Forward-looking business indicators are now more positive than in late 2011 but weak global conditions will limit export growth in this trade-heavy economy. Domestic demand should continue to provide a relatively strong base, supported by rising incomes reaching around US$21,000 per capita this year. A gradually improving global outlook will boost growth in 2013, but longer term, increased R&D and investment is needed to secure broad-based, stable growth through diversification and restructuring of the economy.

Economic performance

Following the post-recession rebound, economic growth slowed to 4.0% in 2011 (Figure 3.13.1). Growth decelerated to 1.9% in the fourth quarter, reflecting the slump in gross capital formation and investor concerns about the global outlook.

Positive net exports accounted for most of the increase in output, despite weak external demand, as the slowdown in exports was less marked than that for imports.

Domestic demand was mixed, as domestic consumption was relatively strong but investment declined. Private consumption rose by 3.0% in 2011, supported by robust job growth, low unemployment (4.4%), and rising earnings. Government consumption picked up by about 2%. Private investment, however, fell by 2.3%, more sharply so in the second half of the year as business enterprises, especially in electronics, put their investment plans on hold. Public investment declined even faster, by 8.4%, as stimulus-related infrastructure outlays were gradually completed (Figure 3.13.2).

Growth was almost evenly distributed between industry and services. The former grew by 4.4% for the year—in contrast to 2010 when it jumped by 23%—slowing sharply in the fourth quarter. Manufacturing rose by 4.9% but construction activity was flat, in line with a slowing property market. Services saw modest gains in wholesale and retail trade, finance and insurance, information and communications, and strong gains in hotel and restaurant services. Agriculture grew by 1.9%, but accounts for less than 2% of GDP.

Inflation of 1.4% was well within the central bank’s target. Measures to curb mortgage lending, as in the previous year, continued to slow residential property price increases. The appreciating local currency against the United States (US) dollar—up 7.4% through end-December 2011, taking it to near the rate before the global financial crisis—also helped curb inflation.

Monetary policy continued tightening in 2011 (Figure 3.13.3). However, from September 2011 the central bank kept the discount rate

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unchanged at 1.875%, as concerns mounted about the risk of another global economic slowdown. Money supply and bank credit expansion climbed only slowly, although loans to the private sector increased faster than in 2010, at 8.1%.

Fiscal policy remained accommodative, with a deficit of 2.5%. Overall government expenditure increased by 4.4%, reflecting rising social welfare payments and development-related initiatives. Revenue rose by 10%, supported by a healthy rate of expansion in nominal GDP. Public debt is projected to rise to the equivalent of 37% of GDP, still below the limit of 40% set by law.

Trade decelerated (Figure 3.13.4). Growth of goods exports slowed to 12.1%, on a combination of weakening external demand and adjustment from the unsustainable 34.6% postcrisis rebound of 2010. Exports to advanced countries slumped while developing Asian markets remained relatively strong. In particular, the Economic Cooperation Framework Agreement with the People’s Republic of China (PRC) resulted in rapid growth in exports of products included under the Early Harvest Program.

Merchandise import growth contracted to 13.0% from 43.1% in 2010, as imports of capital goods fell sharply. The trade surplus increased by 4.5% to US$27.6 billion.

The services account was in surplus, boosted by strong growth in tourist arrivals from the PRC. The income account remained positive as repatriated profits and dividends from Taipei,China’s investments abroad exceeded its payments to nonresidents. A current account surplus of US$41.3 billion was recorded, equivalent to 8.8% of GDP.

Direct investment recorded a net outflow of US$14.8 billion, due mainly to firm expansions abroad and relocation of less advanced parts of the manufacturing base to the PRC (Figure 3.13.5). Portfolio investment registered a net outflow of US$35.7 billion, much higher than the previous year, reflecting both concern about the global outlook and safe-haven capital flight. The decline in the capital account more than offset the rise in the current account, bringing foreign reserves down to 82.6% of GDP, from 89% in 2010.

**Economic prospects**

Growth is forecast to slow further in 2012 to an annual 3.4%, on the uncertain world outlook and moderating rate of expansion of the PRC, the island’s largest trading partner. Improvement to 4.6% is forecast for 2013, as both domestic and external demand strengthen.

Growth of exports of goods is forecast to weaken to about 4% in 2012, or a third of the year-earlier rate. Exports of services will be more robust, growing by more than 7%, supported by greater tourist arrivals from the PRC as visa restrictions are relaxed further. Continued growth of exports to developing Asian markets in 2012 and 2013 will compensate in part for the slow growth of exports to developed countries.

Imports of goods and services will also slow sharply, but less so than exports, in part because of the rising cost of oil imports. Net exports will remain positive. Both exports and imports will strengthen as the economy strengthens in the latter half of 2012 and into 2013. The current

3.13.3 Credit indicators

![Credit indicators graph](image3.13.3)


3.13.4 Trade indicators

![Trade indicators graph](image3.13.4)


3.13.5 Net investment flows

![Net investment flows graph](image3.13.5)

account surplus is expected to decline to about 8.0% of GDP for this year and next.

