Taipei, China

Economic activity picked up in the second half of 2012, compensating for the slump in the first half to record growth at 1.3%. As external conditions improve, this tepid economic expansion is giving way to more robust growth in 2013 and 2014 without igniting inflation. The authorities should continue to maintain adequate policy flexibility to respond to economic challenges that may be posed by a slowdown across the strait or a weaker yen.

Economic performance

After registering 4.1% growth in 2011, Taipei, China’s economy slowed to 1.3% expansion in 2012 (Figure 3.13.1). Exports of goods and services declined in the first half of the year owing to the slowdown in the People’s Republic of China (PRC) and the continued weakness in major industrialized economies but eventually recovered and grew by 3.1% as demand for electronics and precision products picked up. Imports of goods and services declined by 1.9% as weak external demand dragged domestic investment. Net exports contributed 1.1 percentage points to real GDP growth.

Consumer unease caused lower retail sales, curbing growth in private consumption that, with a modest rise in government consumption, saw total consumption increase by only 1.3%. This narrowed consumption’s contribution to growth to 0.84 percentage points. Total investments contracted by 4.2%, as the government stimulus measures had waned since 2009, and as the private enterprises trimmed their investment outlays.

Growth was highly variable across sectors (Figure 3.13.2). Industry, the largest sector, contributed about a quarter of GDP growth, despite rising by a meager 0.9% owing to a slow 1% rise in manufacturing output. Mining and quarrying increased by a hefty 10.4% in 2012 but contributed little to growth because of their small share in GDP. Construction declined, and typhoons left agricultural output down by 5.8%. The service sector grew by a modest 1.0%, as the information, communications, tourism, and entertainment industries picked up and growth in wholesale and retail trade and real estate moderated. Tourist arrivals from the PRC increased dramatically in 2012, as visa requirements relaxed.

Average inflation rose to 1.9% from 1.4% in 2011, owing to acceleration in food prices and the reduction of fuel subsidies that had been in place for 16 months. Rising real estate prices decelerated to 5.7% from 9.9% in 2011, reflecting deteriorating economic conditions and central bank intervention to cool property speculation, which moderated private investments.
Consistent with the government’s policy of narrowing the fiscal deficit, growth in expenditures slowed to 1.5% despite substantial rises in social welfare payments and development spending. Revenues increased by 3.5% as tax receipts grew, bringing the fiscal deficit for the year down to 1.6% of GDP.

The central bank kept the rediscount rate unchanged at 1.875% (Figure 3.13.3), in the face of the continued downside risks arising from the global economic situation and moderating inflation. The money supply (M2) grew by 3.5% in 2012, more slowly than in 2011, reflecting smaller increases in net foreign assets and in bank credit as lending to the private sector grew more slowly and net claims on government enterprises contracted.

Merchandise exports and imports shrunk in 2012 (Figure 3.13.4). Merchandise exports fell by 2.4%, despite a rebound in the second half of the year, when exports increased to the US; the euro area; the PRC; Southeast Asia; and Hong Kong, China. The ASEAN-6 trade bloc within the Association of Southeast Asian Nations took 18% of exports. Imports declined by 3.7%, mainly because of subdued investment.

Buoyed by the tourism boom, services recorded a surplus of $6.1 billion, a 58% rise from 2011, and repatriated profits and dividends into the country remained elevated. Thus, despite slowing exports, the current account surplus climbed to 10.5% of GDP from 8.9% in 2011 (Figure 3.13.5). The balance of payments surplus reached $15.5 billion, triple that of 2011, despite a net capital outflow of $31.6 billion owing to greater investment in foreign debt securities.

**Economic prospects**

Economic growth is projected to rebound to 3.5% in 2013. Industrial activity is expected to ramp up as demand recovers in the PRC, with which warming ties could boost the service sector through tourism. Private investment is expected to be notably stronger in 2013, benefitting from government plans to encourage investment in high-technology manufacturing and lower barriers to foreign investment, as well as an “invest at home” program aimed at local companies that have moved production capacity to the PRC over the past 2 decades. An improving outlook for information technology exports, indicated by increasing orders from developing Asia and the euro area, bodes well for private sector investment. Public investment may not grow, however, and current expenditure may fall as the government intends to further narrow the fiscal deficit to 1.3% in 2013.

The continued recovery in exports, driven by growing momentum in the major industrialized economies including the euro area, could be the main engine of economic expansion in 2014. Improved external demand should encourage private investment and employment, help sustain private consumption, and elevate economic growth to 3.9%.

Inflation is projected to ease to 1.6% in 2013, as international raw material prices stabilize, fruit and vegetable and global commodity prices moderate, and a planned increase in electricity prices is postponed. A tighter labor market may create upward pressure on inflation, mainly in 2014, when inflation will likely edge up to 1.8% on the average.
The central bank has not changed its policy rate since September 2011. Continuing weakness in global demand and the likelihood that the gap between actual and potential output will narrow only slowly will likely keep monetary policy accommodative.

