softening in worldwide electronics demand.

Domestic demand is likely to assume a bigger role in supporting growth in the next 2 years. Private investment, which lagged the export upturn in the second half of 2005, is expected to rebound in the first half of this year as manufactured exports remain buoyant. Capacity utilization rates of manufacturing firms rose to a high 81.2% in December last year, which also supports hopes of an increase in manufacturing investment. Private consumption is forecast to sustain its steady rate of growth owing to continued employment generation and possible gains in real wages that might result from the tighter labor market. A pickup in property prices may also support consumer spending through positive wealth effects.

The increase in credit card debt defaults, while having a social impact, is unlikely to be a serious threat to growth in consumption or to financial sector stability. The nonperforming loan ratio for credit cards rose to 2.4% at year-end, from 2.0% in December 2004. Banks wrote off the equivalent of $2.2 billion of bad loans on credit cards in 2005. As for external demand, solid growth in exports is expected, but stronger import growth, driven by improving investment, will partly offset the contribution of exports to GDP growth. The current account surplus is forecast to average about 5% of GDP in 2006–2007.

The high-base effect on food prices in 2005 will bring down the year-on-year inflation rate in 2006, assuming no severe typhoons. This effect will be partly countered by upward pressures on costs from continued high prices for imported oil and commodities, and possibly from higher real wages. Consumer inflation is forecast to moderate to 1.6% in 2006 and 1.3% in 2007 (Figure 2.12.7).

Medium-term prospects for the economy depend on two main structural factors. First, economic development in Taipei,China has been led by medium-sized firms that supply global electronics companies under original-equipment manufacturing arrangements, and that do not

2.12.1 Selected economic indicators

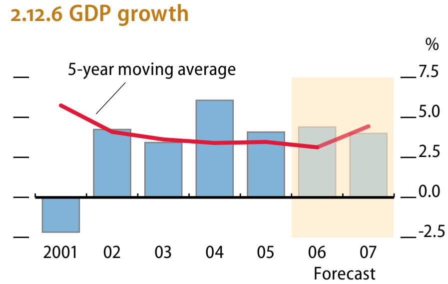
	2006	2007
GDP growth	4.4	4.0
Inflation	1.6	1.3
Current account balance (% of GDP)	5.1	4.8

Source: Staff estimates.

2.12.1 Alternative minimum tax

This tax on income has a rate of 10% on business profits exceeding NT$2 million and of 20% on individual annual incomes exceeding NT$6 million. It broadens the tax base, which has been eroded over the years by exemptions, since firms and individuals who were exempt now have to pay the tax.

2.12.6 GDP growth



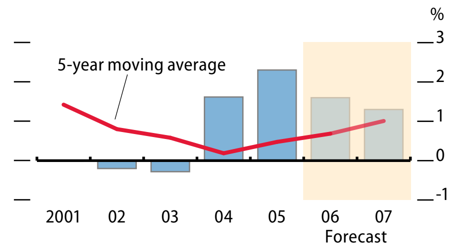
Sources: National Statistics statistical database, available: http://61.60.106.90/officialstat/dbmain.htm, downloaded 27 February 2006; staff estimates.

own the product brands. As these companies have pursued aggressive pricing strategies, the profit margins of domestic suppliers have been severely squeezed, with a profit rate of 2–5% typical for original-equipment manufacturers. Furthermore, competition from low-cost producers, such as the PRC, has reduced the advantage of Taipei,China in this industry. A number of domestic firms have developed their own brands and achieved some success. In terms of global branding capability, however, the vast majority have a long way to go. More effort needs to be made to nurture the larger firms and to strengthen their capacity in branding, research and development, and distribution.

Second, the services sector, now such a large part of the economy, needs to become a key driver of long-term economic growth. Expansion to date has been limited, partly by the generally small scale and domestic orientation of services companies. A higher rate of growth in the sector is likely to require further opening to foreign competition, regulatory reforms, and consolidation of the fragmented banking industry. On the assumption of stable cross-strait relations and continued efforts to push forward with reforms to address these structural issues in the medium term, GDP growth is forecast to be 4.0–4.5% in 2006–2010, broadly in line with the economy's growth potential.

The major risks to the outlook in the short term are the depth and duration of the upturn in the electronics cycle, given the importance of electronics to manufacturing, exports, and investment. A significant deceleration of growth in the PRC would certainly cloud the outlook. Locally, the alternative minimum tax and a possible increase in the value-added tax may discourage domestic investment and spur the relocation of industry to lower-cost countries. If the credit card default problem turns out worse than expected, credit to individuals could be tightened sharply, undermining consumption growth.

2.12.7 Inflation



Sources: Directorate General of Budget, Accounting and Statistics, *Monthly Bulletin of Statistics*, January 2006, available: http://eng.dgbas.gov.tw/public/data/dgbas03/bs2/bulletin_eng/M-2.xls, downloaded 27 February 2006; staff estimates.