Private consumption is forecast to increase by 2.5% this year, supported by relatively low unemployment, low interest rates, and recovering consumer confidence (Figure 3.13.6), which had fallen at end-2011 following cutbacks in overtime work and encouragement for employees to take leave.

Investment is expected to register little growth in 2012, reflecting the high degree of uncertainty about global demand for information-technology products. Opening the semiconductor and flat-panel subsectors to foreign investment (announced in March 2011) has so far not met expectations. However, another round of liberalization, which began in March 2012, together with the expected gradual resurgence of growth in the US and other major markets, should lead to a pickup in investment later this year and during 2013.

The National Development Plan for 2012, announced in December 2011, is also expected to lift investment in the second half of 2012 and in 2013.

Fiscal policy, however, will be less stimulative than last year. Overall expenditure is budgeted to drop marginally, as spending under the Special Budget will fall to almost zero—with the winding up of crisis measures in response to the 2009 typhoon and the stimulus measures related to the 2008–2009 recession. Revenue is expected to increase by 5%, resulting in a narrowing of the deficit to about 1–2% of GDP, consistent with the government’s policy of gradual fiscal consolidation.

Inflation is expected to remain little changed in 2012 and 2013, at 1.5% and 1.6%. Oil prices are forecast to be marginally higher than last year but slow growth, both domestically and internationally, will in general ease commodity and other prices, including those for food. Property prices have started to decelerate, a result of the monetary authority’s policies on curbing speculative activities. The upsurge in consumer prices in December–January is considered a short-term aberration, attributable to bad weather and increased demand during the Chinese New Year.

In January, authorities announced that investors from the PRC would be allowed to acquire stakes in local banks and financial holding companies, helping the local stock market rise (by 14%) and the national currency to appreciate against the US dollar (by 2.5%) from end-2011 to mid-March 2012. Uncertainties about the global economy will, however, encourage the central bank to closely monitor exchange rate movements and to keep interest rates at their current levels, while ensuring that inflation stays in check. Monetary policy is expected to tighten in 2013.

Risks to the economic forecast stem primarily from the eurozone sovereign debt crisis and the consequences for the global economy if it were to deepen. Another risk is instability in the Middle East, with the possibility of an oil spike and derailment of economic recovery in the US and elsewhere.
Policy challenge—industrial diversification and competitiveness

A major policy challenge for Taipei, China is diversifying the economy and achieving a more broad-based, resilient growth model. It is highly dependent on exports, which equal about 70% of total output. Further, more than 40% of its exports are based on electronics products (Figure 3.13.7). As an export-led-economy, it is highly susceptible to conditions in its main markets, notably the PRC; Hong Kong, China; the US; European Union; and Japan (Figure 3.13.8).

The competitiveness of the electronics sector is a further concern. Although the sector has evolved over several decades from pure assembly to a high-tech, well-integrated industry, international competition has increased relentlessly, notably from the Republic of Korea. The growing scarcity of low-cost labor in Taipei, China over the past decade or more has prompted some companies to relocate manufacturing plants to the PRC and elsewhere. In turn, this has raised concern that the migration of industry will “hollow out” the economy. Financial difficulties of Taipei, China’s leading memory-chip makers since the global financial crisis, as indicated in their declining share prices (Figure 3.13.9), have underscored the need for restructuring and innovation.

Taipei, China’s competitive position has been further challenged by bilateral trade agreements. Of particular significance, the Republic of Korea–US Free Trade Agreement signed in March 2012 poses stepped-up competition in a wide range of industries, including electronics. Beyond that, the Republic of Korea is scheduled to start negotiations on free trade with the PRC and Japan in May this year.

Recognizing the need for industrial restructuring and strengthened competitiveness, in 2011 the government stepped up efforts to enhance technological innovation, cultural and creative industries, R&D activities, and traditional industries. It also includes investment incentives for innovative foreign and domestic investors. Diversification into rising industries, such as biotechnology, renewable energy, ecological agriculture, and medical care, will require stronger R&D support: total R&D spending in 2009 was equal to 2.9% of GDP, less than the 3.4% for the Republic of Korea and 3.5% for Japan.

The response of the private sector to diversifying and making itself more competitive will be critical. Innovation in products and processes will be essential, as well as deciding on what products to get out of or to avoid. From a public policy perspective, perhaps the most important focus should be on improving the investment regime and on opening more sectors to investment, thereby creating more opportunities for domestic and foreign investors.

One spur may be that Taipei, China’s rank in Doing Business 2012 was 25—far behind both Singapore and Hong Kong, China (first and second), and the Republic of Korea (eighth, up from 15 in 2010). The government, in partnership with the private sector, needs to improve in those areas where the economy ranks poorly and to ease regulatory impediments in key sectors.