Exports remain competitive as indicated by the real effective exchange rate (Figure 3.13.6), and yen depreciation is likely to have minimal effect, as suggested by the scenario analysis in Box 3.13.1. Exports are projected to improve in 2013 and 2014 with higher growth in the PRC and more geographically diverse export markets. Imports are also expected to increase, especially as tariffs on imported equipment and machinery are cut. The trade account will likely improve and tourist arrivals from the PRC rise. Taipei,China’s current account surplus is expected to remain at about 12% of GDP during the forecast period, generating large surpluses in the balance of payments.

As a highly open economy, Taipei,China is vulnerable to fluctuations in external demand, all the more so because of its heavy reliance on electronics exports. Economic prospects in the euro area remain lackluster, and the PRC may tighten policy to rein in property prices and air pollution, constraining growth in Taipei,China. Exchange rate fluctuations, notably with Japan, could also affect economic prospects.

**Policy challenge—response to external shocks**

Taipei,China is affected by the global economy through changes in foreign demand, which affect its output gap; movements in foreign exchange rates; and the effect of interest rates overseas on the NT dollar. As regional supply chains have developed over the past decade, the economy of Taipei,China has become more interdependent with those of the rest of emerging Asia, which absorb 66% of its exports, the lion’s share going to the PRC (Figure 3.13.7).

Simulations were conducted to gauge the impact of slowing external demand and the weakening of yen on Taipei,China’s growth outlook (Box 3.13.1). They showed a much larger effect from a slowdown if it occurred in emerging Asia than in the euro area and little sensitivity to yen depreciation. These results, while indicative, point to the need for Taipei,China to continue to maintain enough policy flexibility to respond to the changing external environment, especially through monetary and fiscal initiatives.
3.13.1 Impact of developments in trade partners

The impact of slowing external demand and the weakening of yen on Taipei, China’s growth outlook were analyzed using the global projection model (GPM) as detailed in Carabenciov et al. (2013), and a small, open economy model (SOE). The GPM posits six regional blocks: the US, the euro area excluding Estonia, Japan, Latin America, emerging Asia, and a block of other countries. The SOE uses equations on output gap, inflation, real exchange rate, unemployment, and interest rates and links with the GPM through output gap and exchange rate equations. Two scenario analyses were done using the GPM, and the results were used as parameters for the SOE to determine impact on the Taipei, China economy. The results show output gap as the strongest channel for transmitting spillover effects and spillover effects strongest from emerging Asia (box table), with which the island has the strongest trade ties.

The first scenario looks at the impact of a shock that reduces GDP growth in the euro area by 1 percentage point below its baselines of –0.3 in 2013 and 1.2% in 2014 and compares it with the effect of the same development in emerging Asia (setting growth in emerging Asia 1 percentage point lower than the baselines for 2013 and 2014). GDP growth for other blocks remains at their baselines. A simulation is then conducted to see how other macroeconomic variables—output gap, inflation, interest rate, real exchange rate, and unemployment—respond to the assumed scenario.

The results suggest that a 1 percentage point slowdown in the rest of emerging Asia would shave Taipei, China’s growth by 0.2 percentage points in 2013 and 0.4 percentage points in 2014. This is twice as large as the impact of the same developments in the euro area (box figure). There may be secondary and indirect spillover effects of the euro area slowdown, transmitted to Taipei, China through emerging Asia, but they would materialize only in later years and would not substantially change the results for 2013 and 2014.

The second scenario looks at the impact of the Japanese yen depreciating to an average of ¥100 per US dollar in 2013 and 2014 from the average 2012 rate of ¥79. Japan is the fourth-largest destination for Taipei, China exports, with a share of 7%, and it supplies more than 20% of imports, mainly capital goods for manufacturing. Therefore, other things being equal, a weaker yen would make Japanese products more competitive in Taipei, China’s export markets, but it would also lower the cost of producing exports, with the net effect on the economy uncertain.

The simulation results suggest that Taipei, China’s growth would not be affected by a weakened yen in 2013 but might decline marginally by about 0.05 percentage points in 2014. The growth rate would rise initially as manufacturing output increases owing to the lower cost of imported inputs but decline marginally later as competitiveness slightly weakens. The real effective exchange rate would gradually strengthen but only minimally. Factors that could amplify the impacts are the substitutability of products from Japan and Taipei, China and potential changes in the competitive landscape, such as the acquisition of Japanese brands by firms in the Republic of Korea.

### Spillover from shocks in the euro area, emerging Asia, and Japan

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<th>Impact on GDP growth in Taipei, China (percentage points)</th>
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</table>

Source: ADB estimates using the global projection and small, open economy models.

### Spillover effects of shocks on Taipei, China’s GDP growth

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Notes: Euro area refers to euro area-17 excluding Estonia.

Emerging Asia = People’s Republic of China; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei, China; Thailand.

Source: ADB estimates using the global projection and small, open economy models.

Reference